



## **STOP MARKET MANIPULATORS**

**But don't blame short sellers for market panics!**

By Professors Arturo Bris and Salvatore Cantale - August 2011

IMD

Chemin de Bellerive 23  
PO Box 915,  
CH-1001 Lausanne  
Switzerland



Tel: +41 21 618 01 11  
Fax: +41 21 618 07 07  
info@imd.ch  
<http://www.imd.org>

Copyright © 2006-2011 IMD - International Institute for Management Development. All rights, including copyright, pertaining to the content of this website/publication/document are owned or controlled for these purposes by IMD, except when expressly stated otherwise. None of the materials provided on/in this website/publication/document may be used, reproduced or transmitted, in whole or in part, in any form or by any means, electronic or mechanical, including photocopying, recording or the use of any information storage and retrieval system, without permission in writing from IMD. To request such permission and for further inquiries, please contact IMD at [pressroom@imd.ch](mailto:pressroom@imd.ch). Where it is stated that copyright to any part of the IMD website/publication/document is held by a third party, requests for permission to copy, modify, translate, publish or otherwise make available such part must be addressed directly to the third party concerned.

Emergency decisions from Belgium, France, Italy and Spain to impose temporary bans on short selling of financial stocks show that governments who have forgotten history are doomed to repeat mistakes. As it happened in the summer of 2008, regulators have once again abandoned evidence-based rulemaking and cost/benefit analyses, and are rationalizing their decisions based on urgency and a populist agenda.

The bans on short selling are votes of no confidence in the financial markets. Ironically, these are the same markets that the regulators forcing the bans are charged to ensure run smoothly and efficiently.

Last week ended with the downgrade of US debt by Standard and Poors which, even though it conveyed no new information at all, triggered a market panic. This week, as a result, we see extreme volatility in global equity markets amid mounting evidence of a severe economic retreat. And the conditions have led to an extraordinary announcement by the Federal Reserve to lock in historically low interest rates until mid-2013 and the discomfiting news that France may also be downgraded.

Recently, the European Securities and Markets Authority (ESMA) deplored rumors they said caused EU stocks to suffer abhorrent swings in prices. Like cops on the beat, we agree the ESMA should aggressively track down any incidence of market manipulation and be expeditious and harsh in their punishment to demonstrate zero tolerance. But trading "*used in combination with spreading false market rumours*" is not clearly abusive, as the ESMA states, it is a crime!

It would not make sense that, in order to prevent traffic jams, authorities allowed cars to go only in one direction on all lanes of a highway. Instead, the obligation of the police is to ensure that lanes in both directions run smoothly and abide by the rules. The police wouldn't shut down the highway, yet European regulators are preventing market panics by shutting down the market.

The rally in French banks on rumors, ironic enough, that a short selling ban was coming was arsenal to summarily dismiss the disparaging academics who have argued during the last three years against those bans. That bounce, though, as the experience with the 2008 bans shows, will likely be short lived.

Research, including our own, shows that past short selling constraints, however temporary, led to an evaporation in liquidity, wider spreads (the difference between the "bid" and the "ask"), reduced trading volume, higher volatility and limited price discovery—all hallmarks of market quality for investors. Researchers Alessandro Beber and Marco Pagano concluded that the measures "*failed to support stock prices, except possibly for US financial stocks.*"

Lehman Brothers illustrates the case. CEO Richard Fuld blasted short sellers for his stock's collapse. Alas, there is no evidence to support Fuld's claims. An analysis of short selling activity shows that short transactions dropped considerably before the steep descent of the stock price. Second, short sellers traded on Lehman stock after, not before, the sudden price drops in the days around September 9, 2008. When a bank-appointed examiner examined why Lehman went bankrupt, he stressed the "materially misleading" accounting gimmicks used to hide the true state of the bank's finances. "Unbeknownst to the investing public, rating agencies, government regulators, and Lehman's board of directors, Lehman reverse engineered the firm's net leverage ratio for public consumption," the report concluded. They were the market manipulators.

So what are we to make of short selling in the context of difficult times for financial markets and the global economy? Markets need a vigorous "tug of war" between sceptics and cheerleaders to help investors determine whether a security is a good investment opportunity. Hearing only one side creates an "information asymmetry" that feeds into the behavioral biases that help explain why stock market bubbles happen.

But more importantly, it is time for politicians and regulators to state clearly whether they believe in financial markets or not. If they do not, they need to explain to us how they plan to finance their

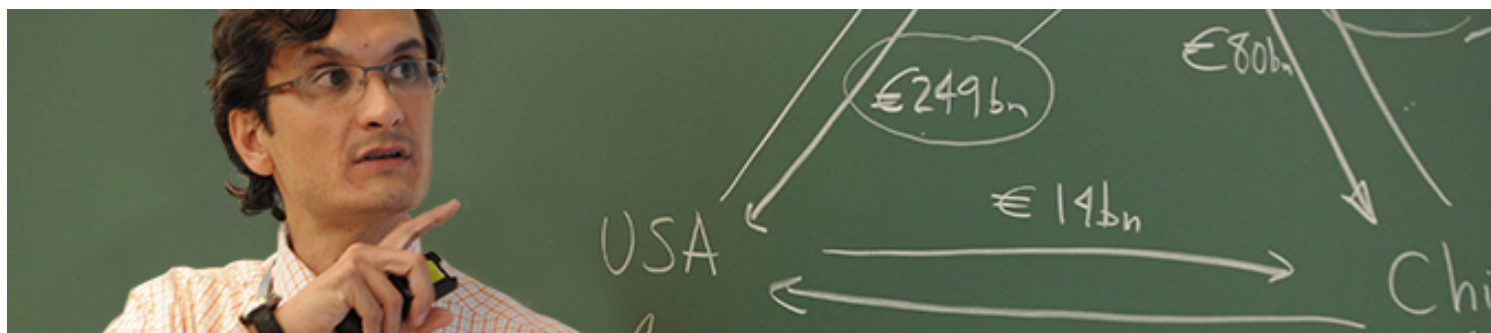
spending without investors. And if they do, then rules are paramount, and the role of financial regulation is to ensure that trading happens smoothly and that rules are respected.

As professors Carmen Reinhart and Kenneth Rogoff have shown us in their history of financial crisis, the road ahead is long, with financial repression part of a process in which leaders swing from one extreme (we need stimulus spending) to the other (budget deficits must be sharply reduced). History provides insights into what governments should do, not the short selling constraints. These are false palliatives that only deepen distrust when trust and confidence, the bedrock of financial markets, must be restored.

Disseminating false information is a punishable offence. Hence the hope is that regulators in Belgium, France, Italy, and Spain will make sure in the coming days that no one will try to prop up the prices of financial stocks with unsubstantial public statements.

*Professor Arturo Bris and Salvatore Cantale are professors of finance at IMD. Arturo Bris is directing the Advanced Strategic Management program (ASM) and Salvatore Cantale is teaching in the Strategic Finance program (SF).*

## **RELATED PROGRAMS**



## **ADVANCED STRATEGIC MANAGEMENT - <http://www.imd.org/asm>**

### **Driving sustainable business results**

Program Director Arturo Bris

- For executives taking on new and significant leadership responsibilities, who are looking to sharpen their analytical skills and strategic leadership effectiveness – as business-unit, region, division, function or country leaders
- Prepare to boost performance at individual, team and business-unit levels
- Ensure that your organization is keeping ahead in a constantly changing business environment



## **BUILDING ON TALENT - <http://www.imd.org/bot>**

### **Developing the next generation of leaders**

Program Director Nikos Tsikriktsis

- Prepare and position yourself for a higher level of responsibility
- Increase your global awareness, business knowledge and capacity to exercise leadership responsibly
- Integrate and apply your learning to your company through a real-life project
- Get ready for IMD's Executive MBA degree