THE PANIC EFFECT: POSSIBLE UNINTENDED CONSEQUENCES OF THE TEMPORARY BANS ON SHORT SELLING ENACTED DURING THE 2008 FINANCIAL CRISIS

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This Article argues that the temporary bans on short selling enacted during the 2008 financial crisis were not grounded in reason and will result in unintended detrimental consequences. This is especially true given the history of placing blame on short sellers during financial crises, the broad purposes of the regulations, and the pressure placed on regulators by the economy. During the financial crisis of 2008, some commentators urged regulatory bodies to take action to limit the power of short sellers to conduct trades. However, enacting temporary bans on financial stocks and employing other similar restrictions on short selling will likely result in unintended consequences that slow the economic recovery process.

I. INTRODUCTION

Amidst the financial crisis of 2008, there is plenty of blame to go around. This article will examine one common scapegoat: investors who engage in the practice known as short selling. In many nations, lawmakers have passed regulations intended to reign in this group of unpopular investors. Several nations have passed hasty regulations that temporarily ban short selling certain stocks.[1] Regulators have typically cited increasing investor confidence or controlling volatility as their justifications when limiting short selling.[2] These justifications, however, do not justify the action taken.

Placing blame on short sellers is not a new development. During almost every financial crisis in modern history, short sellers have been the recipients of blame, and regulators have attempted to limit the practice.[3] This

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[1] *More Countries Put Bans on Short Selling*, INTERNATIONAL HERALD TRIBUNE, Sept. 19, 2008, *available at* http://www.iht.com/articles/2008/09/19/business/sell.php.

[2] *See* SEC Report 2008 - 211, *SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets*, *available at* http://www.sec.gov/news/press/2008/2008-211.htm

[3] *See Nasty Brutish and Short,* THE ECONOMIST, June 19, 2008, at Finance and Economics ("A reaction against short-selling often follows big stock market

article argues that, while some regulation on short selling is necessary, enacting hasty regulations on short selling during negative economic cycles will likely result in unintended, adverse consequences.

More specifically, the temporary bans on short selling that many nations enacted during the financial crisis of 2008 were poor economic policy. In 2008, regulatory bodies in several nations temporarily banned short selling on certain stocks in order to improve investor confidence and reduce volatility.[4] However, banning short selling actually has the exact opposite effect: increasing volatility and hindering investor confidence.

During positive economic cycles, short sellers are tolerated and critics of the practice are much less vocal. Regulators try to step in much more often during negative economic cycles. Unfortunately, poor regulatory decisions made during negative economic cycles can have a severe, negative impact on the economy. For this reason, it is even more important to make well-informed regulatory decisions during negative economic cycles.

In sum, increased pressure stemming from the economic crisis of 2008 resulted in hasty decision-making by regulatory bodies. Some of these regulations involved temporary bans on short selling of certain "target stocks." These regulations attempted to restore investor confidence and control volatility during a negative economic cycle. The goals of these regulations were not furthered by banning short selling, and passing these regulations actually slowed economic recovery.

For all of these reasons, it is apparent that some regulations that were aimed at short sellers during the 2008 financial crisis were misguided. Short selling is a fundamentally sound economic practice that plays an important role in financial markets. Bans on short selling offer no real benefits for financial markets and could easily result in unintended consequences that actually harm the financial markets. The temporary short selling bans of 2008 were rushed and will likely delay, rather than expedite, economic recovery.

II. SHORT SELLING

Put simply, short sellers borrow stock from investors and then sell it, hoping that the price will go down.[5] If the price falls, the short seller can buy

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declines. Congress held hearings in the United States after the crashes of 1929 and 1987, some Asian governments imposed restrictions after the regional crisis in the late 1990s, and America's Securities and Exchange Commission (SEC), the FSA and other national regulators investigated allegations of abuse after September 11th, 2001.").

[4] *See More Countries*, *supra* note 1.

[5] LAWRENCE J. GITMAN & MICHAEL D. JOEHNK, FUNDAMENTALS OF INVESTING 62 (9th ed. 2005). Note that stock is not borrowed in all short-selling transactions. When a short-seller does not locate shares to borrow before effecting a trade, the short seller is engaging in the practice known as "naked short-selling."

the shares back at a lower price and return them to the lender, netting a profit. If the price rises, the short seller will take a loss when the shares are returned.

A. *The Benefits of Short Selling*

Short selling has several positive effects on financial markets. Because short sellers thrive when stocks are overvalued, short positions provide unique information about the perceived value of the stock.[6] As an added source of information, short sellers offer several benefits for investors and financial markets.

By taking short positions, short sellers provide all investors access to more information, which should reduce volatility.[7] If investors obtain information as soon as it is available, it should be priced in more gradually, thereby avoiding large swings in stock prices that occur due to information asymmetry.[8] In other words, quick losses stemming from a lack of information are less likely to occur when short sellers signal to the market that a particular stock is overvalued. This, in turn, should lead to a higher level of overall investor confidence.[9]

1. *Liquidity*

First, short selling increases liquidity in the markets by increasing the number of sellers in the pool.[10] Investors commonly take short positions to hedge their long positions, thereby reducing the overall risk of the investment.[11] This allows investors to invest in long positions that may otherwise be too risky for their individual investment plans.

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[6] *See* Robert P. Murphy, *A Man, A Plan, And a Short-Selling Ban,* LIBRARY OF ECONOMICS AND LIBERTY, (Oct. 6, 2008), *available at* http://www.econlib.org/library/Columns/y2008/Murphyshortsell.html.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] SEC Concept Release: Short Sales, Exchange Act Release No. 34-42037 (Oct. 21, 1990), *available at* http://www.sec.gov/rules/concept/34-42037.htm ("Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that short sales are effected in the market by securities professionals, such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.").

[11] *See A Beginner's Guide To Hedging,* INVESTOPEDIA, http://www.investopedia.com/articles/basics/03/080103.asp.

2. *Information and Market Efficiency*

Short selling also improves market efficiency by providing information about the perceived value of securities.[12] Short sellers, by borrowing high and covering low, employ a strategy that instills information into the stock markets that would otherwise be lacking.[13]

3. *Risk and Volatility*

Increases in liquidity and market efficiency, in turn, make stock price movements less volatile than they would be if this information were not available to investors.[14] Therefore, short sellers, by providing information and decreasing volatility, actually make investments less risky.[15]

Similarly, eliminating short sellers from a particular security will create an environment conducive to large downward swings in stock prices upon the discovery of bad news.[16] This occurs due to the lack of information that would normally be supplied by short sellers.

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[12] *See* SEC Concept Release, *supra* note 10 ("Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.")

[13] *See* Murphy, *supra* note 6.

[14] *Id.*

[15] *Id.* ("By banning one side of this "governor" on financial prices, the SEC will make these particular stocks riskier investments.").

[16] *Id.* ("[T]he people least likely to anticipate bad news about the company are those currently holding the stock. With the SEC's short-selling ban, as more and more people learn of the impending bombshell that will go public in a few days, their only incentive is to unload shares they already own. They can do this quietly without causing ripples. In contrast, when short-selling is allowed, then people who learn bad news about a company can sell many more shares if the news is really that bad. There is an incentive for a knowledgeable person to announce his views to the world, as it were, by massively shorting the stock. Thus, the shareholders will be less surprised by the bombshell announcement because their share prices had been getting pummeled by speculators for days before."). *See also* Jonathon R. Macey, et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799,

B. *Short Sellers: The Historic Scapegoat*

It is clear, therefore, that short selling is a practice that has many benefits. This is more readily apparent during bull markets, when long investors are making money. During bear markets, these benefits are forgotten, and more critics begin attacking the practice. During negative economic cycles, short sellers have historically played the role of scapegoat.

Despite the benefits of short selling, many prominent and well-known figures were quick to get involved in the finger-pointing game during the 2008 financial crisis. Archbishop Rowan Williams of Canterbury and leader of the Church of England is one such figure calling for regulation on short sellers.[17] Bear Stearns, Lehman Bros. and Morgan Stanley have all vocally condemned short selling in the United States.[18]

The practice of short selling is an easy target for public blame.[19] The basic function of betting against the stock market necessarily means making money when the majority of others are losing theirs. Short selling can have a negative effect on the price of shares that are shorted, driving down the price of the shares of a particular security.[20] These factors, combined with the

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811 (1989) ("Short selling improves the efficiency of securities pricing and increases liquidity. The investor who has asymmetric information indicating a stock is overpriced can sell it short with the expectation that the stock will be purchased in the future at a lower price. Investors can use short sales to arbitrage away price differences between markets and between related securities. More recently, short selling has become part of index arbitrage. Index arbitrage arises when the difference between the price of a futures contract on an index and the cash value of the underlying index becomes sufficiently large to warrant arbitrage activity. Index arbitrage improves the efficiency of security markets by moving prices toward their equilibrium level.").

[17] James Mackintosh, *Short Shrift,* FINANCIAL TIMES, Oct. 6, 2008, at 8.

[18] *Id.* Also, many financial leaders throughout the world have spoken out about short selling. German finance minister Peer Steinbrück has even called for a ban on short-selling. *Id.*

[19] *Id.* ("For now, though, it is short selling and the hedge funds that specialize (sic) in it that have become the villains of the financial collapse. They make an easy target, as profiting from someone else's misery is regarded by many as morally dubious--and also involves the easy-to-question practice of selling something one does not own.").

[20] *See* Paul R. Lamonica, *The SEC's Crusade Against Shorts is a Joke: Even Though the Temporary Ban Against Short-selling Financial Stocks has Failed to Stop the Sector's Slide, the SEC Extended the Rule. Huh?* (Oct. 2, 2008), http://money.cnn.com/2008/10/02/markets/thebuzz/index.htm?postversion=2008100212, *citing* the SEC Press Release Concerning Short Selling and Issuer Stock Repurchases, (Oct. 1, 2008) ("'There are circumstances in which short selling can be used as a tool to mislead the market. For example, short selling can be used in a downward manipulation whereby a manipulator sells the shares of a company short

seemingly complex and hard to follow tactics of short selling, make short sellers an easy target for criticism.[21]

Short sellers are gaining a bad reputation among a wide range of groups. Some even liken short sellers to bank robbers.[22] During negative economic cycles, such criticisms of the practice can be expected to intensify. However, before acting on such criticism, it is important to determine that such action stems from rationality and not from pressure being applied by panicked investors looking for a scapegoat.

C. *Short Selling and Fraud*

While short selling is generally healthy for the financial markets, some actors give the practice a bad name by intentionally taking advantage of holes in the system. Fraudulent actors are one of the main reasons short sellers carry such a stigma during bear markets.

Practices such as naked short selling, death-spiral financing,[23] failures to deliver, and plain old stock fraud have burned many investors.[24] It is

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and then spreads lies about a company's negative prospects,' the SEC said. 'This kind of manipulative activity is particularly problematic in the midst of a loss in market confidence. For example, in the context of a credit crisis where financial institutions face liquidity challenges, but are otherwise solvent, a decrease in their share price induced by short selling may lead to further credit tightening for these entities, possibly resulting in loss of confidence in these institutions,' the SEC added."); Macey, *supra* note 16, at 800 ("Short sales are criticized for their potentially harmful effects on both individual companies and the entire market. At one level, short sales facilitate the manipulation of stock prices. Allegedly, speculators sell stock short, spread false rumors about the company, and then purchase shares after the stock price has fallen. The reputation of the company can be damaged, perhaps irretrievably. In addition, short selling can exacerbate a market decline. Many argue that in the 1920s bear raids began the stock price decline that turned into the crash. In the 1980s, program trading, which in some situations relies on short selling, is a frequently cited villain of increased market volatility in general and the October 19, 1987 crash in particular.").

[21] *See* Daniel Trotta, *Short Sellers Have Been the Villain for 400 Years*, Reuters (Sept. 26, 2008), http://www.reuters.com/article/reutersEdge/idUSTRE48P7CS20080926?PageNumber=2&virtualBrandChannel=0&sp=true. ("Shorts came under fire after the U.S. stock market crash of 1929, and U.S. President Herbert Hoover condemned short selling in 1932. More recently, shorts were blamed for the U.S. stock market crash of October 1987 and, in 1997, Malaysia charged Credit Lyonnais with short selling after the collapse of the country's currency and stock market. The next year, the New York Fed bailed out Long Term Capital Management to avoid wider market impact from the hedge fund's short positions.").

[22] *See* Mackintosh, *supra* note 17.

[23] Death-spiral financing schemes involve extensive short selling coupled with pre-arranged trading which is aimed at driving down the price of a particular security. This practice, when employed effectively, can drive the value down so far that it

important to recognize, however, that the actors that engage in such illegal practices are the exception rather than the rule. Just as Enron and WorldCom did not cause us to throw out the corporate form, a few fraudulent acts should not cause us to automatically become fearful of short sellers.

The history of blaming short sellers naturally amplifies the negative effects of any news of fraudulent practice by short sellers. They have a tarnished reputation and news of fraud causes people to become aware of this reputation. It is important to keep this in mind when passing regulations that redefine or alter the scope of short selling.[25] Fraud should be thwarted, but it

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forces companies to go out of business. *See* John Labate, *SEC Widens Probe into "Death-spiral" Schemes,* THE FINANCIAL TIMES, Mar. 9, 2003, at 23.

[24] Naked short selling and failures to deliver have been guarded against by Regulation SHO. However, many investors still overestimate the connection between short selling and stock fraud and other forms of financial fraud.

[25] Jonathan Macey, *The Government is Contributing to the Panic: It's time to let the markets do their messy work,* Op-Ed, WALL ST. J., Oct. 11, 2008 at A13. ("If the SEC had done half the job in ferreting out fraud and funny accounting that short-sellers have done, our capital markets would not be imploding. Now short-sellers, like other market participants, are threatened with new restrictions on their activities as Congress begins to hold hearings on the crisis in the capital markets and politicians and regulators turn their focus to the shibboleth of market manipulation. Of course, market manipulation does exist, but federal regulators deserve much of the blame for this form of market abuse. For years the SEC has hampered companies' ability to protect themselves from manipulation by short-sellers. The most effective way for a company to respond to an attempt to manipulate its share prices is simply to repurchase its own shares, simultaneously 'squeezing' the short positions and sending a clear signal of financial health to the capital market. However, companies have long felt vulnerable to being charged by the SEC with manipulation whenever they go into the market to make share repurchases. The SEC finally acknowledged this problem after the collapse of Bear Stearns and Lehman when it stated publicly that 'historically, issuers generally have been reluctant to undertake repurchases' when faced with manipulative short-sellers because of the massive amount of uncertainty about whether the SEC would sue them for trying to manipulate the market."); Rumor mongering is another illegal practice that short sellers are often blamed for. Many believe short sellers spread false rumors about companies in order to profit, a practice that is illegal. *See* Mackintosh, *supra* note 17 ("the SEC raised the issue of rumour-mongering (sic) by short sellers, where a trader bets against a stock then spreads false rumours to push down the price. This is already illegal. 'This kind of manipulative activity is particularly problematic in the midst of a loss in market confidence,' it said. 'For example, in the context of a credit crisis where financial institutions face liquidity challenges but are otherwise solvent, a decrease in their share price induced by short selling may lead to further credit tightening for these entities, possibly resulting in loss of confidence in these institutions.' Bear Stearns, Lehman and Morgan Stanley all complained this year about false rumours (sic) and short sellers driving down their shares. Some hedge funds have echoed these concerns. Last

is important to ensure that one bad apple does not spoil the entire basket. This is especially true considering the numerous practical benefits that short sellers provide to financial markets.

D. *Practical Effects*

There are at least three typical situations resulting in overvalued stocks that are attractive to short sellers.[26] The first situation occurs when the market overestimates the future earnings of the firm.[27] The second situation arises when the market underestimates the firm's risk.[28] The third situation exists when the market prices in irrational factors, such as a bubble.[29]

Taking advantage of any of these situations takes a great deal of skill and effort. Thus, short sellers must have a strong set of financial skills in order to consistently succeed.[30] This is especially true given the natural rise of markets over time.

During the financial crisis of 2008, some commentators pushed for increasing the amount of regulation on short selling tactics. It is only natural for skeptics to place blame on the risky and complicated practice of short selling. However, this technique provides great value for investors who wish to hedge their long positions.[31] Short selling also provides added value to

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year Philip Richards, co-founder of London's RAB Capital, blamed co-ordinated short selling for the collapse of confidence in Northern Rock.").

[26] Jennifer Francis et al., *Do Short Sellers Convey Information About Changes in Fundamentals or Risk?* (Sept. 2005), *available at* http://faculty.fuqua.duke.edu/seminarscalendar/Short.pdf.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *See Nasty Brutish and Short, supra* note 3. ("In reality, short-selling is far from being financial black magic. It is a difficult strategy to pull off, because in the long run stockmarkets tend to rise. It is also a minority activity: only 4.3% of shares on the New York Stock Exchange had been sold short at the end of May. . . . Data for London are less transparent, but the best proxy is the level of shares being lent (to bet on a share price falling, short-sellers often borrow stock and then sell it). According to Data Explorers, a research firm, only 4.5% of the FTSE 100 index's value is out on loan. Many short sales are innocuous attempts to hedge other positions. Unlike going long, actively betting against a share price involves red tape and runs the risk of unlimited losses (since a share price can, in theory, rise for ever, whereas it cannot fall below zero). The best bears, says Jim Chanos, of Kynikos Associates, the world's biggest short fund, are not bullies but "financial detectives", scrutinising (sic) companies. The short-seller that infuriated MBIA's management, William Ackman of Pershing Square Capital Management, was certainly vocal, but nobody doubted that he had done his homework.").

[31] Hedging comes in many different forms. *See, e.g., A Beginner's Guide To Hedging*, supra note 11. ("The best way to understand hedging is to think of it as insurance. When people decide to hedge, they are insuring themselves against a

bears that wish to cover their trades.[32] Therefore, it is important to take a step back during negative economic cycles before pushing for drastic changes that will affect the scope of the market during good and bad times.

Furthermore, enacting legislative regulations during periods of economic downturn lends itself to hasty decision-making. More specifically, passing hasty regulations on short selling could create unintended consequences that negatively impact the financial markets.

III. PAST REGULATIONS ON SHORT SELLING

For over 400 years the practice of short selling has come under fire during negative economic cycles.[33] Before passing any regulations, it is important to determine whether this criticism is grounded in reason or panic. Why is it, for instance, that serious discussions regarding short selling regulation virtually disappear during periods of economic prosperity?

In the early 1600s the first known short seller arranged to sell shares of the Dutch East India Company in the future.[34] The share price plummeted, and the "speculator" was quickly blamed, prompting the first regulations on

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negative event. This doesn't prevent a negative event from happening, but if it does happen and you're properly hedged, the impact of the event is reduced. So, hedging occurs almost everywhere, and we see it everyday. For example, if you buy house insurance, you are hedging yourself against fires, break-ins or other unforeseen disasters. Portfolio managers, individual investors and corporations use hedging techniques to reduce their exposure to various risks. In financial markets, however, hedging becomes more complicated than simply paying an insurance company a fee every year. Hedging against investment risk means strategically using instruments in the market to offset the risk of any adverse price movements. In other words, investors hedge one investment by making another. Technically, to hedge you would invest in two securities with negative correlations. Of course, nothing in this world is free, so you still have to pay for this type of insurance in one form or another. Although some of us may fantasize about a world where profit potentials are limitless but also risk free, hedging can't help us escape the hard reality of the risk-return tradeoff. A reduction in risk will always mean a reduction in potential profits. So, hedging, for the most part, is a technique not by which you will make money but by which you can reduce potential loss. If the investment you are hedging against makes money, you will have typically reduced the profit that you could have made, and if the investment loses money, your hedge, if successful, will reduce that loss.").

[32] As opposed to a bull, a bear is an investor that prospers when the price of an investment drops. *See What is a Bull and Bear Market?*, http://www.moneyinstructor.com/art/bullbearmarket.asp (last visited May 12, 2009).

[33] *See* Trotta, *supra* note 21 ("Short sellers, or 'shorts,' have been blamed for almost every financial crisis in the 400 years since the Dutch episode.").

[34] *Id.*

short selling.[35] Similarly, during World War I, the New York Stock Exchange enacted regulations on short selling to prevent short sellers from "demoralizing" the markets.[36]

In addition, during the Great Depression, short sellers were condemned by Herbert Hoover.[37] Many regulations on short selling sprung up during this period, such as the "uptick rule"[38] and the Investment Company Act of 1940,[39] both of which restrict the ability of particular parties to engage in short selling.[40]

As this brief history of short selling regulation demonstrates, short sellers are frequently placed under the microscope during negative economic cycles. Many examine the activity of short sellers and quickly conclude that these actors must be responsible for a negative economic cycle. Speculators are blamed as the cause of these events, when, in reality, they could simply be

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[35] *Id.*

[36] Macey, *supra* note 16.

[37] FRANK J. FABOZZI, SHORT SELLING: STRATEGIES, RISKS, AND REWARDS 183 (2004). ("Short sellers were extremely unpopular in 1930, and many politicians, journalists, and investors blamed them for the stock market crash. Press accounts in October 1930 contain certain reports that officials of the NYSE were quietly discouraging stock lending and that the lenders themselves (such as investment trusts) wanted to discourage short selling. President Herbert Hoover met with Richard Whitney, president of the NYSE, to discuss the situation."); *See also More Countries supra* note 1.

[38] *See* Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and A Modest Proposal for Letting More Shorts Go Naked,* 8 J. BUS. & SEC. L. 135, 136 (2008) ("the uptick rule attempts to limit the ability of short sellers to accelerate a downward moving market. The rule prohibits short sales at a price below the last sale price for that security or at the last sale price if that price was itself a downward movement. Empirical evidence shows that sufficient moment-to-moment price volatility allows short sellers to easily avoid the uptick rule. However, the uptick rule may effectively constrain short sellers due to the extra compliance costs relative to longs. The SEC is currently testing a repeal of the uptick rule.").

[39] *See* SEC Report: *The Laws That Govern the Securities Industry* (Sept. 26, 2008), *available at* http://www.sec.gov/about/laws.shtml ("This Act regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. The regulation is designed to minimize conflicts of interest that arise in these complex operations. The Act requires these companies to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. The focus of this Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations. It is important to remember that the Act does not permit the SEC to directly supervise the investment decisions or activities of these companies or judge the merits of their investments.").

[40] FABOZZI, *supra* note 37 at 183.

trying to ride the wave of a downward trend.[41] Since short sellers profit when the market drops, it would be in their interest to bet into a downward trend such as a recession or decline.

During the 2008 financial crisis, speculators could be betting into the downward market cycle, rather than creating the cycle as a result of their positions. If this were true, a more appropriate approach to regulating short selling would target fraud and other unsavory practices. As we have seen recently, it is possible to pass narrowly tailored regulations that target fraud without overreaching.

IV. RECENT REGULATIONS ON SHORT SELLING

Recently, the Securities Exchange Commission (SEC) has taken steps to limit certain forms of short selling. Some of these regulations have resulted in benefits to the economy, but others may result in unintended consequences. Regulations such as Regulation SHO, and the 2006 amendments to that regulation, have proven beneficial to the economy. The 2008 temporary short selling bans, however, will slow economic recovery.

A. *Beneficial Regulations*

As in the past, the short sellers of today have shouldered the blame for many recent down markets. The SEC has stepped in, enacting regulations to limit short selling practices that it deems inappropriate. One such regulation was Regulation SHO, enacted in January 2005.

The purpose of Regulation SHO was specific and narrowly tailored:

> Proposed Regulation SHO would, among other things, require short sellers in all equity securities to locate securities to borrow before selling, and would also impose strict delivery requirements on securities where many sellers have failed to deliver the securities. In part, this action is designed to address the problem of "naked" short selling.[42]

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[41] *See* Murphy, *supra* note 6.

[42] Richard Geist, *New Short Selling Regulations*, THE BULL AND BEAR FINANCIAL REPORT,, *available at* http://thebullandbear.com/articles/2004/0304-geist.html ("The problem arises when short sellers use a scheme called naked short selling to effect their transactions. Naked short selling is a technique whereby you sell short without borrowing the stock. In this way short sellers can sell as much as they want with no accountability for returning the stock. This ability to 'fail to deliver' the stock creates havoc in the micro-cap market. In particular shorts can pick on small emerging companies and drive their stock to zero, thus preventing capital

So-called "naked" short selling, which involves selling securities that have not been borrowed, is particularly unpopular with short selling critics because of the risk that the seller fails to settle the trade,[43] thereby damaging confidence in the markets. Naked shorting is illegal or restricted in many jurisdictions.[44]

The goals of Regulation SHO include: (1) establishing "locate"[45] and "close-out"[46] requirements; (2) relaxing price tests on a certain group of securities in order to evaluate the effectiveness and necessity of such restrictions; and (3) creating uniform "order-marking" requirements for all equity transactions.[47]

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raising and frightening other longs in the stock to abandon their position, not based on the fundamentals, but only on the manipulation of the stock. Obviously when you see your stock price plunging, you are most likely to sell first and ask questions later. Shorts were able to get away with this practice because only those firms that were NASD members were required to comply with delivery rules. There are many groups, such as Canadian brokerage firms, Specialists, options players, who are not NASD members, and therefore do not have to comply with the NASD rules that require members to assure delivery of stock by the settlement date. For example, if you open a brokerage account at a Canadian firm, they are allowed to keep open "fail to deliver" orders on their books. A short selling group trading through a Canadian brokerage firm literally can get away without delivering their shares. In Canada, previous to the new regulation, investors were not required to borrow stock before selling it short.").

[43] Failing to settle a trade is known as a "failure to deliver." "Failures to deliver" have the potential to damage market confidence because buyers are stuck without shares. *See id.*

[44] *See* Mackintosh, *supra* note 17.

[45] SEC, Division of Market Regulation: Key Points about Regulation SHO (Apr. 11, 2005) http://www.sec.gov/spotlight/keyregshoissues.htm ("Regulation SHO requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security. This "locate" must be made and documented prior to effecting the short sale.").

[46] Regulation SHO imposes additional delivery requirements on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency ("threshold securities"). For instance, with limited exception, Regulation SHO requires brokers and dealers that are participants of a registered clearing agency to take action to "close-out" failure-to-deliver positions ("open fails") in threshold securities that have persisted for 13 consecutive settlement days. Closing out requires the broker or dealer to purchase securities of like kind and quantity. Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions (for example, an introducing broker) may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as the "pre-borrowing" requirement). *Id.*

[47] Thus, equity transactions must be labeled "long," "short," or "short exempt." *Id.*

The "close-out" requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to broker-dealers for securities in which a substantial amount of "fails to deliver" have occurred.[48]

Regulation SHO is an example of a well-drafted regulation because it is tailored to eliminate particular acts that are proven to be susceptible to abuse. Naked short sellers have wreaked havoc on securities by acting irresponsibly or even fraudulently. This is an example of the SEC enacting a carefully planned regulation that targets a specific group of short sellers. Regulation SHO was not rushed and its goals were clearly defined and laid out.

1. *2006 Proposed Amendments to Regulation SHO*

The 2006 proposed amendments were intended to reduce the number of "fails to deliver" in certain equity securities.[49] The proposed changes included dropping the grandfather provision and narrowing the options market maker exception.[50] Both the grandfather provision and the options market maker exception are exceptions to the mandatory close-out requirement.[51]

All of these provisions are clearly defined and there appears to have been much deliberation in drafting both Regulation SHO and the 2006 proposed amendments. Judging the efficacy of Regulation SHO is a task for another time. It is mentioned here simply to demonstrate the degree of process and clarity that should be employed in instituting financial regulations. Unlike many regulations on short selling that were passed during economic crises, Regulation SHO is a responsible action that is narrowly tailored to address abuses of short selling.

V. THE 2008 TEMPORARY BANS ON SHORT SELLING

Regulators are charged with the delicate task of enacting meaningful regulations that facilitate efficient markets while being careful not to reach too far and create inefficiencies by restricting information. Quickly drafted regulations with general objectives are more likely to overreach than are

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[48] Securities in which a substantial amount of fails to deliver have occurred are known as "threshold securities." Amendments to Regulation SHO, Exchange Act Release No. 34-54154 (July 14, 2006), *available at* http://www.sec.gov/rules/proposed/2006/34-54154.pdf.

[49] *Id.*

[50] *Id.*

[51] The "grandfather provision" excepts failures to deliver that occur before securities become threshold securities. The "options market-maker exception" excepts short sales made by a registered options market maker for the purpose of establishing or maintaining a hedge on options positions that were created before the underlying security became a threshold security. *Id.*

narrowly tailored regulations enacted after unhurried reflection. The risk of unintended consequences is exacerbated when regulations are aimed at the unpopular short sellers, a group that regulators are quick to blame. This risk is heightened even more when financial regulations are passed in the heat of the moment and under the pressure of a bad financial crisis.

In the summer of 2008, the SEC implemented a temporary short selling ban on the securities of 799 financial services companies in an attempt to boost investor morale and overall confidence in the markets.[52] The process employed to pass this ban (and similar bans in other nations) possessed all of the characteristics mentioned above that lead to overreaching by regulators:

- They targeted broad objectives;
- They were passed quickly due to extreme economic pressure; and
- They targeted the often-blamed short sellers.

A. *Broad Objectives*

Well-drafted regulations target specific goals. Regulation SHO was narrowly tailored to achieve specific goals such as establishing "locate" and "close-out" requirements, and establishing uniform "order-marking" procedures.[53] The temporary short sale ban of 2008 is quite broad by comparison. The SEC stated a decrease in volatility and an increase in investor confidence as two objectives of the ban.[54] A third objective cited by the SEC was an increase in liquidity.[55] These three objectives are broad when compared to other regulations, such as Regulation SHO.

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[52] Lamonica, *supra* note 20; Michael Tsang, *Short Sellers Under Fire in U.S., U.K. After AIG Fall*, BLOOMBERG (Sept. 19, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aTHLqfgpnFYw&refer=home ("Financial regulators in the U.S., U.K. and Ireland, attorneys general in New York, Texas and Connecticut, and the three largest U.S. pension funds all began cracking down on short sellers. The SEC said today that it will halt short selling of U.S. banks, insurance companies and securities firms through Oct. 2, while the Financial Services Authority in the U.K. banned short sales of financial shares for the rest of the year."). *See also,* David Sheer & Edgar Ortega, *SEC Extends Naked Short-Sale Order on Fannie, Freddie*, BLOOMBERG (July 29, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aQRBietUNVyw ("The temporary order, which took effect July 21, requires traders to at least arrange to borrow shares before selling short Freddie Mac and Fannie Mae, the government-sponsored mortgage buyers. The order covers brokerages with access to the Federal Reserve's discount window, which was opened to investment banks after the March collapse of Bear Stearns.").

[53] *See supra* text accompanying notes 45-47.

[54] *See* SEC Release No. 34-58592, at 1 (Sept. 18, 2008). *See also* Lamonica, *supra,* note 20.

[55] *See id.*.

The SEC further stated: "Given the importance of confidence in our financial markets as a whole, we have become concerned about recent sudden declines in the prices of a wide range of securities."[56] This statement indicates that the SEC felt pressured by the economic environment, which may partially explain the broad objectives of the temporary ban.

B. *Economic Pressure*

SEC chairman Chris Cox spoke candidly about the purpose of these regulations in an op-ed to *The Wall Street Journal* in July: "[The ban] is intended as a preventative step to help restore market confidence at a time when that is sorely needed."[57] This language tends to indicate the pressure that Cox was feeling from the financial conditions at the time. The SEC report labeled this action as an "Emergency" order.[58]

Evidence of the influence of the troubling financial landscape on the temporary short sale ban (and the corresponding broad purpose and panicked language) is not limited to the United States. British Prime Minister Gordon Brown told the annual conference of the ruling Labour Party in late September 2008 that his government moved to ban short selling of banks and insurers because "the interests of savers and homeowners and mortgage holders came before the interests of a few hedge funds."[59]

Additionally, Spanish regulatory body CNMV[60] participated in the new wave of short sale regulations in September 2008.[61] The CNMV required

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[56] *Id.*.

[57] Samantha Buker, *Short Selling Regulations,* http://www.whiskeyandgunpowder.com/Archives/2008/20080922.html *citing* Op-Ed, THE WALL STREET JOURNAL, July 24, 2008.

[58] SEC Release No. 34-58592, at 1 (Sept. 18, 2008).

[59] *See* Mackintosh, *supra* note 17.

[60] The CNMV is the Spanish regulatory body Comisión Nacional del Mercado de Valores. CNMV, *What We Do,,* http://www.cnmv.es/index.htm. ("The Comisión Nacional del Mercado de Valores (CNMV) is the agency in charge of supervising and inspecting the Spanish Stock Markets and the activities of all the participants in those markets. It was created by the Securities Market Law, which instituted in-depth reforms of this segment of the Spanish financial system. Law 37/1998 updated the aforementioned Law and established a regulatory framework that is fully in line with the requirements of the European Union and favour the development of European Stock Markets. The purpose of the CNMV is to ensure the transparency of the Spanish market and the correct formation of prices in them, and to protect investors. The CNMV promotes the disclosure of any information required to achieve these ends, by any means at its disposal; for this purpose, it uses the latest in computer equipment and constantly monitors the improvements provided by technological progress. The main beneficiaries of the CNMV's work are Spanish investors, to whom we must assure adequate protection. To this end,

disclosure of all short positions in twenty major financial stocks.[62] Furthermore, Australia placed a complete ban on short selling for all stocks on the Australian exchange—the ASX.[63] The stated purpose, as in the U.S. and the U.K., was to "restore investor confidence."[64] The ban lasted for thirty days and was the strongest regulation on short selling during the 2008 crisis.[65]

It appears that temporary bans on short selling of securities are becoming accepted both in the United States and abroad. It is troubling that these steps are being enacted so quickly during a negative economic cycle. Recent commentary by regulators seems to suggest that the financial landscape is pressuring these actions.

C. *Targeting Short Sellers*

This history of placing blame on short sellers makes it more likely that regulators will be quick to fault this group when looking for a scapegoat.

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the CNMV focus particularly on improving the quality of information disclosure to the market, and particular efforts are made in the area of auditing and in developing new disclosure requirements relating to remuneration schemes for directors and executives that are linked to the price of the shares of the company where they work. Also, considerable efforts are made to detect and pursue illegal activities by unregistered intermediaries.").

[61] Jonathan House, *Spain Regulator Introduces New Short Sales Disclosure Rule,* DOW JONES NEWSWIRES, Sept. 22, 2008, *available at* http://www.lloyds.com/CmsPhoenix/DowJonesArticle.aspx?id=405593.

[62] *Id.* ("In a statement, CNMV said that, as of Thursday, investors must notify it of any short positions they have in a list of 20 financial stocks that are equal to more than 0.25% of one of the companies' share capital." The list of companies includes Banco Santander SA (STD), Banco Bilbao Vizcaya Argentaria SA (BBV), Banco Popular Espanol SA (POP.MC), and 17 other large financials institutions. CNMV also reiterated it doesn't allow the practice of naked short selling, that is, when the seller doesn't have an agreement to borrow the shares it is selling.")

[63] Sarah McDonald, *Australian Short Selling Ban Goes Further than Other Bourses,* THE NAT'L BUS. REV., Sept. 22, 2008, *available at* http://www.nbr.co.nz/article/australian-short-selling-ban-goes-further-other-bourses-35494. ("[T]he Australian ban covers all 2600-odd stocks on the ASX bourse. The decision not to limit the ban to financial stocks, was taken out of concern that if short sellers could not access those stocks, they would target other sectors. 'To limit the prohibition to financial stocks, as has been done in the UK, could subject our other stocks to unwarranted attack given the unknown amount of global money which may be looking for short sell plays,' ASIC chairman Tony D'Aloisio said. The list of Australian listed companies to have their share price ravaged by short selling this year includes Macquarie Bank, ABC Learning Centers and Babcock & Brown. Mr D'Alosio said that in light of the action taken by other regulators, the ASX needed a circuit-breaker to assist in maintaining and restoring confidence.").

[64] *Id.*

[65] *Id.*

Short sellers have an established reputation for "speculating" and causing "death spirals."[66] Furthermore, the fact that they prosper when others are losing their pensions makes them easy targets.[67] The history of placing blame on short sellers has effectively placed a stigma on short selling, causing short sellers to jump to the mind of regulators when the regulatory bodies are looking to "restore investor confidence."

All of these factors render the 2008 short sale ban an overreaching regulation. This is particularly troublesome given the financial landscape at the time of the ban. The stakes are at their highest during negative economic cycles, and regulators must tread with caution during such times. However, by passing overreaching regulations, the regulatory bodies that passed short sale bans in 2008 likely created unintended consequences that slowed economic recovery.

VI. THE UNINTENDED CONSEQUENCES

The temporary bans on short selling enacted in the summer of 2008 appear to have failed. One commentator referred to the step as one of the dumbest financial moves of 2008.[68] The SEC's stated purpose of putting an end to sudden price declines in financial institutions did not manifest itself.[69]

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[66] *See* John Labate, *SEC Widens Probe into "Death-spiral" Schemes,* THE FINANCIAL TIMES, Mar. 9, 2003, at 23.

[67] *See* Trotta, *supra* note 21.

[68] Colin Barr, *21 Dumbest Moments in Business: Cox's Short-Selling Ban,* http://money.cnn.com/galleries/2008/fortune/0812/gallery.dumbest_moments_2009.fortune/12.html ("'The emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets,' Cox promises. But shares in banks, brokerages and insurance companies continue to plunge, losing a quarter of their value during the three weeks the mid-September order was effective. Some investors say the short ban hastened the flight of capital from stock and bond markets, by showing the government could intervene in markets in unexpected and troublesome ways."). *See also* Kirk Shinkle, *Short Selling Ban Backlash*, US NEWS, Sept. 19, 2008 ("Later, I'll bet we'll worry that the government picked one of the most reckless bits of the market and decided to protect it from traders trying to reconcile banking sector abuses with reality. Nobody likes shorts, and there will undoubtedly be some signs of manipulation among bank shares, but blaming shorts for this week's stock market mania is beside the point. The punishment doled out to banks this week is extreme, but so were their inflated risk appetites that spawned reckless lending behavior for the better part of a decade.").

[69] *See* LaMonica, *supra* note 20 ("At the time, the SEC said that the action 'calls a time-out to aggressive short selling in financial institution stocks, because of the essential link between their stock price and confidence in the institution.' The SEC added that 'unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation' and that 'financial institutions are particularly vulnerable to this crisis of

It also appears that investor confidence declined significantly after the ban on short selling along with targeted securities which dropped even further. The SEC regulations were enacted to prevent such results.

Washington Mutual and Wachovia are two good examples of financial companies that saw their stock continue to plummet after the SEC banned short selling.[70] This unintended drop in price, as well as investor confidence, can be partially attributed to the lack of information, liquidity, and efficiency that short sellers provide to the markets.[71] Similarly, European financial firms have experienced declines in value despite restrictions on short selling their securities.[72] The affected firms include Fortis, Hypo Real Estate AG, and Dexia SA.[73]

These are just a few examples that demonstrate the unintended consequences of the 2008 short selling ban. Similar consequences can be expected in the future when actions to ban short selling are implemented. These consequences manifest themselves in many different ways and have consequences across the entire financial community.

A. *Investor Confidence Will be Diminished*

Investor confidence is diminished by banning short selling.[74] Short sellers take positions in companies that are weak, or that the short seller believes are overvalued. This is a source of information for long investors. Long investors in securities that are not shorted very heavily will know that short sellers, like long investors, do not think the investment is overvalued.

In fact, short sellers are often the first to uncover major problems in the markets, as seen in the Enron and WorldCom scandals.[75] It is not

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confidence and panic selling because they depend on the confidence of their trading counterparties in the conduct of their core business.').

[70] *Id.*

[71] *See* discussion on pages 3-5.

[72] Memorandum from Coalition of Private Investment Companies to Chairman Christopher Cox, Dec. 16, 2008, fn 47, *available at* http://www.sec.gov/comments/s7-30-08/s73008-48.pdf (*citing* James Mackintosh, *Funds Seek End to Ban on Short Selling,* FIN. TIMES, Sept. 29, 2008 ("many of London's biggest hedge fund managers pointed out in private that Bradford & Bingley and Fortis needed government rescues even though short selling was no longer possible, while shares in financial companies had fallen in Europe and the US since the rally after the ban was introduced.")).

[73] *Id.* at 13.

[74] Murphy, *supra* note 6.

[75] Claire Suddath, *A Brief History of Short Selling*, TIME MAGAZINE ONLINE, Sept. 22, 2008 *available at* http://www.time.com/time/business/article/0,8599,1843255,00.html. *See also The One Minute Case for Stock Shorting*, http://oneminute.rationalmind.net/stock-shorting (last visited May 12, 2009) ("Short sellers bring to light valuable information about poorly run companies. Short sellers have a strong incentive to

unreasonable to hypothesize that taking short sellers out of the markets might increase the negative impacts of such corporate scandals. There would be no source of information indicating that a company is highly overvalued, thereby either allowing the scandal to continue unnoticed, or delaying its discovery. By eliminating this source of information, regulations will likely have the unintended consequence of diminishing investor confidence.[76]

B. *Increased Liquidity*

The SEC's Office of Economic Analysis conducted a study that indicates that several unintended consequences stemmed directly from the temporary ban on short selling in 2008.[77] Chairman Christopher Cox was

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uncover poorly run companies. If a short seller successfully discovers ahead of others that a company is destroying value through incompetence, bad luck or even criminal activity, he profits by shorting the stock and publicizing the information. Short sellers are similar to good investigative journalists. They make more money if they can "scoop" others with information that will drive the stock down. It is this aspect of short selling that many company managers, regulators and others find discomforting. Yet these same managers and regulators have no problem when an investor uncovers a successful company. Why should they be opposed to someone who does the opposite, and uncovers the overvalued, incompetent, lazy or even fraudulently managed companies?").

[76] *See* Murphy, *supra* note 6.

[77] Rachelle Younglai, *SEC Chief has Regrets Over Short-Selling Ban,* HEDGEWORLD DAILY NEWS, Dec. 31, 2008, Legislative Agenda, at 1. ("Under fire for regulatory missteps, Securities and Exchange Commission Chairman Christopher Cox defended his agency's record but acknowledged some regrets over how he handled the worst financial crisis in decades. The SEC has been lambasted by lawmakers and others for not doing enough to prevent the 2008 collapse of Bear Stearns Cos. Inc. and Lehman Brothers Holdings Inc., interfering with markets and failing to detect the alleged $50 billion fraud at Wall Street financier Bernard Madoff's firm. Mr. Cox, a Republican and former California congressman, said the SEC's focus has been customer protection and broker dealer regulation and that the agency 'performed that traditional role superbly.' However, Mr. Cox, the country's cop securities regulator, said he had some regrets over a drastic action the agency took as markets were hurtling downward in September. For a few weeks, the SEC stopped investors from making bearish bets on financial stocks like Morgan Stanley and Citigroup Inc. The SEC's office of economic analysis is still evaluating data from the temporary ban on short-selling. Preliminary findings point to several unintended market consequences and side effects caused by the ban, he said. 'While the actual effects of this temporary action will not be fully understood for many more months, if not years, knowing what we know now, I believe on balance the commission would not do it again,' Mr. Cox told Reuters in a telephone interview from the SEC's Los Angeles office late on Tuesday [Dec. 30]. 'The costs appear to outweigh the benefits.' Less liquidity in the markets was one of the unintended consequences, experts have said. The SEC imposed the

quoted as saying that "the costs seem to outweigh the benefits."[78] He also noted several unintended consequences that occurred as a result of the ban. One such cost mentioned by Chairman Cox was a decrease in liquidity.[79] Cox claims that a decrease in liquidity "could have been predicted," yet the temporary ban was enacted with increased liquidity as one of its objectives.[80]

C. *Effects on Long Trades*

Short selling provides a means for many investors to lower the overall risk level of their portfolio by hedging. The ban on short selling takes this option away and discourages many investors from taking long positions that they would have otherwise.[81] In other words, investors feel that long investments are less risky when they can hedge by short selling. Without the option to hedge, long positions are too risky in some circumstances. Therefore, banning short selling also discourages investment in certain long positions.

These effects on investment strategies hit hedge fund managers particularly hard. Hedge fund managers are attempting to maintain a certain level of overall risk but they cannot sell short due to the ban. This leaves fund managers with the choice between taking on added risk and exposing themselves to the volatile market, or selling off their long positions.[82]

D. *Increased Volatility*

A ban on short selling decreases liquidity of the targeted securities. Decreases in liquidity have been shown to result in a rise in market volatility. Furthermore, short sellers naturally provide counter-cyclical positions that improve market efficiency.[83] By eliminating these positions, regulatory bodies

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temporary ban under intense pressure from the Federal Reserve and Treasury Department which insisted it was crucial to the short-term survival of these institutions, Cox said.").

[78] *Id.*

[79] *See Id.*

[80] *Id.*

[81] *See* Memorandum from Coalition of Private Investment Companies to Chairman Christopher Cox, *supra* note 72, at 14.

[82] Alistair Barr, *Short-Sale Ban Disrupts Trades for Hedge Funds: Short Sellers, Convertible Arbitrage, Relative Value Managers Hit Hardest* MARKETWATCH,, http://www.marketwatch.com/news/story/hedge-funds-suffer-short-selling/story.aspx?guid=%7BA12A0C0D-55FF-4576-9F2B-9D4C9072200E%7D ("(Hedge fund manager Manuel) Asensio can't increase short positions on financial-services shares, so he said he may have to sell some long positions to hedge against broader declines in the stock market.").

[83] *See* Macey, *supra* note 16, at 800 ("some view short selling as an economically beneficial practice that promotes market efficiency. Short selling provides a method by which investors who know that a security is overvalued can trade on the

actually increase volatility of securities, thus making the investments more risky.[84]

The Wall Street Journal reported that bid-ask spreads in the restricted securities rose from .15 percentage points to nearly .40 percentage points.[85] Similarly, a study of trading patterns prepared by Credit Suisse demonstrates that the temporary short sale bans of 2008 did indeed have an effect that was not in line with the objectives of the bans.[86] The study indicates that bid-ask spreads widened and liquidity dropped across the board while volatility increased.[87]

Furthermore, a study compiled by the NASDAQ OMX concluded that stocks covered by the 2008 ban became more volatile than before the ban.[88] As noted, the ban on short selling was intended to make securities less volatile. However, when the NASDAQ's chief economist actually studied the effects of the ban, he found the SEC did not meet its goals; an unintended, negative result had in fact occurred.[89]

VII. THE PANIC EFFECT AND THE 2008 BANS ON SHORT SELLING

How do we explain these unintended consequences? What caused the leading financial agencies of several countries to enact regulations that were aimed at accomplishing one thing but actually result in the exact opposite effect? The explanation lies in the process of passing these regulations. Regulators were pressured by the economic conditions, which resulted in a rushed regulatory process. This made it easier for the regulatory bodies to inflate the value of the benefits of the regulations and discount the drawbacks.

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information, thereby promoting more efficient pricing. Short selling facilitates arbitrage and enables investors to hedge against stock price declines, allowing investors to take larger positions which in turn adds liquidity to the market.").

[84] Murphy, *supra* note 6.

[85] *See* Memorandum from Coalition of Private Investment Companies to Chairman Christopher Cox, *supra* note 72 at 14, (*citing* Tom Lauricella et al.,, *SEC Extends "Short" Ban as Bailout Advances,* WALL ST. J., Oct. 2, 2008.

[86] Mackintosh, *supra* note 17.

[87] *Id.*

[88] *See* David Greising, *Short-Selling Ban Leaves SEC with Little to Show,* CHI. TRIB., Oct. 10, 2008, at 37, *available at* http://archives.chicagotribune.com/2008/oct/10/business/chi-fri-crisis-greising-shorts-oct10 ("A review of academic literature and a flash study by the Nasdaq OMX of the Securities and Exchange Commission's nearly month-long ban on shorting financial stocks shows that stocks "protected" by such bans actually become more volatile.").

[89] *Id.*

A. *Regulatory Bodies Cannot Have it Both Ways*

The SEC report describing the regulation stated that the temporary short sale ban of 2008 would restore equilibrium to the markets.[90] The SEC's reasoning was not entirely misplaced, but there were several faulty assumptions that contributed to the defective regulation.[91]

The report described the plan as a temporarily halt to the short selling of financial institutions.[92] The reasoning behind this strategy was that short selling was contributing to "sudden price declines" in financial institutions that were "unrelated to" the true underlying value of the securities.[93] The SEC reasoned, therefore, that by temporarily eliminating the short sellers, financial institutions would have a chance to recover.[94] In turn, the SEC believed that investor confidence would rise due to a supposed "essential link" between financial institution stocks and investor confidence.[95]

There are several problems with the SEC's reasoning. The SEC cannot be entirely sure that short sellers are actually contributing to the sudden price declines in financial institutions. The SEC does not entirely explain why it believes the short sellers are to blame. Could this be a reversion back to the historic trend of blaming short sellers during times of financial unrest?

The SEC concedes that short selling contributes to price efficiency and adds liquidity to the markets under normal market conditions.[96] However, during negative economic cycles, the SEC posits that short sellers harm the economy to such an extent that they should be temporarily banned. The SEC and other financial agencies cannot have it both ways. Either short sellers contribute to market efficiency or they contribute to market inefficiency.

Regulatory bodies have been inconsistent with regard to the effects of short selling on financial markets. The explanation for this is the "panic effect." Regulatory bodies have had years to examine the effects of short selling on the fundamentals of financial markets. They have consistently concluded that short sellers provide information and increase investor confidence.[97]

When bad economic conditions force the hands of regulatory bodies, those bodies are pressured to act quickly and fix the markets. In doing so, they are susceptible to errors in judgment. This susceptibility is exacerbated by short sellers' known reputation as financial spectators. Although short selling

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[90] SEC Report 2008 - 211, *SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets*, Sept. 19, 2008, *available at* http://www.sec.gov/news/press/2008/2008-211.htm.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *See* SEC Report, *supra* note 90.
[95] *Id.*
[96] *Id.*
[97] *Id.*

is fundamentally sound, regulators reason that bad economic times call for extreme measures. The problem is that fundamentally sound economic practices cannot be disregarded without unintended consequences. The pressure to act quickly forces the regulatory bodies to overlook these consequences, or at least undervalue them.

The 2008 temporary bans on short selling are an example of the "panic effect." The regulatory bodies abandoned practices that had been considered fundamentally sound for years. Furthermore, they did so very quickly and may not have properly evaluated the possible consequences of their actions.

To make an educated decision, regulators must properly examine the benefits of short selling and balance those benefits against the positive aspects of the proposed regulation. For instance, SEC Chairman Cox stated that the temporary ban on 799 financial institutions was intended to "restore market confidence."[98] This decision was made very quickly and possibly without proper evaluation of any possible unintended consequences.[99]

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[98] *See, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets*, Sept. 11, 2008, http://www.sec.gov/news/press/2008/2008-211.htm ("SEC Chairman Christopher Cox said, 'The Commission is committed to using every weapon in its arsenal to combat market manipulation that threatens investors and capital markets. The emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets. This action, which would not be necessary in a well-functioning market, is temporary in nature and part of the comprehensive set of steps being taken by the Federal Reserve, the Treasury, and the Congress.' This decisive SEC action calls a time-out to aggressive short selling in financial institution stocks, because of the essential link between their stock price and confidence in the institution. The Commission will continue to consider measures to address short selling concerns in other publicly traded companies. Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets. At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation. Financial institutions are particularly vulnerable to this crisis of confidence and panic selling because they depend on the confidence of their trading counterparties in the conduct of their core business. Given the importance of confidence in financial markets, the SEC's action halts short selling in 799 financial institutions. The SEC's emergency order, pursuant to its authority in Section 12(k)(2) of the Securities Exchange Act of 1934, will be immediately effective and will terminate at 11:59 p.m. ET on Oct. 2, 2008. The Commission may extend the order beyond 10 business days if it deems an extension necessary in the public interest and for the protection of investors, but will not extend the order for more than 30 calendar days in total duration. The Commission notes the similar announcement by the U.K. FSA. The SEC and FSA are consulting on an ongoing basis with regard to short selling matters and will continue to cooperate in carrying out regulatory actions.").

[99] *See* Murphey, *supra* note 6.

The most obvious reason for these skewed results is that the 2008 bans on short selling were enacted under pressure and were based on panic rather than a well thought out process.[100] In the future, to avoid such unforeseen results, regulators should carefully examine and weigh the possible unintended consequences of complex financial practices such as short selling. By doing so, regulators will be able to avoid hastily abandoning solid financial principles during times of unrest and will hopefully avoid the associated unintended consequences.

As an example, consider the Australian ban.[101] The ASIC went further than the SEC, including all stocks on the Australian ASX stock exchange in the ban on short selling .[102] ASIC chairman Tony D'Aloisio justified this action on the following grounds: "To limit the prohibition to financial stocks, as has been done in the UK, could subject our other stocks to unwarranted attack given the unknown amount of global money which may be looking for short sell plays."[103] This justification, as evidenced by the previous statement, for the thirty-day ban on short selling enacted in Australia appears to stem from panic.[104] D'Aloisio and the ASIC were afraid of short selling and blamed the market decline on short sellers as we have seen so many times in the past.

As we have already examined, however, banning short selling does not further the purpose stated by the ASIC, the SEC or the FSA: to restore investor confidence. Rather, short selling provides information to investors that boosts market efficiency, liquidity and investor confidence.[105] Thus, the bans had the opposite effect of what was desired.[106]

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[100] *See* Macey, *supra* note 25 ("The Fed, the Treasury and the SEC appear to be in a state of panic.").

[101] *See* McDonald, *supra* note 63.

[102] The ASIC is the Australian Securities & Investments Commission. *Se,* Australian Securities and Investments Commission: Our Role, http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument. ("ASIC is Australia's corporate, markets and financial services regulator. We contribute to Australia's economic reputation and wellbeing by ensuring that Australia's financial markets are fair and transparent, supported by confident and informed investors and consumers. We are an independent Commonwealth Government body. We are set up under and administer the Australian Securities and Investments Commission Act (ASIC Act), and we carry out most of our work under the Corporations Act.")

[103] *See* McDonald, *supra* note 63.

[104] Dominic McCormick, *Selling Australia's Investors Short,* MONEY MANAGEMENT (AUSTRALIA), Oct. 2, 2008, ("The changes came in a panic, with little thought for consequences as the ensuing chaos and subsequent backsliding has indicated. The regulatory risk of investing in, or setting up an investment business in this country has increased significantly.").

[105] Short selling actually increases investor confidence. *See supra* text accompanying note 9. Therefore, passing regulations which ban short selling seems counterintuitive. This, coupled with the quick decisions made by the ASIC,

As one commentator notes, with respect to the emergency regulations of 2008: "Done in haste, with scant study and little strategic thought, the wholesale redesign inevitably will be a mixed bag. The $700 billion plan to buy up mortgage securities and the Federal Reserve's vast expansion of power could have unintended, negative consequences.[107]" NASDAQ chief economist Nathan Hatheway agrees that the SEC regulations on short selling were passed under immense pressure, and were not as well thought out as they should have been.[108]

These commentators are correct in their reasoning with respect to how the SEC missed the mark on the short selling ban of 2008. They were rushed in their decision and pressured into believing that short sellers, the most common scapegoat in history during financial turmoil, were to blame. They discarded time-tested and sound free market policies that have worked for centuries. Given the clear disconnect between the goals of the regulations and the predictable results, there is no other explanation: the SEC panicked.

IX. CONCLUSION

Recently, many commentators have made it clear that the 2008 bans on short selling have failed.[109] Some take the position advocated in this article calling for an end of the temporary bans on short selling.[110] Others, however,

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the SEC and the FSA during the financial crisis of 2008 suggest that the regulatory bodies were acting on panic, rather than sound financial judgment.

[106] *See* McCormick, *supra* note 104 ("If you live long enough you get to see it all. The introduction of short selling restrictions and especially the temporary blanket ban in Australia have astounded most sophisticated participants in local investment markets. The Federal Treasurer said the measures 'will help protect investors as well as the integrity of our financial markets'. They won't. More likely they will increase longer-term volatility, decrease liquidity and make small investors more vulnerable to future losses. With restrictions that went far beyond other countries, Australia has damaged its quest to become a pre-eminent financial centre in the region. Unsurprisingly, the share price of the Australian Securities Exchange (ASX) itself fell by 6 per cent on the day after the changes were announced (after a delayed open), when the overall market rose over 4 per cent.").

[107] *Id.*

[108] *Id.* ("'The SEC was under considerable pressure' to add companies to the list, the Nasdaq's Hatheway said. 'The list was broader than it needed to be.'").

[109] Simon Kennedy, *U.K. MPs Call For Extension To Short-selling Ban: Report,* FOX NEWS, Jan. 2, 2009, http://www.foxbusiness.com/story/markets/industries/finance/uk-mps-extension-short-selling-ban-report.

[110] *See* Murphy, *supra* note 6; Lamonica, *supra* note 20. *See als,* George Liondis, *Relief Temporary, Hedge Funds Warn,* THE AUSTRALIAN FIN. REV., Sept. 22, 2008 ("Hedge funds and market traders have criticised the ban on the short selling of

take the opposite position, reasoning that the bans have simply not had enough time to restore investor confidence, and call for extensions on the bans.[111]

As evidenced throughout this article, enacting similar bans on short selling will only compound the problem and hamper investor confidence. The underlying theory of banning short selling as a means to increase investor confidence is flawed, and therefore no matter how long such bans are in place,

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Australian-listed stocks. The ban will initially be in place for 30 days, and follows moves by regulators in a number of other countries to halt short selling of financial stocks. Damien Hatfield of Hatfield Liptak Advisors warns that a likely rally in Australian financial stocks as a result of the ban will be short-lived.") *See also Analysis: Hedge Fund Anger at Short-Selling Bans*, FIN. TIMES MANDATE, Oct. 1, 2008 ("The Alternative Investment Management Association (AIMA) reacted critically to the temporary short-selling bans introduced by finance regulators from September 17. The industry body was angry that the Financial Services Authority's (FSA) instrument, in force until January 16, calls the practice "market abuse" and was implemented 'without notice or consultation'. 'Short selling is not the real cause of the decline in HBOS share value, nor are hedge funds to blame for wider, exceptional market volatility,' said Florence Lombard, AIMA's Chief Executive. After the ban bank stocks rocketed as shorts were covered before plummeting, forcing governments to step in. FSA CEO Hector Sants re-affirmed the regulator's view that short-selling is 'a legitimate investment technique in normal market conditions', but insisted that 'extreme circumstances' necessitated 'decisive action' to protect markets. It was not clear that the bans - which took in 130/30 strategies and others using synthetic shorts - had a huge impact on returns. 'In general, fund managers do not expect the restrictions to have a significant impact, either because they are already short financials or because they do not want to have significant short positions in this area,' said S&P Fund Services lead analyst Randal Goldsmith."); Polya Lesova, *Netherlands Extends Ban on Short-selling,* MARKETWATCH, Oct. 5, 2008 ("The Netherlands' securities regulator AFM said Sunday that it has extended its ban on short-selling in the shares of financial companies, citing 'persistently exceptional market conditions.' AFM said in a statement that it is taking 'further far-reaching measures against transactions that disturb the trade in securities of financial companies.' The ban on naked short selling announced on Sept. 21 will be replaced by a ban to increase a short position, both covered and naked, in financial companies.").

[111] *See* Murphy, *supra* note 6 ("Some U.K. politicians are calling for the ban on short-selling of financial stocks to be extended by the Financial Services Authority when it expires in two weeks, the Financial Times reported Friday. John McFall, chairman of the Treasury select committee, said the situation hasn't improved enough since the ban was introduced in September, the newspaper reported, citing an interview with the politician.") A better approach was taken by Representative Michael N. Castle of Delaware who issued the following statement in a news release on September 19, 2008. "I am hopeful this new rule will benefit the investment community and bring more stability to the market. I intend to watch the impact, if any, this temporary change will have on the market to see if these changes should be extended further." *Rep. Castle Issues Statement on Security, Exchange Commission Ban on Short Selling*, US FED NEWS (HT Syndication), 2008 WLNR 18424991 (Sept. 19, 2008).

they will not further that purpose.[112] It is important that regulators learn from this mistake and examine any possible unintended consequences that may arise when fundamentally sound economic policies are abandoned under panicked regulation.

[112] *See,* McCormick, *supra* note 104 ("One justification was that the Australian share market was set to be targeted by short sellers/hedge funds. On what basis did the regulator/Government form this view? One fund manager said the idea of a tsunami of hedge fund selling was farcical. And since when has it been appropriate for the Government or regulators to speculate on the likely drivers and direction of our share market and introduce measures that attempt to influence that direction, if only on a short-term basis? In some third-rate developing country perhaps, but Australia? Yes, people are hurting as markets have declined, some share prices have collapsed and businesses have failed. That's what bear markets and financial crises do. But good businesses will survive and prosper. Why beat the messenger? Have there been some manipulation and rumor mongering? Almost certainly, but there are already laws to tackle this (and it occurs on the long and short side). They just need to be better enforced. Improvement in the disclosure of covered short selling is necessary and may make these efforts easier. Investors should realize that over the longer term and across the market, short sellers have minimal impact compared to the buy and sell decisions of long only investors. Covered short sales have to be bought back so the net number of shares bought and sold by their actions over time is zero. I believe redemptions and de-leveraging of long investors, many geared (via margin lending, geared share funds, contracts for difference (CFD) and so on), has been a bigger factor in aggressive selling than short selling.").