

# **Shooting the Messenger:** The Ban on Short Selling



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## Crisis Commentary 2

The Crisis Commentary papers are based on the series of CIS events held, beginning in November 2008, to address the global economic crisis and provide CIS members and the public with in-depth analysis and varied perspectives on the crisis.

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# Contents

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**Contributors** ..... vii

**Crisis Commentary Series—Introduction**

Stephen Kirchner ..... 1

**Shooting the Messenger: The Political Economy of Short Selling**

Stephen Kirchner ..... 3

**Short sellers: Financial Detectives or Villains?**

Robert J. Bianchi ..... 11

**ASIC Should Extend its Short selling Ban, Not End It**

John M. Green ..... 23



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# Crisis Commentary Series—Introduction

Stephen Kirchner

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**T**he global financial crisis that emerged in 2007, and intensified in 2008, has turned into a major worldwide economic downturn more serious than any since the Great Depression of the 1930s. The financial and economic crisis has seen considerable debate about its origins and consequences, as well as the responses of policymakers. The crisis raises important issues about the role of markets and governments in the allocation of capital and the regulation of financial institutions.

Australia went into the economic crisis better placed than most countries. However, as a small and open economy integrated into the world's capital markets, Australia cannot expect to escape the financial and economic issues confronting other countries.

The Centre for Independent Studies initiated a series of Crisis Commentary events, beginning in November 2008, with a roundtable discussion of the global ban on short selling stocks. Subsequent events addressed the federal government's renewed use of activist fiscal policy and other policy responses to the crisis. These events aim to provide CIS members and the general public with access to alternative perspectives on the crisis that are otherwise less well represented in the public debate.

The Crisis Commentary events have provided the basis for considerable media coverage for CIS. The aim of the publications in the Crisis Commentary series is to give these perspectives even wider currency and to serve as a reference for those interested in some of the many important issues raised by these events.

This volume collects the contributions to the roundtable on short selling held at the Centre on 12 November 2008. The contributions by Robert Bianchi and Stephen Kirchner have been updated in light of subsequent developments. John Green's paper is unrevised.

**Stephen Kirchner**

Research Fellow

The Centre for Independent Studies



# Shooting the Messenger: The Political Economy of Short Selling

Stephen Kirchner

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**B**ans on short selling financial stocks were implemented in a number of stock markets around the world at the end of September 2008.

In Australia, a ban on ‘naked’ short selling (see below for definition) was announced by the Australian Securities and Investments Commission (ASIC) on Friday, 19 September, to take effect from the following Monday. Over the weekend, however, ASIC changed its mind. On Sunday, it announced that the ban would also extend to covered short sales of all listed stocks for a period of 30 days. In announcing the decision, ASIC said:

Recent market global conditions, coupled with extensive short selling of stocks, particularly financial stocks, may be causing unwarranted price fluctuations. These fluctuations if unchecked, threaten the operation of fair and orderly stock markets.

Despite ASIC’s concern with ‘fair and orderly stock markets,’ its implementation of the ban was chaotic, resulting in considerable uncertainty for financial market participants. By Tuesday, 23 September, ASIC had to review and further clarify its weekend announcement. In order to address the widespread unintended consequences of the ban, it announced that the ban on covered short selling would not apply to some market-making activities, the hedging of pre-September 22 positions by market-makers, arbitrage transactions involving dual-listed entities, sales resulting from the exercise of options, and index arbitrage transactions that were deemed ‘unlikely to be a mechanism

for market abuse.’ At the same time, ASIC warned that ‘the exemptions may change,’ providing no certainty to the market.

Date	Landmarks
21 October 2008	ASIC extends ban on covered short selling of non-financial securities until 18 November 2008
21 October 2008	ASIC extends ban on short selling financial stocks until 27 January 2009
13 November 2008	ASIC lifts ban on covered short selling of non-financial stocks from 19 November 2008
13 November 2008	ASIC retains ban on short selling financials
8 October 2008	US lifts ban on short selling designated financials
16 January 2009	UK Financial Services Authority (FSA) lifts ban on short selling designated financials
21 January 2009	ASIC extends ban on short selling financials until 6 March 2009
5 March 2009	ASIC extends ban on short selling financials until 31 May 2009
25 May 2009	ASIC lifts ban on short selling financials

The ban on short selling stocks lasted much longer in Australia than in other countries. It was also much more comprehensive in scope, including all listed stocks and not just designated financials.

Australia was already a price-taker in global capital markets, but it seems we have become a price-taker in regulation as well. The main argument advanced in Australia for both the short selling ban and depositor protection arrangements is that other countries are doing it too, and we cannot afford to be left out on a regulatory limb.

The Australian government seems to fear a form reverse regulatory arbitrage in which capital flees from less regulated to more highly regulated markets and financial institutions. These concerns are probably exaggerated, but the Australian government was not interested in carrying out an experiment to find out what would happen if we did not match what other countries were doing.

Of course, in the case of the bank deposits’ guarantee, the Australian government managed to turn an apprehended run on the banks into a

real run on other investment vehicles not covered by the guarantee, a classic case of the unintended consequences that often accompany distortions to financial markets.

If the bans on short selling equities in Australia and a number of other countries were designed to curtail downside volatility in equity markets, then it is not obvious from subsequent price action in these markets that the bans have been a success on their own terms.

After the short selling bans were introduced, there was a reduction in liquidity in equity markets and, not surprisingly, an increase in volatility. Stock prices continued to post new lows until March 2009.

There is a significant asymmetry in the attitude of both investors and managers of firms to price action in equity securities. Rising share prices are seen as vindicating the brilliance and insight of the individual investor as well as being the well-deserved return to superior management. Falling share prices, by contrast, are invariably attributed to dark, irrational and mysterious forces, if not an outright conspiracy against the investing public.

It is not hard to see why short selling has never won any popularity contests—the short seller profits from other people's mistakes.

Short sellers have been described as the investigative journalists of capital markets, exposing failed business models, bad management, and excessive leverage.

Long before the failure of Lehman Brothers, a hedge fund blogger based in London ran a reader poll on the financial institutions mostly like to fail. Lehman Brothers won that poll by a large margin. It is no accident that some of the Australian companies that were targets of short selling in the context of the financial crisis were the companies with the greatest exposure to the United States, as well as being the most highly levered. Speculative short selling is not random market or herd-like behaviour: it is typically highly selective, very well informed, and based firmly on fundamentals.

Prohibiting short selling is analogous to silencing investigative journalism, an attack on the free speech of the marketplace.

Short selling is the sale of a security the seller does not own, and it is this somewhat counterintuitive notion that arouses a lot of suspicion and hostility against short selling.

Some people go so far as to claim that short selling is a fraudulent activity, although short selling is something that happens in markets for goods and services all the time.

Many sellers of goods and services do not own a good or service at the time of entering into a contract to supply that good or service at an agreed price. They may also be short on the necessary inputs to make good on that supply. To the extent that the suppliers have leverage on their balance sheet, they may also be borrowing to make good on the transaction. So the suppliers are in a sense betting that they can go into the marketplace and buy what they need to deliver on the transaction at a lower cost than the price agreed with the buyer.

In share markets, selling a security one doesn't own is facilitated by a market for lending securities. The short seller enters into a contractual arrangement to borrow securities from a securities lender, which are then sold, but the short seller must eventually cover the short position by buying back those securities in the market and delivering them to the lender.

The distinction between covered and uncovered (or naked) short selling comes down to whether such a lending arrangement is in place at the time the securities are sold by the short seller, but even uncovered short sellers must eventually buy back their position.

There is an increased risk that an uncovered short sale isn't settled, which is why regulators typically take a tougher approach to naked short selling. But from an economic point of view, there is little to distinguish covered from uncovered short selling.

One way to think about short selling is a short-run increase in the supply of a security, which all else being equal, we would expect to depress the price of that security. It should also be noted that in Australia, naked short selling was notionally subject to an 'up-tick' rule, which prevents a short sale from being made at a price below that of the immediately preceding sale.

But if we hold everything else constant, then a short sale by itself cannot permanently depress the price of a security. As soon as the seller covers the short position, the supply curve for that security shifts back to its original position, the former price is restored, and the short seller is out of pocket for their transactions costs.

The *only* way a short seller can profit from a short sale is to correctly anticipate a future fall in *demand* for the security that is entirely independent of the increase in supply brought about by the short sale. Only if future demand falls can the short seller hope to buy back the security at a lower price and make a profit. Of course, future demand for the security could just as easily increase, so that short sellers have to buy back their position at a higher price, resulting in a loss.

It may well be the case that short selling has the effect of bringing forward a future fall in demand, because the fall in price induced by the short sale may squeeze out 'weak hands' holding the stock. The weakest hands are often leveraged, speculative buyers. The leverage employed on both the buy and sell side of the market serves to increase market liquidity and facilitate price discovery, but it in no sense determines market prices.

Short selling actually exercises a stabilising influence on the market because it is *after* a share price has fallen that short sellers step in to buy back their positions and take their profits. The phrase 'short covering rally' refers to a situation where prices go up because of short sellers buying back their positions.

Milton Friedman wrote a classic defence of the role of speculation in financial markets.<sup>1</sup> Friedman was talking about foreign exchange markets and arguing in favour of flexible exchange rates, but the same arguments apply in the context of other markets. Friedman observed that speculation is inherently stabilising because the speculator can only profit by buying low and selling high, driving prices towards their equilibrium value. To argue that speculation is inherently destabilising is the same as arguing that speculators lose money. No doubt there are speculators who lose money, but they tend not to survive very long.

The Austrian School economist Ludwig von Mises, also talking in the context of foreign exchange markets, described the role of speculation in these terms:

Speculation does not determine prices; it has to accept the prices that are determined in the market. Its efforts are directed to correctly estimating future price-situations and to acting accordingly. The influence of speculation cannot alter the average level of prices over a given period; what it

can do is diminish the gap between the highest and lowest prices. Price fluctuations are reduced by speculation, not aggravated, as the popular legend has it.

Accordingly, Mises described the suppression of speculation as ‘the lowest form of demagogy ... the resource of governments in search of a scapegoat.’<sup>22</sup>

It would be a mistake, however, to assume that short selling is the exclusive preserve of speculators. It is also widely used as a hedging tool. Speculation and hedging activity are found on both the long and short side of all markets, and both are essential to the liquidity that facilitates price discovery. For example, fund managers will often use short selling to their hedge equity exposures, protecting their investors against downside risk.

Much of the damage that has been inflicted on financial markets through restrictions on short selling stems from the way it has disrupted these hedging strategies. As their name implies, hedge funds are often focused on taking both long and short positions that aim to be neutral with respect to overall market movements. The ban on short selling interferes with the viability of these strategies and, indeed, the viability of the funds themselves.

One of the noteworthy aspects of the financial crisis is that hedge funds, which have been among the most lightly regulated sectors of financial markets, fared relatively well in the crisis, at least until the short selling bans came in. The ban on short selling caused some hedge funds considerable problems and threatened to open up a whole new dimension to the credit crisis, one that was policy induced.

Fund managers have been forced to liquidate long positions in equities that can no longer be hedged, while some of the short-side interest in equities was diverted into the even less transparent derivatives markets, which are not subject to short selling restrictions.

Like any other technology, short selling can be abused. For example, in the United States, it is not unusual to observe a significant increase in short interest in a stock ahead of litigation being launched against the company in question. It is pretty obvious what sort of game is being played here. The expression ‘rumourtrage’ has been coined to describe the process of spreading rumours about a company in conjunction with short selling strategies.



However, the same opportunities for manipulation exist on the long side of the market. For example, in the so-called 'pump and dump' strategy, a company is talked-up after its shares have been bought by the market manipulator, then sold at higher prices to subsequent buyers who get taken in by the hype.

Of course, relatively few investors or managers of firms complain when speculative buying is driving up their share prices. They are often more than happy to go along for the ride.

Market manipulation is more likely to be successful in markets that lack depth and liquidity, and restrictions on short selling serve to reduce liquidity. Market manipulation is asserted far more often than it is proved. Speculative short selling is typically highly selective and well-informed. The targets of short selling often have something to hide.

Market manipulation is already illegal and best dealt with directly rather than by putting in place restrictions that undermine market liquidity and price discovery. There are other regulatory responses to deal with market manipulation, such as increased disclosure requirements, which are better able to handle these issues.

It has also been suggested that fund managers who facilitate short selling by lending their securities are somehow acting against the interests of their investors. Since fund managers attract and retain customers by maximising long-run returns, it seems implausible that they would knowingly facilitate transactions that reduce overall returns. It is also worth recalling that fund managers are buyers as well as holders of equity, and falling share prices may afford them buying opportunities that enhance overall returns to their investors.

If securities lending for the purpose of short selling were not in the interest of investors, then fund managers could attract investors by undertaking not to engage in it, taking business away from other fund managers, which would in turn compensate for the loss of securities lending fees.

Short selling did not bring about the recent turmoil in financial markets. Indeed, if greater short selling opportunities had existed in a broader range of markets, such as real estate, short sellers may well have curbed some of the excesses in both the US housing and global credit markets.

It is worth recalling that there was at least one proprietary trading operation by a major US investment bank that actively shorted the market in structured debt products at the height of the credit market boom. We needed more such speculative shorts, not less.

Ultimately, companies don't go bust because their share price falls. Rather, causality runs the other way. Share prices fall because companies go bust. Short sellers certainly capitalise on corporate and investor misfortune, but they do not cause it.

As much as regulators, shareholders and management might try to shoot the messenger, it is generally better for investors and markets that the short seller's message is heard sooner rather than later.

## Endnotes

- 1 Milton Friedman, 'In Defence of Destabilising Speculation,' in *The Optimum Quantity of Money and Other Essays* (Chicago: Aldine, 1969).
- 2 Ludwig von Mises, *The Theory of Money and Credit* (London: Jonathan Cape, 1953), 253.

# Short sellers: Financial Detectives or Villains?

Robert J. Bianchi

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## Introduction

The controversial concept of short selling has raised debate between short sellers and government regulators for many centuries.<sup>1</sup> Some argue that short sellers are financial detectives who identify overvalued assets and transmit negative information into the markets when they short sell securities. Others argue that short sellers are villains who manipulate asset prices downwards through opportunistic bear raids on individual companies. In September 2008, government regulators around the world shone a light on these market participants when they imposed various types of short selling bans across many stock exchanges.

In this short paper, we review the role of short sellers. Was the 2008 short selling ban justified in saving stock exchanges around the world? How did the ban affect markets? We examine the theory and empirics of short selling and their market effects. Lastly, we assess the policy decisions of the 2008 short selling ban and evaluate the empirical lessons learnt.

### *Primer on short selling*

Short sellers are market participants who develop a view that an asset price is expected to decline. Short sellers wish to benefit from this opinion although they do not possess legal or economic ownership of the asset. To profit from this pessimistic outlook (and for this negative information to be transmitted in the market), short sellers must dispose of an asset they do not currently own in one of two ways. The first is 'covered short selling,' which refers to the practice of borrowing the asset from a counterparty (i.e. a stock lender) *prior* to the short seller disposing the security for cash in the market. The short seller generally

lodges the cash from the short sale as collateral to the stock lender. The second type of transaction is ‘naked short selling,’ which is the practice of the short seller disposing the asset for cash in the market with no certainty that the transaction will be settled. This is because the short seller has not yet borrowed the asset from a stock lender at the time of the short sale transaction. Naked short sale transactions sometimes fail because the security is unable to be borrowed and delivered to the exchange at settlement date. With an understanding of the mechanics of this transaction, we now review the theory of short selling and its benefits of enhancing market efficiency and price discovery.

### **The rationale for short selling**

The theoretical contribution of short selling can be highlighted by reviewing the mechanics of markets. The function of a market is to act as an auctioneer that aggregates the desires of all buyers and sellers. The market as the auctioneer then sets an equilibrium price to clear the market. The prevailing market price is set based on the assumption that all the buyers and sellers in the market are present. The theory of information symmetry informs us that markets are efficiently priced when buyers with positive information and sellers with negative information meet in the market to form the aggregate opinion of the value of the security, which is fully reflected in the equilibrium price. The theory of short selling obviously examines the sellers in the market and considers their market implications when they are restricted from participating.

The first theoretical benefit of short sellers is they increase the supply of a security by the amount of outstanding short positions, which results in a lower market price.<sup>2</sup> This effect facilitates negative opinion in markets, which tempers any excessive overpricing of securities. The collective action of all available information, both positive and negative, leads to symmetric information in the market, which results in more efficient market pricing. Other theorists argue that short selling constraints create asymmetrical effects on market information, where optimistic market expectations are weighted more heavily than pessimistic opinions. As a result, short selling restrictions cause an upward bias in asset prices.<sup>3</sup>

The second theoretical element of short selling is its contribution to price discovery. The concept of price discovery involves the incorporation of new information into asset prices. Markets serve as a central location for the price discovery process of many capital market securities and instruments. The introduction of short sellers allows their negative information to be transmitted immediately in the market, thereby, resulting in more efficient asset prices. Theorists argue that constraining short selling reduces the speed of price adjustment to negative information.<sup>4</sup>

Overall, the theory of short selling suggests that these market participants provide a valuable contribution to efficient markets and price discovery. The negative information from short sellers enhances the informational efficiency of asset prices, and the arrival of this information causes the adjustment of prices to fully reflect all available information as quickly as possible. The theory also suggests that short selling restrictions lead to information asymmetry, impair market efficiency, and cause delays in the price discovery process. Current empirical findings confirming the detrimental impact of one-sided information in markets is considered in the following section.

### *Empirical evidence*

Many empirical studies over the past 30 years have demonstrated evidence of the benefits of short selling behaviour across various stock exchanges. Empirical research has shown that short selling behaviour creates important negative information that enhances market efficiency, price discovery, and liquidity. One of the first empirical studies demonstrated that S&P500 stock prices remain excessively higher than justified when short sellers are constrained from markets.<sup>5</sup> Put simply, short selling constraints reduce market efficiency resulting in buyers purchasing securities at overinflated prices. To support this, subsequent research has estimated that US stocks that are expensive to short generally exhibit high valuations and low subsequent returns.<sup>6</sup> Another empirical study found that short sellers are skilled at identifying US stocks with lower than expected future returns.<sup>7</sup>

Empirical researchers have also examined the role of short sellers in the price discovery process. These studies have demonstrated that short sellers contribute to a near instantaneous adjustment in market prices,

while securities with short selling restrictions exhibit delays in the speed of adjustment to the true valuation of the security. For instance, an Australian ASX study estimated that the negative information from a short sale is transmitted in the market within 15 minutes of the transaction.<sup>8</sup> Most recently, a comprehensive study of 46 countries shows that restricting short selling inhibits downward price discovery.<sup>9</sup>

The third rationale of short selling behaviour is its important contribution to market liquidity. Studies demonstrate that short sellers enhance liquidity by selling stocks into rising markets.<sup>10</sup> Other research suggests that short sellers behave as liquidity providers by short selling stocks as prices rise and reducing short positions as prices decline.<sup>11</sup> Empirical studies show that the introduction of short sellers tends to increase the number of potential sellers and buyers in the market, which increases trading volume, reduces transaction costs, and benefits all investors. The contribution to liquidity by short sellers is important to investors as it causes an appreciation of a company's stock price relative to stocks that are less liquid as investors demand a lower risk premium for stocks that are more liquid.

Empirical studies demonstrate that short sellers do not amplify price declines but rather align prices to their fundamental value and do not push prices below their true valuation.<sup>12</sup> A review of three decades of empirical evidence demonstrates that short selling causes downward adjustments of asset prices to their fundamental value; however, there is no empirical evidence to suggest that they sell asset prices below their intrinsic value. In short, empirical studies do not support the notion that short sellers manipulate markets or accentuate price declines. Furthermore, the evidence suggests that short selling restrictions create market inefficiencies by biasing prices upwards, thereby, causing buyers of securities to pay more than the true market value of an asset. In light of these findings, it is clear that short selling restrictions create distorted outcomes that are inconsistent with the intention of government regulation designed to enhance market efficiency and price discovery. It is in this context that we review the events of September 2008, a time that will be remembered as one of the most dramatic periods in the annals of financial history.

*The events of September 2008*

Markets began the 2008 calendar year in a fragile state with global credit markets in difficulty as investors began to understand the impact of the US subprime mortgage crisis. Credit markets became dysfunctional in March 2008 when the Wall Street investment bank Bear Stearns was unable to continue operations and was forced to merge with the US bank and financial institution JP Morgan Chase. As credit markets continued to freeze, the dramatic events of September 2008 unfolded on an unprecedented scale.

The unusual government intervention in American Insurance Group (AIG) was the result of mammoth mortgage guarantor exposures by the company, which would have resulted in a potential systemic failure if AIG became insolvent. On 17 September, the share price of Wall Street investment bank Morgan Stanley fell 24% to \$21.75 and traded as low as \$16.08. John Mack, CEO of Morgan Stanley, wrote an internal memo to employees stating:

What's happening out there? It's very clear to me—we're in the midst of a market controlled by fear and rumors, and short sellers are driving our stock down.<sup>13</sup>

It is in these volatile financial market conditions that government regulators around the world imposed the 2008 short selling ban. Table 1 summarises the chronology of events preceding the introduction of the bans.

**Table 1** Financial milestones in September 2008

<b>Date</b>	<b>Country</b>	<b>Event</b>
7 September 2008	US	Fannie Mae and Freddie Mac placed in conservatorship
13–14 September 2008	US	Lehman Brothers Holdings Inc. files for bankruptcy
16 September 2008	US	Fed Reserve announces the \$85 billion credit facility for AIG in return for 79.9% of the company's equity
19 September 2008	UK	Financial Services Authority (FSA) prohibits short selling in financial companies
19 September 2008	US	Securities and Exchange Commission (SEC) prohibits short selling in financial companies
19 September 2008	Germany	Federal Financial Supervisory Authority (BaFin) prohibits short selling in financial companies
19 September 2008	France	Autorite Des Marches Financiers (AMF) prohibits short selling in financial companies
19 September 2008	Australia	Australian Securities and Investments Commission (ASIC) bans short selling of all companies

In response to these market conditions, national government regulators announced a string of short selling bans on the 19 September 2008. The rationale for the short selling ban was to remove short sellers from the market as they were blamed for the precipitous falls in the preceding days. The statement released by the US Securities and Exchange Commission (SEC) on 19 September 2008 detailed its rationale for the short selling ban.

The Commission is committed to using every weapon in its arsenal to combat **market manipulation** that threatens investors and capital markets. The emergency



order temporarily banning short selling of financial stocks will restore equilibrium to markets. This action, which would not be necessary in a well-functioning market, is temporary in nature and part of the comprehensive set of steps being taken by the Federal Reserve, the Treasury, and the Congress.<sup>14</sup> [emphasis added]

The above statement claims that market manipulation by short sellers was the first motivation for the short selling ban. This is a serious claim that deserves to be supported by evidence from the SEC as empirical research shows that short sellers are not market manipulators. To date, the SEC has not provided empirical evidence to the public to support its claim that markets were being manipulated by short sellers. The 19 September 2008 SEC statement continues to detail the second rationale for the short selling ban.

Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets. At present, it appears that **unbridled short selling** is contributing to the recent, sudden price declines in the securities of financial institutions **unrelated to true price valuation**. Financial institutions are particularly vulnerable to this crisis of confidence and panic selling because they depend on the confidence of their trading counterparties in the conduct of their core business.<sup>15</sup> [emphasis added]

The second justification for the short selling ban was the US regulator's view that the sudden price declines were unrelated to true price valuation. To date, the SEC has not disclosed empirical evidence to support its claims that market prices in September 2008 did not reflect their true valuation. This is further supported by the fact that global equity markets did not reach their lowest levels until mid-March 2009, six months after the introduction of the short selling ban. In light of this, we can conclude that the US SEC short selling ban can be discredited due to the lack of empirical evidence to support its claims.

At the time, other government regulators followed the US and UK short sale bans in order to avoid the possibility of concentrated short selling on stock exchanges that permitted short sales. One of the fascinating policy decisions enacted on 19 September 2008 came from the Australian regulator, the Australian Securities and Investments Commission (ASIC), which imposed a total short selling ban on all Australian publicly listed companies. The total ban on all Australian stocks was much stronger in comparison to their US, UK, German, and French regulatory counterparts who imposed short selling bans on financial and/or insurance companies only. ASIC media releases 08-204, 08-205 and 08-210 clearly state that ASIC's short selling ban was designed to be temporary; however, the ban on financial securities was not lifted until 25 May 2009. ASIC's rationale for the total short selling ban was to maintain fair and orderly markets given the relatively small size of the Australian market.<sup>16</sup> If the small size of the Australian public equity market was a genuine concern, then regulators of other small markets would also impose total short selling bans. In September 2008, other comparable markets of similar size such as Ireland and Canada imposed short selling bans on financial stocks only and did not resort to a total short sale ban.

Subsequent to September 2008, history shows that the sell-off in world equity markets continued after the global coordinated short selling ban was introduced. In fact, most public equity markets did not trade to their lowest price levels until mid-March 2009. It is clear that the short selling ban did not stop the decline in the valuation of financial stocks. If short sellers are not to blame for the decline in equity market prices, then who is?

#### *Explanations for the September 2008 sell-off*

In complex financial markets, short sellers are akin to forensic accountants who search and trawl for overvalued companies and industry sectors. Like swimming against the tide, the short seller goes against the traditional bullish sentiment of the markets. Because of this contrarian nature, corporate managers of publicly listed companies lament this important role of short sellers. Short sellers critique corporate management and their capital budgeting decisions. Short sellers examine the weaknesses of business models and they tend to

focus on the risks of the cashflows of a business. When publicly listed companies are estimated to be overpriced, short sellers enter the market with the expectation that stock prices will decline.

The September 2008 stock market crunch can be readily explained by the finance theories of capital structure with bankruptcy risk, portfolio theory, and asset pricing.<sup>17</sup> These foundations of finance can easily provide the rationale for the events of September 2008 that seem to confound and confuse government regulators and even CEOs of Wall Street investment banks. Modern portfolio theory and the theory of capital structure with bankruptcy risk inform us that investments or capital projects that are debt financed result in higher rates of return in the good times and higher levels of risk in the bad times. In an environment where debt financing was impossible due to frozen credit markets in September 2008, it was expected that public equity prices would decline.

The decision by many financial institutions and publicly listed companies to adopt highly leveraged balance sheets in the lead up to 2008 was never the design of short sellers. In Australia, short sellers identified the excessive reliance of debt financing in the capital structures of recently failed companies, including ABC Learning Centres and Allco Finance. Recent history has shown that short sellers have correctly identified overvalued companies, including the famous names of Enron, Tyco and Worldcom. The role of short sellers cannot be underestimated as they were the first to signal the troubles of these companies through their short selling activities.

Short sellers have been unfairly demonised and blamed for the decline in equity prices in 2008. The fall in equities was driven by market forces and led by companies whose capital structure was heavily reliant on debt finance. Many banks and other publicly listed companies were the most highly leveraged institutions of all. As the credit markets became dysfunctional in 2007–08, the risks associated with highly geared balance sheets were factored into the value of equities. Short sellers have been inappropriately blamed for the excessive risk taking and misfortune of corporate managers of some Australian and overseas publicly listed companies. Strong companies with sound business models and a lower reliance on debt finance will continue to prosper over the long term.

It is these well-managed companies that short sellers have not targeted as they are not overvalued entities.

Many industry professionals, regulators and academics have failed to understand that there is a tendency for investors to form a severely negative view on a company's stock valuation given a highly leveraged business model and when credit markets subsequently become frozen. Despite criticism from some circles, the theories of capital structure with bankruptcy risk, portfolio theory, and asset pricing have been successful in explaining investor behaviour during these recent turbulent times.<sup>18</sup>

#### *Subsequent empirical research*

Since September 2008, researchers have examined the market impact of these short selling bans during this unique period in finance history. A London Stock Exchange (LSE) study found that stocks with short sales bans exhibited significantly wider bid-ask spreads, deterioration of market depth, and decreased volume in comparison to control stocks.<sup>19</sup> The study also demonstrated that in the period subsequent to the short selling ban, LSE stocks witnessed a statistically significant deterioration of liquidity that was not attributable to market-wide factors such as increased volatility. Another study in the United States revealed severe degradation in market quality as estimated by spreads, price impacts, and intraday volatility as a result of the US short selling ban.<sup>20</sup> A third study in Australia estimated that ASX liquidity decreased with rising volatility in September–October 2008.<sup>21</sup> This resulted in the impairment of the price discovery process, causing increased costs and market inefficiency.

Contrary to the above, an opposing study argues that the short selling bans did not affect the distribution of returns of US, UK, French, German, Swedish, and Japanese stocks in the September–October 2008 period.<sup>22</sup> Whilst this may be statistically valid, the study ignores the impact on transaction costs and liquidity, which were the primary metrics considered in other studies.

Overall, these post-September 2008 empirical studies continue to support the role of short selling in enhancing market efficiency and price discovery. The September 2008 short selling ban was a direct cost to market participants imposed by government regulators. Furthermore, government regulators have failed to disclose direct empirical evidence

to support their claim of market manipulation or mispricing by short sellers during this period. In the absence of this evidence, we can conclude that there was no fundamental or genuine basis for the introduction of the September 2008 short selling ban.

## Concluding comments

The important role of short selling continues to be supported by empirical evidence before and after the events of September 2008. Despite this, short sellers have been the scapegoats for the September 2008 stock market sell-off of highly leveraged companies around the world. The short selling ban was imposed by government regulators on the basis of market manipulation, and prices did not reflect the true intrinsic value of these companies. At present, the burden of proof rests with government regulators in providing evidence to the public to support their claims. After the first anniversary of September 2008, we are still waiting for government regulators to empirically justify the policy decisions that resulted in these short selling bans.

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# ASIC Should Extend its Short selling Ban, Not End It plus comments on the 'tick' rule, disclosure by shorts, and the conflict by fund managers in stock lending ...

John M. Green

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## **Extend the short selling ban**

Today, I call on ASIC (the Australian Securities and Investments Commission) to extend its seven-week-old ban on the short selling of non-financial stocks. The ban is due to expire next week, 18 November 2008. ASIC should extend the ban till late January, when its ban on shorting financial stocks is currently set to expire.

There are two reasons why an extension is warranted.

1. First, we need to see the final form of the government's new short selling law. It will be tabled in parliament soon, but given the fatal flaws that festered in the old rules why shouldn't we double-check whether this new law can actually help avoid unforeseen consequences?
2. The second reason for extending the ban is because the extreme market volatility that led up to the ban and helped justify it has not abated. Stock prices can still see-saw on a single day by more than they would normally swing in a year.

Some see that intense volatility as evidence that the ban has made no difference and is thus a failure. I view it the opposite way: without the ban, the volatility and value destruction could have been far, far worse. Of course, neither view can actually be proven—show me a valid control group to benchmark against—I argue my cautious approach is more appropriate in the current environment.

Some observe that those markets where there is no ban have survived without needing it. New Zealand is one example. But unlike Australia, New Zealand has no significant listed financial institutions whose primary listing is not Australian.

### **Short selling is not prima facie evil**

Even so, like others here, I advocate the free-market view that short selling is not prima-facie evil; indeed that it is normally beneficial, providing the market with greater depth, liquidity, and finer pricing. In normal times, and even in especially buoyant times, short selling can be a considerable aid to market confidence and integrity because it helps dampen excessive exuberance, buy-side rumourtrage, and the manipulative practice of ‘pumping and dumping.’

### **Why a ban?**

So how is it that not only do I support ASIC’s ban but argue for its extension?

Simply because I see short selling as good when it helps the market function efficiently and bad when it helps destroy confidence or when it has great potential to.

*To me, short selling is like mowing lawns. In good times, cutting grass is highly beneficial. It cuts back exuberant spikes and wild runners. It also strengthens the underlying root system and builds greater lawn density to help endure poorer conditions should they come. But during a tough drought, the repeated mowing of dry, withered grass can kill it. A good measure becomes a bad one.*

In a market context where rumour-mongering, panicked selling, a flight to cash, and a massive tsunami of global de-leveraging have shrivelled up buy-side liquidity, to give short sellers free rein to keep viciously slashing at the weakened grass with their machetes, destroying it when it sorely needs time to regenerate, is perverse.

### **Market interference**

Much has been made of the fact that the short selling ban has caused major market interference. To that I offer two thoughts:

1. First, if ASIC had been surer-footed about this and had thought through all the issues well before that breathless panicked weekend



in late September, it could have introduced the ban with far less disruption or rule rewriting on the hop. (I for one advocated a temporary ban a full six months earlier, writing in the *Australian Financial Review* in March.)

2. Second, disruption to a segment of the market is always unfortunate, but before we get carried away let's remember something: the role of short sellers is to serve the greater good of the market. I don't see the market existing to serve short sellers.

## **Short sellers as messiahs**

Those opposing the ban on short selling seem to have an unerring faith in the market judgments of short sellers as if they were seers or gods and that only through them and their good work shall we find ultimate market salvation and price discovery. People like those who famously shorted Enron have become global Jesus Christ figures who must apparently be right no matter what they say.

A common justification of those who believe in untrammelled short selling argue that movements in a company's share price can't bring that company down, unless that company was vulnerable to begin with.

It must be an exhilarating feeling to enjoy that sublime level of unshakeable faith in these shakily uncertain and intensely volatile times.

## **Consequences matter**

But this religious conviction dimly fails to recognise that there is a gulf between a company being merely vulnerable and it deserving a sudden and violent death at the hands of short sellers.

In normal times, a vulnerable company will seek to reduce its susceptibility by recapitalising or by selling assets. Recapitalisation requires confidence from lenders and investors. When markets are so volatile even *without* short selling that banks and shareholders are conserving their cash, recapitalisation is hard enough. But when you torch the chances by firing a short selling missile and a few false rumours at a company's heart, any negotiating position it has with potential asset buyers, or already nervous debt or equity providers, can disintegrate instantly. So yes, in those circumstances, vulnerability can mean death. But is that a death to be encouraged or tossed off lightly as creative destruction when it is not otherwise inevitable? I say not.

While the shorts happily make a fast buck, the company goes to the wall, its creditors go unpaid and themselves become next in line in the cycle of vulnerable-means-death; the company's employees lose their jobs just before Christmas; and its shareholders are also left out in the cold, many of them retirees who thought they'd planned well for their futures but who may become indigent, placing even greater burdens on already punch-drunk taxpayers.

To me, that's not a price worth paying just so a few short sellers can add illusory liquidity to the market and so-called price discovery when right now, no one has a clue about price if they're being honest with themselves. If ever there was a time when there was a disconnect between value and price, this is it. Short selling only widens the gulf in the absence of real buyer liquidity.

### **Government's proposed new short selling law**

Scandalously, the old short selling rules the Australian Securities Exchange (ASX) had in place for years were being rorted daily. The government's new law aims to fix this.

Until the recent ban, by simply borrowing stock short sellers could freely pretend they weren't shorts and bear-raid every ASX-listed stock, even highly illiquid tiddlers the ASX specifically kept off its approved shorting list. Consequently, they could entirely mock the 10% shorting limit and dump as much stock as people were dumb enough to lend them; they could even sell into a plummeting market, forcing it down further and faster, casually waving aside the 'tick' rule that banned short selling at any price below the last sale. And shorts could do all this in private; they didn't have to disclose a thing to the market.

### **Disclosure of shorting—when two weeks is too far**

According to today's *Australian Financial Review*, the Investment and Financial Services Association (IFSA) is unhappy with aspects of the government's new law. IFSA apparently pans the government's idea that shorts disclose their positions to the exchange within a day. Why? Because that would reveal shorts' investment strategies. What? Shock, horror! The market might actually be informed about what shorts are doing? Longs might gang up on shorts for a change? Goodness me, I'm suffering palpitations for the short little bunnies. No, IFSA believes

shorts should only disclose only after two weeks which, according to them, is best practice in the world, including the United States.

Excuse me? Since when is the United States suddenly best practice in corporate disclosure and regulation? The same United States where companies only disclose quarterly and keep their shareholders largely in the dark the rest of the time?

If anywhere is best practice on disclosure, it is Australia where we have long had a system of continuous disclosure, a system the United States and others could do very well to emulate. And Mr Rudd and Mr Swan should say so at the G20 next week.

But no, IFSA apparently wants short sellers to be free to run rampant but in the shadows for two long excruciating weeks in an environment where the companies they aim to trash must disclose everything material instantly, not in two weeks, not in two days, but instantly. Even substantial shareholders on the buy-side must disclose within two days. Their investment strategies can't be kept secret, so why should shorts be advantaged?

Now let's look at two other issues the government has been surprisingly silent on.

### *1. The 'tick' rule*

The 'tick' rule forbids shorting if a stock's last price move was down. Prudently, the rule aims to prevent short sellers dumping shares into an already plummeting market.

If the so-called US best practice is a guide to what will happen here, it is a troubling one. The Securities and Exchange Commission (SEC) abolished the tick rule there in July 2008, despite the New York Stock Exchange opposing the move. The SEC's timing was exquisite, just moments before the angry bear started its global rampage when the rule would be needed most. Go figure.

Perhaps like a lamb to the slaughter, the ASX apparently wants the government to flick our tick rule, too. ASX's October paper to the government on short selling casually asserts that Australia can ditch this rule 'without having any adverse consequences.'

How many retirees whose superannuation has been slashed recently would embrace that plucky assertion for which ASX offers no evidence? The government must assure investors the tick rule will be staying firmly in place.

2. ASIC must shine a bright light on stock-lending by 'trusted' intermediaries

The second issue is the extraordinary market practice where investors' 'trusted' intermediaries—their fund managers, trustees and custodians—casually lend their shares to short sellers.

On its face, doesn't this seem like these managers are putting their clients' best interests at severe risk?

Fuelling up short sellers with cheaply borrowed stock turbocharges the pressure they can drive down onto a market, accelerating the risk of those same shares plummeting.

Of course, if you lend your own personal stock for a fee, that's one thing. It's a free country. But this stock doesn't belong to the managers and custodians who lend it, but to their clients who pay them good money to increase their wealth, not to destroy it.

Previously, short sellers were laughing. For the paltry few cents they paid these loopy intermediaries for this service, they could drive share prices down by dollars. Who drew the short straw on that roort? Hapless investors, that's who.

Economist Stephen Kirchner, who disagrees with me, says:

It has also been suggested that fund managers who facilitate short selling by lending their securities are acting against the interests of their investors. Since fund managers attract and retain customers by maximising returns, it seems implausible they would knowingly facilitate transactions that reduce overall returns.

Let me give one example why this view, though tempting, is naive: index fund managers, a huge segment of the market. All an index fund manager cares about is trying to match the index and keeping costs low. Whether the index rises or falls is of zero consequence. So if an index fund can lend out stock even for a few cents to help offset their costs of mimicking the index, why wouldn't they? The fact that stock-lending punishes their clients is irrelevant to them.

What ASIC should do now—*before* lifting the ban on short selling—is shine a large spotlight on this practice. Disclosure, in my view, will do the trick.

For example, ASIC could require all licensed intermediaries to disclose their answers to these five questions and post them on ASIC's website for all investors, financial advisers, and media commentators to see:

- Does or will the fund manager engage in stock-lending to short sellers?
- Do intermediaries have their clients' express permission to do so?
- Will the intermediary guarantee its investors that their stock-borrowing short sellers will be solvent when they want their stock back?
- How much are the lending fees so investors can assess if the risks are worth it? and
- Who keeps the fees, the fund manager or the client?

If ASIC maintained this register on its website, it would have two benefits.

1. First, investors could access critical information needed to decide if they actually want to stay with a particular fund manager.
2. Further, the prospect of disclosure would have a chilling effect on this practice, with some intermediaries withdrawing from it rather than face public and media enquiry.

If your fund manager phoned up asking you to let them lend your stock to short sellers, would you agree? Or would you laugh hysterically into the handset for the few moments before you switched fund managers?

But the fund managers aren't asking you, are they? ASIC should force them to before it pushes off the short selling rollercoaster on its next death-defying adventure.

## **The short selling ban should not be permanent**

My last point. Despite my call for the current ban to be extended, I agree short selling should not be banned permanently. When the grass is again resilient, short selling will be needed to strengthen it.

But that time has not arrived in Australia. Not yet. When will that be? I don't know.

By advocating the ban be extended, does it mean that I'm setting up the regulators to engage in market timing? Unfortunately, there's no other choice.

Will they get it wrong?

Probably, but that is a far less ugly outcome than the alternative.



