



# Chlebina Capital Mgmt, LLC

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April 15, 2009

The Honorable Mary Schapiro, Chairman  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Dear Chairman Schapiro:

In determining the new short selling regulation, I hope the Commission maintains a keen focus on the underlying intention of the proposed rules, to limit bear raiding activities. I believe the original Uptick Rule best achieves this goal based on empirical evidence, personal observations, and an understanding of how manipulators operate.

The commissioners have stated they want to see evidence that supports the implementation of a proposal. There are two pieces of evidence that I urge the commission to evaluate prior to determining the final rule.

The first is the OEA study<sup>1</sup>, "Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot", that the commission based its decision to remove the Uptick Rule in July of 2007. The study detected "statistically significant increases in short selling volume but not in short interest"<sup>1</sup> in stocks not protected by the Uptick Rule. **Short interest** is an ineffective indicator of stock manipulation because the data is a snapshot of settled short trades collected on a bi-monthly basis, and therefore does not detect intraday manipulation. However, **short selling volume** captures all short sales that are executed, and can be used to indicate manipulative bear raids. The study found "One interpretation is that the increase in short volume is due primarily to increased short selling by parties that close out their short positions within the day."<sup>1</sup> This is an indication of possible bear raiding activity that **short interest** data does not detect.

A bear raid is more effective with low volume stocks, which is typical of small cap stocks. Therefore, one would expect small cap stocks to be impacted more by the removal of the Uptick Rule. The study remarks that "The pilot is associated with an increase in some measures of intraday volatility. These increases appear to be confined to the smaller stocks as larger stocks experienced a decline in volatility during the pilot."<sup>1</sup> I believe the removal of the Uptick Rule biased short selling towards small cap stocks because bear raiding became easier. Bear raiding of small cap stocks also became easier due to the recent explosion of dark pools, whereby short positions can be covered quickly, at a lower price, without impacting the stock price over the exchange.

Secondly, the CBOE Volatility Index broke above a multi year trading range immediately after the removal of the Uptick Rule and hit a record high in October 2008. It's more than just a coincidence that volatility broke out of its range directly after the Uptick Rule elimination, which was implemented to reduce volatility.

A common argument against the Uptick Rule is that short sellers create liquidity, and add efficiency to the market by identifying troubled companies. Manipulative short sellers do not identify troubled companies, they create them. Manipulators float rumors and repeatedly short a stock down, which can make any company appear to be troubled. By destroying the stock price,

manipulators limit the ability of companies to access funds through the capital markets. According to the OEA study, “Our evidence suggests that removing price restrictions for the pilot stocks has had an effect on the mechanics of short selling, order routing decisions, displayed depth, and intraday volatility, but on balance has not had a deleterious impact on market quality or liquidity.”<sup>1</sup> This demonstrates the Uptick Rule did not hinder market liquidity, but did have an impact on intraday volatility, which is exactly what the proposed rules hope to achieve.

The original Uptick Rule is the only proposal that would effectively limit bear raiding. I especially dislike the idea of a circuit breaker. Again, I must emphasize that the goal of the rule is to stop bear raiding. Let’s assume, for illustrative purposes, that a bear raiders strategy is to cause selling momentum by repeatedly shorting stocks, and covering the position intraday for a targeted profit of 10% in one day. The circuit breaker would have no impact whatsoever on this manipulative short seller, and completely ignores the purpose of the rule. It’s an oxymoron to believe the rule can achieve the goal of eliminating bear raiders, and at the same time allow for a 10% decline in stocks.

The Modified Uptick Rule proposal is also flawed. Erik Sirri, director of the SEC’s “Trading and Markets Division”, has acknowledged that bids can be manipulated. Given this acknowledgment, I don’t believe the Modified Uptick Rule would be as effective as the original Uptick Rule.

Opponents to the reinstatement of the original Uptick Rule use the difficulty of implementation as a reason to implement an alternative such as the Modified Uptick Rule or a circuit breaker. This rule is extremely important, and the ease of implementation should not be a deciding factor. I would much rather have a rule that meets its objectives than a rule that fails to achieve its goals but can be implemented faster or easier. I expect the commission will base this decision on the merits of the rule and not the mechanics of implementation.

The commission has a very important decision to make. While you consider the proposals, I hope you focus on the purpose of the rule, and how effective the different proposals will be in achieving the objective. The original Uptick Rule would significantly reduce intraday volatility, it still allows short sellers to provide liquidity, and would help to restore investor confidence. The circuit breakers would be the least effective proposals in meeting the intent of the rule. Please revisit the OEA study with a strong focus on the ultimate goal of the rule, and I believe you will see why the Uptick Rule is so important.

I strongly urge you to reinstate the original Uptick Rule to prevent continued manipulation of our capital markets. I appreciate the ability to comment on the proposals, and look forward to the commission’s final decision.

Sincerely,



Larry Chlebina  
President, Chlebina Capital Management, LLC

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<sup>1</sup> Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot, Office of Economic Analysis, U.S. Securities and Exchange Commission.