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# Maybe short-selling isn't so bad, after all

**By Mark Hulbert**
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U.S. regulators have banned short sales of more than 800 stocks, mostly of financial companies, in an effort to stabilize prices in a shaky market. But the move may have an unintended consequence: reducing the stock market's efficiency and prolonging the current crisis.

That's the consensus of several finance professors who have devoted considerable energy to the study of short-selling a mode of trading in which a profit is made from a price decline. Short-sellers, like investors who go "long" on a stock, make money by buying low and selling high. The difference is that short-sellers reverse the usual chronological order, selling first and buying back later, at what they hope will be a lower price. They accomplish this time switch by selling borrowed shares and agreeing to return them later.

Were short-sellers ganging up on various stocks in the recent tumult, causing prices to plummet? Adam Reed, a finance professor at the University of North Carolina at Chapel Hill who has extensively studied short-sellers' behavior and its effects on the markets, said it was "hypothetically possible" that they were. He added, though, that the question still needs study because real-time information about these possible "bear raids" isn't available. But he would be surprised if short-sellers were a major cause of the market's turmoil over the last year.

"In recent years," he said, "when academic researchers have looked for bear raids even in those areas in which investors suspected that they existed they haven't found them."

Consider a group of 19 beleaguered financial stocks for which the SEC restricted short sales between July 21 and Aug. 15. Arturo Bris, a finance professor at IMD, the Swiss business school, who also is a research fellow at the Yale International Center for Finance, analyzed short-sellers' behavior in the months before this SEC action. He concluded that the poor performance of those 19 stocks in the year leading to that action "cannot be attributed to short-selling activities." One of the statistics on which Professor Bris focused was the so-called short-interest ratio, which is calculated by dividing the number of shares held short by the average daily trading volume. On average, those 19 stocks had short-interest ratios that were no higher than those of other financial stocks in the year leading up to the SEC policy change. And here is another telling statistic: While the SEC restrictions were in place, these stocks, on average, actually performed worse than the rest of the market.

What about the dismal performance of many financial stocks earlier this month? It's too early to know, Professor Reed said, because the data are not all in. But here, too, he said he doubts that short-sellers played any significant role.

Consider, for example, what short-sellers did on Sept. 9, a day that rumors circulated widely about a possible bankruptcy at Lehman Brothers and Lehman's stock fell 45 percent, to $7.79 from $14.15. According to Professor Bris, the average price at which short-sellers sold Lehman stock that day was $9.29, significantly closer to the day's low than to the high. That implies that they were reacting to the downward momentum, not causing it.

Typically, Professor Bris said, "short-sellers trade in response to past negative news, rather than inducing current stock price drops."

What about "naked shorting" or "failure to deliver" borrowed shares, a practice that was the focus of the SEC restrictions in July? These terms are used to describe a breach of the standard practice in which a short-seller has three trading days to actually borrow the shares he is selling short. Naked shorting has been blamed for some of financial stocks' recent woes, but Professor Reed says this claim isn't supported by the evidence.

Each day, the exchanges publish a list of stocks for which there has been even a very small number of

failures to deliver. In recent months, according to Professor Reed, the large financial stocks have hardly ever appeared on those lists.

Then there is the abolition of the so-called uptick rule on short sales in July 2007. When the rule was in place, a stock could not be sold short unless its last trade was higher than its previous traded price. The rule, put into effect in the 1930s, was intended to prevent short-sellers from accelerating the downward momentum of an already-declining stock.

Has the rule's removal been an important contributor to the bear market of the last year? Professor Reed doubts it. Before scrapping the uptick rule, the SEC ran a pilot program to test the possible consequences. In the test, the rule was lifted from hundreds of stocks that were part of the Russell 3000 index. The trading patterns of these stocks were exhaustively analyzed in a number of academic studies, all of which concluded that the rule had no significant impact on those stocks' price movements, Professor Reed said.

Short-sellers may be greedy. But, Professor Bris argued, it makes no more sense to blame them for the woes of financial companies than it does to blame the investors who bought those companies' stocks at inflated prices. If these investors hadn't been willing to buy those stocks, he said, the short-sellers couldn't have sold those stocks short.

ONE point is clear, he said: Banning short-selling will adversely affect the stock market's efficiency by reducing liquidity and making it harder to settle on appropriate prices.

"The ban on short-selling may prolong the crisis," he said, "in the sense that it will now take the markets longer to adjust to the true values of financial companies."

That means investors should think twice before buying shares of any companies for which short-selling is now banned, Professor Reed said. In his research, he said, he has found that "stocks without short-selling not infrequently trade at prices that deviate widely from their true value."

*Correction:*

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