

## Commentary: Politics and Short Sales

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The proposed short sales uptick rule, released by the SEC on April 10, 2009, is a creature of politics. While this is more or less true of every rule, in this case footnote 55 of the rule release refers to letters from various politicians urging the SEC to adopt an uptick rule, including such luminaries as Congressman Barney Frank and other members of the House Financial Services Committee that he chairs, and Secretary of State Hillary Rodham Clinton, formerly US Senator. It is safe to say that more than the usual political influence is pressuring the SEC to adopt an uptick rule.

We generally think of political influence as something seamy, but that is not the point being made here. This is, after all, a democracy. We the people express the democratic will through our elected representatives. When we express preferences, we expect our elected officials to respond. Footnote 55 is democracy in action.

It is also true, however, that not everyone that supported Barney Frank or Hillary Clinton is in favor of an uptick rule. Most, I suspect, have no idea what an uptick rule is, or for that matter, what it means to short a stock. Other constituents are probably opposed to the institution of an uptick rule. I am a long-time Hillary supporter, having contributed generously to every one of her campaigns. But, I am strongly opposed to an uptick rule.

Are you listening, Hillary? I can only assume that other of Hillary's constituents favor an uptick rule, and their voices are louder than mine. That's the way democratic politics works.

So, who are these people clamoring for an uptick rule? I think we should ignore for the time being people who have no idea what an uptick rule is or how it works, but are influenced by various television personalities, such as Jim Cramer. Their support for the rule, like fame, is fleeting. The strongest support for the rule emanates from issuers, or more precisely, their management. They believe the uptick rule will reduce the downward pressure on stock prices.

Issuers and their management are the source of enormous political contributions, which certainly explains the interest of Congressmen and Senators. On the other

side are traders because anything that makes markets less efficient is bad for their business.

It may seem odd that investment bankers support an uptick rule because their firms also have trading businesses. But, it isn't odd at all. Management decides which investment bank will act as their underwriter. The truly spectacular revenues of investment banks derive from corporate finance. The American Bankers Association strongly supports an uptick rule because they represent the management of banks, whose stock has not fared well in the current financial crisis. The exchanges also support the uptick rule. Exchanges are places where traders do their thing, but it is issuer listings that really make things happen for an exchange.

The market price of an issuer's stock is in many ways something of a report card for its management. When the stock price is heading into the stratosphere, it is easy to convince an issuer's board and shareholders that there is a cause and effect relationship between management genius and heady market returns. In contrast, shareholders become downright disrespectful during market downturns. Management, in my experience, perennially believes that the market has placed too low a value on their issuer's stock price, and by extension, on their performance.

Compounding this, depressed stock prices make it difficult for an issuer to raise capital. Bear, Lehman, AIG and others might have survived if only investors were willing to pony up a bit more capital. But, our system relies primarily on market forces to allocate capital. The market's allocation decisions may not be perfect. Indeed, the market may get it wrong much of the time, although in the case of Bear, Lehman and AIG, the market was spot on. But, as a society, we dislike the alternatives, which amount to resource allocation by governmental fiat. We have no confidence that the people who run our government, however brilliant and well-intended, can do a better job of allocating resources than market forces.

Short sales play into this because, using the most primitive economic logic, management thinks that doing away with short sellers must reduce the downward pressure on their issuer's stock price. This theory holds that fewer sellers, all things being equal, must result in higher stock prices. And, lest anyone imagine that the animosity of issuers is directed only at short sellers, the fact is that long sellers are hated even more. Issuers have convinced our elected representatives to punish long sellers in the tax code. Any number of initiatives have been spawned to encourage "long-term" shareholding and punish the greedy "short-term" trader. No economic logic supports the tax preference for long-term capital gains.

This foolishness reaches into some surprising quarters. Dick Fuld, famously the former CEO of Lehman Brothers, railed against the short sellers driving the price of Lehman's stock down in its final hours.

As is so often the case, things are much more complicated than simple economics would suggest. As the SEC's release points out, the empirical evidence gathered to date does not support the view that short sellers caused the collapse of Bear or Lehman. Short sellers retreated from the market as the stock prices of Bear and Lehman collapsed. Their downfall resulted from the activity of long sellers.

The proposed uptick rule, in all of its variations, is a dumb rule that will not serve the public interest. The uptick rule will increase securities transactions costs for no good purpose. It is a sop to management that will not lead to the hoped-for higher stock prices. This is a good thing because if the rule were effective, it would lead to poor resource allocation, causing us all to end up poorer.

With so many other things that need to be done to reform our broken financial system, it is shameful that our elected representatives and regulators must devote so much of their time to such a silly enterprise. But, no one claims that democracy is perfect – simply better than all other systems of government.

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