What happened to the "up-tick" rule?

Constantine N. Katsoris
Fordham University School of Law, ckatsoris@law.fordham.edu

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By Constantine N. Katsoris, professor at Fordham Law School

Short selling occurs when investors borrow shares and sell them, hoping the stock will fall and they can buy back the shares at a lower price; and, if they sell without first borrowing the stock it becomes a "naked" short sale.

Defenders of naked short selling contend it provides liquidity by allowing trades to go through when sellers can't immediately obtain possession of the shares to sell; however, my simple answer to that is why should they be able to sell something they neither own nor possess – particularly in a down market.

Indeed, the principal liquidity they add is to buy back depressed shares at a lower price from shareholders frightened into selling by the downward spiral caused by the excessive selling. Realistically, this scenario often sows the seeds of manipulation resulting from rumors and tips – leading to a feeding frenzy and a collapse in the price of a stock.

The so called "up-tick" rule was in effect from 1938 until 2007, and basically prevented traders from making a short sale unless the price of a stock in its most recent trade had been up from previous levels. Thus, eliminating the uptick rule made it easier for short-sellers to gang up on a stock and made it cheaper to bet against a company because you didn't have to execute at the higher uptick price; and, the cheaper you make the trade, the more trading you get.

Interestingly, several years ago the SEC's Inspector General issued a report that noted that between January 1, 2007 and June 30, 2008 the SEC received 5,000 complaints alleging possible market manipulation using short sales; of which about 2.5 percent were forwarded for investigation, resulting in no case being bought.

No one is suggesting banning short selling (except in the most unusual of circumstances); however, present circuit breakers that halt trading if the market falls precipitously in a short period of time is not the answer to abusive short selling, for the damage to small investors has already been done – particularly in an era of high frequency trading.

The "up-tick" rule, however, acts as a natural and immediate brake by slowing down such selling by those who do not own stock (and who often don't even borrow the stock before the trade).

Accordingly, it is once again suggested that the SEC delay no longer and reinstate the "up-tick" rule, and at the same time enforce its rule that borrowed stock be in hand before short sale can be consummated. Otherwise, our markets will not be trusted by the public as an investment vehicle for their life savings, but instead be considered as a speculative manipulated casino.

Constantine Katsoris is a professor at Fordham Law School and the chair of the Securities Industry Conference on Arbitration.

The Hill 1625 K Street, NW Suite 900 Washington DC 20006 | 202-628-8500 tel | 202-628-8503 fax