



# What's all the Fuss about Short Selling?

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Investment is about price discovery. Identifying the true price of a stock cannot be left up to the markets as markets need a combination of operatives to ensure fair trading. Investment markets are comprised of:

- traditional long term investors; and
- speculators or arbitrageurs.

The latter group plays a crucial role in facilitating the efficiency of markets. Stock arbitrageurs, or short sellers, play a stabilising role in price discovery.

According to recently published data (US specifically), the vast majority of short sellers are 'market makers' who are hedging their bets on the option market. They were not affected by the recent ban on short selling, which means that those who were using options to take synthetic short positions continued to do so. The others involved in short selling were mainly hedge funds. So, if short sellers are important to the efficient functioning of markets, what has all the fuss been about?

## BACKGROUND TO THE BAN: GLOBAL CREDIT CRISIS

The global credit crisis blew a hole in the efficient market theory. The view taken by many, that markets are self-correcting if left to their own devices, was exposed as being seriously flawed.

In the US, UK and Australia, governments (via their market regulators) imposed short selling bans, especially on finance sector shares. This was based on the premise that the irresponsible actions of arbitrageurs in taking a negative position, (i.e. selling short financial stocks), undermined the financial well-being of those institutions and, by default, the market *en generale*.

The introduction of short selling bans split the investment community into two camps:

1. those in favour - mainly trading firms and only a very few long term investors; and
2. those against - comprising market traders and hedge/ absolute return funds.

## WHAT IS SHORT SELLING?

Before we start examining why a short selling ban was introduced, let's be quite clear on what is meant by short selling. There are two types of short selling: covered and uncovered.

### SHORT SELLING COVERED

Short selling covered is where an investor decides that the share which he/she *does not* own is overvalued or over priced against perceived fair value and is due for a fall.

The concept is really very straightforward. The short seller sells the shares which he/she *does not own* with the idea of buying them back at a lower price at a later date and thereby profiting from the fall in the shares' price. To achieve this, when the seller sells shares that are *not owned*, a stock borrow must be arranged so that, on settlement date, the seller can deliver the shares to the buyer/counterparty/market.

After a predetermined period of time, the short seller will buy the shares back and, on settlement date, receive the new shares from the market and simultaneously deliver the stocks back to the stock lender to close out the stock borrow position.

## SHORT SELLING UNCOVERED

Short selling uncovered (or 'naked' short selling) is where the investor has no intention of borrowing the stock having once sold it short. Although many a regulator's red flag has been raised over this perceived inappropriate behaviour, in actual fact, the incidents of naked short selling occurring are extremely low. However, in some cases, a Central Security Depository (CSD), such as the Depository Trust Clearing Corporation (DTCC) in the US, has been sued over naked short selling events. (A CSD is an organisation that holds securities, normally in book-entry form, and is usually the ultimate place of settlement, effected through book entry transfer.)

DTCC's First Deputy General Counsel, Larry Thompson, explains that in many cases there is a lack of understanding over the level and negative market impact of naked short selling.<sup>1</sup>

*"We've had 12 cases to date filed against DTCC, or one of our subsidiaries, over the naked shorting issue. Nine of the cases have been dismissed by the judge without a trial, or withdrawn by the plaintiff. The other three are pending, and we have moved to dismiss all those cases as well. While the lawyers in these cases have presented their theory of how they think the system works, the fact is that their theories are not an accurate reflection of how the capital market system actually works."*

## MISGUIDED REGULATORY DIRECTIVES

Further evidence of misguided directives from the authorities can be seen in a study examining the impact of the emergency order from the US Securities Exchange Commission (SEC) on 15 July 2008 which banned naked short sales. The study<sup>2</sup> was undertaken by Arturo Bris, a finance professor at IMD business school in Lausanne, Switzerland. Released on 12 August 2008, it showed that the banning was hard to justify.

The stocks concerned were not shorted more frequently than those of a control group of firms. In addition, negative returns of off-limit firms were in no way related to shorting; rather, they were a result of market sentiment caused by the global crisis of confidence.

Let's now return to the market furore over the short selling ban. We know the US, UK and Australia had short selling bans in place in late 2008. These will be discussed in more detail later in this paper. The bans were later lifted (the US in Oct 2008, the UK in January 2009, while Australia waited 8 months until May 2009).

In the EU, the German government blamed the activities of hedge funds for causing excessive market turmoil through their shorting activities. This also triggered a ban which, at the time of going to press, will be maintained until 31 January 2010.

The question we need to ask, though, is whether these bans were introduced on fundamental and sound market risk assessments? Or were they a knee-jerk reaction triggered by emotive and misinformed politicians, based on a rather shaky premise that "something must be seen to be done"?

The International Organisation of Securities Commissions (IOSCO), the umbrella organisation for the world's market regulators, acknowledged that short selling plays a key role in:

- price discovery;
- preventing market bubbles;
- increasing market liquidity;
- facilitating hedging; and
- other risk management activities.

So, therefore, unfettered short selling is "good for your health", at least according to the poacher, not the gamekeeper!

## HEDGE FUNDS AND SHORTING STRATEGIES

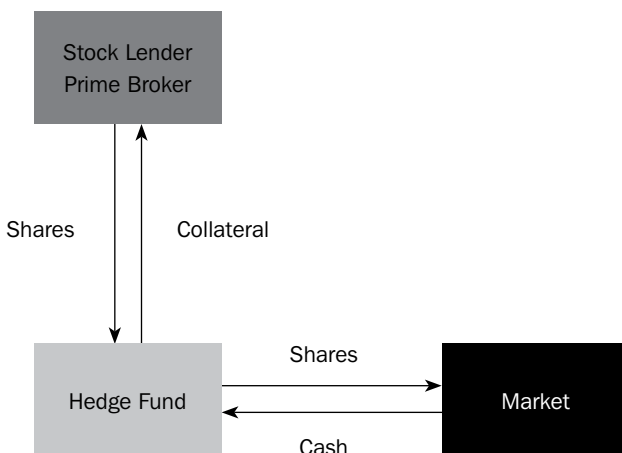
The following diagram demonstrates the fund and stock flows behind a short selling exercise by a hedge fund.

1. The fund manager decides there are stocks that are overpriced and are likely to fall in value.
2. A decision is taken to sell short the shares but, before this can be done, the shares required for settling the short position need to be borrowed from a prime broker or custodian bank to complete the transaction.

1 [http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked\\_short\\_selling.php](http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked_short_selling.php)  
2 <http://www.imd.ch/news/upload/Report.pdf>

3. Collateral is offered to the prime broker in exchange for shares in the 'shorted' companies.
4. As the target shares fall closer to their fair value, the hedge fund manager would buy back the shares and book a profit on the transaction.
5. The purchased shares would be returned to the prime broker who, in turn, would release the collateral.

This is a simple example as, of course, there are many more sophisticated uses of shorting.



Returning to the use of shorting by hedge funds, the average return over the last ten years for hedge funds that used short sale, convertible arbitrage, and long/short strategies was 3 per cent, 4.75 per cent and 7 per cent respectively (according to Le Sourd, 2009). These returns can in no way be regarded as excessive or even abnormal. The shares that were the target of the short selling ban were unaffected by it. The dark side of the short selling ban was that the risk/return ratio deteriorated and volatility in the shares that were 'off-limits' increased. Markets reacted negatively to this ruling.

## WHERE TO FROM HERE?

There still appears to be a wide gap in the understanding of the impact of short selling, with opinions divided between

- regulators and their legal advisers; and
- market practitioners.

Particularly as to how the market actually works – theory versus pragmatism. Short selling is an 'over-the-counter' activity and therefore, by its very nature, it is hard to capture the full market impact, however slight. It is an institutional investor activity rather than a retail activity.

Therefore, introducing a short sale ban actually skews the market and makes it less fair, which is contrary to what regulators want to achieve.

## RECENT REGULATORY ACTION – WAS IT WARRANTED?

In a speech<sup>3</sup> to the Securities and Derivatives Association on 29 May 2009, Tony D'Aloisio, chairman of the Australian Securities and Investments Commission (ASIC), said that, in March/April 2008, considerable pressure was put on ASIC to impose a ban. At the time, ASIC felt that the balance between price discovery and efficiency (benefits of short selling) outweighed possible systemic issues. In September/October 2008, ASIC took the view that a circuit breaker was needed which triggered the introduction of the ban.

Bearing in mind the hue and cry from the investment community, on what evidence did ASIC base its rationale for introducing a ban? Were factors such as market and share price volatility taken into account? What statistical facts, if any, were presented to the market prior to the implementation of the ban?

Looking at another market, on 18 September 2008 when the Financial Services Authority (FSA) in the UK urgently introduced a ban on banking and insurance stocks, it did so without consultation. The ban was introduced under the dark cloud of the global credit crisis amid concern over the potential for market abuse resulting from short selling. The FSA hoped to avoid the consequences of any market destabilisation in such extreme conditions.

The measures banned the active creation or increase in net short positions in shares of UK financial sector companies and required disclosure to the markets of significant short positions in those stocks (Disclosure Obligation). The ban expired in January 2009 and was followed in February by the release of a discussion paper on short selling (DP 09/1)<sup>4</sup> but the Disclosure Obligation was to remain in force until 30 June 2009.

## IOSCO'S GLOBAL REMIT ON THE REGULATION OF SHORT SELLING

On 23 March, 2009, a media release by IOSCO in Madrid<sup>5</sup> recommended that effective regulation of short selling should be based on four principles. Regulation should:

1. be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets;
2. be subject to a reporting regime that provides timely information to the market or to market authorities;

3 [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/sdia-speech-chairman-May-09.pdf/\\$file/sdia-speech-chairman-May-09.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/sdia-speech-chairman-May-09.pdf/$file/sdia-speech-chairman-May-09.pdf)

4 [http://www.fsa.gov.uk/pubs/discussion/dp09\\_01.pdf](http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf)

5 [http://www.cdv-oca.be/fr/press/pdf/2009-03-23\\_shortselling.pdf](http://www.cdv-oca.be/fr/press/pdf/2009-03-23_shortselling.pdf)

- 3. be subject to an effective compliance and enforcement system; and
- 4. allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

## BENEFITS OF SHORT SELLING WITHIN ACTIVE INVESTMENT MANAGEMENT STRATEGIES

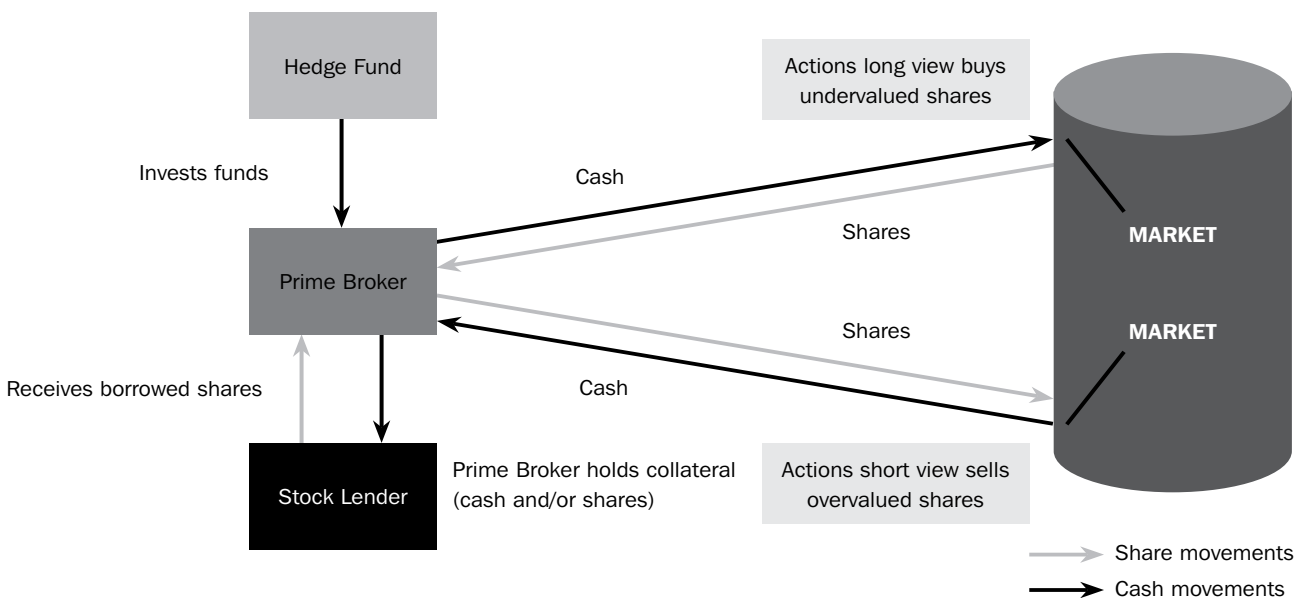
An increasing number of active fund managers use short selling within a traditional portfolio structure; indeed, their institutional investor clients expect this.

Short selling enables managers to display their stock picking skills, often referred to as their ‘alpha’, gained from detailed analysis. Negative positions on stocks can be fully reflected within a portfolio and it allows more ‘information efficient’ portfolios to be created. Furthermore, where a manager identifies a price anomaly between two or more shares, short selling allows the manager to exploit the apparent mispricing.

The diagram below shows how short selling is used within a typical long/short transaction by a fund manager. Here, the manager expresses:

- a long or positive view on a sector by buying undervalued shares; and
- a short or negative view by selling overvalued shares.

### HEDGE FUNDS – LONG/SHORT TRANSACTION ANALYSIS



## STRATEGIES DURING A SHORT SELLING BAN

So, if short selling and stock borrowing were banned, are there alternatives? The answer is yes: welcome to the world of derivatives. There are a range of derivative instruments that allow managers to express a negative position and create a negative trade opinion called a ‘synthetic short sale’ which use options, swaps, and Contracts-For-Difference (CFDs). However, a full exploration of derivatives is beyond the scope of this paper.

## CONCLUSION

Financial markets are continually being innovative. Regulation exists to ensure that markets operate efficiently, fairly and that any action by participants does not destabilise markets or disadvantage other investors. Based on the preceding arguments and evidence tabled in this paper, it is clear that the imposition of any ban needs to be clearly explained to the market before being introduced. Furthermore, prior to the introduction of any restrictions to free market trading, thorough and comprehensive market analysis into the cause and effect should be undertaken.

Short selling covered plays an important role in efficient markets and price discovery; in many ways it exposes market abuse. As we are now well aware, global markets are highly connected and the cliché about major markets sneezing only for others to catch a cold is well worn.

Regulation needs to be global in nature and we hope that the work being undertaken by IOSCO, in conjunction with local market regulators, comes up with a set of rules that is appropriate and suitable based on analysis and research, as opposed to hearsay and dogma. Above all, regulation should be cost-effective, simple to apply and enforced with the minimum of doubt.

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**ASSESSMENT QUESTIONS:** *What's all the Fuss about Short Selling?*

1. What is naked short selling?
  - a) It is the same as covered short selling.
  - b) It is where the investor sells the shares he/she owns with the idea of buying them back later at a lower price.
  - c) It is where the investor has no intention of borrowing the stock having once sold it short.
  - d) It is the term for people who trade shares sans clothing.
2. Which recent study showed that the regulatory ban on naked short selling in the US was hard to justify?
  - a) The FSA's DP 09/1.
  - b) A study released on 12 August 2008 by Arturo Bris, a finance professor at IMD business school in Switzerland.
  - c) IOSCO's media release in March 2009.
  - d) ASIC's presentation to the Securities and Derivatives Association in May 2009.
3. Identify one of IOSCO's recommendations for the regulation of short selling.
  - a) It should minimise the effective functioning and stability of the markets.
  - b) The reporting regime should not be required to supply information to the market or market authorities.
  - c) It should be subject to an effective compliance and enforcement system.
  - d) All uncovered short selling should be banned.
4. What are the benefits of short selling within active investment management strategies?
  - a) Price anomalies between shares cannot be exploited.
  - b) Benefits are minimal as fund managers do not have many institutional investor clients who expect this service within their portfolio.
  - c) Fund managers are unable to display their stock picking skills.
  - d) Fund managers can display their skill at finding 'alpha'.