Riders on the Storm

Short Selling in Contrary Winds

Section 5: Traits of the System – to 1986
[Excerpts]

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with Ben Hill

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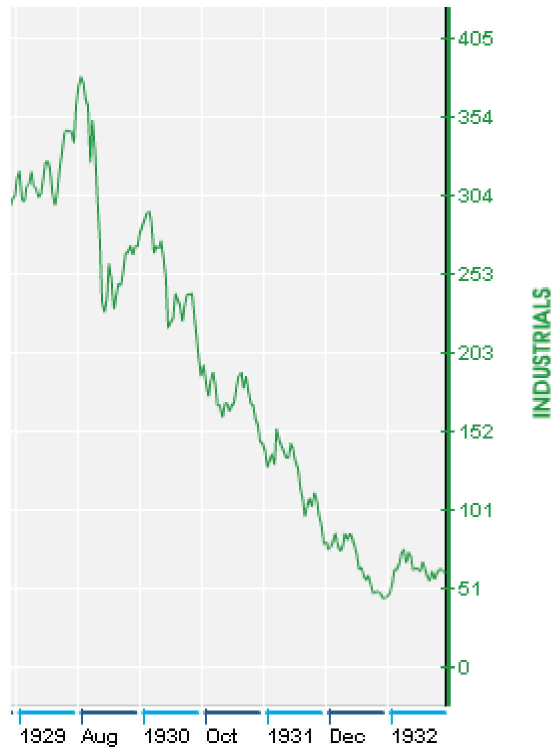
1935 – The Beginnings of the Tick Rule



* www.dowtheoryproject.com

Regulations of short selling have often been enacted, strengthened, or examined following severe declines in the stock market. The Crash of '29 was no exception. As noted earlier, the Dow fell 89 percent, declining from 386 in September of 1929 to 41 in June of 1932. The SEC was created in 1933, and two years later we see the emergence of the tick-rule in its earliest form, when it was enforced by the exchanges.

> "In 1935, the SEC requested all exchanges to regulate the practice of short selling. This resulted in the 16 exchanges then in operation adopting requirements that its members should not effect short sales that would demoralize the market, including sales on a downtick." [24]

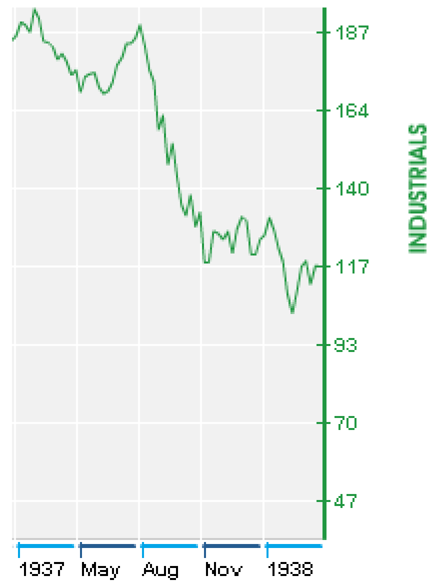
That same year, the 1935 Twentieth Century Fund Study questioned the impact short selling had on markets and the validity of the plus tick rule of the exchanges.

> "The first major study of short sales analyzed the impact of short selling on prices utilizing data of NYSE members. The study found that short selling does not have any appreciable effect in limiting the extremes to which prices may rise. Its tendency is to accelerate the downward trend in prices during the early and middle phases of [price] movements. *However, considered in terms of long positions and total trading, short sales, '…have not been in sufficient volume to warrant the belief that their actual effect is at all material*.' The study concluded that there should be no general prohibition of short selling." [25] (Emphasis mine)

The 1935 Twentieth Century Fund study further proposed that the rule prohibiting members from transaction that would upset the equilibrium of the markets "should also apply with equal force to purchases for long accounts." [26] They reason, rapid buying, as well as rapid selling, can cause markets to become unstable. As such, the same rule should apply.

SEC Study of 1937

From February 1937 to March 1938, the Dow went from 187 to 99, a loss of 47 percent. This precipitated a SEC study of short selling in the latter part of 1937, [27] which concluded that the exchange rules had been ineffective. [28]



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> "The Commission therefore adopted its own rule *prohibiting short sales on an exchange at or below the price at which the last sale was effected* on that particular exchange. Thus in 1938, federal tick-test regulation of short sales on exchanges began. The Commission's [original] rule precluded short sales at the last price regardless of prior price changes. It caused short interest and short selling to decline more than 50 percent. At the request of the exchanges, the Commission modified its rule shortly thereafter to permit short sales at the last price on a zero-plus tick." [29]

The SEC Tick-Test Rule

SEC Rule 10a-1, commonly called the "tick-test" rule stipulates:

> "No person shall, for his own account or for the account of any other person, effect a short sale of any security…if trades in such security are reported… (i) below the price at which the last sale thereof was reported… or (ii) at such price unless such price is above the next proceeding [sic] different price at which a sale of such security was reported…" [30]

Or, if you prefer an easier explanation, you cannot short a stock if the current price is *below* the prior price (a downtick). And, you cannot short a stock if the current price is the *same as* the prior price but lower than the (different) price before that (a zero-minus tick).

I realize this may seem laborious, but convention requires that I include an example even if that example is tedious and adds little by way of clarification. So, without further ado,

> "This requirement of Rule 10a-1 is implemented by means of a 'tick test' which is best illustrated by the following examples:
>
> - If the last sale was at 20 and the last different price was at 20 1/8, a short sale is not permitted below 20 1/8.
> - If the last sale was at 21 ½ and the previous different price was at 21 3/8, a short sale is not permitted at a price below 21 ½.
> - If the last sale was at 22 and the last different price was at 22 ¼, a short sale is not permitted at a price below 22 1/8.
> - If the last sale was at 25 ¾ and the previous different price was at 25 ½, a short sale is not permitted at a price below 25 ¾." [31]

At the time the Pollack Report was written, stocks still traded in one-eighth increments. Though stocks now trade in increments of a penny, the same rules hold true to this day.

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Throughout history, short sellers have often been vilified. Market crashes and sharp declines have often acted as catalysts, bringing harsher criticism and attempts to restrict, restrain, or outlaw short selling. The 1938 SEC tick-test rule, which has been questioned as to its legitimacy and its effectiveness by the SEC itself, is a prime example of this position. Throughout history, the effect of short selling on markets has been arguably negligible. If anything, it has contributed to making markets more efficient by guarding against speculative price increases and by providing support to markets when short sellers buy to close out their positions.

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If this were not enough, the SEC has finally agreed to remove the tick rule on certain stocks. Now, the SEC has discussed the removal of the up-tick rule for decades. Most studies have come to similar findings – that the tick-test rule is ineffective, costly, and should be removed. As noted earlier, the 1976 SEC paper remarked,

> "that the [1937] Commission drew its conclusions from inadequate data and demonstrates trends which are inconclusive with respect to the general impact of short selling,' that the SEC short-sale rule was hastily adopted following a sharp bear market, [17] [and] concluded that the tick test was costly and ineffective." [19]

Pollack seems to believe that, "the SEC tick-test regulation had a far broader goal, i.e., attempting to moderate overall declines in stock prices." [20]

So the removal of the tick-test would bring to a close years of questions concerning its legitimacy and efficacy, and, with less friction or interference on one side of the transaction, would likely make our markets more efficient. But why now? The removal of the tick-rule closer to what arguably looks like a market top is cause for some concern. Perhaps, I am a bit too cynical.

Nevertheless, to meet the objective of "simplifying and modernizing short sale regulation, providing controls where most needed and temporarily removing restrictions where they may be unnecessary," [21] the SHO regulations, issued by the SEC, went into practice in January 2005. One of the issues addressed was rule 10a-1, the tick test rule. As part of the pilot program (which is effective from May 2, 2005 to April 28, 2006) 1000 stocks of the Russell 3000 have been removed from the tick test requirement for a designated period of time. [22 & 23] This means that what is commonly called the plus-tick rule will not apply to short sells on these stocks temporarily.

Though I may have some small misgivings about the timing, the removal of the tick-rule, even if only temporarily, has multiple benefits to the markets. And, with the proliferation of the use of products, like derivatives, options, and ETFs, which have no tick-test restrictions, this change would make stocks more competitive in the short selling arena.

Perhaps my concerns come from my study of history. Short sellers, specifically those who specialize in taking short positions in individual securities to profit from the decline of those shares, have often been the scapegoat for market declines at various points in history. Yet I am sure that if the markets were to decline sharply today, the populace would realize that short interest in derivatives and ETFs would far outweigh any impacts of a group of investors shorting individual companies.