E Q U I T I E S

Restrictions on Short Selling

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In this paper we review the theoretical and empirical evidence on both short sales and restrictions on short sales, concentrating on the uptick rule. The uptick rule, implemented after the 1929 crash, states that “short sale can only occur at a price above (“plus tick”) the immediate sale price, or at a price equal to the price of the most immediate sale if the most recent price change was positive.”

The rule hinders the efficiency-promoting aspects of short selling on the pricing of individual securities and index arbitrage, which relies on the ability to buy and sell baskets of stock quickly at prevailing prices. The rule hampers index arbitrage by inhibiting the ability of arbitragers to quickly short sell a security.

Index arbitrage improves market efficiency by linking the futures and cash markets, transferring information quickly between them. While in certain cases the uptick rule protects property rights of block traders, this has become less important over time, and a broad restriction on short sales is not an efficient way to protect this property right.

Theory and empirical evidence suggest that restrictions on index arbitrage helped to uncouple the equity and futures market on October 19, 1987, exacerbating the decline and helping to turn the decline into a crash. To the extent the uptick rule had a role in the crash, it exacerbated the unlinking of the markets.

The implications of our arguments are that the uptick rule should at least be relaxed for index arbitragers, and probably for all traders.

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