Protecting Investors in Tumultuous Times: How Reinstituting the 1938 Uptick Rule Can Make Markets More "Fair and Orderly" as well as "Black Swan Robust"

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Managerial implications of this historical research

to dilute the potential impact of major crises like wars, pandemics, and other disasters - and to keep the market open and well-functioning in such cases -, prudent stock exchange leaders would benefit by taking steps (such as possibly reinstating the 1938 uptick rule) to improve market fairness and orderliness, and in so doing, strengthen public trust.

"Institutions survive while they serve."
Jason Westerfield, Address to NYSE Institute, 1924.

With the eruption of the COVID-19 pandemic, managers of companies big and small have had to wrestle with a host of massive corporate social responsibility (CSR) dilemmas. Managers of stock exchanges, too, have complex responsibilities to their many stakeholder groups - among them, retail and institutional investors ("the investing public"), listed companies, member firms, the economy, and society at large. While challenging, effective stakeholder management can help organizations navigate through tumultuous times, making them essentially more "black swan robust," to borrow a phrase from Nassim Taleb (2010, p. 322). So how can stock exchanges become more resilient in the face of major crises like wars, pandemics, and other disasters? If Wall Street history is a guide, the key very well may be working harder to ensure that markets are "fair and orderly" in good times and bad. During the Great Depression, in the aftermath of investigations into alleged Wall Street abuses, certain pieces of legislation, like the uptick rule, helped make the playing field more level. Today, reinstituting the uptick rule, which had been removed in 2007, could help improve market fairness and orderliness - as well as perceptions of both traits. As the NYSE learned slowly during the long, lean Depression years, reinvigorating trust in the marketplace, and continually earning that trust - is critically important in order to facilitate a strong and long-lasting market recovery.

Founded in 1792 under a buttonwood tree on Broad Street in lower Manhattan, the institution that became known as the "New York Stock Exchange" (NYSE) grew to embrace the importance of providing a "fair and orderly" marketplace in order to serve their stakeholders effectively. The Securities and Exchange Commission, created in 1934, also embraced the wisdom of those two attributes for well-functioning exchanges, too, while also often adding in the words "efficient" and "transparent." (See SEC website).

Both terms - "fair" and "orderly" - have broad room for interpretation, but can be loosely defined. Writing in 1941, SEC official Raymond Vernon explained, "A 'fair market ... bears the connotation of a market in which the individual investor need not fear for the integrity of his brokers, the safety of his funds, or the possibility that price movements are being artificially controlled." Vernon went on to define an "orderly" market as "one in which there are no 'sudden and unreasonable fluctuations in the prices of securities' and consequently a market which makes no unnecessary adverse contribution to the well-being of the public at large." (pp. 132-135. See also Wolfson and Russo, 1970; Angel and McCabe, 2013.)

Creating an environment where those attributes tended to flourish, the NYSE in its first hundred years developed a reputation as the preeminent stock exchange in the United States. Public companies desiring to list there had to meet more stringent requirements than lesser exchanges. Big Board leaders were anxious to help protect investors from unseasoned companies, in no small part because they realized that in so doing, they were helping preserve the organization's reputation. Likewise, it was in the Exchange's best interests (not just investors) to patrol the trading floor to make sure everyone was abiding by the same rules and not manipulating stocks. As Jason Westerfield, the NYSE's first Director of Publicity, commented in 1924, "Considerations of self-preservation alone, prompted by intelligent self interest, amply account for the determination of the membership of the NYSE to place their institution above reproach and above suspicion." (p. 9)

While providing a fair, orderly, and transparent market has long been the NYSE's cache, there have, of course, been periods when this has not been the case. Witness, for example, the pools, corners, and other stock manipulations that proliferated in the 1920s market.

Also, obviously, a stock exchange has to be actually open for business in order to provide an effective marketplace. Yet there have been times when the NYSE has closed, either due to its own volition, outside intervention, or technical problems.

Most notably, the NYSE closed at the onset of World War I for a period of four long months. Extremely cognizant of the need to protect the nation's gold supply from being drained by foreign investors fleeing the markets, U.S. Treasury Secretary William McAdoo on July 31, 1914 invoked the emergency currency provisions of the Aldrich-Vreeland Act to shutter the NYSE. (See Silber, 2007). Of course, at the time, very few Americans - probably less than 1 percent of the population - owned any stock, but even then, closing the markets caused serious repercussions, and even inspired some traders to illegally gather on New Street to serve stockholders desperate to liquefy their positions. Nevertheless,

McAdoo accomplished his aims, and with his guidance, the NYSE successfully reopened on December 12, 1914. NYSE President Noble took pride in the Exchange's role in helping the country, quickly writing a small book about the NYSE's role in averting the crisis of 1914, even though members initially were far from unanimous in thinking closure to be a good idea. (See Noble, 1915; also see Noyes, 1926).

In subsequent years, the NYSE would experience episodic short closures, due to various disruptions or even occasionally, some celebratory events. But the NYSE would never again close for months like at the onset of World War I. After the terrorist attacks on 9/11/01, the NYSE managed to its systems back up and running within just three days. NYSE President Richard Grasso understood the importance to the country of the institution reopening as quickly as possible, and also understood the necessity of enacting measures afterwards to make "Wall Street" more geographically disperse, to prevent the NYSE from needing to close again. The world had changed since 1914; the NYSE could not choose to stay closed for months - the remedy (closure) would likely be far worse than the disease (chaos and disorderly trading, if trading indeed could even take place).

Nevertheless, in early March 2020, during the height of the COVID-19 pandemic, rumors of a possible NYSE closure gained traction, especially after several states began to close down all nonessential businesses, including schools, restaurants, and other institutions, in a frantic effort to contain the virus. Weeks earlier, few had predicted such closures would occur. Might the NYSE be next - closed (either by the Exchange or by the state or federal government) not to stop the spread of actual germs, but to stop a financial contagion?

A closure might exacerbate the panic and compound investor anxieties, making a smooth reopening exceedingly difficult. Besides, if equity investors' dollars were tied up, trapped in a closed market, this would ignite a dangerous ripple effect, as people rushed to other venues like their savings accounts to access their money. Still the rumors persisted, necessitating NYSE President Stacey Cunningham to refute them on CNBC on March 16, 2020.

Exchange leaders like Cunningham would do well to carefully articulate the reasons why capitalism typically is best served by keeping markets open. While upholding the decision to close the Exchange at the onset of World War I, NYSE President Noble later said that it "would have been an unmixed evil" to have closed the NYSE during an earlier crisis, the Panic of 1907. He explained, "…duty dictates a policy of hands off as long as a continuous market persists and purchasers continue to buy as the decline proceeds." (Noble 1915, p. 7). Like Noble, top Exchange officials today need to explain more deeply the historical reasons why markets have in the past closed, and how the securities markets have changed since those times. Given that a higher percentage of the population is invested in the market than in 1914 or even 2001, the stakes are greater than ever for keeping markets open and well-functioning. To that end, Exchange officials need to take the lead, not relying on the SEC or others, like IEX founder Brad Katsuyama, to find ways to improve fairness and orderliness as markets and technology evolve.

So how has market structure fared during the COVID-19 pandemic? Despite high trading volume, the existing technology has thus far withstood the pressure, with no major problems of delayed stock quotations or order executions. Market volatility, however, has been extreme, with a slew of record point gains and losses in the major indices. Arguably, high frequency trading (HFT), famously highlighted by Michael Lewis in his 2014 bestseller Flash Boys, has exacerbated these wild market swings. For more than a decade, critics have alleged that HFT as well as other practices like dark pools have made markets less fair and less orderly. (See Patterson 2013; Arnuk and Saluzzi, 2012; Macey and Swensen, 2017). Those traders who have access to high-speed data transmission lines can make lightning-speed trades, jumping ahead of slower, smaller investors and "sneaking a peak" at the order book. According to opponents, HFT also has lessened true liquidity, as these traders often exit the market at the time of greatest volatility. For more on the ethical debate underlying HFT, see Angel and McCabe (2013), and also Haigney (2010).

There may, though, be an easy way to slow down HFT, at least to some extent: reinstate the uptick rule. Enacted by the SEC in 1938, during the depths of the Great Depression, this legislation stipulated that a trader could not sell a stock short until it recorded a plus tick - an upward change in the stock's price from the prior sale price. The rule came into play due to a pervasive sense on Main Street that unfair, organized bear raiding had caused the disastrous Great Crash of 1929. Insiders, many feared, had conspired to bring down the market by shorting stocks and then artificially pushing them down. Despite failing to find evidence of organized bear raiding, the newly created SEC decided to prevent shorts from ever being able to unduly beat up a stock that was already falling. (See The ShortSelling Decree, 1938 and Waltman, 1938.) Decades later, in 2007, the uptick rule was repealed even though rule still had served an important purpose, slowing down HFT traders who were trying to sell quickly stocks they were short. Now with the uptick rule removed, they no longer had to wait for a plus tick. Markets moved faster and faster, and the share of trading volume attributable to HFT radically increased.

As Traflet and Gruver (2015) have argued, and as billionaire investor Leon Cooperman recently emphasized (Imbert 1 March 2020), bringing back the uptick rule would help slow things down and make the playing field more level. Left unchecked, HFT-induced volatility might someday precipitate a market closure like 1914, which was exactly what some investors in 2020 worried might happen.

Even during a crisis - perhaps even more so -, opportunities abound for forward-thinking NYSE leaders to better serve their multiple stakeholder groups and in so doing, create added value for society as a whole. Reinstating the 1938 uptick rule might be a powerful step in that direction.

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