Analysis Shows Uptick Rule Vital to Market Stability

November 18 2008

(PhysOrg.com) -- A new study by researchers at the New England Complex Systems Institute found that interpretations of data from an SEC pilot program used to justify the repeal of the "uptick rule" in the summer of 2007 are unsound. The uptick rule was designed to limit the rapid selling of borrowed shares and was implemented after the crash of 1929 to prevent future crashes.

The SEC decided to repeal the long-standing rule after conducting a six-month pilot program, which was interpreted to show the rule had a “statistically insignificant” effect on the market. The NECSI report, however, reveals the interpretation of the SEC’s pilot program to be severely flawed. The study is described in a Wall Street Journal op-ed by NECSI President Yaneer Bar-Yam and MFS Investment Management Chairman Robert C. Pozen. A technical report describing the findings is linked from the New England Complex Systems Institute Web site.

The SEC’s 2005 pilot program compared stocks that were subject to the uptick rule to stocks that were unregulated starting in May, 2005. After six months, the SEC found that unregulated stocks had 2% lower returns than those subject to the uptick rule, but dismissed this difference as statistically insignificant relative to the variation in returns among stocks.

A more comprehensive analysis in the NECSI study tells a different story. “Using more detailed information the results are unambiguous--the 2% difference is statistically significant," says Bar-Yam, "The daily returns had a consistently lower trend for unregulated stocks over the

entire period. More critically, the 2% difference is economically significant when you consider that the market generates an annual return of 6 to 7%. A 2% reduction every six months would radically shift the investment landscape."

The NECSI report also reveals that by repealing the uptick rule, the SEC left the market more vulnerable to spikes and drops. The SEC found that unregulated stocks experienced more extreme reversals, but ultimately dismissed this evidence. "The SEC discounted the increased volatility because the reversals occurred in both directions, but large reversals are an important clue to market behavior in times of economic stress," argues Bar-Yam.

The uptick rule had been in place since 1938. Yet the SEC's pilot program lasted a mere six months, and the repeal was tested during a relatively calm period of the market when prices were steadily rising. "The unregulated stocks were never put through the rigors of a volatile market," explains Dion Harmon, a NECSI researcher and co-author of the study. NECSI researchers compared stocks before and after the repeal during volatile 12 month periods and found dramatic results: a doubling in the number of stocks losing over 40% of their value in a single day.

Professor Bar-Yam affirms the data do not support the SEC's decision and argues that the uptick rule should be reinstated. "The research strongly suggests the repeal of the uptick rule is contributing to today's market turmoil. The SEC should reconsider the evidence and restore the uptick rule."

The New England Complex Systems Institute (NECSI) is a non-profit research and education institute developing new scientific methods, and applying them to the challenges of society.

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Provded by New England Complex Systems Institute

Citation: Analysis Shows Uptick Rule Vital to Market Stability (2008, November 18) retrieved 26 April 2024 from https://phys.org/news/2008-11-analysis-uptick-vital-stability.html

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