

BLAME GAME

Short selling not the reason for market woes.

BY JAMES SLATER

SHORT selling is a hotly contested topic and its role in financial markets bears closer examination and further research. Although short sellers may increase the speed of market corrections, many academics believe short sellers play an important role in our financial markets. Among other things, short sellers balance the bullish views of long investors, and convey valuable information or clues about the condition or fair value of companies.

Historically speaking, short sellers have been blamed for several financial market crises. According to the International Securities Lending Association (ISLA) short selling has been used to explain crises as wide-ranging as: the East India Company crisis in 1609, the South Sea bubble of the early 18th century, the Wall Street Crash of 1929, Black Monday in 1987, the Asian currency crisis of 1997, the bursting of the dot-com bubble in the early 2000s and, most recently, the decline in the share prices of banks and securities firms in 2008.¹

Over the last 18 months, governments, regulators and financial institutions, preoccupied with restoring global credit markets and improving confidence in the financial system, have instituted bans on short selling of financial sector equities. These bans, intended to limit downward selling pressure on such equities, ended on October 8, 2008 in the U.S. and Canada.

The events of the last few months have brought a lot of attention to short selling and, in turn, securities lending. The securities lending industry has suffered from a lack of transparency for years, hampering accurate measurement of market size and preventing investors from leveraging knowledge on short selling trends. This has changed in the last couple of years with consultants and vendors stepping in to provide additional transparency.

According to the UK-based securities lending consultant Data Explorers, outstanding securities loans in Canada totalled \$122 billion at the end of October

2008. Globally, the market is much larger with \$4 trillion in securities on loan, with more than 50% of these assets in the U.S. Short selling provides crucial support for the efficient functioning of financial markets. It benefits a broad range of players including retail and institutional investors, broker-dealers and alternative funds through:

- **Alpha strategies:** enabling long/short and arbitrage strategies
- **Efficient price discovery:** curbing excessive valuations, often providing valuable information to market participants
- **Price support:** cooling overheated markets and generating upward momentum in share prices when short sellers close out their positions (i.e. buying the shares in the open market)
- **Adding to market liquidity:** broker-dealers may temporarily cover client buy orders where inventory does not currently exist
- **Hedging derivative exposure:** broker-dealers may offset market risks of futures and options contracts
- **Securities lending revenue:** long holders earn incremental income by lending securities to prime brokers and other borrowers.

SHORT SELLING BANS

On September 19, 2008 the Securities and Exchange Commission (SEC) took emergency action to prohibit short selling in 799 financial companies, to “restore equilibrium to markets.” According to the SEC, financial services firms received protection because of the “essential link between their stock price and confidence in the institution.”² The Ontario Securities Commission (OSC) followed suit, in large part to prevent regulatory arbitrage of interlisted shares, and banned short selling in 13 TSX-traded financial services companies. Both bans expired on October 9, 2008 after one extension dated October 3, 2008.

During these bans on short selling the Investment

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Industry Regulatory Organization of Canada (IIROC) presented some important findings. Among other things, IIROC analysis of surveillance data indicates that the ban on short selling brought:³

1. Lower trading volumes in the restricted financial companies
2. No “appreciable impact on the price of securities” issued by these restricted financials
3. A “significant increase” in volatility of restricted financials in the first week of the OSC order.

The U.S. ban on short selling may also have influenced greater market volatility and inefficiency. A Bloomberg article written during the SEC ban reported that trading volumes fell 35% on the New York Stock Exchange (NYSE) while the Chicago Board Options Exchange Volatility Index (VIX) hit a third consecutive daily record.⁴ The VIX is a measure of the implied volatility of S&P 500 index options. The article goes on to quote the NYSE Euronext chief executive officer who claimed that the ban had “slowed stock trading and contributed to wider swings in prices.”

Arturo Bris, a finance professor at IMD in Lausanne, Switzerland, conducts extensive research on short selling. He recently examined the impact of the ban on short selling in the U.S. Far from being the cause of downward selling pressure, Bris suggests “Increases in short selling of individual stocks more often occurred the day after a sharp price drop, not before.”⁵

As a case in point, Bris claims that on September 9, 2008 (a day of many rumours over the possible bankruptcy of Lehman Brothers) “Lehman’s stock fell 45% to \$7.79 from \$14.15.” On average, short sellers sold at \$9.29, indicating they reacted to the price drop and did not cause it.⁶

Additional analysis suggests restricted stocks were less liquid during the ban as seen in wider bid-ask spreads in restricted stocks. From January 1, 2008 to the first week of the ban, relative spreads in these stocks (bid-ask spread relative to the quote mid-point) increased from 3.38% to 5.33%.⁷

Bris admits that prices of restricted companies did increase during the ban but suggests this has less to do with the absence of short selling: “Between September

1 and September 19, [the restricted financial stocks] outperformed the market on a risk-adjusted basis by 6 per cent. To be sure, one has to believe that much of this movement was attributed to the likelihood of some type of bailout package being passed”. However, upon announcement of the Emergency Economic Stabilization Act, “The 799 [restricted] shares reacted more slowly to news than stocks outside the ban’s umbrella—a key sign of market inefficiency.”

Slower responses to news, and market inefficiency, appear in other research. A comparison of countries with liquid securities borrowing markets to those that do not showed that price discovery is more efficient in markets that permit short-selling.⁸ The study measured market efficiency by the delay in which information impacts prices.

Although short sellers may hasten market corrections, short selling is the most efficient way to disseminate information into the market. Moreover, short sellers also provide price support when they close out their positions. As Bris suggests, “For every short sale, there is a commitment to buy. That generates liquidity.”

The debate on short selling has traditionally centred on whether short selling is detrimental to the interests of long investors. However, as many institutional investors adopt alternative investment strategies, they are more frequently benefiting directly from short selling. More Canadian research on the impact, benefits and uses of short selling is encouraged. ■

ENDNOTES

1. ISLA. 2008. “Securities Lending and Short Selling.”
2. SEC. 2008. “SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets,” Sept. 19.
3. IIROC. 2008. “IIROC Responds to Current Market Conditions,” October 6.
4. Martin, Eric and Kisling, Whitney. 2008. “Hedge Funds May Cut Volatility as Short Selling Ban Ends,” Bloomberg, October 9.
5. Bris, Arturo. 2008. “Shorting Financial Stocks Should Resume,” *The Wall Street Journal*, Sept. 29.
6. Bris, Arturo quoted in Hulbert, Mark. 2008. “Maybe Short-selling Isn’t So Bad, After All.” *New York Times*, Sept. 27.
7. Ibid. Bris, Arturo. 2008. “Shorting Financial Stocks Should Resume,” *The Wall Street Journal*, Sept. 29.
8. Saffi, P.A.C., Sigurdsson, K., 2007. “Price Efficiency and Short Selling.” Working paper, London Business School.