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SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 274

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Statement of the Shadow Financial Regulatory Committee on

Reinstatement of Short-Sale Restrictions

May 4, 2009

The Securities and Exchange Commission (SEC) is proposing to reinstate short-sale restrictions to restore “investor confidence.” The SEC had previously eliminated all short-sale price restrictions on July 3, 2007, including prohibiting any self-regulatory organization from imposing restrictions such as the “tick” test. This action was based upon a well-designed statistical analysis demonstrating that restrictions on short selling produced little benefit.

In the rule-making process that led to its 2007 removal of short-sale price restrictions, the SEC staff carried out a study in which short-selling restrictions were removed for one-third of the Russell 3000 universe. This rule change was made known to the public. Both the Commission’s staff and highly-regarded outside economists used data from this lengthy natural experiment to evaluate the impact of removing short-sale pricing restrictions. These studies did not find evidence that the pricing restrictions reduced short interest, but did conclude that the pricing restrictions distorted the trading process. Similar results were obtained in a subsequent academic study that compared the impact of the eventual complete removal of the pricing restrictions to the effect experienced during the natural experiment. Many observers considered the use of economic analysis in that rule-making as a model for securities regulation.

In its recent proposal the SEC acknowledges the value of short selling in enhancing market liquidity and price efficiency. The proposal even recognizes that short-sale pricing restrictions can increase the costs and lessen the benefits of short selling. The undocumented assumption underlying the SEC's current proposal is that reinstatement of pricing restrictions would reverse the decline in investor confidence in the volatile marketplace of today. While there is a reference in the proposal to short-sale pricing restrictions potentially making bear raids more difficult, there is no analysis of the tradeoff between the reduction in market efficiency that result from making short sales more costly and the hypothetical cost imposed by bear raids.

Of course, there are a variety of fundamental causes for the recent decline in stock prices including the recession, solvency challenges facing a number of financial institutions, declines in corporate earnings, the deleveraging of financial institutions and the economic concerns expressed by the current and prior Administrations and federal regulators. The tangible benefit that would derive from reimposing pricing restrictions on short sales is not clearly identified.

In an unusual step, the Commission's formal proposal includes five alternatives, including the reinstatement of the up-tick rule. The other four alternatives (a "bid" test and three variations of a circuit breaker to initiate short-sale pricing restrictions) are less onerous than the imposition of up-tick pricing restrictions. This suggests that the Commission is struggling with the issue of imposing price restrictions.

The Shadow Committee is convinced that short selling is important to the vitality of our capital markets and has previously expressed concerns about regulatory actions related to short sales during the market crisis (e.g., Statement No. 261, September 15, 2008). In late September 2008, the Commission banned short sales on about 900 financial institutions, an action that the then Chairman of the Commission subsequently characterized as the biggest mistake that the SEC made during the financial crisis.

Securities regulations should not be based upon perceptions or political pressure, especially in a context where—as in this case—the regulator's action was based on careful economic analysis.