July 6, 2009

To:

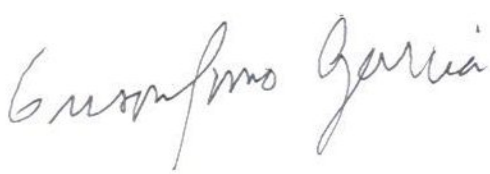
US Securities and Exchange Division, Rules
Department of the Treasury, Economics
Honorable House of Representatives Barney Frank
National Economic Council
White House Counsel Christina D. Romer
New York Times, Opinions Editorial
Business Week, Editorial
CNN Money Magazine, Editorial
The Journal of Investing Editor, Brian Bruce

Sirs/Madames:

Below, please find a copy of “Short selling is toxic for the stock market”, an opinion piece based on my technical paper in the latest volume of the Journal of Investing, “A simple model for the study of short selling", June, 2009. (**http://www.iijournals.com/toc/joi/18/2**)

In the opinion piece, I argue why I strongly believe that short sellers do not belong to the stock market, and why they should be relegated to the derivatives market.

Sincerely,



C. B. Garcia
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Short selling is toxic for the stock market

by

C. B. Garcia

author of "A simple model for the study of short selling", Journal of Investing, June, 2009.

Warren Buffett astutely warned that financial derivatives are "financial weapons of mass destruction" that can push companies onto a "spiral that can only lead to a financial meltdown". What he left unsaid is that short selling is even more destructive. Whereas derivatives are traded in a separate market, short selling is made in the stock exchange itself, trading with unwitting long-term buyers.

Brokers and money managers lend stock

The average investing public is not aware of the practice of short selling. Owning stocks is different from owning a home, car, or other material goods. The owner of the home or car has the sole right to sell such goods. With stocks, a shareholder does not have this "right of exclusivity." Unbeknownst to the shareholder, his stock can be borrowed and sold by a speculator whose intent is to buy the stock back at a reduced price.

Why would a typical owner lend his stock to someone who would want to bring his stock down? Unfortunately, brokers and money managers can lend his stock without his consent. Money managers get a fee for lending stock. Brokers hold the cash proceeds from the short sale without paying interest (unless the owner is a big player). Furthermore, brokers demand a margin deposit from the short seller, paying little or no interest. Lending stocks to short sellers is a lucrative business for brokers.

Short selling brings the stock price down

With short sellers in the market, the supply of stocks for sale increases tremendously, and Economics 101 teaches that an increase in supply brings prices down. The lower price hurts owners holding on or selling the stock. Additionally, it hurts the company that issues the stock, because the lower market capitalization discourages new investors from buying the stock, and banks from lending to the company.

Short selling increases liquidity

Liquidity definitely increases since there are more buyers and sellers in a market where shorting is allowed. The new buyers are those unwilling to pay the higher "no-shorting" market price. In a no-shorting market, their buying orders will not be filled. The new sellers are the price-downward-wishing short sellers who crowd out the owners selling stock. As a result, fewer owners are able to sell. (Note that investors who want to hedge their long positions buy contracts in the derivatives market, not sell short in the stock market.)

Short selling increases volatility

Without short sellers, the number of potential sellers is always the same, which is the number of stocks outstanding. With short sellers going in and out of their positions, such as in the first and last hours of the trading day, the supply curve may violently fluctuate, causing stock volatility. This discourages long-term investors from buying or holding the stock.

Is short selling an efficient price discovery mechanism?

It is often argued that short selling is an efficient price discovery mechanism. However, this argument discounts data that there are more than enough long-term buyers and sellers able to discover the rational price in a no-shorting market. In fact, without short sellers, one only needs to find that one buyer willing to pay the rational price. With short sellers and owners looking for buyers, the stock price may drop to less than the rational price. This drop may be heightened in this current recession, when investors are extremely risk-averse.

Short selling may encourage wild incentives

Aside from bringing the stock price down, short selling may lure the greedy with wild incentives. If a big investor sells short millions of shares of a stock, he may have an incentive to bankrupt the company. He can take control of the company and fire competent managers.

In the unregulated credit default swap market, AIG sold trillions of dollars of "insurance". Institutional buyers and sellers did not care about the contracts defaulting, because their compensation and bonuses were tied to the short-term profits of the firm. In the long term, they will be gone, and shareholders will be left holding the bag. Lack of regulation allowed entry of fraudulent short sellers whose intent was to default on the short sale.

No short selling in the stock market

The stock market should be left to owners selling their stock and to buyers prepared to hold the stock for the long term. The supply and demand from these buyers and sellers would provide ample liquidity in the stock market. Imposing rules such as the uptick rule (where one can short sell only if the last trade is higher than the second-to-last trade), or a rule requiring custodians not to lend stock without its owner’s agreement, may help slow down the short sellers. But short sellers do not belong in the stock market. They should be relegated to the options and futures market, where they can seek buyers willing to hold short-term contracts instead of stocks. These weekly, monthly or quarterly derivative contracts are for short-term speculators. Arbitraguers will make sure that prices in the derivative markets will be fair.

No short selling in the stock market will prevent short-selling day traders (who do not need to borrow stocks in order to sell short), market makers and specialists from profiting from a sale without having first invested in the stock.

Short sellers can signal their price discovery in the derivatives market. Leave price discovery in the stock market to long-term buyers and sellers and the analysts. They have a strong incentive for discovering the rational price.

Finally, strong regulation is needed to prevent manipulation of stocks through trading in both the stock and derivative markets. Disclosure should be required of any significant owner of a derivatives contract who wants to trade in the stock market. Such a speculator should be subject to rules of trading, similar to insider trading rules in stock.