View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

The Regulation of Short Sales and its Reform

Emilios Avgouleas*

Introduction

Short selling has long been regarded as an extreme form of "casino capitalism" that destabilises financial markets, raising also concerns regarding their moral foundations. Hostility against short selling gathered unstoppable momentum in September 2008 in the middle of the market price collapse of financial sector stocks. Short sales were seen as the principal cause of those precipitous falls. As a result, most developed market regulators declared a ban on short sales in financial sector stocks.

However, a large number of empirical studies indicate that short sales are, in fact, a beneficial source of market efficiency. This view has been confirmed by studies on the September 2008 ban, which show that the prohibition did not yield any concrete benefits, especially in terms of reduction of price volatility. On the contrary, it had an adverse impact on liquidity. The market abuse rationale, offered as the main justification for the September 2008 ban, was also unconvincing. Furthermore, US and European regulatory orders banning short sales revealed how disparate are the regimes governing cross-border securities trading.

This article argues that the best way to regulate short sales is through a dual strategy of disclosure and short trading halts, rather than a prohibition or an uptick rule. The short trading halts should be based on a sophisticated circuit breaker system that is focused on short and medium term market conditions and preserves the proper function of the price formation mechanism. Disclosure and short trading halts should be complemented by a strict settlement regime, which would eliminate the scope for aggressive speculation through uncovered positions.

What's the matter with short sales?

A broad definition of short sales would describe them as sales of securities which the seller does not own.[1] Normally, the seller has borrowed the securities concerned and engages in relevant transactions against a commitment to buy the securities back later at a lower price, returning also any borrowed shares to the lender.

Short selling often appears as a risk free bet that destabilises financial markets. Thus, it is viewed by the public and the press as an extreme form of speculation associated with the dark side of financial capitalism. The fact that hedge funds are among the most aggressive short sellers only helps to reinforce this view, which was shared, at the height of the crisis, by regulators, policy makers, and senior bank executives.

Furthermore, selling something that the trader does not own on the spot market goes counter to one of the deepest rooted traditions of western (free-market) economies, namely that parties in spot asset markets entering for profit in any kind of economic exchange must have property rights, probably title, of some form over the traded asset. This is normally not the case with short sales, at least, with "naked" short sales. [2]

Apart from moral concerns, the main economic issues arising from short selling is the ability of this practice to destabilise orderly markets and increase market volatility. This becomes a very serious problem when short selling pushes prices further downwards in a falling market, a so-called "bear raid". In a market where some traders are rational and some irrational (Shleifer and Summers 1990), a "bear raid" may trigger a precipitous fall that is not justi-

* Reader in International Financial Law, School of Law, University of Manchester.

[1] For an extensive definition, see IOSCO (2009, Appendix III, 24).
[2] "Naked short sales" is a term used to describe transactions in securities the seller does not hold at all.

fied by both inside and publicly available information and is primarily caused by investor sentiment: commonly called "animal spirits" of the market.[3] Another very important concern is the possibility to use short sales in order to manipulate the market in a stock or act profitably on inside information.

Nonetheless, all of the above concerns must be weighed against a large number of studies (starting with Miller 1977 and Diamond and Verecchia 1987), which indicate that short selling is an important factor with respect to:

- efficient price discovery (inter alia, Bris et al. 2007), because it allows all buying and selling interest in the market to be revealed and be better reflected into prices. Also short selling ensures a more rapid re-pricing of over-valued securities than would otherwise be the case;
- controlling over-pricing[4] (price bubbles), because it helps "contrarian investors" to mitigate, through rapid sales, steep, temporary price spikes (mini "bubbles"); and
- increasing market liquidity and facilitating hedging and other risk management activities. In the absence of restrictions on short selling, short traders and their counterparties find it easier to trade. This translates to a bigger number of trading parties for a specific stock, higher trading volume, and lower bid-ask spreads, boosting liquidity and facilitating hedging strategies.

Traditionally, the regulatory treatment of short sales has been either hesitantly heavy-handed, such as the US uptick rule under Rule 10a-1, which, in a modified form, was in force since 1938 and was repealed in July 2007, or fretfully relaxed, relying on convoluted disclosure arrangements of stock-lending data, as was the case for the UK regime (FSA 2002). The watershed moment in the regulation of short selling was the market price collapse of financial sector stocks, following the bankruptcy of Lehman Brothers and the publication of the financial troubles of American International Group (AIG), in the first two weeks of September 2008. The collapse of Lehman Brothers not only underscored the depth of the financial distress that financial services firms faced at the time, but also the US government's unwillingness to see all banks as "too big to fail". This signalled to creditors and shareholders of financial firms that there was a strong possibility of serious losses in their investments. As a result, stock markets witnessed in September 2008 a massive increase of short selling orders for financial sector stocks. That surge in short selling interest was castigated as the main reason for the amplification of downward price pressures in what was already a falling market.

Heeding the public backlash against short selling, stroked by the press, and under strong pressure by governments and financial sector firms and shareholders, the Securities and Exchange Commission (SEC), the Financial Services Authority (FSA), and most European and other developed market regulators issued orders banning short selling in financial sector firms,[5] which came into effect on 21 September 2009. However, the global ban was more of a "knee-jerk" reaction to the precipitous price falls and less a comprehensive regulatory response to the challenges posed by short selling. As a result, the relevant regulatory orders presented several loopholes and were rather asymmetric, both in their reach and exemptions, causing distortions to cross-border securities trading. For instance, the FSA's ban covered short-selling positions accumulated through the use of derivatives[6] but the SEC's did not.

The vexed issue of short-sales regulation

It is not surprising that the regulation of short sales has always been a vexed issue and regulators have not so far found an effective way to deal with this practice. Yet the September 2008 prohibitions provided the opportunity to empirically test the results of restrictions on short selling and the results were overwhelmingly not in favour of prohibition. Studies of the ban's impact on US and UK markets have shown that short selling was not the main driver of the precipitous price falls in financial sector stocks (Office of Economic Analysis 2008; FSA 2009;

[3] The phrase was coined by Keynes to describe the impact of optimism (i.e., over-confidence/exuberance) on economic decision-making. It has, however, evolved to describe all forms of economic decisions based on sentiment (Keynes 1936, 144).
[4] E.g., Jones and Lamont (2002) found that stocks that are expensive to short or to enter the borrowing market have high valuations and low subsequent returns, consistent with the overpricing hypothesis.

[5] Securities Exchange Act Release No. 34-58592 (18 September 2008; "Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments"); FSA, Short Selling (No 2) Instrument 2008 (relating to UK Financial Sector companies), FSA 2008/50 (18 September 2008).
[6] There are various derivative instruments which allow investors to take a short position in a particular security in order to hedge or speculate. Use of these derivatives generally results in a short sale of the related securities further down the chain of transactions in order to hedge the position.

Boehmer et al. 2008). The FSA's study on the impact of its own ban also showed that the prohibition brought very little benefit in terms of price stability and had an adverse impact on liquidity (FSA 2009; also Clifton and Snape 2008). Arguably, other factors such as news about a very serious deterioration in the quality of bank assets due to the ongoing credit crisis, the developing economic crisis, de-leveraging by hedge funds and other investors, and genuine market panic, amplified by strategic trade behaviour (so-called herding; Scharfstein and Stein 1990) had a much bigger impact on falling prices than increased volumes of short selling.

Furthermore, while short sales may be implicated in market abuse, this is usually an implementing strategy in the context of wider schemes to manipulate the market by spreading false rumours. It is thus the latter area which regulatory efforts should concentrate on. Only "naked" short sales and short sales before seasoned offerings have the potential to manipulate market prices without the aid of false rumours (Lecce et al. 2008). However, regulators have at their disposal a multitude of other means to protect the market against market manipulation without eliminating the liquidity and information and pricing efficiency benefits that short-selling seems to bring on many occasions. Therefore, the market abuse argument is an unconvincing rationale for banning short sales. Arguably, extensive disclosure, short-trading halts, in the case of highly precipitous market price falls, and strict penalties for non-settlement, may be sufficient to contain the adverse impact of these practices without banning short sales (London Stock Exchange Group 2009).

Given the failure of the September 2008 short-sales ban to curb market volatility, the vexed issue of short-selling regulation still calls for a well-designed and far-reaching solution which would also lead to symmetric/compatible national short-selling regimes. Most developed market regulators, including the SEC[7] and the FSA have consulted on the best way to regulate short selling. Moreover, since the asymmetric/incompatible nature of the earlier national prohibitions created impediments to cross-border trading of securities, the most important international regulatory networks for securities markets: the Commission of European Securities Regulators (CESR 2008) and the International Organization of Securities Commissions (IOSCO 2009) have also consulted on the most suitable regulatory treatment of short selling.

A global framework for the regulation of short sales

Regulation governing short sales must allow the liquidity and information benefits of short selling to accrue, preventing, at the same time, extreme speculation that destabilises the market. Also, it must create a transparent market that allows traders to have information on the volume of short sales with respect to a tradeable stock and its potential price impact.[8]

However, a regulatory strategy that merely focuses on disclosure will provide unsatisfactory results. The presence in the market of "noise" traders and of serious transaction costs (actual stock purchases) means that arbitrage trading on the demand side may not materialise in such a quantity as to provide a counterbalance to the downwards price trends initiated by sizeable short sales.

The apparent inability of the market to provide stabilisers to unnecessary downwards price movements will trigger further sales due to herding, and professional investors are likely to join the herd amplifying downward pressures. Hence, the need for a circuit breaker halt rule that operates on the basis of a sophisticated price threshold, in order to keep in "check" the destructive "animal spirits", preventing price falls from destabilising the market. Therefore, a combination of properly calibrated disclosure requirements for short sales and of sophisticated circuit breaker trading halts would be sufficient to control the undesirable effects of short selling. When this two-pronged strategy is complemented by a strict settlement regime, it may protect issuers of securities and the market from the undesirable consequences of heavy short selling that destabilises the market, without eliminating the efficiency benefits of short sales.

The circuit breaker halt rule that stops short trading on the stock concerned for the rest of the trading day – if the market price falls below a certain threshold – must be a much more sophisticated mechanism than the one proposed by the SEC[9] and should not be

[7] SEC 17 CFR PART 242 [Release No. 34-59748; File No. S7-08-09] ("Amendments to Regulation SHO").

[8] Increased disclosure also creates an information barrier to the successful implementation of designs to manipulate the market.

[9] SEC Release No. 34-59748.

part of general circuit breaker mechanisms, as the FSA's paper implicitly suggests. First, relevant systems must identify whether there is a negative corporate announcement affecting prices. Next, in the absence of such an announcement, they should ascertain whether there is an absolute increase in the volume of short sales. Once the second test is met, then, the third test examining falls in the market price should be triggered. The price test should refer to a percentage fall in the market price as compared to a weighted average price comprising the previous day's closing price, which should be assigned the biggest weight, the average closing price of the preceding week, and the average closing price of the preceding month, which is assigned the lowest weight. Setting the price threshold as a percentage fall over a weighted average would allow the circuit breaker to capture market trends that extend beyond a day's trading and thus be more restrictive of sudden price falls, possibly caused by a "wild" swing in investor sentiment. It would also allow the circuit breaker system to be less restrictive in the case of market price falls that are closer to market expectations over a short and medium-term period.

Moreover, in order to take into account actual differences in price fluctuations of very liquid, less liquid, and relatively illiquid stocks, and facilitate the implementation, through symmetric national regulations, of an effective global regime governing short sales, the price threshold should be set at the same level (e.g., 10 percent fall of the weighted average price) for all stocks belonging to the main indices of developed markets, e.g., FTSE 350, S&P 500, Nikkei 500, regardless of the country of issuer's incorporation. Another uniform threshold should apply to lower cap stocks that are not part of the main index of a developed market and stocks traded in developing markets. Admittedly stocks participating in one of the major market indices are much more liquid and less prone to wild price swings than stocks that belong in small cap market indices or stocks traded on developing markets. The same uniform principles may be applied to thresholds triggering the disclosure of short positions as part of local regulations.

The suggested strategy for the regulation of short sales is easily transferable from jurisdiction to jurisdiction allowing IOSCO and CESR to build standards and rules, which, may lead, through national implementation, to symmetric local regimes governing short sales. Therefore, it may be used as the foundation of a new global framework for the regulation of short sales that would eliminate the obstacles to cross-border trading created by the current regulatory asymmetry. As a result, costs of compliance and other costs of cross-border equity trading would be lowered.

The introduction of symmetric or harmonised national short-selling regimes in order to lower the costs of cross-border equity trading is a very pressing request of large institutional investors with international presence. Finally, a combination of lower costs of equity trading and reduced possibilities of overpricing, which is countered by legalisation of short-selling activity, essentially translates into lower cost of capital. The cost of capital is, of course, a very important factor with respect to access to capital and capital investment, both essential ingredients of economic growth.

References

Boehmer, E., C.M. Jones and X. Zhang (2008), "Shackling Short Sellers: The 2008 Shorting Ban", Working Paper, Columbia University, http://www2.gsb.columbia.edu/ faculty/cjones/ Shorting Ban.pdf (accessed on 10 January 2010).

Bris, A., W.N. Goetzmann and N. Zhu (2007), "Efficiency and the Bear: Short Sales and Markets Around the World", Journal of Finance 62, 1029.

Clifton, M. and M. Snape (2008), "The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange", http://www.londonstockexchange.com/NR/rdonlyres/5EDD66EF-B589-4974-95B1-73C51F1C9DFC/0/ShortsellingRestrictionsandMarketQualityDecember2008.pdf (accessed on 10 January 2010).

Diamond, D.W. and R. E. Verrecchia (1987), "Constraints on Short-selling and Asset Price Adjustment to Private Information", *Journal of Financial Economics* 18, 277.

FSA (2002), "Short Selling", *Discussion Paper* no. 17.

FSA (2009), "Short Selling", *Discussion Paper* no. 1, Annex 2.

Gilchrist , S. and E. Zakrajsek (2007), "Investment and the Cost of Capital: New Evidence from the Corporate Bond Market", *NBER Working Paper* no. 13174.

IOSCO, Technical Committee (2009), "Regulation of Short-Selling – Consultation Report", Appendix III.

Keynes, J.M. (1936), *General Theory of Employment, Interest and Money* (1936, rep. 2006), 144.

Lecce, S., A. Lepone and R. Segara (2008), "The Impact of Naked Short-Sales on Returns, Volatility and Liquidity: Evidence from the Australian Securities Exchange", *21st Australasian Finance and Banking Conference 2008 Paper,* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1253176 (accessed on 10 January 2010)

London Stock Exchange Group (2009), "Letter: Response to CESR Call for Evidence on the Regulation of Short Selling", http://www.londonstockexchange.com/NR/rdonlyres/1C714C8B-52B3-4798-8E10E98A690B80FD/0/LSEGroupresponsetoCESRcallforevidenceonshortselling.pdf (accessed on 10 January 2010)

Miller, E.M. (1977), "Risk, Uncertainty, and Divergence of Opinion", *Journal of Finance 32*, 1151.

Office of Economic Analysis (2008), "Analysis of a Short Sale Price Test Using Intraday Quote and Trade Data".

Scharfstein, D.S. and J. Stein (1990), "Herd Behavior and Investment", *American Economic Review 80*, 465.

Shleifer, A. and L.H. Summers (1990), "The Noise Trader Approach to Finance", *Journal of Economic Perspectives* 4, 19.