The S.E.C. stepped up its rhetoric against naked short selling today, and imposed rules that sound really tough. What they don’t do is impose a reasonable financial penalty.

Said the S.E.C.:

“In an ordinary short sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price). But in an abusive naked short transaction, the seller doesn’t actually borrow the stock, and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.”

The idea that short sellers can force a stock down and keep it down is taken for granted. There are plenty of shorts who have scars to prove they cannot often do that.

But on to the rules. First, there is a new rule against fraud in short selling. That makes it clear that if you lie to your broker about whether you can deliver the stock, that is a violation the S.E.C. can go after.

Second, and most important, the options market maker exception is removed. That exemption let market makers short stocks without borrowing them, so long as they are hedging their options positions. That meant that you could buy a put option — another way to bet a stock will fall — and the short sale would be made by the options market maker who sold the put to you.

Finally, there is a rule that if you a broker fails to settle one short-sale on time, it cannot make further short sales of the same stock unless it has pre-borrowed the shares. It is not clear from the news release whether this prohibition lasts forever, or whether it expires when the orignal trade is settled. I assume it is the latter.

Unlike the temorary rules the commission adopted in March, and which later expired, these rules apply to all stocks, not just to shares in some financial institutions.

What will be the impact?

It could prompt short squeezes in some heavily shorted stocks, pushing up share prices, at least temporarily.

Presumably, market makers will be hesitant to write puts on shares that are hard to borrow. Or at least they will charge more. Either way, it will be more difficult or more expensive to bet against a company.
But will it save Wall Street? Don’t be too sure. The real problem is that financial companies got themselves in deep trouble with bad decisions. The short sellers who figured that out before the rest of us made money, but it is hard to believe the shares would not have come down anyway.

In any case, there are other ways to bet against real companies. “That is the new template,” one hedge fund manager told me today. “All you have to do is buy credit default swaps and spread rumors. No cost to borrow. No accountability.”

In fact, if you buy the credit default swaps, and drive up their price, you don’t even have to spread rumors. Other investors may conclude that the market knows something, and start selling shares. If you were already short the stock, there is plenty of profit to be made even if you did pay too much for the credit default swaps.

Is that happening now? Perhaps so. The swaps market is relatively illiquid and nervous, and prices of swaps on Morgan Stanley and Goldman Sachs have soared in recent days, helping to push their share prices lower. The swaps market is not regulated.

There are no credit default swaps on the very small companies, often traded on the over-the-counter market, that are most often on the Reg. SHO lists of companies where there appears to be a lot of naked short selling. So the impact of the rules may be greatest on the share prices of those companies.

In some cases, the short selling is heavy because the shorts believe the companies have used fraud to inflate their share prices. “It will help the frauds,” muttered the hedge fund manager quoted above. “It won’t do anything for the financial companies.”

One idea the S.E.C. did not pursue is to simply raise the financial cost of naked short selling. A naked short seller takes the same risks as other short sellers, and gets the same rewards. If the share price rises, the naked short will lose.

But the financial difference is that when shares are hard to borrow — that is, when there is a lot of short selling — the fees to borrow shares can become very high. Naked shorting, if successful, enables a trader to avoid paying those fees. Economists have suggested that the commission try to determine how much is being saved, and simply levy a larger fee that would increase each day the trade was not settled. But there is no hint of such a move in today’s S.E.C. announcement.