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Statement of the Shadow Financial Regulatory Committee on

Regulation of Short Selling

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During the recent turmoil, short selling has been widely blamed by managers, the media and the Securities and Exchange Commission (SEC) for causing unwarranted declines in the value of financial institutions. The SEC has expressed its fear that false "rumors" might artificially reduce the stock price of financial services firms in particular. This triggered a renewed interest in regulating short sales, resulting in an "emergency order" limiting short sales in nineteen financial firms.[1]

The Committee sees no good reason for intensifying the regulation of short selling. Short sales play an important role in our stock markets, allowing investors to express legitimate concerns about accounting irregularities and other reasons for the overvaluation of individual firms. In line with the SEC's investor protection mission, short selling informs and protects investors against artificially inflated stock prices. Empirical evidence about the stock price of companies who blame short sellers for artificially driving down their stock prices indicates that, far from regaining value, on average over a period of many months these companies actually underperform a benchmark sample of comparable firms by approximately 2% per month.

Short sale restrictions cannot suppress the information content of rumors. Rumors can be true or false, but often precede the revelation of adverse information. The propagation of malicious and fraudulent rumors is already punishable under the securities laws.

The SEC's preexisting rules required short sellers to locate securities available for borrowing before the execution of their order. However, traders may be unable to borrow or deliver the stock within the three-day settlement period. Brokers currently control damages that delivery difficulties might cause by imposing suitability and margin requirements. The SEC's emergency order (now expired) required short sellers in the nineteen stocks to enter a delivery agreement in order to trade. This action did not target positions or trades based on rumors, nor was there any evidence that these stocks experienced substantial delivery problems. Only one of the nineteen was on the SEC's "threshold list" for elevated delivery failures. Less than 1% of all equity transactions encounter delivery problems. In contrast, delivery has been a genuine problem in the market for credit default swaps.

Where policymakers could improve the handling of short sales is to focus on increasing the transparency of securities lending. Making prices paid on securities loans more transparent would potentially increase the supply of loanable securities, ease lending and delivery concerns and make investors more aware of profits that can be made by making their securities available.

One of the worst things that authorities might do would be to reintroduce some version of the tick rule. The tick rule was a Depression-inspired notion. The rule, which was repealed last year, allowed a stock to be sold short only after a trade that had increased the stock's price. The basis for repeal was an SEC-designed experiment in which the tick restrictions on when investors could sell stock short were removed for a pilot sample of stocks and retained for a matched control sample.[2] The experiment showed that tick restrictions increased trading costs and generated no trading benefits. In a decimalized market the old tick rule could not have much bite. Imposing a new x-cent tick test (requiring an up-tick of at least x cents in the stock price) would be tantamount to an outright ban on short sales for securities trading with spreads less than x.

Notes

[1] See Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, July 15, 2008, www.sec.gov/rules/other/2008/34-58166.pdf

[2] Two of these were presented at the SEC's Roundtable on the tick test and short selling. See "It's SHO Time! Short-Sale Price-Tests and Market Quality by Karl Diether, Kuan Hui Lee, and Ingrid M. Werner (forthcoming, *Journal of Finance*), www.afajof.org/afa/forthcoming/4131.pdf and "How do Price Tests Affect Short Selling? by Gordon J. Alexander and Mark A. Peterson http://www.siu.edu/%7Emap1/papers/UptickRule.pdf, in addition to the SEC's staff analysis in "Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot" http://www.sec.gov/news/studies/2007/regshopilot020607.pdf