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SHOULD SHORT SELLING BE BANNED DURING PERIODS *of market turmoil?*

During times of market turmoil, market regulators are often called upon to ban short selling. This paper considers a number of arguments commonly used to justify banning, which revolve around issues of volatility, stability, market abuse and settlement disruption. A literature review focusing on the 2008 period provides little evidence to support these arguments against short selling, suggesting that regulators should be circumspect when considering any future bans.[1]

Short selling is a trading strategy designed to profit from falling asset prices. It involves the sale of an asset that the trader either does not hold at the time of the sale (a 'naked' short sale) or has borrowed in order to fulfil his or her settlement obligations (a 'covered' short sale). Where the asset is vested, the loan typically is collateralised with either cash or some other form of asset (see King 2005 for details on the operation of the securities lending market in Australia). A vast securities lending market exists to facilitate short sales and Faulkner (2007) conservatively estimates that the securities on loan globally exceed £3 trillion.

There is a vast theoretical and empirical literature which provides support for short-selling as a market practice that increases the efficient operation of asset markets (McKenzie 2012). Nevertheless, short selling is an extremely controversial practice and financial market regulators are ambivalent about it. They often espouse the eulogistic view that short selling is essential to the efficient processing of information in asset markets. For example, US Securities and Exchange Commission (SEC) Commissioner Kathleen Casey has indicated that short selling plays an 'important and valuable role … in our market'.[2] Similarly, the NASDAQ views short selling as a 'legitimate trading strategy'.[3] In Australia, the Chairman of the local regulator, Greg Medcraft, recently noted that 'ASIC sees short-selling as a legitimate business in the market'.[4] Also, the UK FSA (Financial Services Authority 2002, p. 4) has stated that its 'assessment of short selling remains that it is a legitimate investment activity, which plays an important role in supporting efficient markets'.

On the other hand, market regulators often resort to banning short selling, particularly during periods of market turmoil.[5] For example, on 19 September 2008, Australian authorities announced an across-the-board ban on naked short sales, which was quickly modified to a ban on all short selling by the time the announcement came into operation on 22 September (although this was also quickly revised to allow some exceptions). On 19 November 2008, the bans were lifted for all non-financial securities and all bans were lifted on 25 May 2009.

Popular support for these bans is easily garnered since companies often publicly blame short sellers for their falling share prices. For example, ABC Learning Centre CEO Eddy Groves said that the practice of short selling was, 'sad for Australia'.[6] Further, NAB Chief Executive John Stewart commented that major listed stocks were hostage to the trading strategies of global hedge funds.[7] Short selling has been linked to almost every financial crisis, including the current one, and short sellers tend to have a poor reputation. Rothchild (1998) observes that '[k]nown short sellers suffer the same reputation as the detested bat. They are reviled as odious pests, smudges on Wall Street, pecuniary vampires'. In a similar vein, Jickling (2005) notes that '[s]hort sellers have always been unpopular on Wall Street. Like skeletons at the feast, they seem to oppose rising values, increasing wealth, and general prosperity'.

Faced with the prospect of further declines in the equities market as the sovereign debt crisis plays out, regulators are likely to face further calls to ban short selling in the near future. The purpose of this paper is to critically examine some of the arguments that are often made against short selling.

It is worth noting at the outset that while many markets banned short selling in 2008, some did not (including Finland, Sweden, Hong Kong and New Zealand) and China introduced short selling at the time. Each of these markets continued to operate in an orderly fashion during the 2008 crisis and the continued presence of short sellers did not cause their downfall. Further, from a brief survey of the literature focusing on the 2008 period, there is little evidence that the bans reduced volatility (see Marsh and Niemer 2008; Bris 2008; Lioui 2009; FSA 2009; Boulton and Braga-Alves 2010; Saffi and Sigurdsson 2011) and may even have made it worse (see Boehmer et al. 2009; Charoenrook and Daouk 2009). Evidence from the Australian market (Helmes et al. 2009; Hamson 2008) is consistent with the international evidence. In light of this evidence, it is interesting to note that the outgoing Chairman of the SEC, Christopher Cox, admitted that the 2008 short selling bans were the 'biggest mistake' of his term.[8] Further, SEC Commissioner Kathleen Casey has also publicly expressed her view that the bans created 'significant disruption and distortions' in the market.[9]

A key difficulty in assessing the impact of short selling is that little is known about short sellers and their activities. The commonly held view is that all short selling is speculative in nature and is utilised solely to profit from price falls. The reality is that the motives for short selling are not well known and the only hard evidence comes from a 1947 survey of the NYSE in which two-thirds of short selling were found to be speculative (SEC 1963, p. 249). Financial markets have changed considerably since that time. Short selling is now integral to the risk management strategy of many market participants. Market makers also rely heavily on short selling and many market neutral trading strategies require short positions. As such, the speculative component of short selling is likely to be considerably less in the modern era.

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The arguments against short selling

Short selling exacerbates price volatility

The most commonly cited argument against short selling is that it exacerbates stock price volatility. The logic behind this view is fairly straightforward: when there is bad news for a stock, short sellers increase their positions, i.e. they sell. Of course, the reverse is true for good news. Thus, short sellers' trading activity is seen as adding further pressure to prices, resulting in increased volatility. This view was commonly advanced by regulators to explain the motivation for the 2008 short selling bans. For example, ASIC indicated that it was 'concerned that the recent market global conditions, coupled with extensive short selling of stocks, particularly financial stocks, may be causing unwarranted price fluctuations'.[10]

There are a number of points that need to be taken into account when considering the validity of this argument. First, short selling is an extremely risky trading strategy and the FSA reports that hedge funds tend to reduce their short positions in volatile markets (FSA 2002, p. 13). Thus, some short sellers appear to be averse to volatility. Second, some traders take long positions in stocks known to be sold short (Shao and Weiss 1991; Foust 2005). This is known as a short squeeze and it counters the short sellers' impact on the market by creating offsetting long positions. Finally, many other participants also buy stocks following good news and sell on the back of bad news, yet there are never calls to ban momentum and non-contrarian technical traders from the market. Some advocates argue that there is a key difference in that short sellers are selling something they don't own. However, the same argument may be made with respect to traders who borrow money to take long positions as they too are buying something that technically they don't own until such time as the loan is repaid. And, given that short sellers typically have to put up more than 100 per cent of the trade value in collateral, it is possible to argue in favour of short selling over leveraged momentum trading which does not require any collateral.

Short selling destabilises the markets

A second argument commonly made against short selling takes a more macro view that short selling destabilises the market. For example, in 2010, the Chairman of the SEC, Mary Schapiro, stated that the SEC was concerned that unconstrained short selling could 'destabilize our markets and undermine investor confidence'.[11]

To put this argument into context, consider Figure 1 which shows the Hong Kong Hang Seng market index as well as the daily total short sales volume for all stocks in the index over the period from January 2001 to April 2006. The Hong Kong market was chosen because it provides a long and reliable source of short sales data at a daily frequency. The figure clearly highlights two salient points. The first is that short sellers are always active in the market. If we accept the proposition that short sellers destabilise the market, then their continual presence means that markets are always less stable than would otherwise be the case. This proposition has not been substantiated and it is more likely that the periods of abnormal short selling activity are the main area of concern for critics. Figure 1 reveals a number of spikes in the level of short selling activity and many of them correspond with periods in which the market is falling. Other such spikes, however, coincide with reversals in the market (in particular, during the early part of the sample) and even occur during periods in which the market is rising. Thus, it is not clear that episodes of heightened short selling lead to falls in the market. Even at the individual stock level it is unclear that high levels of short selling activity translate into negative returns (Boehmer et al. 2008; Boehmer et al. 2010).

Short selling leads to disorderly markets

The Chief Executive of the UK FSA, Hector Sants, justified the introduction of the short selling bans in 2008 by noting that '[w]hile we still regard short selling as a legitimate investment technique in normal market conditions, the current extreme circumstances have given rise to disorderly markets'.[12] This is a particularly interesting turnaround given that the FSA had previously stated that they 'see no case for any prohibition on short selling, either generally or for particular stocks in times of market stress' (FSA 2002, p. 4). In 2008, SEC Chairman Chris Cox argued that the short selling bans would, 'not be necessary in a well-functioning market'.[13] Such statements may be interpreted as suggesting some form of causality between short selling and 'disorderly' markets.

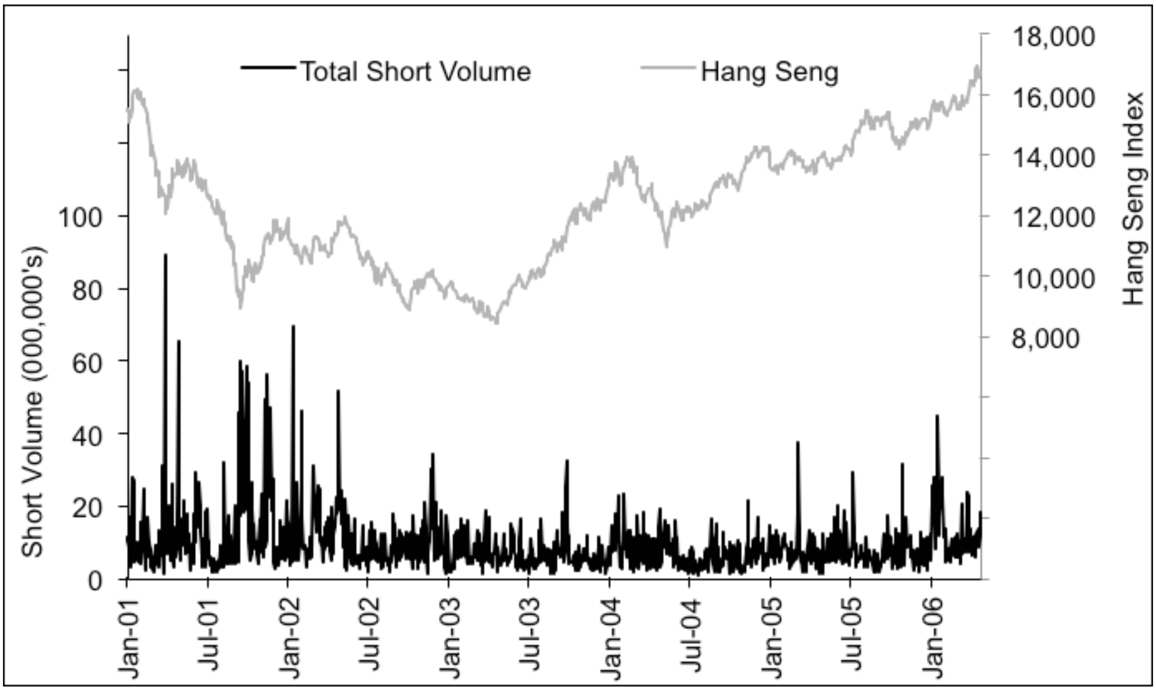
It is unclear exactly what is meant by a 'disorderly' market in this context. While it may refer to a volatile or unstable market, as this issue has already been discussed, I will consider another possible interpretation. Specifically, the reference to a disorderly market may reflect the view that short selling magnifies the speed of the price correction following bad news. In this case, the argument centres on the notion that an immediate price response to bad news is undesirable and a more drawn-out and predictable response is preferred.

Efficient market considerations would certainly suggest that, while they may be disruptive and painful, there is a benefit associated with rapid asset price adjustments whereas the benefits of trying to achieve a slow adjustment (to an unknown new equilibrium price) are unproven. Further, in terms of the link between short selling and volatility, the current discussion raises the question of whether short selling leads to greater volatility or whether the market pressures just take longer to work themselves out when short selling is banned.

Short selling facilitates market abuse

In the early 1900s and again during the Great Depression, illegal bear raids were commonplace in the markets. This type of trading practice typically involved a coordinated effort among a group of traders who would short sell a stock (and often spread pernicious rumours) in an attempt to profit from the resultant decline in prices. Concerns over the practice led the SEC to introduce a number of new trading rules in 1938, which were designed to prevent the 'use of the short sale by the "bear raider" to drive the market down' (SEC 1963, p. 251). The most notable change was the introduction of the uptick rule to all short trades, which is largely credited with ending this practice.

FIGURE 1: Total daily short sales for the Hang Seng Index constituent stocks



Source: HKEX and Datastream.

Thus, it is not clear that episodes of heightened short selling lead to falls in the market. Even at the individual stock level it is unclear that high levels of short selling activity translate into negative returns.

During 2008, claims of bear raids were frequently used to support the case for short bans to be introduced. For example, the downfall of Bear Stearns was attributed to a bear raid by a number of hedge funds and Goldman Sachs (Burrough 2008). The wholesale and institutional markets Managing Director of the FSA, Sally Dewar, commented that '[t]here has been a series of completely unfounded rumours about UK financial institutions in the London market over the last few days, sometimes accompanied by short-selling'.[14] More recently, the European Securities and Markets Authority justified the reintroduction of short selling bans in 2011, noting that it is clearly abusive when short selling is 'used in combination with spreading false market rumours'.[15]

With current levels of transparency and regulatory supervision of trading it is highly unlikely that short selling is used to facilitate market abuse in the form of a 'bear raid'.[16] It is more likely that the term is used in a sensationalistic sense to refer to a stock that has attracted the collective attention of a number of short sellers and is experiencing an unusually high level of short trading. The key point would seem to be whether prices fall in response to short selling or whether short sellers are reacting to market events such as a stock price falling following the release of bad news to the market. The impotence of the short bans in stopping stock prices from falling and reducing volatility certainly suggests that short sellers alone do not drive the market. It is much more likely that short sellers get swamped by long stock holders rushing for the exit and selling down their positions. By way of example, Data Explorers stock lending data reveals that six weeks prior to the collapse of HBOS, 18 per cent of available shares were on loan to short sellers. By the time of the collapse, however, this figure had fallen to only 2.75 per cent of available shares on loan.

Short selling disrupts the settlement process

The final argument against short selling considered in this paper is the notion that shorting selling disrupts the settlement process. For example, the IOSCO (2009) report on the regulation of short selling noted that 'market regulators may also be concerned about the potential for short selling, particularly "naked" short selling, to create settlement disruption'.

Recall that when short selling, the trader may borrow the stock, make a corresponding purchase prior to settlement or make no delivery arrangements, in which case market buy-in rules are invoked. The disruption argument focuses on the latter two propositions and their possible impact on the settlement process. In terms of closing out positions intra-day, the argument can be equally applied to those day traders taking long positions, in which case a call for a ban on one might equally be applied to the other. The more serious concern focuses on the failure to deliver stocks and there is no evidence that short sellers are any more or less inclined than long traders to fail to deliver. The notable exception is market makers, who have been known to fail to deliver when stock is expensive or difficult to borrow (Boni 2006; Evans et al. 2009; Stratmann and Welborn 2010).

Conclusion

In 2008 and again in 2011, the latest rounds in a long history of short selling bans were invoked by market regulators. This paper examines a number of different justifications for short selling bans, focusing on concerns related to excessive volatility, market stability, market abuse and settlement disruption. From a literature review focusing on the 2008 period, there is little clear evidence to support any of these arguments, suggesting that regulators should be circumspect when considering whether to ban short selling.

It should be recognised that there are many reasons for short selling beyond speculative trading such as risk management, market making and non-directional trading strategies. Further, short selling bans may not yield the anticipated benefits in terms of reducing volatility and stabilising markets. ■

Notes

1. This paper represents a consolidated version of presentations given at the following industry forums: Macquarie Connections: Global Quant Conference, July 2010, Hong Kong; Data Explorers Security Financing Forum, October 2010, Hong Kong and November 2010, Dubai; the BNP Paribus Securities Lending Forum, January 2011, Singapore; and the Global Investor, Master Class, Asia Pacific Region 2012, Australia. The author would like to thank an anonymous referee and Kevin Davis for their helpful comments, and Steve Sedgwick for inspiring this article.
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3. www.nasdaq.com/quotes/short-interest.aspx
4. www.theaustralian.com.au/business/markets/securities-regulator-will-not-ban-short-selling-says-greg-medcraft/story-e6frg916-1226113803879
5. A review of the history of short sales restrictions may be found in Chancellor (2001). A summary of short selling regulations during the financial crisis may be found in Jain et al. (2012).
6. news.smh.com.au/business/abc-shares-plunge-on-debt-concerns-20080226-1uwi.html
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14. www.telegraph.co.uk/finance/newsbysector/banksandfinance/2786534/FSA-to-launch-probe-as-rumours-hit-UK-banks.html
15. www.theaustralian.com.au/business/markets/securities-regulator-will-not-ban-short-selling-says-greg-medcraft/story-e6frg916-1226113803879
16. A form of front running, known as 'predatory trading', refers to a strategy whereby stocks are sold in advance of a distressed large trader being forced to liquidate their position. Brunnermeir and Pedersen (2005) provide anecdotal evidence and derive a model of such behaviour.

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