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August 13, 2008, 3:05 pm

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The Great Short-Selling-Ban Debate

Posted by Heidi N. Moore

On July 21, the Securities and Exchange Commission issued [an emergency order](#) to ban so-called naked short-selling on 19 financial stocks in order to prevent rumors from disrupting the "normal price discovery process."



Last night, the order lapsed as scheduled. Now comes the job of answering the critical question: did the SEC ban work? If successful, the SEC could claim victory, perhaps extend the naked short-selling ban while opening the door to further government intervention. Failure would give financial firms fodder for arguing that financial regulators should get off their lawn. Deal Journal is interested because the battered stock prices

of financial stocks that gave rise to the ban also had driven furious M&A speculation this year. If Washington is influencing these stock prices, it also is influencing the natural course of mergers.

Unfortunately, this is one messy autopsy. First, how to define success? The SEC standard was about protecting the "normal price discovery process," but really it seemed more motivated by preventing the prices of the 19 stocks from falling further. To the latter criterion, the data show that the financial firms' stock prices were resilient. Bloomberg today [reported](#) that the 19 covered stocks as a group rose 26% since the July 15 announcement, adding \$270 billion of market cap. The 19 now are trading roughly where they were on Monday, March 17, the day Bear Stearns was sold.

Floyd Norris, in [his Marketplace column](#), noted that the 12 pure U.S. stocks rose 23% after July 15; the S&P 500's financials rose 22% in the same period.

Still, S3 Matching Technologies, an Austin, Texas, data firm, points out that Fannie Mae's stock fell 40% and Freddie Mac 41%. Those two stocks, you will remember, provided much of the catalyst for the emergency order.

But academic and corporate research indicate the experiment failed. Perhaps the strongest antiban argument comes from [Arturo Bris](#), a professor at Swiss business school IMD who is affiliated with the Yale International Center for Finance. He tracked the 19 stocks protected by the SEC's Emergency Order and examined short-selling data provided by the NYSE.

Bris says—you can [read Bris's report here](#)—the SEC probably didn't even need to get involved because, from Jan. 1 to July 15, 2008, short-selling accounted for 12% of trading in the 19 stocks, compared with 13% for other, similar U.S. financial institutions. He concludes that the SEC order meddled with market efficiency, that the risk-adjusted return on the 19 protected stocks actually fell for investors, and that the rest of the financial sector—a sample size of 73 financial institutions traded on U.S. exchanges—performed a lot better in the market than the protected 19. Bris also argued that the increased short-selling in some of the 19 financial stocks could be explained by the fact that some of those firms were more active issuers of convertible bonds.

Bris's most damning finding was that the emergency order impeded market efficiency—in effect, it distorted the "price discovery" process that it was hoping to fix. "The G19 stocks have suffered a significant reduction in intra-day return volatility and an increase in spreads, which suggests a deterioration of market quality," Bris wrote.

In addition, some unprotected financial stocks—including Washington Mutual—were hit really hard. Bris told Deal Journal of the ban: "I think it targeted the wrong stocks."

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Deal Journal is an up-to-the-minute take on deals and deal-makers, updated frequently with exclusive running commentary, news flashes, profiles, data and more. The Wall Street Journal's Heidi N. Moore and Dennis Berman are the lead writers, with contributions from other Journal reporters. Send news items, comments and questions to deals@wsj.com.



EVAN NEWMARK

Mean Street

[Mean Street: Russia Says, "We Will Bury You, Shareholders."](#)

This weekend, a Barron's/Value Line Survey identified America's best fund manager. It is Jan-Wim Derks of the ING Russia Fund. "This is the best time to make money," pronounced the No. 1-ranked Derks. Ironically, Barron's real #1, Rupert Murdoch, would beg to disagree. A week ago, in talking about News Corp. in Russia, Murdoch observed, "We have great growing business there but...the more I read about investments in Russia, the less I like the feel of it. The more successful we'd be, the more vulnerable we'd be to have it stolen from us, so there we sell now." Derks and Murdoch can't both be right. ([Read more](#))

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The data, of course, show only that short-selling didn't hurt the firms; no one can track naked short-selling, the kind of risky bets that aren't disclosed by investors and the target of the SEC's ire. There are good points on either side of the debate, which is inconclusive, but we do know this: the talk of bailing out Fannie and Freddie has died down. That's a nice reminder than an emergency order is still a heck of a lot cheaper than a government bailout.

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The objective wasn't to support the share price but to prevent the companies from being taken down like Bear Stearns. In that it was successful, they didn't get taken down.

Comment by windsor - August 13, 2008 at [3:44 pm](#)

the practice is not legal, it is fraud, and there are billions of un-settled transactions out there. All naked short positions should be forced to cover NOW.

It is a disgrace that this had to happen in order to even bring the subject up.

We are being fleeced. Wake-up.

Comment by richard valenzuela - August 13, 2008 at [5:02 pm](#)

Funny how the regulators seem to BE THERE for their freinds and associates. On any given day there are professional shorts out there that destroy company values and stampede otherwise well run companies into mergers that are unwanted (eg Yahoo not long ago).

If you suddenly apply arbitrary regulations to save your buddies then you are demonstrating to one and all the "Controlled Market" syndrome that we all suspected all along.

Sure these 19 banks were at risk of a huge downdraft in their price. So what! If they clean up their act (which of course, the SEC, FED etc. were complicit in the first place)the stock will recover and if they persist in deceiving the public then they deserve to be beaten down, just like all the animals on Wall Street.

It makes me sick to watch the Old-Boy-Network at work!

Comment by Phil Max - August 13, 2008 at [5:23 pm](#)

Does anyone know what Arturo Bris's oar is and why it is in our pond. His conclusions are specious for a variety of reasons, the number one being that naked short selling affects the price of the stock shorted and this is not efficient.

Comment by atavist - August 13, 2008 at [5:36 pm](#)

The SEC's ban on naked shorting is at minimum a tacit admission that Bear Stearns was helped off the plank by something that the government sees as at minimum destructive, and at worst, in the future probably illegal. How'd you like to be a shareholder/employee of Bear and read stuff like this?

Comment by Nick - August 13, 2008 at [5:44 pm](#)

Nick, the practice is not legal, there was no ban...the SEC just decided to enforce the law in this case because we the people were days from an all out run on the banks and a catastrophic meltdown.

All naked short selling should curtailed and enforced.

Most retail investors and day traders probably do not even understand what this is and its implications.

Most people do not understand that naked short sells are not settled!!!! They are left as foating IOUs out there.

IT IS CRAZY!!!!

Comment by Richard V - August 13, 2008 at [6:03 pm](#)

The irony is traders were allowed to sell short a stock as long as the prime broker said there is a locate. They would make some number up depending what they thought of you and the firm you worked at. But prime brokers are at the very same big banks the government is trying to protect.

[Means the Joke's on You](#)

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The government cannot soft circle a few favorite names. It should enforce it across the whole market for every asset class.

Of course, this would promote further deleveraging of risk as hedge funds would continue to unwind. That is hardly bullish in the long run as there would be less risk takers in the market. Plus that nice consistent prime brokerage business the banks love would be hurt.

Comment by Blame it partly on Prime Brokerage - August 13, 2008 at [6:12 pm](#)

Traders would get their locates on securities from the prime brokers at the very same banks the government is trying to protect. The government should not just monitor naked short selling at a few firms but the whole market and every asset class. Of course, this would cause hedge funds to further deleverage risk and less earnings from prime brokers, which is both very bearish for the market in the long run.

Comment by Prime Brokerage is partly responsible - August 13, 2008 at [6:17 pm](#)

I sent an email to the SEC Chairman's office today. The email pointed out that the Chairman's predecessor Harvey Pitt was shown on national TV yesterday calling for a ban on ALL NAKED SHORT SELLING and for the current SEC to enforce this ban. Further I indicated the issue was important enough to determine my support and vote on the upcoming presidential election. Harvey Pitt tells me the Democrats will not condone this illegal practice. Something has to be done to break up the old boys club that is ripping off everybody. I am looking for some action on this or I am going to be a contributing advisor to the Democratic nominee.

Comment by Daniel DeBusschere - August 13, 2008 at [6:47 pm](#)

The first realization the regulators need to have is that short selling can destabilize a market - in fact that was the problem they tried to address. They have to stop talking about the alleged efficiency short selling adds to the market. Naked shorts add selling supply that does not have actual stock behind it. This additional supply distorts the market. Knowing this, there are two steps that the regulators should take right now. First, require all short sales to be noted as such in real time when trading, and require them to be reported as such in real time by exchanges when the daily buy-sell tables are made available for print in newspapers, etc. This takes away the stealth aspect of short selling that no other buying or selling has. Second, require brokers with shares in street name to obtain express permission from the actual "owners" or purchasers of the stock in order to make the shares available for short sellers. This would greatly contract the number of shares available since most persons who own shares for investment don't want those shares used for shorting against their position and would not give this permission. Brokers would have to keep track of this so the SEC and others could see if a broker was loaning more shares than available.

Comment by Chaz - August 13, 2008 at [6:57 pm](#)

Naked short selling should be permanently banned. Only the owners of company shares should decide whether the price of the stock is too high or too low by their purchases or sales. In the age of program trading, it is ridiculous to allow others to manipulate the stock price and benefit from an orchestrated "run" on the share price.

Comment by Derek C - August 13, 2008 at [7:20 pm](#)

Informed Traders as Liquidity Providers: Anonymity, Liquidity and Price Formation

Barbara Rindi*

Bocconi University

The tendency to introduce anonymity into financial markets apparently runs counter to the theory supporting transparency.

This paper studies the impact of pre-trade transparency on liquidity in a market where risk-averse traders accommodate the liquidity demand of noise traders.

When some risk-averse investors become informed, an adverse selection problem ensues for the others, making them reluctant to supply liquidity.

Hence the disclosure of traders' identities improves liquidity by mitigating adverse selection.

However, informed investors are effective liquidity suppliers, as their adverse selection and inventory costs are minimized.

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Comment by Illinois... - August 13, 2008 at [9:02 pm](#)

The same reasoning should apply to short sales as does printing counterfeit currency: you can't sell what you don't own and you can't spend what you don't have. The short 'counter argument' that there is not a similar restriction on buying long on an uptick also does not apply as a 'short sale' is an artificial influence on a natural market (that will find its own equilibrium through supply and demand - not artificial supply). Our capitalistic system was designed to create wealth; naked short sales destroy wealth.

Comment by Bernie Salamon, Bethesda, MD - August 13, 2008 at [9:03 pm](#)

If you have to ask the question, then you wouldn't understand the answer.

To selectively pick a few financial companies that have made fortunes on naked short-selling themselves - and not allow short-selling unless you had the shares/certificate in hand. Give me a break.

Comment by Toad - August 13, 2008 at [9:07 pm](#)

Regardless of the balancing mechanism that short-selling is supposed to provide, does anyone truly feel that the owners of stocks would deliberately allow them to be loaned for short-selling, i.e. undermine their own portfolio value? Current short-selling allows for this to occur. Surely this is theft by deception? As for naked short selling, it is illegal and by their own admission, the SEC by not enforcing the law, is an accomplice in an illegal activity - says it all.

Comment by johndelf - August 13, 2008 at [9:21 pm](#)

Naked short selling is trading counterfeit stock certificates. How can anyone justify this type of activity. I don't get it!

Comment by lakeman - August 13, 2008 at [9:31 pm](#)

The law against Naked Short-selling should be enforced and hedge funds/individuals prosecuted ... as stated above the idea is to force companies and financial institutions to reach a point that if capital is needed it can't be raised — these funds have no intention of covering they are trying to force the company under ... in addition this is typically followed with false rumors to increase the rate of decline ...

Comment by downed by shorts - August 13, 2008 at [9:59 pm](#)

In order for the markets to be efficient and fully self correcting Naked short selling should be allowed. Banning it looks too much like a Greenspan's Put to me.

Comment by Jens Kjaer Sorensen - August 13, 2008 at [11:38 pm](#)

I've never thought of short-selling as investing—it's no different than playing craps.

Comment by Gnirk - August 13, 2008 at [11:47 pm](#)

If naked short selling is illegal, then why is it that only 19 financial stocks were temporarily frozen from the naked short selling technique, except for market makers and option/index book runners? Market makers were allowed to naked short these same 19 financial stocks but they were supposed to settle the naked short shares within 3 days. Typically, the self-policing SEC would accept non-deliverable shares as clerical errors. Why do we use computers, I wonder.

In the real world, criminals are not allowed to counterfeit currency, but only in a so called free market are the rising hedge fund industry's "Sell Side" trading desks able to use poor excuses of clerical error for non-deliverable fictitious counterfeited shares. In the mid of night, without warning the SEC leadership dismantled market curbs and a series of market circuit breakers. I hear John McCain calling for your typical "free market" system. The lobbyists don't mind screwing the public with the politicians' help while helping give tax breaks to investment banks and oil companies, while they jack up commodities prices (tax on the masses) through artful trading techniques. Wonderful.

Comment by ctenn - August 14, 2008 at [12:54 am](#)

There's nothing wrong with short selling. If only the brokers and trading desks borrowing our shares would pay us 5% and up to lend out our shares without our knowledge. Allow everybody to get paid instead of allowing counterfeiting of shares in an effort to freak out short term traders to sell their shares which the professional trading desks use to deliver at settlement. Buy high, sell low and the naked short shares get to recoup real deliverable shares at settlement. Clerical errors for those failing to settle.

Comment by ctenn - August 14, 2008 at [1:02 am](#)

Name a Company that has been "taken down" by short selling...you can't. If you say Bear Stearns, you are full of it. It went under due to them being highly leveraged in toxic paper.....and guess what? they won't be the last. These short selling restrictions were great for shorts....it gave us a much better entry to reshore these toxic, insolvent companies. Keep believing that these Financials have value and future earnings at your own peril.

Comment by That Just Happened - August 14, 2008 at [1:41 am](#)

Eight years of Reagan (remember 'supply side economics') and eight years of Bush II; given the distortion these two put into the market against 'the average guy,' it'll be long, long time before the pendulum swings back to being a 'fair market.'

Comment by Mark - August 14, 2008 at [3:29 am](#)

Mark, not to diminish the anguish you must feel, but where is it written that "life is fair?" In my experience this cry is heard only when someone is on the losing side of a perceived wrong, and there are many suffering during this housing downturn. From personal experience being on the wrong side of a "trade" can be very painful.

Naked short selling is illegal; the correct response should be rule enforcement and individuals telling their brokerage firms to register securities in the accounts name, not street name. No one would ever knowingly stand for the shorting of their own shares when they are themselves long.

The only thing new is the history we forget, read your Kindleberger, this time is not different. The only difference, once again, is which rules are enforced. You do have a point there Mark, but don't blame Reagan or Bush. People, in general, seem only to want free markets when the tide is rolling in, never when it inevitably rolls back out. No one complained when home prices were on the way up, it's now time for a free market to naturally correct. Free markets without the possibility of loss are like religion without sin. Adults made greedy decisions regarding housing, mostly by taking on equity debt, to sustain a lifestyle beyond their income levels. The holders of Bear Stearns stock did the same thing. The firm narrowed its positions to one idea, mortgages and thus housing, layered on toxic amounts of debt, had too much hubris and was caught when the tide rolled out. The same can be said for the holders of Freddie and Fannie and they should have received the same fate. Let the chips fall where they may, but do this within current regulations and naked short selling is not an approved act.

Comment by jpoeflorida - August 14, 2008 at [4:52 am](#)

For those who support naked short selling (don't confuse this with regular short selling with borrowed shares), how about I would naked short sell you a house and fail to deliver after you have paid me in full for a long time. That's what the naked short sellers are doing albeit with phantom stocks instead of phantom houses. There are so many stocks on the Reg SHO list (failed to deliver) consecutively for up to three hundred+ days! There should be a class action against the SEC for failing to enforce the law of the country!

Comment by canby88 - August 14, 2008 at [5:13 am](#)

Shares held in margin accounts are borrowed for short sales. If you don't want your shares to be borrowed, quit using a margin accounts. Leverage requires a source of funds. SHO was an attempt to flag and restrict short sales in those stocks that were having delivery problems, which is usually discovered long after the trade in the settlement process. You would need a mechanism to place a hold on shares needed for settling a short sale at the time of the trade, which would require an infrastructure overhaul. You would still have delivery failures, but possibly less impact on the market.

Comment by David - August 14, 2008 at [5:54 am](#)

Short selling or even naked short selling cannot destroy a company that has any real underlying value to it. Bear Stearns and the other financials aren't getting pounded because of short selling. They are getting pounded because the leverage game is over and the delevering process is destroying the real value of the companies. The entire financial sector is still a great short and will be until real value returns to the sector.

Comment by CreditBubbleGoesPOP - August 14, 2008 at [6:42 am](#)

My interpretation of equity market basics is supply and demand. What short position trading does to enhance this process is questionable to say the least--insider influencing could be very present. Regulators should have an official website listing short position trading participants. Corporationstions/companies should function in accordance to their government

charters.

Those who wish to gamble can go to the numerous casinos.

Comment by normand - August 14, 2008 at [7:59 am](#)

If naked short selling is not bad for companies, then let's make it legal so that it is understood that everybody can sell stocks that they don't own and make money. Let's flood the market with this worthless paper and bring the entire market down. Why not if you can profit.

Comment by lakeman - August 14, 2008 at [8:07 am](#)

Yes. Let Government ban all the naked short sells and reimpose uptick rules on all shorts. Let Government create another stock market bubble like the one in the Clinton era. We will all cash out at the peak of that bubble and let someone behind the tree to hold the bags.

Comment by CKC - August 14, 2008 at [8:08 am](#)

Mark Mitchell of DeepCapture fame comments on the lame article written by floyd norris of the new york times which you referenced - (which is followed by a rather alarming expose of Carol Remond of the Dow Jones Newswire - quite shameful behaviour from her.....maybe criminal.

>>>

<http://www.deepcapture.com/>

Comment by lucas - August 14, 2008 at [5:13 pm](#)

God, I wish if a debate was really going to take place that we could find a financial media representative that could actually present the facts as they truly exist. It is clear by what we have read to date that few understand the variations of the short sale that take place (long investment v. day trade) and how loopholes in the settlement process and short sale policies can allow certain trade strategies to be used to manipulate and distort markets. As for Bris, the guy is a moron. Of course he never factored in where the market would have been without this protection in place.

Comment by Dave - August 15, 2008 at [11:29 am](#)

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