Impact Assessment Case Study

Short Selling

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Objectives of this case study

This case study takes the form of a role play exercise. The objectives of this case study are to enable the delegates to:

- Study a regulatory problem from a MFA/CBA perspective;
- Discover the insights into the problem that such analysis can give;
- Understand how those insights can help in the choice of regulatory solutions.

Preliminary observations

This case study is a much simplified version of reality and it should not be seen as descriptive of the true position.

What is short selling?

Short selling is the sale of a financial instrument the seller does not own. The seller can undertake a ‘covered’ short sale by borrowing the instruments he is due to deliver to the purchaser or a ‘naked’ short sale in which the seller does not have stock to complete the transaction at the time the sale is made. In both cases the seller will at some point need to purchase an equivalent amount of the instruments so that they can fulfil their obligations.

Short positions can be obtained through derivatives (whether exchange-traded or over the counter products) as well as by selling in the cash market.

Who short sells and why?

Short selling is a feature of most organised financial markets (whether equities, fixed income or commodities) and is undertaken by a wide variety of market participants including hedge funds, traditional fund managers such as pension funds and insurance companies, and investment banks.

Any of these investors could use short selling for hedging market risk and meeting client/counterparty demand as well as for speculative purposes – taking a view that a particular instrument is over-valued and whose price is therefore likely to fall.

For example, investors could simply take a short position in a comparable share in which they hold a long position. If the share price goes down, they can limit their losses through the rise in the value of the short position. This is a common practice and is used in most of the developed financial markets.

Hedge funds use short selling as a strategy and will often combine a short position with a long position, using pairs trading or even trading two stocks that are in different sectors, but that are correlated to one another in some way. The profit would come from the price differential between the two stocks. They may also use derivatives to create short positions.

Although they normally tend to buy shares and hold them for the long term, buy-side fund managers, such as insurance funds, often use short selling to hedge some of market risk in their portfolios. This is seen as more efficient and less costly than other methods.

Short selling trading strategies using derivatives are also employed by investors wanting short exposure to multiple shares of different companies in the same sector. Rather than selling short each individual share the investor could simply take a short position in an index that included each of the shares. This is a cost effective and a simpler way of taking the position than shorting each individual share.

Market makers use short selling to fill client orders when the stock they need is not immediately available. They are an important participant in financial markets and provide liquidity through their market making activities. Put simply, when meeting customer demand market makers may need to go short if they do not already hold sufficient stock on inventory.

Short selling and market efficiency

Short selling is generally considered to make an important contribution to the efficiency of markets through helping price discovery, liquidity and risk management. It is a legitimate practice and is not in itself inherently abusive.

If market participants are constrained from short selling, investors with negative information that do not hold stock inventory, will be constrained from selling and their information will not be fully reflected in stock prices. Restrictions on short selling can, therefore, increase the magnitude of overpricing and subsequent corrections or (if investors take account of short selling restrictions when forming their expectations and so do not systematically overvalue stocks) reduce the speed of price adjustment to private information. Empirical literature analysing information from 46 equity markets around the world for the period 1990-2001 shows that measures of efficiency tend to improve when short selling is feasible and practised.

Short selling can also enhance liquidity by increasing the number of potential sellers in the market. This increases efficiency by tending to increase trading volumes and reducing transaction costs (through a reduction in bid/offer spreads).

Framework

The Regulator's objectives include consumer protection, market confidence, consumer awareness and prevention of financial crime.

Problem and Regulatory Action

In recent times markets have gone through a period of extreme turbulence, manifested in the forms of high and prolonged price volatility and downward pressure on the prices of financial stocks in particular.

The Regulator has been concerned by the heightened risks of market abuse and disorderly markets posed by short selling in these conditions. Short selling can be employed in an abusive fashion (for e.g. accompanied by the spreading of false or misleading information) to drive down the price of a financial instrument to a distorted level. More widely, short selling – whether or not used in conjunction with abusive strategies – may cause or magnify disorderly market conditions. This is particularly the case in times of extreme turbulence and worries about market confidence and financial stability.

Short selling can convey a signal to the market that a firm is overvalued. If investors act appropriately on this signal, this improves the accuracy of the valuation of the stock in question. However, if investors over-react (e.g. in the context of a general lack of confidence in some financial services stocks), the price decline may be excessive. Such volatility reduces the ability of a firm to raise equity capital or to borrow money and makes it harder for banks to attract deposits. In exceptional circumstances, prophecies of financial difficulties may even become self-fulfilling. Empirical literature indicates that, while short sales do not affect the frequency of extreme negative returns, they may increase the size of the negative returns.

The regulator is particularly concerned that if short selling precipitates the collapse of an issuer, this may have further implications for market confidence, leading to contagion for related stocks which can ultimately result in further disorderly markets. These issues can be particularly severe if the issuer is a systemically important firm and in times of severe market stress.

In the light of very turbulent market conditions and concerns about the threat to financial stability the Regulator has taken emergency measures to impose conditions on short selling. The emergency action taken by the Regulator means:

1) Short selling is prohibited in all financials sector stocks.

2) Naked short selling is prohibited in all stocks.

3) Market participants need to disclose to the market their identity and the size of their short positions when these exceed 0.1% of a stock's market cap – and at every incremental 0.05% increase after this.

When imposing these restrictions the Regulator argued, a ban on short selling in the financial sector would eliminate, in this sector which is particularly vulnerable in times of market crisis, the scope for the potential negative effects of short selling (the potential for market abuse, disorderly markets, and market transparency deficiencies).

The Regulator also argued that a ban on naked short selling across the market reduces the risk of settlement failures brought about by the inability of a naked short seller to source stock to fulfil delivery obligations, and limits the speed and the extent to which a short selling strategy can be executed and thus can act as a brake on more aggressive short selling.

On the disclosure obligation the Regulator argued this would enhance transparency by providing insight into short sellers' price movement expectations which could improve pricing efficiency if the information is correctly interpreted. Applying the disclosure obligations could also help in detecting short selling that is being used to commit market abuse, and help identify when investors are overreacting and, hence, give the Regulator more advance warning of conditions in which they may have to consider intervention

Regulators in other regions have also taken action in their jurisdictions. Some have banned short selling completely, some have imposed bans in specific sectors, others have only imposed disclosure obligations, and some have only acted against naked selling, or asked for firms to report significant short positions to the relevant Supervisors.

Proposal and Task

The Regulator now proposes to make these changes permanent.

Several types of market participants have argued against this, mainly on market efficiency grounds, though there is broad support for the Regulator going even further among some

newspapers and politicians. Hedge funds are particularly against these restrictions. They argue in part that the disclosure requirements would mean revealing their trading strategies, driving down profits and in the extreme forcing them to exit the market.

The Regulator has agreed to open discussions with market participants before making these proposals permanent. In this session they are meeting hedge funds who do not think the short selling restrictions are justified.

Attendees will be split into two groups, one acting as the Regulator and the other as Hedge Fund representatives. The task has two stages:

1. Both groups should prepare for the Regulator-Hedge Fund session by examining the issue from an economic point of view. They should consider:

- market and regulatory failures;
- the costs and benefits of the proposals;
- further evidence that might be helpful in informing policy; and
- alternative policy options that may improve on the Regulator’s proposals.

This should allow both groups to understand the strengths and weaknesses of their own position and the other side’s position (think both about arguments stated in this note and further potential arguments the other side might make).

70 minutes

2. The groups will then enact a role play exercise acting as the Regulator and Hedge Fund representatives arguing their respective positions. The discussion should mainly focus on the economics of the issue rather than political or other considerations. Groups should show flexibility where the other side demonstrates a convincing case.

35 minutes

Market / Regulatory Failure Analysis

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Table 1

The Problem	
What is the problem?	
What evidence shows that the problem is significant?	
Is the problem due to market failure? What is the market failure?	
Is the problem due to regulatory/supervisory failure? What is the regulatory/supervisory failure?	
What regulatory objective is put at risk by the problem?	
Is it or is it not likely that the problem will be solved over time without a new regulatory policy? Give reasons.	
Is the case for regulatory/supervisory action justified?	

Table-2

Benefits & Costs – no action	Qualitative Description	Quantitative Description (e.g., major, minor)
Benefits		
Direct Costs (to supervisors)		
Compliance Costs		
Quantity of products offered		
Quality of products offered		
Variety of products offered		
Efficiency of competition		