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Short Sellers Find Friends in Banks

By TOM LAURICELLA, JENNY STRASBURG and JONATHAN CHENG

As traders at [Morgan Stanley](#) were frantically trying to shore up [Facebook](#) Inc.'s share price following the company's initial public offering, other managers on the deal were helping short sellers bet that the newly minted stock would fall.



AFP/Getty Images

Last Friday, at least 25% of trading volume in Facebook shares—more than 143 million shares—were short sales, according to data from exchanges that handled 94% of Facebook's total trading volume over the first four days

Trading desks at [Goldman Sachs Group](#) Inc. and [J.P. Morgan Chase](#) & Co., two of the firms that helped Morgan Stanley underwrite the IPO, were among those lending out Facebook shares that hedge funds needed for short sales, according to people familiar with the matter.

The role of the firms in enabling short sellers in Facebook's stock shines a light on a long-standing Wall Street business that has the potential to create conflicts of interest. Even as one arm of a brokerage firm is getting paid to drum up interest in a stock, another part of the firm could be earning big profits by helping bet that the stock will fall in price.

"In general, Wall Street has conflicts of interest, and conflicts of interest are profitable," said Daylian Cain, a Yale School of Management professor of business ethics. "It's hard to navigate them when there are millions of dollars at stake."

In a short sale, investors sell borrowed stock, hoping the shares fall so they can buy the stock at a lower price, return the shares and pocket the difference.

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[How to Short an IPO](#)

[The Cost to Short Facebook](#)

[Facebook Trading Glitches To Cost Market Makers](#)

Clients of Goldman, J.P. Morgan and other banks were also helping contribute to a downdraft in Facebook's shares. The decline in the stock in the days after the IPO added to widespread anger among investors over the handling of the IPO after trading was

disrupted by glitches on the first day.

While it isn't uncommon for Wall Street firms to make shares available for shorting on IPOs they manage, Morgan Stanley, the lead underwriter, didn't lend shares, according to people familiar with the matter.

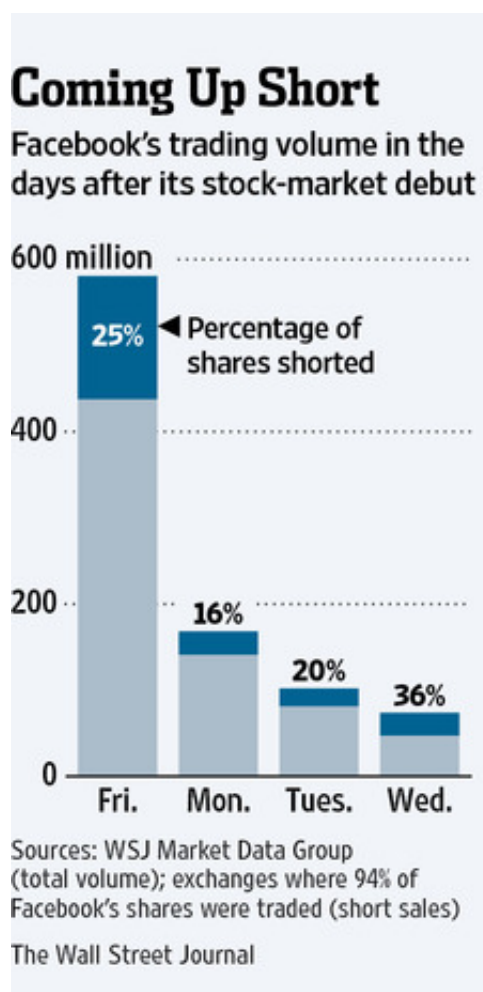
Facebook shares were priced at \$38 last Thursday. They held above that level last Friday as Morgan Stanley helped support the stock.

But they fell 11% on Monday and a further 8.9% on Tuesday, providing the opportunity for a rich profit for short sellers. The stock rebounded on Wednesday and ended 4 p.m. trading at \$33.03 on Thursday.

Representatives for Goldman, J.P. Morgan and Morgan Stanley declined to comment.

Banks often cite a "Chinese wall" that separates various divisions, such as the syndicate desk handling an IPO and the prime brokerage desk, which deals with hedge-fund clients, ensuring they don't communicate.

The short sales in the days after Facebook also created confusion, and at times anger, among traders and investors as Facebook shares continued to tumble. Many small traders said they weren't aware they were even allowed under securities law to short sell a stock so soon after an IPO. In fact, there are no rules that bar the short selling of new stock.



As Facebook shares fell, demand became heavy to bet against them. That meant anyone who was awarded Facebook shares at Friday's sale could command a hefty price in exchange for lending them out. The going annualized interest rate paid by those who borrowed shares in the social networking company was anywhere from 10% to 40% on the amount borrowed on Friday, compared with 0.25% to 0.5% for the typical big-company stock, according to Robert Sloan, managing partner of S3 Partners, a New York firm that advises hedge funds on counterparty risk and financing of trade.

Last Friday, at least 25% of trading volume in Facebook shares—more than 143 million shares—were short sales, according to data from exchanges that handled 94% of Facebook's total trading volume over the first four days. On Monday, that percentage dipped to 16% but rose to 20% Tuesday.

On Wednesday short selling accounted for at least 36% of total volume.

Facebook shares have been in the "hard to borrow" category since Friday, said Mr. Sloan. Some Wall Street banks Wednesday were lending out Facebook shares at 3%, he said.

Selling a newly minted stock short isn't a much discussed strategy outside of Wall Street trader circles, but it is a common practice.

However, the logistics of short selling an IPO make it a trickier affair than shorting other stocks.

Regulations require that investors "locate" a stock to borrow. That means finding somebody to lend out the shares.

In the case of an IPO, there is an additional catch: Until the purchases are settled and shares delivered, nobody outside the underwriters actually holds any shares. In Facebook's case, purchases didn't arrive in investors' accounts until after the close of trading Tuesday.

But brokerage firms are able to lend out shares from clients who were allocated stock in the IPO on the expectation that most of those shares would still be there when the time came to deliver them to the short seller.

Caught in the middle Friday was Morgan Stanley, where telephones were ringing steadily in the sixth-floor offices of its prime-brokerage unit, which caters to trading by hedge funds. The prime brokerage desk operates independently from its syndicate desk, which led the underwriting of Facebook's shares.

Hedge-fund managers were calling wanting to borrow Facebook shares so they could sell them short, said people familiar with the matter. But Morgan Stanley wouldn't lend shares. The prime-brokerage sales staff cited long-standing practices at the firm prohibiting doing so when the bank is lead underwriter on an IPO, according to the people.

"Who do you think you're protecting?" one hedge-fund manager said to a prime-brokerage manager as Facebook shares were falling. "We can get it everywhere else."

Later, hedge-fund managers told client representatives at Morgan Stanley that the bank had lost money by refusing to lend shares. A Morgan Stanley spokeswoman declined to comment.

Traders at T3 Trading Group LLC in lower Manhattan, were caught in the confusion. They tried to short Facebook on Monday, but their clearing firm told them it was prohibited.

At the same time, T3 traders were hearing from friends and former colleagues at rival firms who were making money shorting the stock.

"The right side of the trade was to the downside, but we had no access to the downside,"

said Scott Redler, a trader and chief strategic officer at T3. Even if the short trades that others were making wasn't technically illegal, he says, "it's frustrating that there people who will spend big money to stretch the rules in their favor."

—Tom McGinty and Jacob Bunge contributed to this article.

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