CFA Society
United Kingdom

SHORT SELLING

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SHORT SELLING

IN SUPPORT OF SHORT SELLING

CFA UK believes covered short selling is a legitimate investment activity which enhances the integrity of the capital markets and helps impose market discipline. This position applies to equity and non-equity capital markets.

CFA UK does not support naked short selling. This practice not only affects owners of securities by depriving them of the basic benefits of ownership; it also may detrimentally affect the issuer's reputation and subvert the appropriate workings of the market by avoiding certain restrictions applicable to those who deliver on time.

Short selling contributes to price discovery and greater liquidity.

Capital and its associated risks would be mispriced without short selling.

Regulators need to be wary of restricting short selling. The evidence we have reviewed on short selling indicates that restricting or banning it brings costs that are not outweighed by the benefits of such actions. What a difference a few months makes:

"The emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets"
(Christopher Cox, SEC Chairman, 19 September 2008, SEC News Release 2008-211).

"Knowing what we know now, I believe on balance the commission would not do it again. The costs (of the short-selling ban on financials) appear to outweigh the benefits."
(Christopher Cox, telephone interview to Reuters, 31 December 2008).

Short selling facilitates the stock lending industry and enhances the returns of passive portfolios.

Members support short selling. In a May 2009 survey conducted among CFA Institute's global membership, 91% of respondents agreed that short selling benefits the market by providing price discovery and market liquidity.

PERCEPTION AND ASYMMETRY OF TREATMENT

Short selling is the practice whereby (equity and non-equity) market participants sell securities they do not own with a view of buying them back at a lower price. There are two main types of short selling –

1. Covered short selling – the sale of securities that have been borrowed from the holder for a fee, so that the short seller can ensure delivery of the stock at settlement.
2. Naked short selling – this is when securities have been sold but there is no arrangement in place to borrow or locate the securities.

When significant market dislocations arise, the causes of which are often complicated, short sellers make for convenient culprits and the result is the capital market equivalent of bear-baiting.

Short selling has long been vilified even though the views of short sellers have often been vindicated. However, the converse is not true when asset prices are rising, even if they are unjustified by the fundamentals; there is little call against those that have been buying securities in an exuberant manner. Both buyers and sellers should be able to express their views without impediment. Identifying one party as unwelcome encourages regular mispricing in the future. The prospect of placing constraints on short sellers is even more worrying when one considers the asymmetric risk and return trade–off these participants face; the maximum profit potential is 100% and the maximum potential loss is infinite, whereas the opposite applies to the unleveraged long position. If restrictions on short selling are to be pursued then logically these should be matched by limits on buying securities. We favour no such restrictions on either party.

EVIDENCE

According to Professor Charles Jones, Chair, Finance and Economics Division, Columbia University[1], "virtually every piece of empirical evidence in every journal article ever published in finance concludes that without short sellers, prices are wrong". The study by Marsh and Payne[2] of the impact of the UK ban states that "through the period of the ban, markets for financial stocks were substantially less efficient and that the role of the trading process aiding in price discovery was greatly reduced. The effects identified above were largely reversed once the ban was lifted. We thus argue that the ban had detrimental effects on the quality of UK equity markets and that, far from being stabilising, the ban exacerbated problems of volatility in the prices of and uncertainty in the values of UK financial stocks."

A recent EDHEC publication authored by Abraham Lioui[3], professor of finance at EDHEC Business School, reaches similar conclusions based on an analysis of French financial stocks where short selling was prohibited. Lioui states that "The ban on short selling was followed by a sharp rise in the volatility of the markets, and on the stock markets concerned the impact of the ban was systematic; the impact on volatility was greater than that of the financial crisis. In general, the risk/ return possibilities of investors worsened. And although it is hard to substantiate the impact on the volatility of the shares, the rise in the volatility of these shares, which is undeniable, is a result of the rise in idiosyncratic risk and thus of the noise in the markets. As a consequence, share prices deviate yet more from their fundamental value. Furthermore, the desired effect on market trends has not been achieved (no reduction of the negative skewness of returns is being observed) and there is no evidence of the possible impact of this measure on extreme market movements."

The EDHEC report concludes that market participants viewed the bans as indicative of a deviation of the market authorities from their primary mission. In another paper by Lioui that looked at the impact of the ban on short selling on the broader market, Lioui concluded that: "(The) ban had a broad impact on the markets. It was responsible for a substantial increase in market volatility. The impact of the ban on the higher moments of index returns is not systematic (skewness and kurtosis of the return distribution of only few indices were affected) or robust (using some robust measures of higher moments makes the impact of the ban disappear). Thus, the ban didn't ease the downturn pressure in the financial markets."

[1] "Assessing the Shorting Ban," Professor Charles Jones, Columbia Ideas at Work', 17 December 2008 http://www4.gsb.columbia.edu/ideasatwork/feature/501376/As-sessing+the+shorting+Ban
[2] Marsh, Ian W. and Payne, Richard G., Banning Short Sales and Market Quality: The U.K.'s Experience (July 20, 2010). Available at SSRN: http://ssrn.com/abstract=164584
[3] Lioui, Abraham, The Impact of the 2008 Short Sale Ban On Stock Returns (March, 15 2010). Available at SSRN: http://ssrn.com/abstract=1571387
[4] Lioui, Abraham, Spillover Effects of Counter-Cyclical Market Regulation: Evidence from the 2008 Ban on Short Sales (March 15, 2010). Available at SSRN: http://ssrn.com/abstract=1571315

In Beber and Pagano's[5] study of the short-selling bans in 30 countries (including several EU nations) during 2007-2009 found that the bans –

(i) were detrimental for liquidity, especially for stocks with small market capitalization, high volatility and no listed options;

(ii) slowed down price discovery, especially in bear market phases, and

(iii) failed to support stock prices, except possibly for U.S. financial stocks.

In situations where the markets are experiencing periods of rising securities prices there may be technical and behavioural factors at play that limit the effectiveness of short selling. Short sellers may have been unable to borrow the securities because of a tightness of supply. Similarly, when securities' prices are riding a wave of optimism, short selling would have proved to be a highly risky activity given its risk/return trade off.

All too often when markets are experiencing dislocation, short sellers are often cited as a cause of the rise in volatility, when in fact such dislocations are caused by fundamental or structural factors. The market can often overlook the signals sent by the activity of short sellers and delay the incorporation of this information[6]. Karpoff et al find that equity market short sellers are able to identify and focus on companies that misrepresent their financial information. Short selling offers two benefits: a hastened pace of discovery and mitigated share price inflation of misrepresenting companies. Short sellers contribute to the imposition of market discipline.

Similarly, the fiscal concerns about periphery Eurozone nations were due more to fiscal dynamics and imbalances in their economies than the actions of short sellers. The EU Commission's detailed empirical investigation carried out by Arghyrou and Kontonikas[7] presents some key findings that are pertinent to the cause of the Eurozone debt crisis. It was when the broad market paid more attention to these countries' fundamentals that their borrowing costs rose. The report states that the premium required of many Eurozone countries was "mainly driven by accumulated intra-EMU macroeconomic imbalances and international risk conditions." In relation to the influence of activity in the Credit Default Swaps (CDS) the report states that although it cannot rule out that speculation in this market does take place; the authors "do not find evidence in favour of the hypothesis that speculation in CDS markets is a major force driving the euro debt crisis." The sharp decline in these nations' bond prices reflects the delayed incorporation of information. This raises a more important question- why did the implications of this publicly available information take so long to be incorporated into market prices?

Markets may decline rapidly due to inadequate market structures, rather than short selling. In the case of the 'flash crash' in May 2010, the trigger was a traditional US mutual fund hedging its equity portfolio; its hedging activity then exposed deficiencies in many of the structures of the electronic stock exchanges in the US[8].

In addition to being a source of allocative efficiency, short sellers are also a source of revenue for holders of securities. Securities lending is a key element of covered short selling. Securities are lent to a third party in exchange for collateral in the form of shares, bonds or cash; the borrower pays the lender a fee and is contractually obliged to return the securities on demand. This payment enhances the returns of typically more passive portfolios. The borrower has to pass over to the lender any dividends/interest payments and corporate actions that may arise.

There are risks in securities lending but all securities lending arrangements are underpinned by market standard legal agreements (such as the Global Master Securities Lending Agreement or GMSLA). This is a trillion pound industry; DataExplorers' Q4 2010 review[9] states that in 2010 US$1.7tn of securities were lent globally resulting in beneficial owners and custodians sharing revenues of $7.6bn. Aggarwal, Saffi and Sturgess[10] state that, "most institutions have a securities lending program and consider it to be an important source of revenue with estimates of $800 million in annual revenue for pension funds alone." The evidence we have reviewed on the impact of the bans or restrictions on short selling is unanimous in that such constraints add to volatility and detract from

5"Beber, Alessandro and Marco Pagano (2009), "Short-Selling Bans around the World: Evidence from the 2007-09 Crisis", CEPR Discussion Paper 7557.
6Short Sellers and Financial Misconduct (Digest Summary) Jonathan M. Karpoff and Xiaoxia LouJournal of Finance, Vol. 65, No. 5 (October 2010): 1879-1913Summarized by Hue Chye Ling, CFA CFA Digest February 2011, Vol. 41, No. 1 (doi: 10.2469/dig.v41.n1.4)
[7]The EMU sovereign-debt crisis: Fundamentals, expectations and contagion," Michael G. Arghyrou, and Alexandros Kontonikas; European Economy. Economic Papers. 436. February 2011
[8]"Flash Crash Forensics," Sherree Ducovny, CFA Magazine, Nov/Dec 2010.
[9]DataExplorers: Securities Lending Review - The future of borrowing demand, Q4 2010 http://www.dataexplorers.com/sites/default/files/DX_Quarterely_q4.pdf
[10]" Does Proxy Voting Affect the Supply and/or Demand for Securities Lending?", October 2010, Reena Aggarwal, Pedro A. C. Saffi, Jason Sturgess; paper can be found at http://www.dataexplorers.com/data-and-analysis/research

allocative efficiency. With the developed economies facing their toughest economic outlook for at least fifty years, any limits on making these economies less allocatively efficient is likely to undermine the strength of any recovery. Without short selling, capital would be mispriced resulting in a wasteful use of valuable resources.

CALL TO POLICYMAKERS AND STANDARD SETTERS

Evidence

The evidence regarding short selling does not support the perception that the practice imposes net costs on market integrity. Instead, policymakers should review the evidence as cited above and ensure that appropriate short selling is not hindered. Policymakers and standard setters should not intervene in ways that are not supported byevidence.

Take into account how markets operate and interact

We support the spirit of regulation that promotes a level playing field, ensuring that regulatory arbitrage is minimized while not impeding the functioning of the securities' markets. The focus of policy should be on naked short selling rather than covered short selling. For example expressing a bearish view via the CDS market is significantly different from expressing a bearish view in the equity market.

Consistent disclosures of short and long positions

Covered short selling is a necessary part of the functioning of a liquid market and nothing should be done which would inhibit the legitimate use of that practice. Consistent with our belief in openness and transparency, CFA UK supported the Financial Services Authority's introduction of new provisions in the Code of Market Conduct, but did so with reservations due to apparent anomalies in disclosure.11

[11] *CFA UK Response to FSA's Discussion Paper on Short Selling disclosure (DP 09/01) https://secure.cfauk.org/assets/1304/CFA_UK_response_on_short_selling_May_09.pdf*