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It's Time for the SEC to Constrain Abusive Short Selling

Last July, the SEC eliminated the "Uptick Rule," a 70-year-old regulation that constrained short selling in declining markets by requiring that listed securities be sold short only at a price above their last different sale price. In recent months, there has been a dramatic increase in short selling and volatility in a declining market environment. The SEC, on an urgent basis, should consider re-imposing the Uptick Rule, or taking alternative measures, in these extraordinary times to dampen volatility and address abusive and manipulative short selling.

Adopted in 1938 in response to growing negative sentiment toward short sellers, the Uptick Rule was designed to prevent short selling from being used to hammer down stocks in "bear raids" and to prevent short sellers from accelerating declines by exhausting bid supplies and forcing prices lower — while still allowing unrestricted short selling in advancing markets. The SEC abolished the rule following (1) a pilot program, conducted between May 2005 and August 2007, that suspended the Uptick Rule for certain stocks, and (2) the receipt of three academic studies examining the results of the pilot. The decision to eliminate the Uptick Rule was prompted by the SEC's view that market changes had rendered the Rule less effective (decimal pricing, derivative proliferation, regulatory arbitrage, and numerous exceptions and exemptions) and less essential (increased liquidity and transparency, sophisticated surveillance, and stringent penalties). The SEC also cited a need for "regulatory simplicity and uniformity," and the lack of specific evidence of "manipulative" or "abusive" shorting, in voting to eliminate the Rule.

The limitations of the SEC's pilot program, which was conducted in a period of a rising market and unusually low volatility, have become painfully clear in recent months. The risks associated with unrestricted short selling in periods of high volatility and large market declines were necessarily beyond the pilot's scope. Today, many of the same conditions that led to the adoption of the rule in 1938 are re-appearing. Short sales are at record levels and there are suggestions that false rumors about the demise of firms (e.g. Bear Stearns and Lehman) and bear raids are taking place. Other regulators have begun to address abusive short-selling – for example, the U.K.'s FSA introduced a disclosure regime for short selling during rights issues last week. By contrast, the SEC is merely relying on its surveillance and enforcement efforts to address these abusive activities. Those tools are not adequate in today's market. Manipulation and fraudulent intent are difficult to prove. Moreover, the SEC's enforcement efforts can address wrongdoing only after the fact — a delay that imperiled stocks cannot afford.

The Uptick Rule was effective for over 70 years in addressing abusive short selling and manipulative conduct, and similarly effective measures are needed today.

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