Regulation

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REGULATION was first published in July 1977 "because the extension of regulation is piecemeal, the sources and targets diverse, the language complex and often opaque, and the volume overwhelming." REGULATION is devoted to analyzing the implications of government regulatory policy and its effects on our public and private endeavors.

The Supply of 'Phantom Shares'

In the previous issue of *Regulation* (Spring 2008), two articles were published on the issue of naked short selling and its effect in the marketplace. While there are points I could note on both articles, it bears mention that the first, "The Economics of Naked Short Selling," is based on a flawed understanding of the securities markets.

The authors seem to presume that purchases and sales of stock operate in a vacuum and that trading momentum is not a factor in price discovery. While I agree with the authors that naked short sales can have a detrimental effect on the price of a stock, they state that the demand curve of that stock remains unaffected. This is flatly incorrect. While naked short selling has some legitimate market uses in particular for market makers to stabilize prices, it can also be used to sell more stock than exists in the marketplace. This violates the core principal of supply and demand that our markets are based on and that the authors assume is used in practice.

Naked shorting shifts out the supply curve, dropping the price. The market is no longer expressing its opinion based on the expectations and regulatory constraints of market participants. Without naked shorting, listed shares are fixed in number, which creates price discovery based on a known supply and demand. Naked shorting introduces excess supply through a process that distorts price discovery and for which there is not necessarily a natural buyer of liquidity. Hence, demand for the stock is elastic, not inelastic as the article assumes.

The authors are correct that short selling is borrowing from future buyers. They are incorrect that naked short selling has the same effect.

JOSH GALPER
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The authors respond:

Mr. Galper takes issue with our assumption that naked shorting should not affect the demand curve for the underlying securities. He also takes issue with the result we derive that naked short selling has essentially the same economic impact as permissible short selling. He calls this assumption "flatly incorrect" but provides no argument that supports his criticism. Such an argument would need to demonstrate why naked short selling — a supply impact — causes an impact on the demand curve.

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