

Short-selling: A major cause of market volatility

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September 29, 2008: Among the financial methods that have been used to dangerous effect in the current global financial crisis has been “short selling”, a favourite and routine practice of speculators to make quick profits by targeting vulnerable companies and institutions.

It is ironic that the huge Wall Street investment banks as well as commercial banks such as HBOS were among the victims of the speculators who used short selling not only to bet on a trend that the share prices of the companies would decline, but to influence and even help determine that trend.

Short selling in financial companies was temporarily banned by the US Securities and Exchange Commission mid this month.

The financial regulators have finally recognised how destabilising and dangerous short-selling can be and has been.

Short selling is now pin-pointed as the major cause of the drastic and dramatic falls in the share prices of huge financial companies and banks including Lehman Brothers (which collapsed last Sunday) and HBOS in the UK.

The fall in their equity prices contributed to the substantial weakening of their market value and capital base, and thus threatening their viability.

Influences prices

The shares of the two remaining Wall Street investment banks, Morgan Stanley and Goldman Sachs, were also subjected to attacks by short-selling speculators.

With their share prices dropping dramatically in the middle of this week, questions about their survival were being posed as well.

Short selling is a practice in which the speculator borrows the shares of a company and then sells them at the current price in the expectation that the share price will drop.

The speculator then purchases the shares at the reduced price to deliver, and makes a profit. In “naked short selling”, shares are not even borrowed by the speculator, who sells shares that he neither owns nor has borrowed.

In selling large quantities of the shares of the targeted companies, the speculator in fact influences the prices of the shares to go down.

Short selling can force share prices to fall below what is justifiable, and this destroys market

and public confidence in a company which then faces collapse; without the short selling activity, it may have survived.

During the present crisis, as the shares of one big company after another have been targeted and fallen (leading to the demise of the companies or their rescue or take-over), regulators in the UK and US have finally recognised the manipulation involved and in the past few days proceeded to ban the practice, at least as applied to financial firms.

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