Getting Under the Hood with Short Sale

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On Feb. 24, roughly one year after first proposing new rules to curb short selling, the Securities and Exchange Commission adopted Rule 201, or the alternative uptick rule. It stops traders from selling short by hitting the bid if a stock falls by 10 percent or more from its previous day's close. In the event a stock drops by that much, they will only be able to short by posting an offer an increment above the best bid. The intention is to slow down the shorts as well as the descent of the stock. The rule will remain in effect for the remainder of that trading day, plus the entirety of the following day. It will go into effect on May 10, 2010. The industry will have six months, or until Nov. 10, to comply.

In its proposal, the SEC presented six possible short sale rules, ranging from an outright ban if a stock fell precipitously, to a return of the uptick rule that was rescinded in 2007, to the one it finally adopted. Although the industry criticized all six candidates as unnecessary and detrimental to market efficiency, it grudgingly conceded the alternative uptick rule was the least bad choice.

SEC chairman Mary Schapiro said that the new rule is intended to "preserve investor confidence and promote market efficiency." At least one former SEC official disagrees. Larry Harris, an SEC chief economist from July 2002 to June 2004, told Traders Magazine the new rule will do the opposite. Investors who buy a stock once it falls under Rule 201 may be overpaying, Harris argues. That's because the shorts have been temporarily slowed and the stock hasn't reached its natural bottom yet. "You have a massive loss of confidence when an investor buys a security that is overpriced," Harris said. "They'll end up losing another 10 percent or whatever. That's a huge investor confidence issue."

Rule 201 has many facets. We explore the main ones below.

How Frequently?

Very few stocks drop by 10 percent or more on any given day. The SEC determined that, on an average day, only 3.4 percent of National Market System stocks would have been affected by Rule 201 in the eight and a half years between the full adoption of decimalization on April 9, 2001, and Sept. 30, 2009. Because Rule 201 carries over into the next day, the total number of stocks that would have been impacted by the rule on an average day during the period rises to 6 percent.

The averages mask the extremes, of course. On Oct. 10, 2008, at the height of the panic in the U.S. financial markets, the SEC estimated that over two-thirds of all stocks would have fallen under the rule for all or part of the day. At the other extreme, on the relatively calm Nov. 26, 2006, just 0.6 percent of all stocks would have traded under the price-test regime. During a three-year period of relatively low volatility-Jan. 1, 2004 to Dec. 31, 2006-the price-test rule would have triggered go-slows on only 1.3 percent of the covered securities on an average day, the SEC found. "This is not significant from a trading or volume perspective," Dan Mathisson, AES head at Credit Suisse, told Tabb Forum.

The Price Tag

The SEC estimates it will cost the industry $28.7 million up front and $50.6 million every year thereafter to comply with Rule 201. That works out to about $85,000 up front and about $122,000 annually for each of 10 self-regulatory organizations. It's about $67,000 up front and $122,000 annually for each of 407 broker-dealers, according to the SEC's calculations. The charges are attributable to attorneys, compliance officials, operations and information technology personnel. The industry will have to establish written policies and procedures and carry out ongoing monitoring. The SEC's up-front estimates are substantially lower than those provided by SIFMA and at least one trading house. That's because the SEC numbers only take into account the final rule and none of the other candidates that would have been more costly to comply with, according to the SEC.

Minimum Increment

The SEC did not specify a minimum increment above the bid at which a short sale can be effected. However, the minimum trading increment in the public markets is 1 cent. Because private markets, such as dark pools, allow trading in much smaller increments, some observers expect short selling to move to these venues whenever Rule 201 is triggered. Others note that the SEC is considering permitting trades in sub-pennies for low-priced stocks.

Market Makers

Traders engaged in "bona fide" market making were not excepted from Rule 201. Neither cash equities market makers nor options market makers who must short to satisfy customer orders or hedge positions caught a break. The SEC acknowledged the threat to liquidity that the lack of an exemption meant, but felt any impact would be "limited." That is because Rule 201 will apply only infrequently (see above) and for two days at most. The rule will impact options market makers even less frequently than equities market makers because not every stock has an option traded on it. The SEC also based its decision on comments by market-making shop Getco and the Chicago Board Options Exchange that cash equities market makers typically sell at their offer anyway rather than at the bid. (Both organizations supported exemptions for both stock and options market makers.) In addition, the SEC reasoned that market makers typically buy stock during market routs rather than sell. Still, some hope the SEC will reverse itself. SEC commissioner Luis Aguilar remarked that SEC staff will be studying the impact of the rule on the options market and will make adjustments, if warranted. "We're disappointed [by the rule] because of the potential impact on the options markets," said CBOE chairman and chief executive Bill Brodsky. "Nonetheless, we are heartened by Commissioner Aguilar's remarks. Hopefully, if there are harmful impacts, the SEC will also take quick action to provide an exemption."

Hedge Funds

A study by Tabb Group last year found that the group most affected by the imposition of a short-sale rule would be hedge funds. Thus, their reaction to Rule 201 was no surprise. "We are disappointed that the short-selling restrictions adopted are not supported by empirical data," the Managed Funds Association, which represents the hedge fund industry in Washington, said in a statement. In a bid to console those upset with Rule 201, the SEC, in its 334-page final rule, said that even when a stock suddenly becomes subject to the rule, "we expect there will be purchasers in the market willing to buy the security at the offer or at a price between the current national best bid and offer."

How to Get Around Rule 201 (Illegally)

A rule forcing a short seller to wait for a buyer to come to him rather than permitting the short to hit a buyer's bid can be circumvented, according to one former trader. Here's how it works: The trader places a short sale at the best ask on an exchange or ECN that does little volume. The trader then takes that offer himself via a second trading system he or a confederate may use. The trader is now long the stock. The trader then immediately closes the long position by hitting the bid. That leaves the trader with the desired short position, effected at the best bid. The cost was two commissions instead of one.

Circuit Breakers

Rule 201 is not the first to incorporate a so-called "circuit breaker." New York Stock Exchange Rule 80B, introduced after the market crash of 1987, halts all trading temporarily if the Dow Jones Industrial Average declines precipitously. The rule takes a three-tiered approach, halting trading for various periods of time depending on whether the market falls by 10 percent, 20 percent or 30 percent. Nasdaq has its own version of Rule 80B that goes into effect if the New York's 80B does. The major derivatives will halt trading in certain index products if NYSE Rule 80B goes into effect. Rule 80B has only been triggered twice: both times on Oct. 27, 1997, during the financial crisis that struck several Asian countries.

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