Regulators move to crack down on rampant short selling

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Regulators, pension funds and beleaguered companies took aim yesterday at a common villain lurking behind the upheaval in the financial markets: short sellers.

Securities watchdogs on both sides of the Atlantic moved to limit the heavy short selling that many observers have blamed for decimating the stocks of several financial industry pillars, pushing those companies to the brink of insolvency.

New York's Attorney-General vowed to investigate and prosecute illegal short selling, amid allegations that shorts may have spread false rumours and conspired to manipulate stock prices downward, while European regulators are investigating similar allegations.

The three biggest pension funds in the United States – the California Public Employees' Retirement System, California State Teachers' Retirement System and New York State Common Retirement Fund – suspended lending stock of Morgan Stanley and Goldman Sachs Group Inc. to short sellers, after an alarming drop in the share values of the two U.S. investment banks.

The target for all this venom is short selling – a generally legal investing practice.

An investor borrows shares and sells them with the intention of buying them back later at a lower price and profiting on the price difference.

But critics believe rampant short selling – in some cases done illegally by traders who never actually held any stock to sell (so-called "naked shorts"), and in other cases allegedly accompanied by the spreading of unfounded rumours aimed at undermining a stock – has been pouring gasoline on the fire sales in global stock markets, especially in the financial sector.

Such battered U.S. names as Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Morgan Stanley and Goldman Sachs, as well as Europe's Halifax Bank of Scotland and Fortis NV, are all said to have been caught in the short sellers' trap.

Many key players in the securities industry are now saying, enough is enough.

"By removing some of the fuel that is feeding this speculative fire, my action is intended to bring stability and rationality back to our equity markets," New York comptroller Thomas DiNapoli, the official responsible for the New York State Common Retirement Fund, said in a statement. The fund also ceased lending of shares in 17 other key U.S. financial companies.

The U.S. Securities and Exchange Commission reinstituted restrictions to clamp down on naked short selling in financial sector stocks, after similar temporary limits in the wake of the Fannie/Freddie bailout were allowed to expire in mid-August. Britain's Financial Services Authority went a step further, placing a temporary ban on all short selling in the financial sector.

But critics charge that regulators are nibbling at the edges of a problem the SEC itself created – when it decided in July, 2007, to drop a 69-year-old rule that had protected stocks from runaway short selling.

The so-called “uptick rule” required that a short sale could only be made after an “uptick,” or rise, in the price of a stock, which meant that shorts could not pile into a stock in an unbroken freefall.

The SEC felt the rule was a constraint on market liquidity and did little to prevent market manipulation. But critics say the removal of the rule has left the market a more volatile and risky place.

“Any investor out there can tell you that the elimination of the uptick rule has been an unmitigated disaster,” said money manager David Brady, head of Brady Investment Counsel in Chicago.

“Changing the rule has made short selling easier – which, in essence, means that some of these institutions that are able to execute a lot of trades quickly can make more short sales,” said Cleve Reuckert, analyst at U.S. research firm Birinyi Associates Inc. “That has really increased the volatility.”

Many market participants suspect that hedge funds are behind some of the more aggressive short selling raids seen in recent weeks. The theory is that the healthier hedge funds have been identifying prominent stocks in their more cash-strapped competitors' portfolios and shorting them, forcing those competitors to sell stock to keep their heads above water, thus accelerating the declines – driving stocks down and making more money for the shorts.

“That's just greed, pure and simple,” Mr. Brady said. “They're just sharks, they smell the blood.”

Given the growing chorus in opposition to the short selling frenzy, the political and market will may finally be in place to address the problem. And, indeed, there is evidence that tighter restrictions on short selling do work.

From the time the SEC announced its temporary short selling restrictions in July until the order expired in mid-August, the S&P Financials sector surged 14 per cent. The VIX index of market volatility eased by 26 per cent.

But ultimately, the latest restrictions and investigations may not be enough. Critics say the SEC can expect to face mounting pressure to swallow its pride, admit its mistake and restore the uptick rule.

Mr. Brady said. “The uptick rule absolutely has to come back.”