SEC to Target Short Sellers

The Securities and Exchange Commission (SEC) made public on April 8 several alternative plans under consideration for regulating the activities of short sellers. Short selling, the inverse of purchasing stock shares in the hope that share prices will rise, consists of borrowing shares, selling them, and then repurchasing them at a later date and returning them to their owner. Short selling is undertaken when a stock is expected to decline in value; a short seller who borrows a thousand dollars worth of stock, sells them, and then repurchases them and returns them to their owner when the stock's value has declined to $500, pockets a profit of $500.00.

Short selling has its risks, like all free-market activity. If the borrowed stock's value rises, the short seller will suffer a loss when forced to repurchase the appreciated stocks and return them to their owner.

Invented by Dutch investors in the 1600s, short selling acts as a natural counterpoise against the kind of heedless speculation that causes investors to overvalue stock. But because the process of short-selling is poorly understood by the general public, short sellers are easy political targets in times of market distress. Short selling has been restricted in various countries during recessionary times. FDR and the newly minted SEC imposed a slew of onerous regulations on short-sellers during the Great Depression, some of which, most notably the "uptick rule," were allowed to persist into the very recent past.

{modulepos inner_text_ad}

The "uptick rule," which prohibits short sellers from taking action until a stock has risen at least one penny above its previous price, supposedly prevents short-selling from turning into a feeding frenzy that drives stock values below rational levels. In reality, "rational" pricing is whatever market activity warrants; government powers like the "uptick rule," quite aside from being constitutionally illegitimate, are based on the fanciful notion that government has the omniscience and the wisdom to determine what just price levels should be.

In reality, SEC and other government regulators of financial activities take no risks themselves, and consequently have no moral authority to impose their judgments on the legitimacy of market activities of those who do. Unfortunately, the federal government has never allowed itself to be distracted on moral grounds from its alleged duty to instruct the rest of us in the error in our ways.

So it is proving to be with the SEC and short sellers. Restoring the "uptick rule," which was finally jettisoned in 2007, is one option up for public comment. Another is forcing short sellers to sell their shares for more than the going market rate if the stock's value falls by 10 percent or more. Still another is what is being called the "upbid rule," which would allow short sellers to acquire their shares only at a price higher than the current share price.

All such measures are intended to punish a perfectly legal activity that ought to operate without government restraint. But so deeply ingrained has the hatred for the free market become that, absent a strong and principled public outcry, the SEC will likely adopt one or more of the proposed measures and throw yet another spanner in the workings of the free market.