SEC faces calls to rein in shorts (Financial Week)

Did it end uptick rule at worst possible moment?

By Matthew Monks July 14, 2008

With the financial markets in turmoil, some traders, lawyers and at least one legislator are questioning the Securities and Exchange Commission's decision last year to scrap an obscure Depression-era trading rule that for 70 years had curbed short-selling while a stock's price tumbled. They say the SEC reversal-made just as the credit crunch unfolded last summer-has exacerbated the downturn by unleashing a wave of unchecked short-selling. The loudest critics even argue that regulators should consider reinstating the old rule.

For its part, the SEC appears to be standing by its decision last July to do away with the so-called uptick rule, which decreed that a stock could only be sold short after rebounding from a prior trade. The rule was drafted in 1938 in response to a steep market decline driven by short-sellers hammering down stocks in a bear raid.

Backers of the SEC's move say the credit crisis and softening economy are to blame for market woes, not the undoing of a 70-year-old regulation they say became outdated with the advent of modern trading. They say critics are looking to demonize short-selling (selling a borrowed stock and buying it back after it declines in value, and pocketing the difference-minus a fee-upon returning the security to the lender). The practice has long been controversial, as it relies on a stock faltering.

"It's a topic that people are passionate about," said John Giesea, president and chief executive of the Security Traders Association, which represents 5,200 traders.

His organization backed the removal of the uptick rule, arguing that it was unenforceable and unnecessary in a market where stocks are tracked by the penny, and regulations vary from exchange to exchange.

The STA isn't the only trade group behind the SEC's move. The Securities Industry and Financial Markets Association lobbied the SEC to remove the uptick rule and still supports that stance.

"Short sale price tests impose unnecessary costs and frictions in today's markets," Travis Larson, a spokesman for SIFMA, said in an e-mail interview. "The rule has not kept pace with current developments in the markets and also imposes restrictions that are burdensome."

SEC chairman Christopher Cox made a similar argument when he defended the SEC's decision in April to Rep. Michael Castle (R-Del.), who had sent Mr. Cox a letter in March questioning the move.

Mr. Cox described the uptick test as "a discredited rule that had been shown empirically not to work and was too easily circumvented."

"Some commentators have attributed the increase in U.S. market volatility since the third quarter of 2007 to the elimination of the uptick rule. However, the increase in volatility is an international phenomenon," Mr. Cox wrote. "Market volatility has increased significantly, not only in the United States, but in several countries in which price tests similar to the U.S. tick test remain in effect, including Japan, Australia, Canada and Korea."

Stephanie Fitzpatrick, a spokeswoman for Mr. Castle, said the congressman was satisfied with some of Mr. Cox's responses but was arranging a meeting to "further discuss the issue." Mr. Castle is a member of the House Financial Services Committee. A spokesman for the SEC, Kevin Callahan, declined to comment.

The SEC phased out the uptick rule after consulting scores of industry experts and running a trial that removed the restriction on about 1,000 stocks in the Russell 3000 Index from 2005 through 2007. The test found that removing the uptick rule did not increase overall short interest in a security. It did, however, drive an increase in the volume of short-selling.

One critic says the SEC's data from that test are flawed, as it was conducted during a time of relative market tranquility. The test didn't gauge the risks of unrestricted short-selling in periods of high volatility and large market downswings, the prominent global law firm Wachtell Lipton Rosen & Katz wrote in a recent memo to clients.

Wachtell Lipton partners Edward D. Herlihy and Theodore Levine called on the SEC to consider reinstating the uptick test, as "many of the same conditions that led to the adoption of the rule in 1938 are reappearing," they wrote. "Short sales are at record levels and there are suggestions that false rumors about the demise of firms (e.g., Bear Stearns and Lehman) and bear raids are taking place."

Short-selling is up from a year ago, and the markets are more volatile.

Short-selling on the New York Stock Exchange climbed to a record high in June. Short interest rose nearly 11%, to 17.7 billion shares, from May 15 to June 13, the exchange's highest level of short interest ever. A year earlier, short interest rose nearly 7%, to 12.5 billion shares, between May 15 and June 15.

At the same time, a snapshot of a key gauge of market volatility, the Chicago Board Options Exchange's VIX index, indicates that volatility has risen considerably in the past year. The VIX, which measures implied volatility of the S&P 500 index options, on average closed at 14.95 in June 2007. In June 2008, in turn, its average close was 22.11.

At the time it repealed the rule, the SEC argued that the regulation had become meaningless after equity markets began quoting stocks by the penny in 2001. That meant a trader had only to wait for a stock to rebound by a cent before initiating a short position.

Some critics say the SEC's rationale was short-sighted-that even a penny increase indicates that a stock has stabilized. Now short-sellers can keep selling down a stock without waiting for the slightest rebound.

"Prior to the rule change a stock could not be shorted unless there was a [higher] bid that had entered into the market, which is a sign of strength," said Dylan Wetherill, a former trader and president of Shortsqueeze.com, a website that tracks short-selling. "Short-sellers like to see weakness when they're going short. If you see a sign of strength then you are out of the money. When they got rid of the rule all of a sudden, it allowed traders to find stocks with momentum on the downside and sell into that downward momentum."

Some people argue that things might have played out differently for Bear Stearns had a price test blocked short-sellers from beating down its stock in four days in March from more than $61 to the $2 a share J.P. Morgan initially agreed to pay for the company.

"The uptick rule creates some temporary price stability," said Charles Geisst, a Wall Street historian and professor of finance at Manhattan College. "Maybe it would have bought them a few more days. Maybe a few more days would have brought them a different result."

In March, James Cramer, the former hedge fund manager and host of CNBC's Mad Money, called on the SEC to revisit its decision, arguing the lack of an uptick test had created a potential for raids on Bear Stearns rivals such as Lehman Brothers, which, like other financials, has been struggling.

"The last I looked, the SEC was on the side of the investors. But they've completely defaulted on that. They're on the side of hedge funds," Mr. Cramer said. "[It should] revisit this moronic policy that is absolutely playing into the bear market hands of 1932 in this country."