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The Uptick Rule: The SEC Removes a Limit on Short Selling

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Gary Shorter
Specialist in Business and Government Relations
Government and Finance Division

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Summary

Historically, in much of the popular lore surrounding short selling (borrowing stock with the objective of making a profit if its price falls), the activity has been unfavorably described as a destructive force for both stock markets and the firms whose shares are sold short. In the 1930s, due to concerns that a concerted kind of manipulative short selling known as a bear raid had contributed to the stock market collapse, federal securities regulations were adopted that restricted short selling. Known as the uptick rule, the restriction essentially forbade short sales on stocks unless a stock's previous price movement had been upward.

However, modern economics orthodoxy generally views short selling to be a beneficial economic force. Among the benefits commonly ascribed to it are its ability to (1) counter an unwarranted, speculative upward price pressure in stocks, and even uncovering and exposing fraudulent issuer activities; (2) enable an entity to hedge the risk of a stock position owned, thus protecting against price declines; (3) provide liquidity in response to buyer demand; and (4) provide latent buying interest.

This perspective on the virtues of short selling was bolstered by the results from a Securities and Exchange Commission (SEC) sponsored pilot program in which the lifting of the uptick rule for a sample of stocks did not appear to have adverse economic outcomes. As a result, in June 2007, the agency voted to rescind the uptick rule.

Since then, domestic stock markets have experienced greater volatility and there is a contentious debate over the extent to which the turbulence derives from the freer hand that short sellers can now exercise in a post-uptick world, or from heightened financial and economic uncertainty engendered by the subprime mortgage meltdown. Representative Michael Castle, for example, has written the SEC, inquiring about the relationship between the greater volatility and the cessation of the rule.

This report examines the uptick rule's background and various public policy considerations and controversies surrounding both its genesis and its removal several decades later. It will be updated as events dictate.

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The Uptick Rule: The SEC Removes a Limit on Short Selling

Introduction

On June 13, 2007, the Securities and Exchange Commission (SEC) voted to eliminate Rule 10a-1 under the 1934 Securities Exchange Act, the uptick rule, which for 70 years had placed restrictions on short selling on exchange-listed stocks. In the aftermath of the agency's decision to rescind the rule, controversy has surfaced over whether the action is perhaps related to an observed spike in stock market volatility.

This fallout from rescinding the rule has also generated some congressional concern: on March 28, 2008, Representative Michael Castle wrote SEC Chairman Christopher Cox, asking about the nexus between market volatility and the lifting of the rule. In the letter, Representative Castle observed that "... today's market is vastly different than the market of 70 years ago and given that current market conditions are more volatile than those prevailing during the pilot program, it is important that we monitor closely any impact of unrestricted short selling...."[1]

This report looks at the background, public policy considerations, and controversies surrounding the genesis and the eventual repeal of the uptick rule.

Short Selling

Short selling involves selling a stock that the seller has borrowed. If the stock price goes down, the seller buys it again from the market and settles the transaction. Generally, in the short selling process, to sell a stock short, an entity like a broker-dealer will lend stock to the prospective short seller, stock taken from the entity's inventory. At some point, the short seller closes the short position by buying back the same number of shares (called covering) and returns them to the broker. If the price drops, the trader can buy back the stock at the lower price and make a profit on the difference. But if the price of the stock rises, the trader must buy the stock back at the higher price, thus losing money. A frequent source of this borrowed stock is broker held margin stock.

Short sellers are generally considered to be speculators seeking a profit or brokerage house employees such as market makers managing their positions. One measure of short selling is known as the short interest, the total number of shares of

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[1] "Letter from Representative Michael Castle to the Honorable Christopher Cox," March 28, 2008.

a particular stock that have been sold short by investors but have not yet been covered or closed out. When expressed as a percentage, it represents the number of shorted shares divided by the number of shares outstanding. For example, at the close of business on the settlement day of May 15, 2008, the NYSE Group announced that short interest equaled 4.2% of the total shares outstanding.[2]

In popular lore, short selling is often depicted as a questionable form of stock market manipulation. Indeed, the history of the U.S. markets is dotted with various instances in which certain kinds of manipulative short selling appear to have had a problematic market impact. Throughout history, there have been instances of a particularly egregious form of stock manipulation known as a "bear raid." In a bear raid a particular stock is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. The operatives then place themselves in a position to acquire the stocks at artificially deflated prices. In addition, unfettered short selling can exacerbate a declining market in a security by increasing seller-based pressure, thus reducing interest in bidding to acquire the stock, and thereby causing a further reduction in the price of a stock by creating an appearance that the security price is falling for fundamental reasons.

Short selling can, however, also confer a number of economic benefits on markets, including providing them with the following:

- **Greater Market Liquidity.** Short selling by market professionals can offset temporary imbalances in the demand and supply for stock shares. Additionally, short sales can also add to the trading supply of stock that is available to prospective buyers and reduce the risk that the share prices paid by them are artificially high because of a temporary contraction in a given stock's supply.

- **Greater Market Efficiency.** Efficient markets require that prices fully reflect all buy and sell interests in traded securities. Investors who think that a given stock is overvalued may conduct short sales in an attempt to profit from a perceived divergence of stock prices from their actual values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance, an evaluation that is reflected in the resulting market price. Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security like a convertible security or an option on that stock. An arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.

[2] "NYSE Group Inc. Issues Short Interest Report," *NYSE Group Inc. News Release*, May 21, 2008.

The Tick Test

Rule 10a-1 under the 1934 Securities Exchange Act placed restrictions on short sales. The rule, which was adopted in 1938, provided that, subject to certain exceptions, an exchange-listed security (New York Stock Exchange and American Stock Exchange) can be sold short: (1) at a price higher than the preceding transaction in the same security (called the plus tick rule), or (2) if the price is the same as the previous transaction price but at a higher price than the last trade of a different price (the zero plus tick rule).[3] Short sales, however, were not permitted (1) on the sale of a stock at a price that is less than the previous sale price (minus tick);[4] and (2) at the same price as the previous price but at a lower price than the last different price (zero downtick).[5] Collectively, these proscriptions are known as the tick test or the uptick rule.[6]

By eliminating both the prohibitions on minus ticks and zero downticks, the SEC's elimination of the tick test effectively lifted the proscriptions on selling stock short when its price has recently been falling.

In adopting Rule 10a-1, the SEC's declared goal was to prevent short sellers from manipulating stock prices, causing successively lower share prices. The proscriptions were also seen as a way of stopping the practice of bear raids.[7] Many observers at the time believed that bear raids were major contributors to the stock market declines of 1929 and in the late 1930s. In subsequent years, however, some of those assumptions have been challenged.[8]

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[3] For example, a stock trade is consecutively executed at $21, $22 and $22. The last transaction at $22 was at a zero plus tick. It was executed at the same price as the prior trade, but at a higher price than the last different price of $21. Under the tick test short sales could only be executed on plus tick or a zero plus tick.

[4] For example, if a stock traded at $12 a share, the next trade would be a downtick if it is at $11 7/8.

[5] For example, a stock trade is consecutively executed at $22, $21 and $21. The last transaction at $21 was at a zero minus tick. It was executed at the same price as the prior trade, but at a lower price than the last different price of $22.

[6] Among others, the SEC has granted exemptions from Rule 10a-1: (1) for transactions in exchanged traded funds, (2) to permit registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit orders at the consolidated best offer, regardless of the last trade price; (3) for certain transactions executed on a volume-weighted average price basis; and (4) to electronic trading systems that match and execute trades at independently derived prices during random times within specific time intervals.

[7] Bear raids involved well-financed stock operators who conducted repeated waves of short selling targeted toward particular stocks, actions that often resulted in downward price spirals, which then enabled them to purchase the stocks at artificially deflated prices.

[8] For example, a 1951 academic study done at the behest of the New York Stock Exchange found that as a whole, there was no conclusive statistical evidence that short selling materially affected the extent of a major decline or a major advance in the market as a

(continued...)

Eliminating the Tick Test

In 2005, the SEC, as part of Regulation SHO,[9] in an initiative aimed at updating short sale regulation in light of various market developments that had emerged since the initial 1938 regulation, began a pilot program to test the market impact of relaxing the uptick rule for a select group of 1,000 securities. The pilot lasted a year and then was extended into 2007. It was an attempt to test widespread industry, academic and regulatory perceptions that the uptick rule was no longer necessary.

In an analysis of results from the pilot, the SEC's Office of Economic Analysis found that short trade restrictions had a limited effect on a stock price and that there appeared to be no association between manipulative short selling activities like "bear raids," and the presence of the tick test. It also found confirmation of the notion that the tick test appeared to have some potentially adverse market effects in discouraging short selling. The study also revealed little empirical justification for maintaining price test restrictions, especially for large securities. Although it found some changes in the displayed liquidity, all the tested securities showed about the same level of liquidity and pricing efficiency with or without the tick test. When the differences between large and small securities were examined one of the most counter-intuitive discoveries was that the short selling restrictions increased volatility in large securities while dampening it in smaller ones. Overall, the SEC found that there was little evidence suggesting that removal of the short selling restrictions would have a negative impact on market volatility, price efficiency, or liquidity.[10]

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[8] (...continued)
whole. (Macaulay, Frederick, and Durand, David, *Short Selling on the New York Stock Exchange*, New York: Twentieth Century Fund, 1951).

[9] "Securities Exchange Act Release No. 50103," July 28, 2004.

[10] "Office of Economic Analysis U.S. Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot," February 6, 2007, available at [https://www.sec.gov/news/studies/2007/regshopilot020607]. In addition, the SEC encouraged outside researchers to examine the pilot. In response, it received four completed studies from outside researchers that examined data from the pilot. In addition, the agency held a public roundtable on September 15, 2006, that looked at the empirical evidence gleaned from the pilot data. Among other things, there was widespread agreement that short sale price restrictions were outdated and provided minimal if any value to the market except in the sense of fostering the perception that something is being done to restrain "bad" short sellers. Most panelists reportedly agreed that short sellers who benefit markets greatly exceed those who have a negative impact. A number of panelists stated that long side conventional stock manipulation in "pump and dump" scenarios in which there is upward price manipulation pressure is far more pervasive and detrimental than the traditional short sale "bear raid." A transcript of the roundtable is available at [http://www.sec.gov/about/economic/shopilottrans091506.pdf]. The external studies and the roundtable panelists were in general agreement with the SEC's analysis of the pilot's results. For example, one study found that under the pilot, the volume of short selling increased and stocks did experience higher short-term volatility immediately after the suspension, but that returns from the stocks and daily volatility were unaffected. Karl Diether, Lee Kuan-Hui, and Ingrid Werner, "It's Sho Time! Short-Sale Price-Tests and Market Quality," *Fisher College of Business Working Paper No. 2007-03-00*, August 4, 2007.

On December 7, 2006, the SEC commissioners voted to issue a policy proposal that, among other things, would eliminate Rule 10a-1's tick test.[11] Prior to that decision, Chairman Cox observed that

> The core provisions of Rule 10a-1 have remained virtually unchanged since the 1930s. But a great deal else has changed in the marketplace over that very long time. Over the years, decimalization and changes in trading strategies have undermined the effectiveness of the price test. And at the same time, increased transparency and better means of surveillance appear to have lessened the need for the price test....
>
> Through the pilot program, we sought to understand the effect of this particular regulation on our markets. The evidence gathered from the pilot suggests little empirical justification for maintaining short sale price test restrictions, at least for the exchange-traded stocks in the pilot....
>
> In light of the results of the pilot program and the market developments that have occurred in the securities industry since Rule 10a-1 was first adopted, we will today consider proposals to remove the tick test of Rule 10a-1, and to prohibit the SROs from maintaining their existing price tests or adopting any new ones....[12]

Among those who backed the lifting of the tick test were a number of individual traders, academics, broker-dealers, the Securities and Financial Market Association (an association of several hundred securities firms, banks, and asset managers), and the Securities Traders Association (STA, an association of individual professionals in the securities industry).[13]

Among the staunchest opponents of rescinding the restrictions were a number of individual investors who invoked the specter of a greater likelihood of bear raids. Qualified support came from the New York Stock Exhange, which expressed concerns over unrestricted short selling during periods of unusually rapid and large market declines. Exchange officials noted the pilot did not gauge the effect of an unusually rapid and large market decline because such decline did not occur during the period. American Stock Exchange (AMEX) officials expressed related concerns. The exchange specializes in smaller stocks, and its officials stated that the removal of the tick test from smaller stocks was premature and needed further study.

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[11] "Amendments to Regulation SHO and Rule 10a-1," File No.: S7-21-06, December 7, 2006.

[12] "Speech [before his fellow SEC Commissioners] by SEC Chairman Christopher Cox on Opening Statement on Eliminating the Short Sale Tick Test," December 4, 2006, available at [http://www.sec.gov/news/speech/2006/spch120406ccc-10a.htm].

[13] Rachel McTague, "Stock Markets Increased Market Volatility Not Related To End of Short Sale Tick Test, STA Says," *BNA's Securities Regulation and Law*, September 24, 2007, p. 1445.

On June 13, 2007, the SEC voted to adopt the proposal to eliminate the tick test.[14] Thus, the proscription on short sellers solely being allowed to sell at a price above the last price of a stock or at the price of the stock's last trade if it was higher than the previous price was no longer in effect.

After the abolition, which went into effect in July 2007, media reports indicated that SEC spokespersons made assurances that the agency would, however, "... closely monitor for potentially abusive trading activities."[15]

The Post-Uptick Rule Era and Concerns over Market Volatility

Among other things, the high asset price variability that defines volatile markets is problematic because of the heightened investor uncertainty that it tends to generate. By various measures, (1) the elimination of the tick test coincided with an exceptionally volatile time in U.S. stock markets;[16] and (2) the months that followed the removal of the uptick rule saw more pronounced market volatility than the months that preceded the removal.[17]

As a result, a number of market participants have alleged that the reform appears to have significantly exacerbated volatility. For example, Andy Brooks, head of equity trading at T. Rowe Price, has opined that, "the power of the short sellers — or you could call them hedge funds — has grown significantly in stature.... We're in the thick of it, and I think [eliminating] the uptick rule is a major contributor to what's happening in the stock market. I'm not saying the markets wouldn't have gone down, but they would have gone down in a more orderly fashion."[18]

In addition, Martin J. Whitman, founder and co-chief investment officer of Third Avenue Management observed, "[i]n my 58 years in the market, it's never been

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[14] NASDAQ, which was not technically an exchange when Rule 10a-1 was adopted, has been subject to a "bid test" under NASD and NASDAQ rules, which prohibits short sales at prices below the stock's best published bid (offer to buy) price, when that bid price is below the previous different best published bid price. The elimination of the tick test for exchange-listed stocks also meant that the bid test would also be eliminated.

[15] Jeff Benjamin, "Did Repeal of the Uptick Rule Unleash Market Havoc? Surge of Volatility, Rising Number of Short Sales Cited as Evidence," *Investment News*, September 10, 2007, p.3.

[16] For example, according to some observers, in a three months period between early November 2007and early February 2008, the Dow Jones Industrial Average rose or fell by at least 1% approximately half the days. By contrast, there were 27 such days in all of 2005 and 25 such days in all of 2006. Mark Hulbert, "Choppy Waters," *MarketWatch,* February 6, 2008.

[17] Laszlo Birinyi, Jr., "Living With Vix," *Forbes,* April 21, 2008, p. 244.

[18] Benjamin, "Did Repeal of the Uptick Rule Unleash Market Havoc? Surge of Volatility, Rising Number of Short Sales Cited as Evidence," p. 3.

easier to conduct bear raids."[19] Mr. Whitman's funds incurred losses when shares of firms like CIT Group and bond-insurance companies, such as MBIA and Ambac Financial Group, plummeted, behavior he ascribes in media reports to the action of short-sellers.[20]

Somewhat related concerns appear to have been behind the New York Stock Exchange's earlier and unsuccessful request to the SEC during the proposal comment period that it be given the authority to voluntarily impose the tick test during periods of rapid stock price declines. Exchange officials had concerns that the period in which the pilot was conducted did not experience severe price declines, making it hard to draw any conclusions about the impact that the tick test's elimination would have in a volatile market.[21]

Others, however, have questioned the existence of a causal relationship between the change and market volatility. Officials at STA, the trade association for securities professionals, for example, have rejected any suggestions of a cause and effect between the lifting of the tick test and more volatile markets. They claim that the juxtaposition of the two was merely coincidental.[22]

In the context of the claims that rescinding the uptick rule has appreciably added to market volatility, another possible view of the issue is that the lifting of the short sale restrictions may have had a marginal impact on volatility but that larger and more significant forces were already at work before the restriction was rescinded. Those taking this position might argue that those forces included uncertainties over the impact and reach of the subprime meltdown; historically high oil price spikes; and anxieties over the prospect of a possible recession.[23]

Moreover, some also note that even before the removal of the rule, trading strategies existed that allowed traders to essentially circumvent the rule's restrictions. Such alternative strategies would have included put options trading, trading exchange-traded funds, or even violating the uptick rule and facing a relatively small fine.[24]

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[19] Gregory Zuckerman, "Blame Game: The 'Uptick' Rule Debate," *Wall Street Journal*, April 1, 2008, p. C-1.

[20] Ibid.

[21] A key criticism of giving exchanges voluntary control over when to impose such restrictions was that they might then use their possession of such authority as a marketing tactic to attract corporate listings.

[22] McTague, "Stock Markets Increased Market Volatility Not Related To End of Short Sale Tick Test," p. 1445.

[23] In addition, some academics have been hotly debating the identity of the core factors behind market volatility for decades, a debate that to this day continues without a consensus. For example, see Hehui Jin and Maurizio Motelese, "Determinants of Stock Market Volatility and Risk Premia," *SIEPR Policy Paper No. 03-001*, October 2003.

[24] Zuckerman, "Blame Game: The 'Uptick' Rule Debate," p. C-1.

Still, a 2007 empirical study raises additional questions over the possibility that certain types of short selling in a world devoid of the tick test may have an effect on intraday[25] market volatility and a negative impact on market quality.[26] The study examined a sample of short sellers who submitted aggressive short orders and were able to avoid tick test kinds of restrictions by, for example, posting their orders on trading venues without such constraints. During those occasional times when stocks were experiencing liquidity problems, the research found that the traders caused pronounced intraday stock price reversals, that short selling tended to intensify at the beginning of significant stock price reversals. The research, which examined price reversals of a much longer duration than did the SEC pilot, generally concluded found that the aggressive and price destabilizing short selling was both recurrent and contagious and could not be fully attributed to corporate or macroeconomic news releases, although these did appear to increase the probability of such "predatory" short selling. The study also observed that it had found evidence of the existence of a new and heretofore unexplored class of short sellers who appear to exacerbate market frictions and create temporary liquidity shortages.[27]

Such findings would appear to add a more cautious note to the less troubled perspectives on the effects of banishing the tick test. Potentially deleterious short selling practices might, this empirical study suggests, be facilitated in certain circumstances when trading is not restrained by tick test controls.

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[25] Intraday refers to occurrences within a given day.

[26] Andriy Shkilko, Bonnie Van Ness, Robert Van Ness, "Price-Destabilizing Short Selling,"*AFA 2008 New Orleans Meetings Paper,* November 2, 2007, available at SSRN's website, at [http://ssrn.com/abstract=971210].

[27] Ibid.