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Shortsighted?

The chatter over short-selling and its impact goes on, and one study says the benefits of these trades need to be acknowledged

By Thomas A. Dubbs and Adam Reed

The recent lively debate over short-selling has resulted in the Securities and Exchange Commission's proposal of several new rules that prevent market participants from short-selling when markets are in decline. However, a new study suggests that we should be cautious in considering the benefits -- and the surprising unintended consequences -- of short-selling regulation.

The new rules come in two main categories: permanent approaches and temporary approaches. The permanent approaches change the way short sellers execute every trade. In the two proposed permanent rules, short sellers would not be able to trade if prices were falling. One rule measures prices with quotes, and prohibits short selling if quoted bid prices are falling. The other rule measures prices using trade prices.

The temporary approaches, on the other hand, impose certain limits that, if exceeded, trigger short selling restrictions. In the first temporary rule, short selling is prohibited if there is a severe decline in prices. The effect of this rule is similar to trading halts currently in place on the major exchanges, but the proposed rule only stops short sellers from trading, in much the same way the SEC banned short selling in financial stocks in September of 2008. The second temporary rule prevents short sellers from trading if quoted prices are falling on a trade-by-trade basis after a severe decline in prices, and the third temporary rule prevents short selling if trade prices are falling on a trade-by-trade basis.

Most of the proposed permanent and temporary rules are simply variations of short selling regulations that have been imposed in the past. The permanent approaches and two of the temporary measures are simply new implementations of the old uptick rule, while the temporary rule that prohibits short selling is much like the short-lived outright ban on short selling which the SEC implemented for financial stocks. A look at the effects of these measures in the past may shed valuable light on the current proposals.

The uptick rule was passed in the 1930s as a response to perceived abuses by short sellers. The rule generally made short sellers wait until the most recent trading price was equal to or above the previous trading price. In other words, short sellers couldn't trade if prices were falling.


Thomas A. Dubbs

In 2004, the SEC began the careful process of considering a repeal of the uptick rule. The SEC established a set of stocks for which the uptick rule would be suspended in a pilot program. The pilot stocks were a deliberately selected set of around 1000 stocks chosen to represent the variety of exchange listing and volume characteristics in US stocks. The SEC made the pilot program easy to study by making the set of stocks and the timing publicly available. The SEC even extended the time span of the pilot from one year to over two years.

As a result, a number of teams independently analyzed the effect of the uptick rule. The approaches differed, but the conclusions were very similar. The researchers generally found that the removal of the uptick rule resulted in no degradation in liquidity or price efficiency, and that there was no significant increase in volatility in the 1000 pilot stocks. In other words, they found that the uptick rule wasn't making much of a difference, in that there was no group of short sellers waiting to abuse other market participants once the uptick rule was lifted. However, because these studies were based on a less volatile market, they may not speak to current market conditions.

After this process, the SEC decided to repeal the uptick rule. In 2007, the SEC voted to remove the uptick rule and other exchange mandated short-sale price-tests. Moreover, the SEC voted to prohibit exchanges from implementing price tests in the future.

In addition, the SEC tightened the rules around delivery and established a threshold list aimed at reigning in failed deliveries. By establishing this threshold list, the SEC reduced the potentially illegal practice of naked short selling. In other words, the SEC reduced the barriers to short selling by removing the price tests—an arguable loosening of regulation-- while increasing the barriers to illegal forms of short selling—a tightening of regulation.

As markets declined, fears about abusive short sellers resurfaced. In response to those fears, in 2008, the SEC passed an emergency order requiring short sellers of certain securities to borrow stock before making a short sale, a requirement that increased the costs of short selling dramatically. The rule was effective six days after it was announced, and it was effective for less than a month. As markets declined further, the SEC acted again by prohibiting short sales in financial stocks. This time, the rule was effective immediately. Although researchers have not yet finished their analysis, there is preliminary evidence that these rules led to dramatic decreases in the volume of short trading. The implications of that decrease are still being studied.

In a recent working paper, the two rule changes were analyzed, and the findings echo the results from the earlier studies of the uptick rule. Specifically, the research found that liquidity fell significantly after short selling was restricted, and the study found that borrowing costs had a seven-fold increase, making it especially difficult for short sellers to trade. The study also found that each trade actually became more informative. In other words, if short sellers face increased barriers to trade and they still short sell, the market takes those trades as strong signals about future prices. An increase in informed trading can widen bid-ask spreads which may make trading more expensive for many investors. (Kolasinksi, Reed, and Thornock, "Prohibitions versus Constraints, the 2008 Short Sales Regulations", University of North Carolina Working Paper).

Since the rule changes consisted of new trading requirements for all short sellers as well as new delivery requirements aimed at naked short sellers, it is unclear which changes drove these effects.

Given the preliminary findings of at least one study, thoughtful deliberation by the Commission is called for, and perhaps, a determination of which had the greater impact—the trading restrictions themselves or the increased regulatory scrutiny surrounding naked shorts.

Thomas A. Dubbs, a senior partner at the New York law firm Labaton Sucharow LLP, specializes in the representation of institutional investors in securities fraud and other types of litigation. Adam Reed is an Associate Professor of Finance and Julian Price Scholar at the University of North Carolina, Chapel Hill.