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Stocks Under 'Short' Order Fell During Protection Period

By Judith Burns
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WASHINGTON -- A Securities and Exchange Commission emergency order to tighten short sales in 19 sensitive financial stocks appears to have backfired, a study found.

Shares in federal housing-finance titans Fannie Mae and Freddie Mac; Wall Street firms Lehman Brothers Holdings Inc., Goldman Sachs Group Inc. and Merrill Lynch & Co.; and others covered by the order saw declining prices and deteriorating market quality over the course of the 23-day emergency order, according to the study.

Arturo Bris, a finance professor at IMD business school in Lausanne, Switzerland, conducted the study and said the SEC-imposed restraints "contributed to a decline in share prices for the 19 stocks" while the order was in effect, totaling about $60 billion in losses.

SEC Chairman Christopher Cox characterized the order as a precaution against rumor-driven market turmoil, and the SEC had the rule take effect July 21. The order, which expired at 11:59 p.m. EDT Tuesday, required short sellers to borrow or arrange to borrow shares in advance of short sales in the 19 targeted stocks.

Short sellers sell borrowed shares and profit from price declines that allow them to replace shares at a lower price. Naked short sellers don't borrow shares before selling them short, a practice that critics say can lead to punishing stock-price declines.

The study examined the 19 stocks covered by emergency order, comparing their performance before and after the order took effect. It also compared results for the 19 shares against 59 U.S. and 73 non-U.S. financial companies that weren't subject to the emergency order.

Shares covered by the order lost 3.8% of their value compared with their peers' stock between July 21 and Aug. 4, the study concluded, or roughly $60 billion.

Overall, the study found the 19 shares targeted by the order had been sinking over the past six months, and fared "significantly worse" than comparable stocks.

SEC short selling rule made little impact - studies
By Emily Chasan
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NEW YORK, Aug 13 (Reuters) - U.S. regulators' emergency rule to restrict "naked" short selling in 19 major financial stocks had little impact and may have even backfired, two studies of the rule's effects showed on Wednesday.

While overall short selling declined in nearly every firm affected by the rule, many of the 19 stocks still suffered declines in their share prices, the studies showed.

The U.S. Securities and Exchange Commission issued an emergency order last month requiring short sellers to pre-borrow stock in mortgage finance giants Freddie Mac and Fannie Mae and 17 other Wall Street firms, such as Goldman Sachs Group Inc and Citigroup Inc . While the rule expired at 11:59 p.m. on Tuesday, the SEC had billed it as an attempt to crack down on illegal "naked" short selling, that could allow reckless short selling of the stocks.

"While the SEC's intentions may have been good, their attempt to protect price with rule-making was quite flawed and without intended effect," said John Standerfer, Vice President of Financial Services for market data firm S3 Matching Technologies. "The market has its own mind."

An S3 study of market data showed short sells for the 19 stocks dropped by about 63 percent while the rule was in effect, but the firm concluded the rule was "ineffective," saying short selling "did not seem to be a significant factor" in the market's determination of price for the stocks.

Shares of Fannie Mae and Freddie Mac are off more than 20 percent since the protective rule was first announced, despite an almost 5 percent rise in the benchmark Standard & Poor's 500 index <.SPX> in the same period.

Even with the protection, S3 found the number of short sells in shares of Bank of America Corp were often higher while the rule was in effect than they were the day

before the rule was announced. But despite the higher levels of short selling, Bank of America's stock price is up more than 40 percent in the past month.

A separate study from **Arturo Bris**, a finance professor at IMD business school in Lausanne, Switzerland, found that, even controlling for short selling, market efficiency had deteriorated more for the 19 stocks affected by the rule than for other comparable U.S. financial stocks.

Bris found that shares affected by the order lost about 3.8 percent of their value, compared to their peers -- a figure that translates to about a $60 billion loss for the firms' shareholders.

"Our belief is that naked short selling was never a problem with these stocks," said Eric Newman, portfolio manager at long/short fund TFS Capital in West Chester, Pennsylvania.

Indeed, prior to the SEC's rule only one of the 19 stocks, the U.S.-listed shares of Deutsche Bank , had been listed on the New York Stock Exchange's list that tracks stocks with "fails to delivers" -- an indication of naked short selling.

"We think the SEC are going to read into this data that a lot of short sellers exited positions," Newman added. "But we believe a careful look will show was that naked short selling was not ferreted out, but that it was regular legitimate short sellers who were closing their positions." (Additional Reporting by Kristina Cooke)

SHORTSELLING-STUDIES/|LANGEN|ABN|E|RBN|U|D|M|RNP|DNP

COMPANIES - INTERNATIONAL
Short-selling rule backfires
By Joanna Chung in New York
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An emergency rule protecting a select group of 19 financial companies from abusive short-selling has contributed to a decline in their share prices, a study has concluded, raising questions about the rule's effectiveness.

Short-sellers aim to profit from share declines, usually by borrowing a stock, selling it and buying it back after its price has decreased. In "naked" short-selling, the shares are sold without being borrowed first.

The emergency rule - due to expire last night - required investors to borrow the security first and deliver at settlement, but it only applied to shares in 19 financial companies.

It was issued by the US Securities and Exchange Commission last month amid alarm about the health of key financial institutions, including Fannie Mae and Freddie Mac, the government-sponsored mortgage groups, and Lehman Brothers, the investment bank.

However, the "impetus for the SEC's emergency order, that short-selling was adversely affecting the performance of the 19 financial stocks, is groundless", said **Arturo Bris**, professor of finance at IMD Business School in Switzerland, who conducted the study.

"Worse, the order has resulted in a decline in market quality for the emergency order covered securities compared with comparable financial stocks," he said.

"As a consequence, the restraints on short-selling contributed to a decline in share prices for the 19 stocks."

The 19 stocks lost 3.83 per cent in value - or about $60bn - compared with their peers between July 21, when the rule went into effect, and August 4, he added.

Though the 19 shares have performed significantly worse than stocks of their peers this year, "after controlling for short sales, the performance of 19 stocks is still worse than for comparable firms", the study concluded.

Moreover, it said stocks other than the 19 had been shorted more heavily in 2007 and 2008.

The SEC said: "The emergency order's purpose was not to artificially prop up prices or restrict legitimate short sales, but to protect against illegal 'distort and short' schemes that could have threatened fair and orderly markets at the time of the order."

SEC officials, who are developing proposals for rule changes to guard against abusive short-selling in all shares, are still studying the impact of the emergency rule.

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An SEC campaign backfires

NOT all short lists are worth being on. The Securities and Exchange Commission (SEC) announced rules on July 15th to restrict short-selling of 19 financial stocks. Many suspected that America's market regulator wanted to resuscitate the shares of these firms, especially those of Lehman Brothers, an investment bank, and Fannie Mae and Freddie Mac, two quasi-official mortgage agencies. The temporary regime, which expired on August 12th, banned naked short-selling--the sale of shares one has not yet borrowed. The SEC also indulged in some blood-curdling rhetoric against market "manipulation". From a simplistic perspective, its actions worked. The market value of the nine American companies on the list rose by 30%, after adjusting for capital raisings.

Yet on closer examination the picture is very different. The 19 stocks have not outperformed their peers. Nor did the SEC's action result in hordes of dishonest short-sellers scurrying to cover their positions by buying shares. Far from it. As the chart shows, for the nine American firms on the list, aggregate short positions fell only slightly: from 4.5% of shares outstanding on July 15th to 4.3% on July 31st. (For the market overall, short positions represent about 5% of shares outstanding). The net change represented an insignificant part of trading activity in these stocks over the 17-day period.

The SEC's action was not only pointless; it may have had a perverse impact. **Arturo Bris**, a professor at IMD Business School in Switzerland, points out that the 19 stocks had higher risk profiles than their peers, so should have bounced back more strongly than they did. He also reckons trading in the 19 stocks became less efficient. Their prices took longer to react to bad news than other firms', perhaps reflecting the red tape that short-sellers faced under the regime.

The SEC has promised a post mortem of its experiment. At this stage the conclusion looks pretty clear: the regulator picked the wrong target.

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Bank Stocks vs. Shorts: SEC's Clout Seen As Limited

Emma Trincal, Senior Financial Correspondent
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NEW YORK (HedgeWorld.com)—The controversy around short-selling and its impact on financial stocks is mounting on the Street amid the lift Tuesday night [Aug. 12] of the Securities and Exchange Commission's temporary order put in place last month to curb naked short-selling.

To begin with, the rule was unpopular among many market participants, including short-sellers and hedge funds that have placed selling bets against financial institutions. As the SEC lifted its ban, the debate continued. For some, the ban worked in stabilizing the financial sector. For others, the government's impact on financial share prices is highly questionable or at the very least, impossible to substantiate.

On July 21, as bank share prices were battered by investors, the SEC imposed a temporary order that forced traders to borrow shares of some large financial stocks prior to selling them. The government put together a list of 19 financial institutions whose shares it was eager to protect. The rationale was that short-sellers manipulated the market by betting against the stocks of large financial institutions, which posed a systemic risk. The 19 companies covered by the rule included primary dealers as well as Fannie Mae and Freddie Mac .

SEC Order Had Its Backers

Supporters of the SEC temporary order who believe it helped financials over the past three weeks have one solid argument on hand. During its 23-days of enforcement, U.S. bank stocks rallied significantly. From July 21 to Aug. 12, the S&P Banking Index surged by 79% to 185 from 171.43. The theory works both ways, proponents of the rule said, citing the fact that prices fell again suddenly when the order expired. On the first trading day that followed the lift of the SEC temporary rule—that is Wednesday [Aug. 13], shares of Fannie Mae fell more than 4%. Investment banks suffered too. Two of the icons of the banking industry— Goldman Sachs Group Inc. and JP Morgan Chase & Co.— as well as Lehman Brothers Holdings Inc saw their share prices fall on that day as well. On Wednesday alone, the S&P Banking Index dropped by 36% from 185 to 178.35.

In a research note titled "Wake Up, Mr. SEC," financial stock analyst Dick Bove of Ladenburg Thalman put it bluntly. "On Tuesday night the SEC strictures on trading 19 financial stocks were lifted. The anecdotal data I am receiving suggests that shorting these companies was resumed with a vengeance." That is the same as saying that banking stocks enjoyed a short respite courtesy of the SEC, one that perhaps was too short.

For a long time, a popular hedge fund trade had investors buy energy stocks while shorting financials. "When the SEC controls were put in place, the positions were reversed allowing the financials to recover in price and forcing the utilities to fall back," Mr. Bove wrote.

Mr. Bove also noted that on Wednesday [Aug. 13] positions may have reversed again, urging the SEC to study the impact of its forced rule to financial stock prices. While he admitted that shorting stocks was a "valuable technique" for investors as it "provides liquidity to the markets," Mr. Bove called for the SEC to do a better job at tracking "fails to deliver." In other words, Mr. Bove blamed the SEC for not adequately monitoring naked short selling.

In a naked short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a "failure to deliver" or "fail," according to the SEC website.

Naked short-selling is not a violation of the SEC rules so long as the seller locates the shares prior to selling them. The temporary order was seen as a measure aiming to limit what the SEC perceived as the "market manipulation" impact of abusive naked-short selling practices.

Mr. Bove urged the SEC to better enforce its own naked short-selling regulations. One of his points was that naked shorting allowed investors to create synthetic stock in a company without a registration statement. Arguing that investors in this process are "allowed to do something that companies are not allowed to do," Mr. Bove wrote: "It should be disallowed, if the SEC cared. It would be easy to stop the process. All the SEC has to do is to track ‘fails to deliver.'"

For The Shorts, Fundamentals Are Bad For Financials

Obviously many disagree with this tough take on short-selling. For the shorts, the SEC has little to do with the health of financial stocks seen as falling for fundamental reasons. Additionally, the temporary rule had little if no impact at all on the volatile evolution of the energy/financials paired trade over the past three weeks.

To be sure, financial shares dropped on Wednesday due to renewed fears concerning the credit cycle and the economy, notably concerns over the economy.

A Greenwich Associates survey released Wednesday revealed that investors, especially hedge funds, are deeply worried about the financial health of global investment banks .

According to this study, pessimism is rampant among financial institutions after the collapse of Bear Stearns Cos. Inc. in March. Greenwich found that 60% of the institutional investors it polled now expect another major financial services firm to collapse within six months. Hedge fund managers were the most pessimistic of all respondents, according to the study.

This pessimism is fueled by the aggravation of the credit crisis. Banks continue to add more write-downs and there appears to be no end in sight to the housing slump. Meanwhile Europe is now at risk of a recession, which explains the recent rally of the dollar against the euro. And the fundamentals of some large financial firms remain gloomy. Despite the passing by Congress of rescue legislation to support the two endangered government-sponsored mortgage entities— Fannie and Freddie—both mortgage giants continue to be undercapitalized and vulnerable to mortgage loan delinquencies. Fannie reported a second quarter net loss of $2.3 billion compared to a $1.9 billion loss a year before.

Goldman Sachs is now under attack by two of the most respected analysts on the Street, who several months ago had correctly predicted serious problems at Citigroup Inc. Both Meredith Whitney, analyst at Oppenheimer & Co., and Mike Mayo, her counterpart at Deutsche Bank AG on Wednesday lowered their third-quarter profit estimates for Goldman citing revenue decreases in underwriting and investment-banking. Goldman's share price fell by 6% on that day as a result of those reports, a significant move if one considers that Goldman has so far gone through the credit crisis without too much pain.

A second argument proposed by those who believe that the SEC had little impact on financial share prices is macroeconomic. The temporary order played out coincidentally at a time that combined falling oil prices and a dollar rally. Many said that falling oil prices are the real reason that incited traders and hedge funds to reverse their trade—as they began to short energy and go long financials.

Such argument however did not hold on Wednesday, as financial stocks gained again—the Standard & Poor's 500 Financials Index closed up 3.45%—and oil continued to slide, to $115 per barrel. The rally was spurred by a trade association announcement: The Securities Industry and Financial Markets Association announced that Fannie and Freddie would be allowed to finance larger loans.

From crude oil prices to regulatory support for the U.S. mortgage engine, there is little evidence that the recent actions of the SEC have had any significant market impact. Banks are in a perfect storm and many different variables contribute to push up or down their share prices, without taking into account a recent enactment followed by a pull-back of a government action on short sales. Things may be different if the SEC undertook more radical actions such as reenacting the uptick rule, for instance. But so many people

oppose the idea of putting back the old rule, which was lifted last summer, in the dawn of the subprime crisis, that this option remains unlikely.

Academia could perhaps provide evidence regarding the relationship between a very unpopular and short-lived SEC rule and banking share prices during the rule's 23 day-length. The SEC wanted to stabilize the markets and protect banks from the assault of short-sellers. Did it work?

Arturo Bris, professor of finance at Geneva-based business school IMD and an associate with the Yale International Center of Finance, said that it did not. In a report released on Wednesday, Mr. Bris made a clear case: The bad stock performance of the 19 stocks listed by the SEC had nothing to do with short-selling activities.

"Our preliminary findings show that the impetus for the SEC's emergency order—that short-selling was adversely affecting the performance of the 19 financial stocks—is groundless," he wrote. Comparing prices between what he calls "G19"—or the 19 financial stocks protected by the SEC order and other financial stocks—which he called "non-G19", Mr. Bris said that non-G19 stocks have been shorted more heavily both in 2007 and 2008 than G19 stocks.

Mr. Bris wrote that even during the term of the SEC temporary order, which aimed to control short sales, the performance of G19 stocks was still "worse" than for comparable firms. "The efficiency of G19 stocks has also deteriorated more than the efficiency of comparable U.S. financial stocks," Mr. Bris added in his report.

If this is true, opponents and supporters of short-selling could at least agree on one point: The SEC when enacting and removing its temporary order merely did some political posturing.

LawandReg

Doubt cast on short-sale limits

by Donna Block and Ron Orol

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An emergency order that went into effect July 21 made it more difficult to bet against 19 of the largest financial stocks trading in the U.S., but there are divergent views on the order's effectiveness and whether it is to blame for Wednesday, Aug. 13's stock drop.

Most market watchers agree that short sales were curtailed and the market stabilized somewhat during the 23 days the emergency limits were in place. But others noted that shares in federal mortgage giants the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corp., or Freddie Mac, and the other 17 institutions covered by the order did not fare very well.

Questions about the temporary shorting limits' effectiveness muddy the debate over the need for permanent new limits on short selling. The Securities and Exchange Commission is drafting proposed rules that could, among other things, limit "naked" shorting by preventing brokerage firms from lending the same shares to multiple short sellers. Naked shorting is believed to fuel unjustified downward pressure on a stock because it allows short positions to grow much larger than the number of shares available to cover them.

The additional rules are being considered because of indications that speculators are colluding to drive down the prices of financial firms facing short-term credit problems. In the meantime, the SEC and the New York Stock Exchange announced Wednesday they will cooperate to monitor insider trading, another move aimed at preventing short sellers from acting in concert to drive down a company's shares. That action was prompted by revelations that some traders were spreading negative rumors about companies with the intent of pushing their share prices down. The SEC is proposing to centralize stock exchange monitoring, investigation and enforcement of insider trading cases, though regulatory observers argue that the move would be a small step toward detecting trading violations.

NYSE Regulation Inc. and the Financial Industry Regulatory Authority Inc., or Finra, would have central control over any insider trading examinations for a number of stock exchanges including American Stock Exchange, Boston Stock Exchange and the Chicago Stock Exchange.

The rule, if adopted, would end the existing regime where each exchange is responsible for combating insider trading within its own market. Under the new regime, NYSE Regulation would be responsible for NYSE and NYSE Arca listed securities, and Finra would focus on Nasdaq, Amex and Chicago Stock Exchange securities.

John Coffee, a Columbia Law School professor, said he doesn't believe the rule would make a major contribution to fighting inside traders. Nevertheless, he predicted it would be a small step forward because other participating stock exchanges would have the benefit of proprietary computers owned by the NYSE and Finra that are programmed to identify insider trading trends. "The computer monitors trading data, and it kicks out an alarm if it identifies insider trading trends," Coffee said. "But I don't expect that you can expect that much expertise or commitment from the relatively small regional exchanges."

John Sturc, a partner at Gibson, Dunn & Crutcher LLP in Washington, agrees that it is a small but rational step. "Getting more data into those computers could be helpful," Sturc said.

The data collaboration is the latest step in creating an investigative partnership that works within a system where securities are traded on multiple exchanges. Sturc noted that years ago the SEC required each security to be traded on a single exchange, making surveillance easier. Multiple listings were permitted to give investors better prices. "This is the SEC catching up its insider trading rules with the multiple-trading regime," Sturc said.

As for short selling limits, a new study concluded that even the temporary order served no purpose. **Arturo Bris**, a finance professor at IMD business school in Lausanne, Switzerland, and an associate with the Yale International Center for Finance, conducted a study on the 19 companies covered by the SEC's temporary shorting limits. "The impetus for the SEC's emergency order — that short selling was adversely affecting the performance of the 19 financial stocks — is groundless," he said.

Even worse, Bris added, the order may have reduced liquidity for the covered financial stocks and consequently may have contributed to the decline in their share prices while it was in effect. The restrictions "resulted in a decline in market quality for the EO [emergency order]-covered securities compared to comparable financial stocks."

Coffee said if the SEC extends the temporary short-selling rule to the broader market it would drive short sellers to migrate to other trading strategies that could also drive a company stock down, including single stock futures, the options market and cash settled equity securities, also known as total return swaps. "I'm not saying it's a complete substitution but people who want to avoid preborrowing stock might be able to achieve these things through these other means."

Nevertheless, the SEC plans to consider new rules meant to provide additional protections against abusive naked short selling in the broader market. The SEC "will continue exploring other remedies for the broader marketplace to further protect investors from 'distort and short' artists," SEC Chairman Christopher Cox said in a statement issued July 29, when the order was extended.

That prospect has raised concern among advocates for hedge funds and private equity companies, which protested against the SEC's extension of its order. Jim Chanos, chairman of the Coalition of Private Investment Companies, argued that restrictions on short sales undermine the integrity of prices because they remove liquidity and healthy skepticism from the marketplace.

Others noted that short selling is a form of speculation no less legitimate than going long or buying a stock outright. "By blocking short sellers, you are adversely impacting liquidity and impeding a stock's price from reaching market equilibrium," said Perrie Weiner, a partner and international co-chairman of securities litigation at DLA Piper US LLP. "Short sellers don't make a stock worth less than it otherwise should be," he said.

But advocates for smaller banks and investment firms have been urging the SEC to expand the ban on naked short selling to cover other hard-hit financial companies. The

American Bankers Association expressed concern for its members in a letter to the SEC, noting banks not on the select list could be vulnerable.

Some of the options for the rule reportedly being debated involve imposing fines on people who fail to deliver borrowed shares within the mandatory three-day period. Another is a price test limiting short selling during specific situations and also the reporting of short positions in the same way that holders of 5% must report their holdings to the SEC.

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