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2012

## Banning short sales and market quality: The UK's experience

Ian W. Marsh

Richard Payne

### **Abstract**

We study the effects that the ban on short sales of shares in financial firms introduced in late 2008 and removed early 2009 had on the microstructure and the quality of UK equity markets. We show that the ban did nothing to affect order flows: financial stocks were being more aggressively sold off than their peers pre-ban and this situation persisted through the ban period. Trading volume in financials was massively reduced, however. The ban decimated order book liquidity for financials. The deterioration was symmetric, affecting the limit buy and limit sell side of the order book equally. Finally we show that, through the period of the ban, markets for financial stocks were substantially less efficient and that the role of the trading process in aiding price discovery was greatly reduced. The effects identified above were largely reversed once the ban was lifted. The persistence of the deterioration in market quality and liquidity though the relatively long-lasting UK ban on short selling suggests that other major market developments such as the TARP program were not responsible since these were concentrated in the early half of the ban. We thus argue that the short selling ban was responsible for detrimental effects on the quality of UK equity markets and that, far from being stabilising, the ban exacerbated problems in valuing UK financial stocks.

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