MarketWatch

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Coming up short

Commentary: SEC's new version of 'uptick rule' lets investors down

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- Last week, the Securities and Exchange Commission adopted a new rule "designed to preserve investor confidence and promote market efficiency." Sadly, the rule does neither. Mostly it serves to make politicians and regulators feel like they are doing something.

The "alternative uptick rule" is regulators' new twist on limiting short sales -- attempts by investors to bet against securities and to profit when they fall in price -- which was deemed necessary because a previous version that had stood for 70 years was eliminated in 2007.

Trading rules always sound like inside baseball because the logic behind both the rules and stock trading can be hard to follow. But short-selling is a controversial subject, with many market observers suggesting that the betting against the market artificially depresses stock prices and keeps the market chained down, accelerating the effect of bad news and heightening volatility.

Market sends static signals

Once-clear leading economic indicators such as the Treasury yield curve are now widely disputed. But what growth trend is priced into stocks?

A short sale is a bet against a stock; it typically involves borrowing shares, selling them, and waiting for the stock's price to decline before "covering" the trade and buying the shares back on the open market. The short-seller keeps the difference between the higher selling price and the lower repurchase price.

The original uptick rule, put in place in the late 1930s, required an upward move before a short sale was allowed; it made short sales more difficult by easing some of the downward pressure that builds when a market is in freefall. Eliminating the rule was like cutting the bars out of the cage and letting the bears run free.

That said, critics noted that traders and market sharpies never worried much about the uptick rule, knowing that plenty of stocks that are dropping will take a momentary pause for a quick upside trade. Moreover, short-sellers and their trading partners would sometimes create those upside trades just so they could implement the short sale they really wanted to do.

Armed with several economic studies showing the rule had little effect in stabilizing the market, the SEC scuttled the uptick rule.

This is much different than the agency's crackdown on naked short-selling, which involves betting against a stock without ever securing the shares, a practice that can have truly dangerous consequences for a stock being attacked. Efforts to curb naked shorting have been well received and should continue to be stepped up.

Stop signs

Ever since the uptick rule was repealed, both sides on this issue have taken opposite approaches; each has its points.

Proponents of the uptick rule argue that eliminating the rule made it easier for short-sellers to gang up on a stock and cheaper for them to bet against a company, because they did not have to execute at the higher, upticked price. This is how market bears get into a feeding frenzy; the first bear takes a bite and the others quickly follow. Since short-sellers thrive on tips and rumors, whispered actions were much more likely to instigate an attack on a stock.

Studies by Birinyi Associates have traced the rise in volatility in U.S. stocks back to mid-July 2007, coinciding with the repeal of the uptick rule.

The anti-uptick crowd argues that selling frenzies are more coincidental than a result of the rules change. They point out that the worst of the market's meltdown in 2008 occurred at a time when most short-selling was banned completely, an extreme measure that hardly slowed the free-fall. Moreover, short-covering -- a short-seller cashing out and taking the profits -- actually helps to slow a stock's decline. And having the uptick rule in place didn't stop the bear-market declines from 2000-2002 or Black Monday from 1987, and so on.

About the one thing that is clear is that the politicians and regulators approached this situation backwards. They should have left uptick in place and tinkered with it, rather than eliminating it and then trying to put on collars.

The alternative uptick rule enacted in late February triggers a circuit breaker with respect to a stock if the stock's price declines by 10% or more from the prior day's closing price. At that threshold, short selling in the security is permitted only if its price is above the current national best bid; the safety measure remains in effect for the remainder of the day and the entire following day.

Now, apparently, the idea is to limit the damage at 10% in a day. Considering that most investors would be happy making 10% on a stock in a year, waiting to slow a bear-driven frenzy until the stock has moved 10% seems a bit like closing the cage after the bears have looted the kitchen.

"The new rule has no teeth," said David Brady of Brady Investment Counsel in Chicago. "The uptick rule protected us, the same way stop signs protect us. The stop sign becomes really important when a two-year-old stumbles into an intersection or when two cars come to the same point at the same time. The stop signs in the market -- the upticks -- become really important when your financial system is collapsing.

"It's a great rule to have when the market is under extreme stress. The rest of the time, no one even notices it," he added, "but this new rule is pretty much the same as having no rule at all."

"It's a compromise," said John Standerfer of S3, an Austin, Texas firm that analyzes market data. "They

needed to do enough to show to Congress and the American public that they have put rules in place to protect against a perceived threat. I'm not sure it's a valid threat but, even if it is, this isn't really strong enough to stop it."

The next logical move in this saga won't come until the market takes a tumble, at which point someone on Capitol Hill will recommend reinstituting the uptick rule and starting the reform process over.

Maybe then they will get it right, because this time -- for all parties involved -- it feels all wrong.

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