

Regulation

EDITOR

Peter Van Doren

MANAGING EDITOR

Thomas A. Firey

DESIGN AND LAYOUT

David Herbeck Design

ARTISTS

Morgan Ballard and Kevin Tuma

CIRCULATION MANAGER

Alan Peterson

EDITORIAL ADVISORY BOARD

CHAIRMAN

William A. Niskanen, *Chairman, Cato Institute*

William A. Fischel, *Professor of Economics, Dartmouth College*

H.E. Frech III, *Professor of Economics, University of California, Santa Barbara*

Richard L. Gordon, *Professor Emeritus of Mineral Economics, Pennsylvania State University*

Robert W. Hahn, *Director, AEI-Brookings Joint Center for Regulatory Studies*

Scott E. Harrington, *Alan B. Miller Professor, Wharton School, University of Pennsylvania*

James J. Heckman, *Henry Schultz Distinguished Service Professor of Economics, University of Chicago*

Joseph P. Kalt, *Ford Foundation Professor of International Political Economy, John F. Kennedy School of Government, Harvard University*

Michael C. Munger, *Professor of Political Science, Duke University*

Robert H. Nelson, *Professor of Public Affairs, University of Maryland*

Sam Peltzman, *Ralph and Dorothy Keller Distinguished Service Professor Emeritus of Economics, University of Chicago*

George L. Priest, *John M. Olin Professor of Law and Economics, Yale Law School*

Paul H. Rubin, *Professor of Economics and Law, Emory University*

Jane S. Shaw, *Executive Vice President, John William Pope Center for Higher Education Policy*

S. Fred Singer, *President, Science and Environmental Policy Project*

Fred Smith Jr., *President, Competitive Enterprise Institute*

Pablo T. Spiller, *Joe Shoong Professor of International Business, University of California, Berkeley*

Richard L. Stroup, *Senior Associate, Property & Environment Research Center, and Professor of Economics, Montana State University*

W. Kip Viscusi, *University Distinguished Professor of Law, Economics, and Management, Vanderbilt University*

Richard Wilson, *Mallinckrodt Professor of Physics, Harvard University*

Clifford Winston, *Senior Fellow in Economic Studies, The Brookings Institution*

Benjamin Zycher, *Senior Fellow, Manhattan Institute for Policy Research*

PUBLISHER

Edward H. Crane, *President, Cato Institute*

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

*Managing Principal
Vodia Group LLC*

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.

CHRISTOPHER L. CULP

CompassLexecon

J. B. HEATON

Bartlit Beck Herman Palenchar

& Scott LLP

**The proposals
before Congress
have long-term
effects on
our nation's
budget — and
potentially
yours.**



WashingtonWatch.com delivers the numbers behind federal legislation in the form that matters most: the price for you and your family.

Let **WashingtonWatch.com** be your starting point for investigating what the government does with your money, and for taking action to control it. Whatever your viewpoint, you will have more power to effect change.

Subscribe to the **WashingtonWatch.com Digest**, free e-mail notice of new legislation — and, most importantly, its price tag.



washingtonwatch.com

the numbers behind proposed legislation and regulation

Southern Economic Journal



SOME RECENT ARTICLES

July 2007

Russell S. Sobel and Todd M. Nesbit

*Automotive Safety Regulation and the Incentive to Drive Recklessly:
Evidence from NASCAR*

Babatunde Buraimo, David Forrest, and Robert Simmons

*Freedom of Entry, Market Size, and Competitive Outcome:
Evidence from English Soccer*

April 2007

Catherine C. Eckel

People Playing Games: The Human Face of Experimental Economies

January 2007

Geoffrey K. Turnbull

*Government Form and Performance:
Fiscal Illusion and Administrative Ability in U.S. Counties*

W. David Allen

The Reporting and Underreporting of Rape

An individual subscription is a benefit of membership in the Southern Economic Association, which also sponsors an annual meeting in the fall. The 2007 convention is in New Orleans, LA, on November 19–21.

Membership in the Southern Economic Association, which includes an individual subscription to the *Southern Economic Journal*, is \$60.00* for regular members, and \$20.00* for student members.

An institutional subscription is \$140.00 in the United States, and \$150.00 in all other countries.

*Canadian members please add \$10.00.
All other foreign members please add \$15.00.

To begin your membership or start your institution's subscription to the *Southern Economic Journal*, please send your payment to:

Southern Economic Journal
Business Office
PO Box 7065
Lawrence, KS 66044-7065

Phone: (785) 843-1234
Fax: (785) 843-1274
E-mail: sea@allenpress.com