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Short-Selling Regulation and the Development of the Stock Markets

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Abstract

The purpose of the paper is to take into discussion the benefits, as well as the negative effects that regulation might trigger for the development of the stock markets, focusing on the case of short-sale transactions. The paper outlines the regulatory changes that were made in this respect for the European Union countries in the aftermath of the 2007-08 financial crisis. Alongside reviewing the most significant empirical papers which have approached the connection between banning or short-selling disclosure requirements and stock market quality, the authors investigate whether the current regulation brings more benefits than costs to the European financial markets.

Key words: regulation, short-selling, liquidity, stock exchange
J.E.L. classification: G10, G14, G18

1. Introduction

While the majority of the investors buy stock (or other financial instruments), with the objective of making a profit when the stock price goes up, it is also possible to make profits when the financial markets go down, by making short-selling transactions. Short-selling can be defined as a trading strategy that aims on capitalizing the expected decline in a security price, which involves borrowing stocks (most commonly through a broker, but also from a bank or institutional investor) and selling them immediately at the current market price. It is followed by the repurchase of the stocks at a future date and by their return to whoever they were borrowed from, making a profit from the difference along the way. According to IOSCO (2009), some jurisdictions allow only "covered" shorts - which imply that "the seller has borrowed or made provision to borrow the securities before the sale is executed" and prohibit "naked" shorts - when the seller has done no previous arrangement in order to cover the short-selling transaction.

In the aftermath of the financial crisis, banning of short-selling was on many countries' agenda. Whether the answer to the reason why is it good to have a short-selling regulation at all can be found in the desire of the authorities to ensure a maximization of the market efficiency, while preventing the situations of market failures or market abuse, there are still many questions arising from the oppportunity of taking over-burdensome or more radical regulation measures concerning short-selling. A large body of literature has focused on the effects of banning on the quality of the stock market, while many practitioners argue against the current regulation concerning short-selling.

The rest of the paper is divided as follows: chapter 2 presents the theoretical and regulatory framework regarding short-selling, chapter 3 realizes a review of the empirical literature with the aim of determining if short-selling restrictions led to more favourable market conditions than if short-selling was unrestricted, chapter 4 concludes.

2. Theoretical background

There is a broad agreement that short-selling enhances market performance and improve resource allocation. Numerous papers emphasize on the benefits that short-selling brings to both market efficiency and price discovery (Miller (1977), Boehmer et al. (2008), Saffi and Sigurdson (2011)). Some authors outline the importance of naked short sellers as liquidity drivers and value arbitrageurs (Fotak et al. (2009)) while others view them as predictors of the future stock performance (Diether et al. (2009)).

Short-selling is considered a riskier transaction due to the theoretical unlimited loss that can be experienced when the market has a different dynamics than the one expected in comparison with the situation of going long, where the loss is limited to the amount that has been invested. The increased risks associated with these instruments can also lead to market volatility and increase the risk of default, when the traders leverage a significant percentage of their assets and if called, they would not have the possibility of covering their positions (Gregoriou, 2011).

At the beginning of the financial crisis, the International Organization of Securities Commisions (IOSCO) has ellaborated a report including some non-mandatory general principles for short-selling, dedicated to support the financial regulators in their attempt to create a regulatory framework for the short-selling transactions. In this report, IOSCO (2009) considered the very important functions of short-selling: enhancing price efficiency, mitigating financial bubbles and increasing market liquidity. However, the same report draws attention on the fact that using specific short-selling strategies on vulnerable markets can also contribute to the market destabilization, outlining the importance of understanding the consequences of naked short transactions on the stock markets. The report objective was the one of emphasizing the importance of proper regulatiion of the short-selling activity to the financial authorities, rather than the one of recommending short-selling transactions on the stock markets. The report established four general principles concerning short-sellling transactions (IOSCO, 2009, p. 6):

a) they must be "subject to appropriate controls that reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of the financial markets";

b) they must be "subject to a reporting regime that provides timely information to the market or to market authorities";

c) they must also be "subject to an effective compliance and enforcement system";

d) the regulation of short-selling "should allow exceptions for certain type of transactions" that contribute to the effective functioning and development of the fianncial markets.

The first three principles dealed with the importance of a stricter regulation of short-selling that reduces the destabilizing effects that might be caused by a certain type of short-selling, establishing an effective system that reinforces the transparency of these operations. The fourth principle outlined that regulation of short-selling does not prevent the realization of operations that are suitable for the good functioning and development of the markets, consequently, there are some exceptions.

The report considered that short-selling activity has to be developed within a regulated framework in order to be maintained a fair, orderly and efficient market. The four principles served to establish a harmonized framework that each country's market authorities could develop in order to create the regulation regarding short selling and ensure a better supervision of the transnational operators.

The new regulation of short selling that has become applicable in November 2012 (EU Regulation on Short Selling and certain aspects of credit default swaps no.236/2012), aimed at a harmonization of the short selling rules in all European Union member states, at an increased transparency and a lower settlement risk on the European financial markets. The regulation is a consequence of the problems experienced by the member states of European Union, alongside the reports provided in time by IOSCO and CESR (Committee of European Securities Regulators). The regulation imposes reporting to the regulator of all initial and incremental short position in shares (as % in the issued capital of a company), that are above the threshold of 0.2 %, as well as when the company reaches 0.1 % thereafter ir when the short position falls below the thresholds. It also required the companies to make public all positions above 0.5 %.

ESMA (The European Securities and Markets Authority) was the one entitled with implementing powers, the one who had to draft Regulatory and Implementing Technical Standards. The Regulation was supplemented by some following implementing and delegated acts[1].

3. Regulation of short-selling and the quality of the stock markets. Review on the empirical literature

In the aftermath of the 2008 financial crisis, regulators considered that the equity markets were in danger due to the pressure of short-selling transactions. Consequently, on the global financial market, some restrictions or even banning regarding the short-selling of some equity securities were taken. The general belief behind these regulatory actions was the speculation that the short-selling transactions of the hedge funds were responsible for generating a decline in the stock prices and that these transactions would undermine the confidence in the stock markets (Wyman, 2011).

The regulatory measures varied in intensity, duration and object of banning. U.S. and UK were the first countries implementing short-selling banning, as a reaction to the bankruptcy of Lehman Brothers Bank in September 2008. In some countries, the banning of short-selling transactions included also the disclosure of the short positions in the existing shares. From the considered European Union countries, with the exception of Spain, the targeted stocks for banning included only the financial sector. In other countries, banning was applied to all stocks. The duration of banning also varied among countries. While in the US, the short-selling ban had a minimum duration (of only 14 days), in the UK and in the majority of the European Union countries the initial banning lasted more and was replaced by the mandatory public disclosure of short interest for all financial sector stocks that were subject of the previous banning. In other countries, there was no ban at all (see Table 1).

Table no. 1: Differences in banning short-selling in the aftermath of the 2007-08 financial crisis

Country	Targeted stocks	Disclosure	Duration of banning (days)	Ban start Date
European Union				
Austria	financial sector stocks	financial sector stocks	240	26.10.08
Belgium	financial sector stocks	financial sector stocks	274	22.09.08
Bulgaria	no ban			
Cyprus	short selling is not practiced			
Czech Republic	no ban			
Denmark	financial sector stocks		253	13.08.08
Finland	no ban			
France	financial sector stocks	financial sector stocks	274	22.09.08
Germany	financial sector stocks		276	20.09.08
Greece	all stocks	all stocks	234	10.10.08
Hungary	no ban	all stocks		
Ireland	financial sector stocks	financial sector stocks	277	19.09.08
Italy	financial sector stocks, then all		252	22.09.08
Netherlands	financial sector stocks	financial sector stocks	252	22.09.08
Poland	no ban			
Portugal	financial sector stocks	all stocks	274	22.09.08
Romania	short selling is not practiced			

[1] 1) Commission Delegated Regulation (EU) No. 826/2012 of 29 June 2012 supplementing Regulation (EU) No. 236/2012 of the European Parliament and of the Council with regard to regulatory technical standards on notification and disclosure requirements with regard to net short positions, the details of the information to be provided to the European Securities and Markets Authority in relation to net short positions and the method for calculating turnover to determine exempted shares; 2) Commission Delegated Regulation (EU) No. 918/2012 of 5 July 2012 supplementing Regulation (EU) No. 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events; 3)Commission Delegated Regulation (EU) No. 919/2012 of 5 July 2012 supplementing Regulation (EU) No. 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to regulatory technical standards for the method of calculation of the fall in value for liquid shares and other financial instruments

Slovenia	no ban			
Spain	all stocks	financial sector stocks	272	24.09.08
Sweden	no ban			
UK	financial sector stocks	financial sector stocks	119	19.09.08
U.S.	financial sector stocks	all stocks	19	19.09.08
Canada	all stocks	all stocks		19.09.08
Australia	all stocks	all stocks	245	22.09.08
New Zealand	no ban			
Hong Kong	no ban			
South Korea	all stocks		265	1.10.08

Source: adapted from Wyman (2011)

However, taking into consideration the large body of empirical literature that has investigated the effects of such regulatory restrictions or banning on the financial market, it has been concluded that their effect was in the best case neutral to the market, while in most cases, detrimental for the liquidity, bid-ask spreads or price discovery (Diamond and Verrechia (1987), Boehmer et al. (2009), Wyman (2011), Beber and Pagano (2012)) (see also Table 2).

More recently, Lensberg et al. (2015) propose a new methodology in order to measure the leverage restrictions on market quality and reach the conclusion that short-selling banning leads to a decrease of short-term volatility and to a lower cost of capital. Leverage ban, however, enhances the market stability, while it drives lower liquidity and higher cost of capital.

Table no. 2: Review of the empirical literature which has approached the connection between short-selling regulation and stock market development

Authors	Country of analysis	Methodology	Main results
Bris et al. (2007)	46 global equity markets	Cross-country regression analysis	In the countries where short-selling is allowed and practiced, the stock prices incorporate faster the bad news faster; short-selling bans drive less efficiency in the process of price discovery
Beber and Pagano (2009)	30 stock markets	Panel data analysis	There can be depicted, especially in the case of lower market capitalization stocks and high volatility stocks, a connection between the short-selling ban and the decrease of the market liquidity
Boehmer et al. (2009)	U.S.	Panel data analysis	Short-selling ban is decreasing market liquidity
Kolasinski et al. (2010)	U.S.	Panel data analysis	Through ban stocks, liquidity and market quality decreased more for those with traded options
Marsh and Payne (2012)	U.K.	VAR	There was no justification for introducing banning exclusively for the financial sector stocks since market quality indicators were getting worse prior to the ban for all stocks, not just for the financial sector; banning made the trading process less informative, generated a reduction in liquidity and market quality
Mertzanis (2015)	Greece	Co-integration, Granger-causality tools	When short-selling is allowed, it is associated with a small increase in return volatility and a low effect on market liquidity

Source: realized by the author

There is a significant number of recent papers that have concentrated their attention into proving that the current regulation applicable on the European financial markets, that requires disclosure of short positions is also detrimental for the market efficiency in general and for short-sellers in particular. One general explanation for this would be the short squeeze situations, enhanced by the increased transparency, that force more short sellers to close out their short positions, putting more upward pressure into the market. Other explanations rely in the concern of the short-sellers that

their strategies would be directly revealed to the market. It is important that within the process of information disclosure to the financial authorities, anonymity should be ensured on the way.

Wyman (2011) brings valuable insights on the reasons why investors (European and North American hedge fund managers) reduce their short-selling transactions in the presence of over-burdened regulation, from which we outline:

- the "herding effect", that the disclosure brings resulting in "crowded trades";
- the risk of taking unpopular short positions, from a political point of view;
- an increased operational risk for the cases of substantial equity exposure.

4. Conclusions

Market quality is something that is currently on all policy makers' agenda. The quality of the financial markets imply, among others: liquidity, efficiency and price discovery. Disclosure of any relevant information to the market contributes to the market efficiency. Short-selling is generally seen as a trigger for price efficiency, by incorporating negative information to the market, and enhancing the process of price discovery, while restriction of short-selling is able to create a bias in the stock prices, due to overpricing. The question arises from the benefits that short-selling regulation could bring to the market quality, over-burdensome regulation being in general criticized by the financial practitioners.

In the aftermath of the 2008 financial crisis, banning of short selling has been registered in the majority of the European Union countries. The evidence provided by the majority of empirical papers that have investigated the effects of banning on the market quality lead to the idea that it was counterproductive, having negative consequences for the market liquidity, bid-ask spreads or price discovery.

The current regulation implies a mandatory public disclosure of short interest that surpasses a certain initial and incremental threshold. Public disclosure of the short-selling transactions could also impact negatively the market efficiency. From these, we summarize: herding behaviour, a drain on hedge fund profitability (which dominate the short-selling transactions), allowance on more short squezees.

Consequently, we consider that a balanced short selling regulation is needed, a regulation that increases market efficiency, whilst not over-burdening short sellers, a regulation that should not be designed in order to ban or disincentive short-selling transactions, for which history proved the negative effects on the market quality. Furthermore, research should focus on the empirical effects of the regulation of short-selling on the informational efficiency of the stock markets. An analysis focusing on the European Union countries, and especially Central and Eastern European countries, with similar development of the stock market would bring a new insight to the existing literature.

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