The Uptick Rule Should not be Implemented

I have already submitted commentary but feel compelled to add a few more remarks to the SEC's latest decision regarding the uptick rule. I take the position that it is unnecessary, and can base my argument on elementary principles of finance.

One can't help but feel that the SEC is being pressured from, within or without, to simply "do something" regarding trading regulations, since doing nothing would indicate a lack of courage or understanding of the problem, or even worse, spur questions on why we need the SEC as it is.. But did the Commission actually read through the commentary that a wide variety of people send in? Did it notice that the more lengthy and scholarly responses showed that adding additional restrictions lead to illiquidity and inefficient price discovery? That shorting stock is an essential component of hedging or arbitrage strategies that keep related securities in alignment? That unrestricted (not to be confused with naked) shorting is an essential part of market making?

Let me briefly reiterate (from my previous commentary), why the SEC should not impose the uptick or similar rules on short trading.

Let's start from first principles. What is an exchange? A place where buyer and sellers engage in price discovery, and a fair exchange would be one where there is no built-in bias against one group over another. That means there should be little or no friction for participants to engage in trading. This further implies that there has to be symmetry between buying and selling. So why do we allow for shorting? Suppose we instituted a rule, starting tomorrow, that only the owners of a stock would be allowed to buy more shares in that stock. But this would be an absurdity, as new buyers would be prohibited. By the same reasoning we would not allow only the owners of the stock to sell, for if we did, we would have an imbalance on the sell side, since the buy side includes both the current owners of the stock as well as newcomers. Allowing traders to sell short gives the market a chance match buying and selling pressures. It does not mean that any moment we cannot have a preponderance of side over another – only that there is no friction or bias against either side.

The restrictions we place on short selling should only be derived from borrowing requirements. As you cannot buy more stock than is available in the float, it stands to reason that the amount of short interest also be some fraction of the float. Yet this common sense observation was violated during the last administration due to naked short selling and the SEC's inadequate attempts to thwart it.

If we place some kind of uptick rule, we are violating the symmetry that is necessary to ensure market efficiency. In fact, the only time this symmetry is "broken", comes from the buy back provision of short selling. Ordinarily, if you buy stock, you can hold onto indefinitely, even bequeathing it to your heirs. But if you short stock, you will be buying it back in considerably less time, and this short squeeze provides a built in support for any fall in stock prices.

Now the claim is made that if we allowed for some kind of uptick rule, applied to say, the last price or best bid, this would limit the runaway feedback loop of bear raiding. So first of all, is this true?

Suppose for whatever reason a significant number of traders wish to short a stock. Let us also say that you can only short if the best bid increases. The SEC does not say that if traders send in a marketable short order (below the current best bid) that the exchanges won't reject the order. If the order is not rejected, we would have a crossed market, since a better ask price is below the current best bid. Market makers are likely pull down their best bids, at least after all long sell orders are executed. So now this leads to a drop in price, which generates more selling, both long and short.

So suppose instead that the exchanges rejected all marketable short orders that are below the current best bid, or that short sellers only send limit orders at or above the best ask, leading to a build-up of limit orders ready to short. This leads to an especially strong resistance level for upward price movement. As buyers test the level, the high number of short orders will resist an increase in price, so this is likely to signal market makers to pull their prices down to tease out a lower price. This leads to a lower price and more short sellers chasing the best ask price, and the process repeats.

So we see that the best bid uptick rule as currently described would not necessarily lead to an end to bear raids, and you can still trigger a "runaway feedback loop" that generates price declines.

And all this begs the question, what are we trying to achieve? The claim is that without something like a uptick rule stock prices will occasionally get pushed down to levels below which their fundamentals would warrant as fair. And this is a bad thing? Most investors would perceive these declines as being fire sales where the discounted price is a bargain, and start buying to bring the price back into equilibrium.

Of course, people want short selling restrictions so as to be protected against undue losses. But everyone loves a rally, even though many people inevitably buy at the rally's top and then suffer considerable losses on a pullback, especially since ordinary retail investors almost never short but only buy stocks. Shall we also have a down tick rule? This kind of excessive micromanaging of intraday trading does nothing but decrease liquidity and undermine price discovery. The decrease in liquidity shows up as a wider bid-ask spread, which imposes a "tax" on trading. It is the worse kind of tax, since it is not going to government revenues to be redistributed for any worthwhile purposes, just to market makers who are feeding off an ill-defined law, or to an increased cost of hedging that gets passed onto consumers. The government loves to say that it is protecting people, but there is no basis in this case.

The ludicrous nature of the whole enterprise becomes clear when we realize that had anything like the uptick rule been in place it would have had little effect on the downward spiral on banks due to the excessively risky bets they had made. And what was the one of the major drivers of this risk taking? In 2006 the SEC effectively doubled the leverage that banks could have for loan making. The rest is history. What happened to the banks was inevitable, given the loss of faith in that sector. What could not be shorted during market hours, did or would have happened in after hours trading – a time when the up tick rule would not be in effect.

If the SEC needs to show that it is "doing something," it can begin by

1. showing that naked short selling is virtually non-existent by putting in place appropriate audits and periodically revealing the results
2. review all hedge funds for any Madoff –like schemes. Can the SEC confidently say there are no more such scams occurring?
3. have a reliable mechanism in place that catch bear raiders who quietly accumulate short positions (with or without an uptick rule) and then spread negative rumors about a company, to cash in on the panic. This is admittedly hard to detect, but a concerted effort should pick up a few offenders, and perhaps scare the rest. The fact that "Fast Money" Cramer could confidently boast on video that his firm was doing it shows that little or no safeguards were in place.
4. set up appropriate exchanges for all derivative trading that exceeds some notional size and require participants to ante up sufficient capital to cover losses. There was the equivalent to naked shorting with synthetic credit default swaps, so putting these on an exchange would be a good first step to ending this practice.

Some of these are in motion now. Is it not enough? Has the SEC nothing else to do? My concern is that this proposal is the result of too many lawyers looking at the problem and not enough people with trading experience, which is precisely what Markopoulis suggested in his testimony regarding the Madoff scandal.

Kevin Holley
New York City