Albert "Pete" Kyle
Charles E. Smith Professor of Finance
Robert H. Smith School of Business
University of Maryland

Owen Lamont
Professor of Finance
Yale School of Management
Portfolio Manager DKR Fusion

George Sofianos
Vice President, Equity Execution Strategies
Goldman Sachs & Co.

Bruce N. Lehmann
Professor of Economics and Finance
Graduate School of International Relations
and Pacific Studies
University of California at San Diego

Richard Lindsey
President, Bear Stearns Securities Corp.

C O N T E N T S

The Commission seeks evidence of the impact of short sale price tests on factors such as liquidity, market volatility, price efficiency and manipulation. Now let's turn it over to the economists who did the studies.

MS. EDWARDS: Okay. As Chairman Cox mentioned, our first speaker will be Charles Jones. And I'd just like to announce to our listeners on the web cast that you can download the slides of the presentations today. I'm not sure if they're available at this moment, but they should be available sometime today.

PRESENTATION BY CHARLES JONES

MR. JONES: Thank you very much, Amy. I want to start out by opening the discussion by helping us understand the historical context by which we came to the current regulatory environment.

So in particular we want to look at three discrete events from the 1930s, the initial prohibition of short sales on downticks, which happened in 1931; a 1932 requirement that brokers get written permission to lend a investor's shares so that they can be shorted; and, finally, the 1938 strict uptick rule that was introduced by the SEC.

So we want to look at various characteristics of the markets before and after these regulations changed in an effort to determine the effect of the regulations. I'll be looking at returns, volatility and also liquidity.

To give you a little context we need to go back and think about what shorting was like prior to the Great Depression. Shorting in the 1920s was largely unencumbered. It was very popular among professional traders in the U.S.

The various markets, the lending market was very highly developed with very little regulatory oversight or restrictions. For instance, there was no uptick rule in the 1920s. There was no formal requirement to locate shares to deliver before short selling.

There were no minimum margins set by any sort of central government authority. There were margins set by the exchange or by the broker, but they were done by the Self-Regulatory Organization, by the exchange, by the NYSE or by the broker who was responsible for the account.

For instance, near the close each day NYSE members would gather around what was known as the loan crowd or the loan post in order to borrow and lend shares for delivery into short sale positions, and this centralized market was probably a great thing. It probably reduced search costs for those people who were looking for shares to borrow in order to short sell.

Well, of course, after the crash of 1929, things changed dramatically and quite quickly. We saw dramatic reductions in stock prices beginning in 1929 and extending all the way through 1932.

So there was huge pressure to ban short selling entirely. There were laws introduced in Congress. Short sellers were blamed very much as portfolio insurers were blamed for the 1987 crash. Short sellers were the scapegoat in 1929 and 1930.

So for instance, in 1930, there was political pressure to rein in or ban shorting. Holders were urged not to lend their shares out to short sellers.

In September of 1931, there was a two-day ban on short sales on the New York Stock Exchange when England went off the gold standard. And then, in October of 1931, all short sales were prohibited if they were below the last sale price. So that was our very first tick rule.

Then there were some additional prohibitions after that. In 1932, the U.S. Senate released a hall of shame listing all of the largest short sellers in an effort to, sort of, shame them into not taking those short positions.

And then finally, after 1938, after the market had come back for a while but after another small decline, the SEC imposed an uptick rule that was actually much more severe than the rule that's in existence now.

Let me say a couple of words about the event in 1932 where the NYSE changed its rules to require that investors give written permission to hypothecate their shares or to lend their shares out to a short seller.

I put little asterisks by that, because I want to come back to that and talk a little bit about what we may mean by liquidity.

Okay. To get to my caveats, the starting point is statistical power. How can we really tell that what we see in the data was unusual? Market conditions at this time was very, very volatile. It weakens the statistical power of the test.

Charles showed you the chart with the biggest all time increase in the Dow Jones Industrial Average, 14 percent, October 6, 1931. The day before was the fourth big biggest decline in the history of the Dow, the first 10 percent decline since the events of October of 1929.

It was a then record low for the Dow Jones Railroad Index, which became transports, and close to a record low for the Dow itself.

Economists have a way to deal with these types of clustered periods of high volatility. We call it auto regressive conditional heteroskedasticity, and we're not going to say any more about it today. Suffice it to say it makes it hard to tell whether the events are abnormal or not.

The second caveat is whether these effects persist. A benchmark for this might be decimalization. We went to penny trading five years ago. Spreads are still pretty close to a penny in most liquid stocks.

Motivation 2 was are these stocks subject to bear raids? Overall returns aren't showing that they are. The returns of the pilot stocks are exactly the same as the returns of the control stocks.

According to this study there is no reason to think that bear raids are more prominent in these SHO pilot stocks where short selling is unrestricted in the sense of the price tests.

What about volume? Short volume. There's no difference in short volume on either exchange, Nasdaq or NYSE, but if you dig into it a little bit deeper what you see is that NYSE volume starts to take a different form.

This is something that was pointed out by Gordon, that NYSE volume takes the form of more frequent, smaller trades. So trades were bundled up more frequently than they were -- more frequently in May than they were in April.

Volatility, no differences in this particular study. Of course, that's in contrast with Diether, Lee & Werner.

Overall, Motivation 1 of SEC's study was to say short selling unfettered in advancing markets in particular? The volume results here show that there's absolutely no difference. In terms of volume of short selling there's no difference between advancing markets and -- there's no different between pilot stocks and control stocks.

MS. EDWARDS: Okay. Thank you. It's about time to break for lunch. We'd like to thank our authors and discussants again for taking the time to share their research and opinions here today. We'll break for lunch now and reconvene at 1 o'clock for the afternoon panel.

(Whereupon, at 12:05 p.m., a luncheon recess was taken.)

S E S S I O N T W O

MR. COLBY: Welcome again all the esteemed scholars that have joined us today to discuss Reg SHO. The papers presented this morning reflect thoughtful and careful examination of the short sell price tests and the pilot data, and we really thank the authors for their efforts.

We expect the pilot results will help assist the Commission in determining whether further revisions of the current short sale regulatory landscape are in order.

This afternoon we ask the panelists for their opinions on how the Commission should use this empirical evidence. For example, should the Commission eliminate commission mandated price tests for all securities or for some securities?

Are the concerns articulated by the Commission when it adopted Rule 10a-1; namely, prohibiting short selling from being used to drive down a market or accelerate a declining market, are these still a concern today?