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Banking groups call on the SEC to investigate trading misconduct amid increase in short selling

Article

The news: The turmoil in the US banking sector is proving to be a boon for many **short sellers, but their profits may soon come under scrutiny** as the Securities and Exchange

Commission (SEC) considers a probe into abusive trading practices, per Reuters.

Lucrative short selling: Since the beginning of the banking crisis in March, short sellers have been bagging handsome profits at the expense of failing banks' stock prices.

- From the collapse of **Silicon Valley Bank** until the early days of May, hedge fund managers banked $7.25 billion in unrealized profit from short-selling regional bank stocks, according to data firm Ortex.
- In the first two days of May, short sellers nabbed $1.2 billion in profits, and another $379 million last Thursday alone.
- Some of the biggest profits came from the short sales of **Truist Bank**, **PacWest Bank**, and **Citizens Bank** stock.

Short selling—selling borrowed shares of stock with the intention of buying them back at a lower price—is completely legal. And with a handful of regional bank names in the news each day, it's not terribly hard to identify which banks investors should bet against.

Strong fundamentals, weak stock prices: The collapses of SVB and **Signature Bank** were fueled by high interest rates, tanked bond valuations, and bank runs. But something different is happening now with regional banks. The stock prices of banks like PacWest and **Western Alliance** are plummeting even though they've been touting their stable deposits and sufficient liquidity and capital.

- PacWest Bank's stock dropped over 50% last week, though it assured consumers and investors that it's holding cash levels that exceed its level of uninsured deposits.
- Western Alliance also assured customers that their cash was safe and deposits were stable after it denied a Financial Times report that it was searching for a buyer. Its stock was down as much as 38% last Thursday.

This is where short selling gets hairy. Some investors take their bets too far and begin piling on trades in the specific stock to incite volatility and to pressure long-term holders to dump the stock. This drives the stock price down further, earning them a bigger profit.

Regulators are digging in: Calls for an investigation into abusive trading practices are growing, and the SEC appears likely to open a probe into the increase in short selling.

- Last Thursday, the American Bankers Association requested the SEC look into the short-selling activity and social media engagement that's occurring around regional bank stocks. The group points out that the activity is disconnected from financial reality.
- The Biden administration also said it's watching financial markets closely to analyze how short selling is affecting healthy banks. It identified the SEC as the agency that would take corrective action.
- SEC chair Gary Gensler said in a statement on Thursday that the SEC was "focused on identifying and prosecuting any form of misconduct that might threaten investors, capital formation, or the markets more broadly."

The bottom line: If regional bank stock trading remains volatile, the SEC might determine abusive trading practices by short sellers is the culprit. The agency could put a temporary ban on short selling, as it did during the 2008 financial crisis. But recent research shows that the short-selling ban actually caused those stock prices to fall even further.

In addition to investigating short selling, financial regulators must also consider other factors as potential catalysts for the continuing upheaval, such as rapid communication via social media, incendiary news headlines, and a gap in financial literacy among US consumers.

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