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Short-Selling: The Next 'American Idol'?

Bill Singer 04.17.09, 2:00 PM ET

In *American Idol*, the public decides who the next great pop star should be. Sometimes this vox-pop gets it right, like when it crowned Kelly Clarkson. But just as often it misses. After all, Jennifer Hudson may be a star now, but she was famously booted from the show before even getting a whiff of the finals.

Clearly, letting the public decide has its merits, but is this how we should regulate our financial markets? We're about to find out, as the Securities and Exchange Commission opens its phone lines for the public to decide whether to reinstate the Uptick Rule. But this is one area where the commission should be the judge, not the public.

But first, a little history on the Uptick Rule and how we got to our current crossroads.

Back in 1938, the still-new SEC adopted the "tick test," which permitted the short-sale of an exchange-traded security, provided it was priced above the immediately preceding sale. Subsequently, the NASD/Nasdaq adopted its own short-sale test for non-exchange-traded securities based on the last bid, also known as a "bid test." These tests have come to be colloquially known as the Uptick Rule.

But this entire framework changed in the then-roaring bull-market of 2004. It was during this time that the SEC authorized a pilot program to consider revising or even removing the Uptick Rule. Why? Hedge funds and traders wanted to short without being hamstrung by annoyingly inconvenient rules and regulations. Against that canvas, the pilot program began. Frankly, you had to be an idiot not to know it was a foregone conclusion: They were going to abolish the Uptick Rule.

In June 2007, the SEC eliminated the rule. At the time, I gave this news a yawning "duh." The SEC stated that its own internal analysis and that of an industry roundtable had determined that "the empirical evidence"--it actually used that phrase--did not support the need for retaining the now unnecessary Uptick Rule. After some 70 years on the books, such protection was deemed obsolete.

Only a year later, the markets imploded. Many blamed the absence of the tick and bid tests for fueling the collapse--oddly, some screaming the loudest were the very same regulators, academics and Wall Street hot-shots who thought abolishing the tests was a great idea. All that talk about empirical evidence and unnecessary regulation was forgotten.

In July and September 2008, amid political pressure and panic, the SEC issued emergency orders imposing borrowing and delivery requirements on certain short-sales and prohibiting the short-selling of some securities.

How ironic. Those same financial institutions hemorrhaging from "predatory" short-selling had long practiced those black arts against other publicly traded companies. There was also another nagging question: Was the shorting of the shares of those financial institutions predatory or just smart investing based on the belief that the books had been cooked, the assets inflated and management clueless? Should such failed businesses have been protected by the SEC or tossed in the garbage?

In early 2009, investors and industry alike awaited the SEC's bold, decisive action on the issue of whether to reinstate some tick/bid test or to stay the course and go without them. But on April 8, 2009, the SEC instead informed us it was seeking public comment. The commission wants to know whether you think they should restore price restrictions, go to a circuit-breaker solution or maybe just keep things as they are. We are in the finals, but no one wants to pull the trigger. SEC Chairman Mary Shapiro has to unleash her inner Simon Cowell already!

Personally, I don't believe in the tick or bid tests. I think such regulation adds a dangerous artificiality to the market and prompts worse abuse through the creation of synthetic short positions that use futures or options to circumvent the tests. Nonetheless, if regulators are going to implement short-selling price tests, they can't look the other way when it suits them.

Half-hearted regulation is simply unacceptable.

What the SEC should have announced April 8 was a comprehensive rule reforming short-selling abuses. Or it should have announced it had abandoned such rules because it did not believe reinstating the Uptick Rule was in the public's interest. Instead, the SEC wants you to decide. Is the regulation of Wall Street now just another reality show?

If you think the SEC should reinstate the tick/bid rule, vote at 800-SEC-0001; if you think the SEC should not reinstate the tick/bid rule, vote -0002. Void where prohibited. Calls may be charged by your provider.

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