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Selling stocks short: Ever controversial

Selling securities short has been a controversial practice as long as financial markets have existed, and the recent financial crisis brought short selling to the fore yet again. In the last week, a bill to impose new restrictions on short selling was introduced.

And earlier this month in its inaugural conference, the Atlanta Fed's new Center for Financial Innovation and Stability (CenFIS) provided a forum for discussing the topic of short selling.

Why does short selling have such a bad reputation? Financial economists generally have a positive view of short selling because short sellers take positions with risk of loss based on their view of a firm's prospects. Some others, though, generally do not take such a benign view of short selling.

Attitudes toward short selling reflect views about speculation. As Stuart Banner notes, a common historical view was that "[s]peculation was both productive and wasteful; it satisfied an evident demand, but its practitioners added no value to the community" (Banner 1998, p. 23). Banning short selling also has a long history. In the United Kingdom, "An act to prevent the infamous practice of stock-jobbing" was passed in 1734, an effort that attempted to ban short selling and was not repealed until 1860. In the United States, contracts to sell stock not owned at the time of sale were unenforceable in New York courts from 1792 to 1858.

Possibly short selling has a bad reputation partly because of its association with "bear raids." A bear raid is a set of trades in which a stock is sold short at a high price, negative rumors are spread to cause the price to fall, and then the short sales are covered by purchasing the stock at the lower price. Some discussions of bear raids suggest that buying stock on the way back up is a way of adding to the raider's profits from manipulating the stock price.

Bear raids are similar to speculators' manipulation of foreign exchange (Friedman 1953). Both are based on attempts to move a financial market price independent of any underlying development. Successful instances of bear raids and exchange-rate manipulation are similar in another way: They are far less frequent than complaints about them.

Selling securities short has a long and controversial history. While it's not clear whether proposed legislation on short selling will be enacted, it's a good bet that short selling's risks and benefits will be debated for quite some time.

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References

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Friedman, Milton. 1953. "The Case for Flexible Exchange Rates." In *Essays in Positive Economics*, pp. 157-203. Chicago: University of Chicago Press.