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SEC Uptick Rule Proposals

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The Securities and Exchange Commission (SEC) has proposed reinstating the "uptick rule" in order to stabilize the stock markets. However, the SEC has made five distinct proposals for comment prior to enacting one of them. These proposals are in two categories --- with or without a circuit breaker condition. Here we show the difference of the effects of enacting these proposals on price movements under short sale attack (bear raids). We use as a test case, the example of Lehman Bros on July 10, 2008. Using a circuit breaker based rule does not prevent rapid price declines.

On March 10, 2009, Congressman Barney Frank, head of the U.S. House Financial Services Committee, announced that he was hopeful the Uptick rule would soon be reinstated by the SEC. [1] This announcement followed a meeting with SEC Chairman Mary Schapiro. The Dow Jones Industrial average increased by 5.8% on that day and has increased till today (April 19) by 24%. Prior to March 10, the market had declined by 25% since January 1 (see Fig. 1).

On April 8, 2009, the SEC announced that it will consider five different alternatives for a new uptick rule replacement. The original uptick rule, an upbid rule (which weakens the limitation of short selling to be above the current national bid rather than the most recent price), and three options based upon a circuit breaker approach. In the circuit breaker approach there would be no short selling restriction unless a significant drop (e.g. 10%) in security price occurred.

We compare the effect of the different rules on large volume short selling in Figure 2. This plot shows the effect of a large short sell order on the price of Lehman Brothers (LEH) if the short sale order occurred on July 10, 2008 at 9:49:17 AM. The calculations for this effect are based upon the actual order book at that time, i.e. the number of standing orders. Selling short with the full uptick rule (blue) would not give rise to a price reduction as the price would be the most recent price. The "upbid" rule (green) would reduce the price by a small amount --- the difference between the most recent order and the most recent bid. If there is no uptick rule (red)
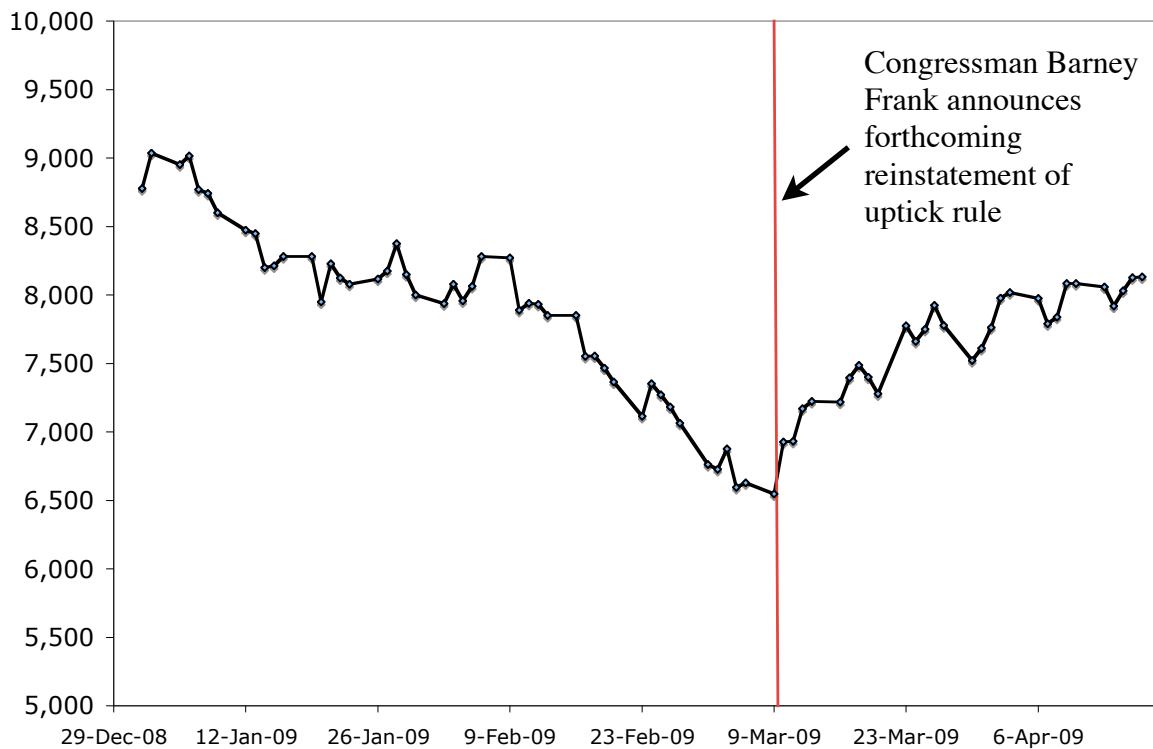

Fig. 1: Dow Jones industrial average in 2009 showing date of announcement of uptick rule reinstatement by Congressman Barney Frank (red).

or a circuit breaker (orange), the short sale will be met by standing orders and the price would decline till the entire order is fulfilled or the circuit breaker condition is met (orange).

This plot shows that the circuit breaker would not have the same effect on stock prices as the uptick rule.

According to the SEC:[2] "The [Securities and Exchange] Commission adopted the tick test after considering the effects of short selling in downward moving markets. In adopting this approach, the Commission sought to achieve three objectives:
(i) allowing relatively unrestricted short selling in an advancing market;
(ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and
(iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.

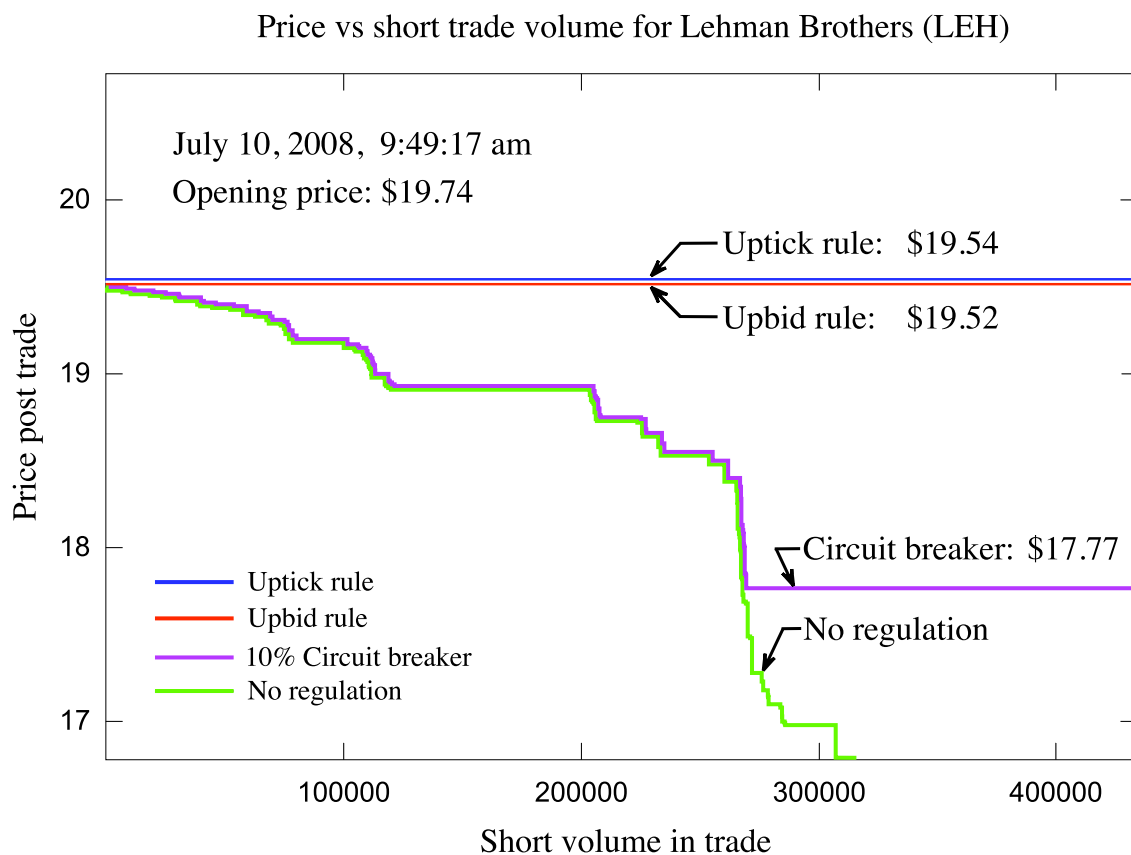These objectives are not met by the circuit breaker versions of the uptick rule as shown.

Figure 2: Comparison of the current SEC uptick rule proposals if they were active on July 10, 2008 for Lehman Brothers (LEH) stock price. Horizontal axis is the current short volume. Vertical axis is the stock price.

References:

1. Rep. Frank: SEC to reimpose uptick rule soon, Reuters, March 10, 2009. http://www.reuters.com/article/governmentFilingsNews/idUSN1052424120090310
2. SEC Concept Release: Short Sales. http://www.sec.gov/rules/concept/34-42037.htm