Return of the Uptick Rule?

A Canadian Marketplace Perspective

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Return of the Uptick Rule? How Will Canada React?

Earlier this week four of the largest U.S. exchanges – Bats Trading, Nasdaq OMX, National Stock Exchange and NYSE Euronext – sent a letter to the Chairman of the SEC recommending the implementation of a new 'Modified Uptick Rule'. The next few paragraphs will outline the proposal as well as discuss what this might mean to the Canadian marketplace.

The Proposal

The proposed rule would only allow short selling to be "initiated at a price above the highest prevailing national bid by posting a quote for a short sale order priced above the national bid. As such, the execution of a short sale would occur only at a higher price than the prevailing market at the time of initiation, and only on a passive basis (i.e., short sales cannot hit bids). Furthermore, the exchanges propose that the modified rule only comes into effect if a "Circuit Breaker" is triggered. The circuit breaker could either be unique to each stock (i.e. XYZ triggers the breaker and the modified rules comes into play for that issue) or market wide (i.e. S&P500 is down X% all short sales must satisfy the new rules).

Some thoughts on the proposal:

1) The legacy rule was problematic in a 40+ trading venue environment. Trying to determine what the last price was, and what a legal tick is, would be extremely difficult in today's markets. As such, the proposal replaces a neutral or uptick test with a requirement that stock be sold passively at levels above the national best bid. (Some cynics might argue that four visible marketplaces are proposing a rule to sell short passively to prevent short sales occurring on dark pools at 1/10 of a penny above the last tick, creating an uneven playing field.)

2) The proposed rule places the obligation for "ensuring compliance with the rule before sending a short sale order into the marketplace". The proposal further states that "exchanges could offer order types to assist brokers in performing their compliance duties, but would rely on a broker's indication that they had performed the required due diligence on the order when so indicated". Were this implementation easy, the exchanges would likely have offered to build systems to comply with the rule. Given that they haven't, this suggests building systems to comply with the proposed rule will be fairly complicated work.

3) The implementation of a circuit breaker approach is clever. It allows for short sellers to add liquidity and pricing efficiency to the marketplace during normal market conditions, while preventing predatory short sales when the market (or a stock) is most vulnerable.

4) The proposal notes that exemptions must be made for legitimate market making to ensure markets continue to work well during the circuit breakers.

We expect that the SEC will eventually implement a policy very much like the proposed one. The visible marketplaces are clearly onside with the proposal. The large broker dealers will be hard pressed to argue given their collective whining when their own stocks were getting pounded last fall. And the vast majority of issuers will be thrilled to see the return of the uptick. The only potential dissenters will be the quant funds that run long / short funds, and even they will be largely placated by the circuit breaker portion of the rule. The big push for the rule is coming from Duncan Niederauer, CEO of NYSE/Euronext Group, who is well spoken and well connected. We expect he will win the day in the fairly near future. (Although we caution that implementation of the rule may take some time).

So What Does This Mean For Canadian Markets?

In August of 2007 the CSA (Canadian Securities Administrator) reacted to the U.S. elimination of the tick test by quickly eliminating the tick rule on U.S.–Canadian interlisted equities. They also followed the U.S. lead in temporarily reinstating the tick test on financial stocks in the fall of 2008. Every indication leads us to believe they would follow any U.S. initiative on an uptick rule to avoid any regulatory arbitrage on interlisted securities. We have spoken to several Canadian regulators this week and all have suggested this is likely the case, although none would do so on the record.

If the U.S. were to adopt the current proposal, the Canadian marketplace would face the following logistical issues implementing a similar rule:

1) Most importantly the Canadian marketplace does not have the experience with circuit breakers that the U.S. marketplace has. Currently the TSX follows suit should any U.S. circuit breaker temporarily halt trading. (Some of you may remember the near chaos last fall when Canadian stocks were getting pummelled early on U.S. Thanksgiving and no circuit breaker rules were in place – fortunately the market rallied late in the morning and the problem was averted.) Any new circuit breakers would have to be built from scratch which would likely take significantly more time than adopting current breakers.

2) There would exist the potential for regulatory arbitrage in the event one marketplace or a single (or group of) interlisted stock(s) were down more in one marketplace than the other. This could result from either a significant move in the exchange rate between the U.S. and Canadian dollars, or due to one marketplace being closed the previous day while the other was open. In any event, the Canadian marketplace would have to prepare for a situation where the tick rule was invoked in one jurisdiction and not in the other.

3) Implementation of a new rule, under the current Canadian regulatory framework, would take considerable time. Currently any substantial new rule in Canada would have to be agreed upon by 13 regulators, most likely after seeking public comment from the street. This process could easily take more than a year to complete. It is highly unlikely we would be able to keep pace with the U.S. in approving any new regulatory changes.

Overall, we consider the proposal to be a reasonable one. While we would argue that the real damage to the markets was caused by unregulated instruments including Credit Default Swaps (CDSs), we are pleased that the proposal is attempting to implement new regulations only during significant market disruption, and is not a ham fisted approach to outlaw or hamper short selling during periods of stability. Furthermore we applaud the proposal's guidance that exemptions must be made for legitimate market making to ensure markets are able to trade efficiently during times of turmoil.

We believe that changes to the current short sell rules will likely occur in the near future and will be actively monitoring any and all developments.

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