Chapter 12: Executive Summary

Short Selling

Menachem Brenner and Marti G. Subrahmanyam

Background

Until the current global financial crisis, the practice of selling shares that one did not own, known as short-selling, was generally permitted in most countries. Of course, there were some restrictions placed on such transactions, such as the requirement to borrow the stock ***prior*** to the sale ("no naked shorts"), selling at a higher price than the previous trade ("the uptick rule") and disallowing short-selling to capture gains and postpone tax payments ("no shorting against the box").

In a dramatic decision in the early weeks of the current crisis, the SEC banned short-sales of shares of 799 companies on September 18, 2008 and subsequently lifted the ban on October 8. However, most countries around the globe, and in particular, the U.K. and Japan, homes to the two other major world financial centers London and Tokyo, have declared a ban on short selling for "as long as it takes" to stabilize the markets. Even in the U.S., there is continuing pressure on the regulators to reinstate the ban, at least in selected securities or to bring back the "up-tick" rule.

The Issues

The immediate policy issues are as follows:

1. Should there be any restrictions on short selling equity shares of individual companies, if not a total ban on such transactions?
2. If so, what specific restrictions should be instituted, and under what circumstances should they be enforced by the regulators? In particular, should the "uptick" rule be reinstated?
3. What is the appropriate framework for timely reporting of short interest and/or short sales to ensure transparency of these transactions to the market?

Financial Markets: Fairness and Efficiency

A highly desirable feature of financial markets is that they be fair to all participants who wish to trade. An aspect of this fairness is that these markets operate in a transparent manner, making information available to all participants at the same time, so that the markets can be efficient. In efficient financial markets, the prices of financial assets reflect all available information – favorable and unfavorable – that may affect the magnitude and the risk of future cash flows from these assets. An important tenet of fair regulation and taxation of financial markets is the symmetric treatment of buyers and sellers of financial assets. This is because the combined actions of buyers and sellers, reacting to new information, cause that information to be reflected in market prices. This process is referred to as price discovery. Restrictions on short selling constrain the participation of potential sellers, who may have bearish views on a stock. Equally, they also affect buyers who want to be long on a particular company's securities, but limit their risk exposure. For example, buyers of convertible bonds or stocks who buy put options to limit their downside losses will find it difficult to buy them from sellers, since the latter use shorting to hedge their own exposure. Thus, restrictions on short selling reduce transactions in the stock market, which in turn, delays price discovery, curtails liquidity and causes prices to fall further. They also increase liquidity risk if the volume of these future transactions is uncertain. Thus, a ban on short sales would generally have adverse consequences for liquidity as well as liquidity risk in a given stock and its derivatives.

At a broader level, the wealth of available empirical evidence in the academic literature as well as accumulated regulatory experience, suggests that restrictions on short-sales are largely ineffective in halting declines of stock. All they do is throw some sand in the gears and delay the inevitable incorporation of bad news into stock prices. It has been shown that in countries with fewer short-selling constraints, there is more efficient price discovery, less co-movement of stocks, and lower volatility than in those where short-selling is more restricted. Most importantly, no study has shown that short-selling constraints reduce the likelihood of crashes. Similar conclusions have been reached regarding the "uptick" rule which prohibits short sales, except when prices move up. In particular, a recent study commissioned by the SEC, which showed the "uptick" rule to be ineffective, influenced the SEC to rescind the rule last July.

Policy Recommendations

1. **Short Selling should never be banned**. In cases where there is strong evidence of market manipulation, a trading halt should be considered, since such manipulation may affect both buyers and sellers.
2. **No "Naked Shorts."** Regulators should also strictly enforce the requirement that stocks must be borrowed *prior* to a short sale **by any investor who is not a market maker.**
3. The **"uptick"** rule should ***not*** be reinstated. It does not reduce volatility; it only slows down the price discovery process.
4. **Reporting Requirements.** Transparency in the form of *timely* reporting is a precondition for efficient financial markets. We propose that daily short selling trading activity, and not just short interest reported with a lag, on all listed stocks, be transmitted online to the exchange/clearing corporation. Every short sale that appears on the sales and trade ticker should be marked as such. (Of course, the identity of the seller would not be disclosed to the public.)