

The role of short selling in markets and the implications of a short selling ban

Response to the CESR call for evidence on regulation on short selling

Introduction

Short selling plays an important role in global financial markets and brings many benefits to the global economies, including investor protection against market volatility, increased liquidity for all market participants, more efficient price discovery, dampening of price bubbles and prevention of other market inefficiencies, and ultimately more efficient capital allocation.

The ability to sell stocks short makes investing far more attractive at times of stress because it encourages investors to stay in the market even when prices are declining. By hedging their positions through short sales, investors can continue to hold other stocks with the aim of achieving absolute returns. Without the option to short sell, investors are much more likely to withdraw from a declining market, accentuating the market contraction during major crises like the present one.

The recent short selling ban has brought this investment management and hedging instrument to the forefront of the public debate. The wider public debate has been accompanied by widespread misconceptions about short selling and doubts around its usefulness.

The HFSB would like to contribute to this debate in order to provide a perspective on the benefits of short selling, to offer an analysis of the impact of the short selling ban on markets, and to discuss the effectiveness of a short selling ban as an instrument of regulatory intervention in markets in times of distress.

The role of short selling in markets

We believe it is important to highlight the broader function short selling performs in capital markets and the benefits it brings to the economy as whole given the widespread misconceptions in the current public debate around short selling and its benefits.

1. *Efficient price discovery*: The ability to sell short allows markets to incorporate new information more quickly, in particular pessimistic information in the price discovery process. This results in more robust prices. Short sellers can be seen as “market detectives” who spot excessive valuations early on and provide a corrective force, thereby preventing misallocation of capital in the economy.
2. *Dampening of bubbles*: Short-sellers can help dampen price bubbles, by smoothing out excessive peaks in market prices and accelerating price corrections, while at the same time buying at times when prices are falling (i.e., to cover the short position).

3. *Reduced cost of capital to companies:* Short selling activity (i.e., selling when everyone else is buying) reduces volatility in the markets, thereby reducing price volatility and ultimately reducing the cost for companies to raise capital in the markets.¹
4. *Viability of capital raising instruments:* short selling is inextricably linked with the viability of certain fundamental capital raising instruments, such as convertible bonds; without short selling, convertible bonds become much riskier to investors; the result is in effect to shut down a very important channel for raising capital, particularly for financial institutions.
5. *Enhanced liquidity and reduced transaction cost:* Short-selling increases the depth of the market, thereby reducing the spreads (=the transaction cost to all market participants). Academic research examining short selling practices in 111 countries confirms that market quality improves (ie greater liquidity, less volatility) when short selling is allowed.²
Current example: Research shown in the subsequent section (Figure 2) demonstrates how spreads have increased since the introduction of the short selling ban, hurting all investors.
6. *Revenue enhancement for long investors:* Investors holding long positions can lend out their securities to short sellers and earn a fee from this activity. This allows pension funds, for example, to enhance their returns and ultimately benefit their investors.

In conclusion, short selling is a crucial component of an efficient capital market. Without it, investors will be far less confident about remaining invested and markets will be far less efficient. A good example of the inefficient capital allocation that can occur when markets operate without correction is the wasteful investment in overpriced securities that is observable during bubbles. The dot.com bubble of 1998/2000 or the house price bubble of 2005/2007 provide ample evidence of this. Short selling is a crucial mechanism to burst bubbles, sometimes even preventing them from happening.

Notwithstanding these benefits, we are aware that there can be cases of market abuse in the context of short selling. One such activity is called “short and distort”, where false rumours are spread causing a stock to fall. This is similar to market abuse activity in the context of long positions such as “pump and dump”. All such market manipulation is already illegal under current EU legislation (Market Abuse Directive), and the HFSB has set out best practice standards to help hedge fund managers comply with these legal and regulatory requirements. It is important to note that the best practice approaches identified by the HFSB might well merit consideration for adoption by all investors in addition to hedge funds.

The situation in September 2008

This section provides an overview of events since 18 September 2008, starting with an overview of the short selling ban across many markets and an analysis of the subsequent impact on markets.

¹ Charoenrook and Daouk find strong evidence that the relaxation of short selling restrictions results in a significant decline in the cost of capital (Charoenrook/Daouk, Vanderbilt University/Cornell University, 01/2005: A Study of market-wide short selling restrictions, p. 16)

² Also confirmed by empirical research by Charoenrook and Daouk, Vanderbilt University/Cornell University, 01/2005: A Study of market-wide short selling restrictions

The short selling ban

Since midnight on Thursday 18 September, regulators throughout Europe have restricted the short-selling of shares in financial companies. The measures were taken “to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector.”³

Regulators in US, Canada, Australia, India, Taiwan, and Dubai have also taken similar actions in response to the crisis.

The approach and restrictiveness of the short-selling regimes varies by country. The following table provides a short overview.

Table 1: Overview on short selling regimes in select countries

	UK (FSA)	US (SEC)	Spain (CNMV)	Germany (Bafin)	Australia
What is prohibited:	Active creation or increase of net short positions	Covered and uncovered short selling	(Uncovered short selling already prohibited)	Uncovered short-sales	Total ban on (covered and uncovered) short-selling
Scope	Financial stock	Financial stock		Select financial stock	All stock
Disclosure requirement (yes/no), threshold	Yes, all net short positions in excess of 0.25%	Yes, for institutional investors of all new short positions, no thresholds	Yes, >0.25%	No	Yes, daily of all short positions, no threshold
Duration	16 Jan 2009	Lifted 8 Oct (for covered), but ban on uncovered prevails (ban was not on uncovered shorting per se, but rather failures to deliver)		31 Dec 2008	27 Jan 2009 (fin. stock); 30 days for non-financial stocks, has been extended

The FSA has stressed that it sees short-selling as a legitimate investment technique in normal market conditions.

Impact of the short selling ban

Preliminary research indicates that the short selling ban enacted by regulators has had a series of short term implications for markets:

- Reduced liquidity in affected stocks
- Higher trading costs in affected stocks
- Volatility of affected stock has not significantly reduced

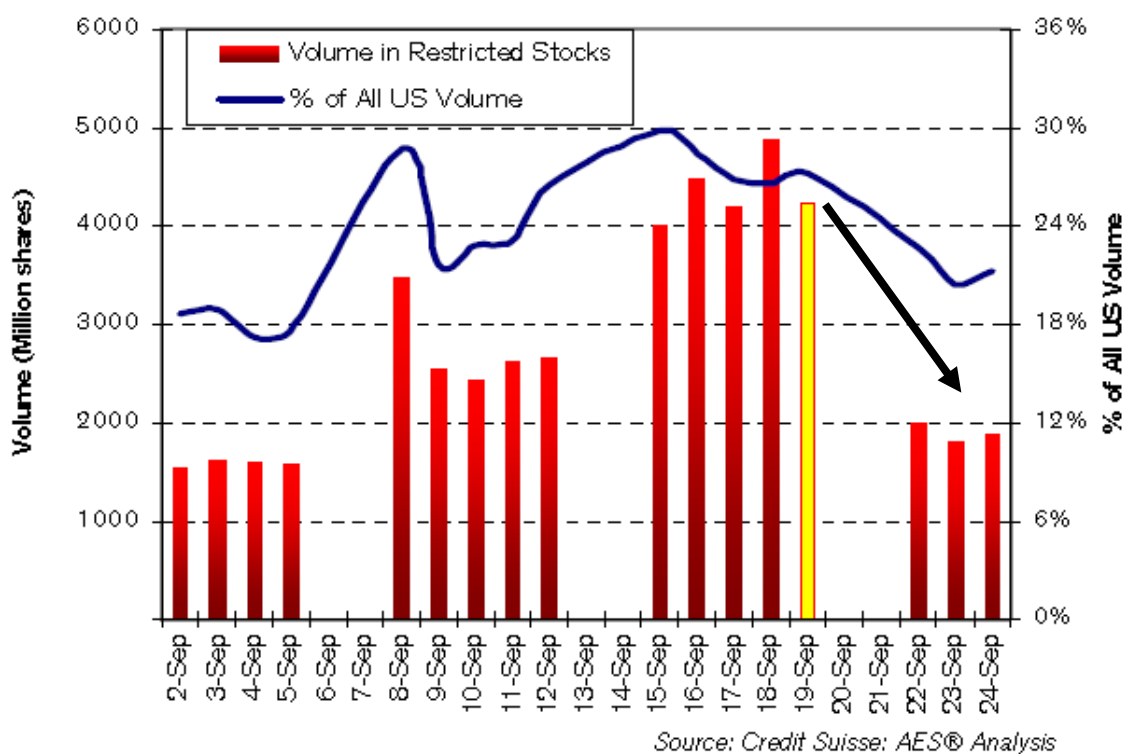
Reduced liquidity in affected stocks

Research⁴ based on US market data indicates that liquidity in affected stocks has significantly decreased since imposing the ban.

³ FSA statement on short positions in financial stock (FSA/PN/102/2008), 18.09.2008

⁴ Credit Suisse, What happened when Traders' Shorts Were Pulled Down, 30 September 2008

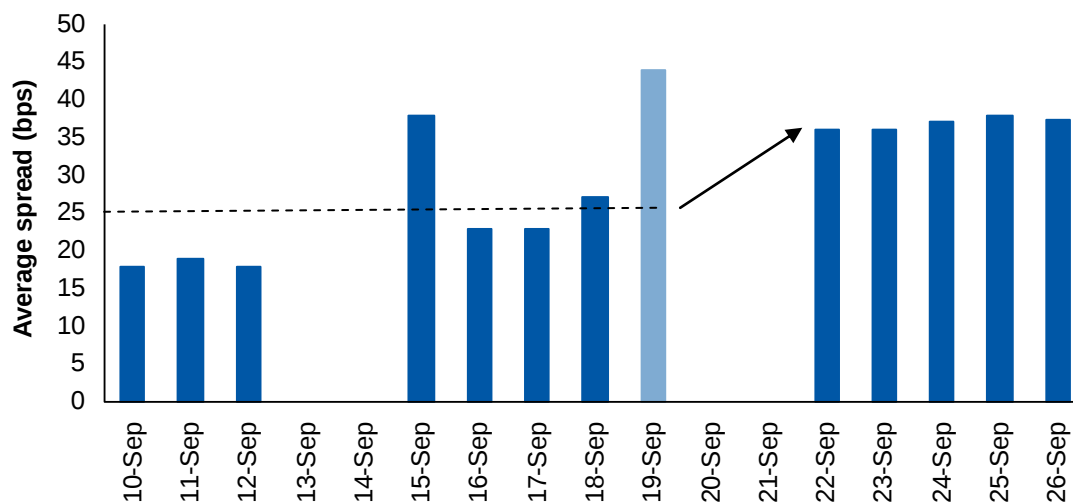
Figure 1: Trading volume



Higher trading cost in affected stock

The cost to trade restricted stock has increased when comparing pre and post short selling ban spreads.⁵

Figure 2: Trading cost



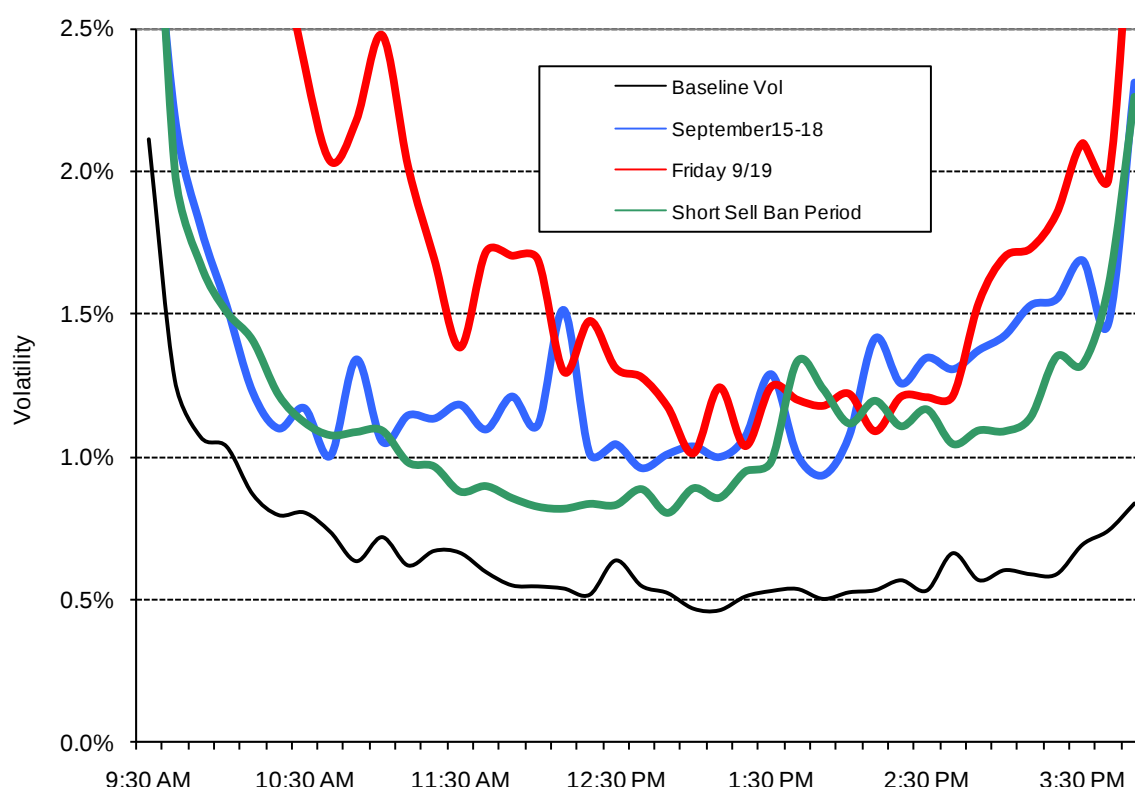
Source: Credit Suisse Portfolio Strategy/ AES® analysis

⁵ Source: Credit Suisse Portfolio Strategy / AES Analysis, 09/2008, based on US market data.

Volatility of affected stock has not significantly reduced

The short selling ban was enacted during a “crisis” week dominated by gloomy headlines, and it coincided with the expiration of index options and futures, a market event that usually incites enhanced volatility. As demonstrated by research in US markets, volatility spiked directly after the ban (19 September). Though that volatility has since reduced, it continues to remain above the baseline levels (measured as the normal August to the first two weeks of September). Many researchers do not believe there is conclusive evidence that the restrictions on short selling were effective in reducing volatility.

Figure 3: Intraday volatility of stocks subject to the short selling restrictions (10 min intervals)⁶



In many markets, a technical short term rally was observable in stock directly impacted by the short selling ban immediately after it was imposed. Simultaneously, a drop was observable in other stocks (i.e., those constituting the long position in a hedge transaction). This price correction induced by regulatory activity has led to winners and losers in an arbitrary manner (regulatory hazard). Ultimately, this adds to the “risks” investors face in financial markets. Market participants will be wary of future regulatory intervention, and this ultimately increases the cost of capital to companies.

⁶ Source: Credit Suisse AES Analysis

Is a short selling ban a useful instrument for regulators in times of distress such as the current crisis?

We have no doubt that regulators are aware of the overall benefits of short selling as outlined above, and are also aware of the explicit and implicit damage a ban on short selling of certain stocks inflicts on markets and the economy as a whole. Recent statements by regulators have also confirmed that short selling is not seen as the root cause of the current crisis, but that falling bank stocks are instead the consequence of the broader problems in the banking sector and a general loss of confidence which ultimately could only be resolved through massive government intervention. With or without short selling, the public realized that banks were extremely vulnerable, due to their exposure to risky assets far beyond what their reduced levels of equity would support. Since this lack of confidence very quickly led to bank runs and given that several financial institutions filed for bankruptcy, investors shied away from bank stocks for reasons which have no relation to short selling. We acknowledge that when regulators and politicians are coping with an emergency brought on by fears of a meltdown of the banking system (i.e., a run on the banks caused by plummeting bank stocks), extreme measures may be warranted. In such instances, however, it is important that regulators and politicians assess the adequacy of a specific measure to resolve a given problem (“Does the measure help to restore order to the markets?”, “Does the measure prevent bank stocks from falling further?”, Does the measure clearly facilitate vital capital raising activities?” or ultimately “Does the measure reduce the probability of a run on the bank?”).

We believe that there is insufficient evidence to justify a short selling ban on the grounds that disorderly markets were due to short selling:

- We do not find evidence that a disorderly market existed in banking/financial stocks in the first place; even assuming such a situation did exist, we have no reason to believe that short selling was the root cause of it. Research confirms that hedge funds (which engage in short selling, opposite to “long only” funds) have been net buyers of financial stocks in the weeks up to 12 September, while long only players have been heavy sellers of financial stocks (see Figure 4, based on flow data from UBS)⁷. In addition, no single bank was included in the Top 10 FTSE 100 stocks on loan (as a percentage of all outstanding stock) on 8 September (see Appendix A)
- Despite an immediate short term rally in banking/financial stocks, the shorting ban has not prevented banking/financial stocks from falling further since (see Figure 5).
- Finally, the “what if” assessment of whether the measure has prevented a run on banks (e.g., on Friday 19 September and the subsequent week end) cannot be answered given that the alternative scenario is not known.

We acknowledge that the short term rally on Friday 19 September might have contributed to re-establishing some confidence in the banking sector in the short term, particularly among the broader public. This technical reaction was short lived, however, and not a reflection of an actual mispricing of banking/financial stocks, as demonstrated by the subsequent further drop in financial/banking stocks. One can clearly argue, then, that markets were not disorderly in the first place and that there was no inherent mispricing. Unfortunately, the

⁷ Source: UBS Investment Research, European Equity Strategy 12 September 2008 (based on internal UBS flow data)

shorting ban and the perceived easing of the pressure due to the subsequent rally has given rise to a widespread criticism of short sellers and hedge funds in particular. We believe these claims to be completely unfounded and detrimental to the reputation of financial markets as a whole.

Figure 4: Net flows (4 weeks average prior to 12 September) by sector and fund type

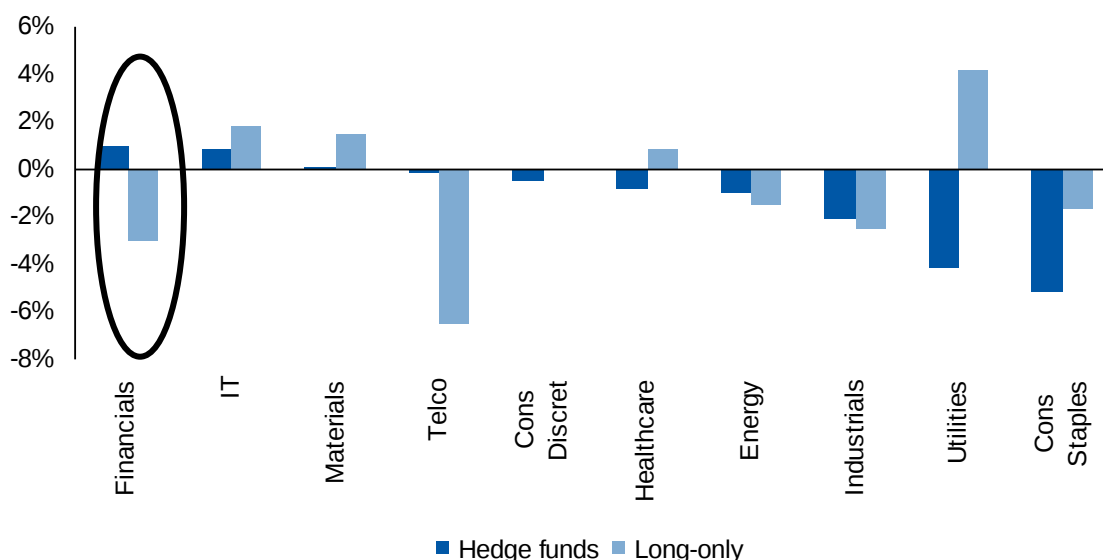
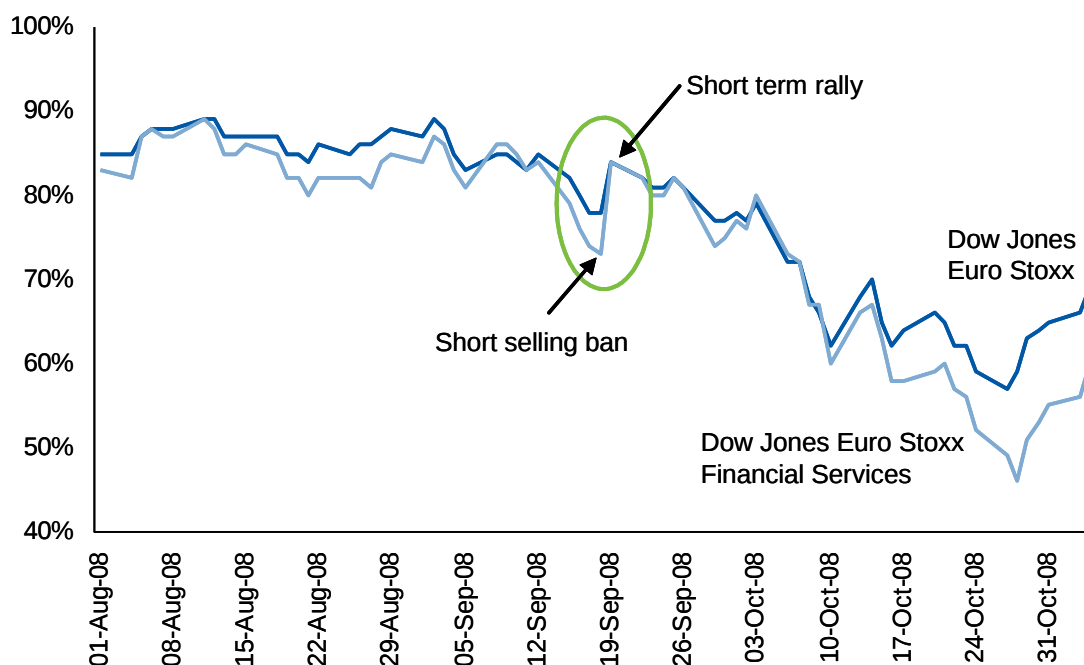


Figure 5: Evolution of Financial Services Stock vs. Stoxx 50 Index



Based on this assessment, we are not convinced that the short selling ban was a suitable measure in the first place. In fact, we believe that the ban actually sent an ambiguous message to the markets.

Regulators have implicitly told the markets that the practice of short selling resulted in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, we believe that, on the contrary, the price discovery process did function, and that the short selling ban has actually distorted the price discovery process. The ban has ultimately undermined confidence in the markets.

Finally, available evidence shows that the introduction of the short selling ban drove many investors away from the markets. Many mainstream investment strategies were suddenly no longer viable and investors had to sell or reduce their exposure. The short selling ban contributed to the general shrinkage of the market, which disproportionately affected financial institutions.

In particular, without short selling, the concept of absolute return is constrained and many hedge funds cannot operate. Because hedge funds are significant investors in financial institutions, the short selling ban significantly increased the general pressure to sell the stock of financial institutions. It may actually have been counterproductive.

Given these findings, we believe that the FSA's decision not to renew the ban on 16 January was the right one.

How to deal with disorderly markets

Clearly, no regulator will ever exclude any particular measure (including a short selling ban) from its arsenal when confronting the risk of a major financial meltdown. Although we have no convincing evidence thus far of disorderly markets or of short selling being the core problem, we would be pleased to engage with regulators to discuss a framework of measures to restore order to dislocated markets by:

- a) Developing a rigorous process for identifying disorderly markets
- b) Discussing the spectrum of tools/mitigants regulators can employ to counter disorderly markets

As part of this, restrictions on short selling might be only one of the available tools. We believe that in many instances short selling will not be the cause of disorderly markets. However, we would also be happy to discuss tools and approaches in the context of disorderly markets with respect to short selling, including for example a staggered ("waterfall") approach applicable to short selling (as illustrated in Table 2).

Table 2: Illustrative overview of "waterfall" approach to counteract disorderly markets

	Potential measures
Stage 1	Short selling restrictions during rights issuance periods of banks (eg lowered disclosure threshold)
Stage 2	Banning of uncovered/naked shorting
Stage 3	Enhanced disclosures (aggregate disclosure to regulators)
Stage 4	Uptick rule
Stage 5	Banning of covered shorting
Stage 6	Suspending stocks from trading /closing a market

This waterfall approach would equip regulators with a more finely tuned arsenal of tools with respect to short selling and to correcting disorderly markets while avoiding the most draconian measures, such as banning covered shorting or suspending stocks/markets. This approach, we believe, will reduce the overall damage to the markets. It should be noted that some key countries (notably Germany) have only imposed bans on naked short selling in the recent crisis. This is indeed significantly less interference with the market process (given that uncovered shorting is uncommon in Europe) than a complete ban (as enacted in the UK).

Should there be a general disclosure of short positions

Discussion has recently emerged around whether there should be a general disclosure regime around short positions, in particular since several regulators have recently enhanced disclosure requirements in this area.

In the UK for example, the FSA has introduced emergency measures in June 2008 requiring the disclosure of short positions representing 0.25% or more of the issued capital of a UK-listed company which engage in rights issues. Additional measures have been introduced relating to financial companies in September 2008, prohibiting the active creation of net short positions in publicly quoted financial companies as well as disclosure of all net short positions in excess of 0.25% of the ordinary share capital.

HFSB believes that there are two major motivations behind additional disclosures of short positions, 1. financial stability, and 2. market integrity/efficiency. The following table assesses to whom disclosure is relevant, what type of information should be disclosed, and what potential concerns could arise.

Assessment of short selling disclosure regimes

Factor	Reasoning	Relevance to whom	Type of information	Potential concerns	Application
Financial stability	Enabling regulators to spot and counteract risk of disorderly markets and financial instability	Regulators	Aggregate short position (eg to assess it in relation to trading volume)	• Cost to collect/aggregate data • Leakage risk of individual position	Only during times of distress
Market integrity/efficiency	Allowing better price discovery Allowing transparency for control purposes	All market participants Regulators	Individual (manager level) short positions	• Discouraging information acquisition	Always

There is one important distinction to highlight regarding the disclosure regimes illustrated above: While for financial stability purposes, the aggregate level of shorts is relevant to regulators, it is the individual manager level disclosure that is relevant in the market efficiency/integrity context to all market participants and regulators. In the latter context, the question arises what should be the

adequate disclosure thresholds for individual short positions. The HFSB believes that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions for the following reasons:

- The market impact of long and short positions is similar;
- Underpriced stocks are equally damaging as overpriced stocks from a market efficiency perspective;
- The risk of market manipulation is equally damaging whether it takes place in the form of long or short positions.

Currently, the long position disclosure regimes vary by country: In the UK, the Disclosure and Transparency Rules require disclosure of the combined long position of shares and CFDs if the 3% threshold is exceeded and for each percentage point thereafter (UK issuers).

Beyond establishing a symmetric approach for short disclosures, HFSB would welcome further European/global harmonisation of disclosure mechanisms.

Appendix A:

Top 10 FTSE 100 stocks by % shares on loan (8 September 2008)⁸

*“no banks among top 10 stocks by % share on loan”**

Instrument Name	% of share on loan
SAINSBURY	34.3
AMEC ORD	25.7
LIBERTY INT	25.3
LON ST EX	22.7
VEDANTA	21.2
THOMAS COOK GRP	19.7
WOLSELEY	19.4
BA	17.7
KINGFISHER	17.4
INTER HTL	15.7

For comparison purposes: Most borrowed stocks in the European banking sector⁶

*“no UK banks among the most borrowed European banking stocks”**

Instrument Name	Mkt Cap (US\$bn)	Days of Impact *	Estimated Market Short as a % of Mkt Cap
BCO POPULAR	12.4	14	10.0%
SWEDBANK	8.7	7	8.7%
ERSTE BANK	18.0	21	7.9%
HYPO REAL ESTATE	5.0	6	7.0%
DEXIA	16.7	15	6.8%
DEUTSCHE BANK	43.7	5	6.5%
EFG INTERNATIONAL	4.6	25	3.9%
BANCO SANTANDER	100.0	3	3.2%
BBVA	62.7	3	3.0%
SNS REAAL GROEP	4.0	7	2.7%
SOC GEN	53.9	4	2.7%
PARTNERS GROUP	3.6	22	2.6%
FORTIS	31.4	3	2.1%
INTESA SANPAOLO	65.9	3	1.6%
NORDEA BANK	32.8	5	1.5%
KBC GROEP	31.3	6	1.4%
JULIUS BAER HLDG	12.5	2	1.4%
UNICREDIT	69.8	1	1.1%

Source: UBS estimates

Note: * Days of Impact is the estimated number of days of average traded volumes to unwind the position

* Share on loan/borrowed stock does not only include “classical” short selling, but also includes stocks borrowed to facilitate settlement of trades and hedging.

⁸ Source: UBS Investment Research, European Equity Strategy, 12 September 2008