



The decision to suspend short selling is a response to complaints that some short sellers spread false rumours in order to lower the price of shares. Another concern is the naked short selling, where investors sell shares without first having obtained the loan and then fail the settlement.

Both operations are already illegal. The first one is market manipulation and punishable by law. It is interesting to note that this kind of manipulation occurs much more on the buy side ? called “long” ? (for instance, false takeover rumours), yet no one in his right mind thinks of forbidding the purchase of stocks. The second one is also prohibited, although many brokers allow it, since the penalty is very small and so the “crime” pays off. And yet this is a point that deserves supervision and the heavy hand of regulators.

However, now one is trying to ban a legitimate operation (as opposed to naked short selling) and that is as beneficial as the purchase, since it allows the market to adjust quickly and precisely to the value perspective of its participants, reaching an equilibrium price faster. Often this is done with recourse to arbitrage, which reduces the mispricing and increases the market efficiency and liquidity.

To ban the legitimate operations of short selling is to amputate a leg of the market and to make it less efficient and less fair, creating frictions that make it impossible for short sellers to drive the shares price back to fundamentals, as argued by Duffie, Garleany & Pedersen (2002). Miller (1977) and Harrison & Kreps (1978) conclude that such restrictions take the pessimists out of the market and so the optimists no longer take into account the effect of pessimism on price formation.

This suspension is only a scapegoat for something more complex, as already happened with the up-tick rule, which would only allow an investor to sell short after the stock went up 80 pence (just 1 penny in 2001). Such rule was implemented in 1930 in the U.S. (and also in Japan in 2002) and abolished in 2007 (in the U.S.), since it was found (in the pilot program conducted in 2005) that it went against the quality and efficiency of the market (for instance, not allowing to cover a position in convertible bonds by shorting the underlying asset), as Boehmer, Jones & Zhang (2009) and Diether, Werner & Lee (2009) concluded.

Currently, this “something more complex” is related to the financial sector stocks, which saw short selling banned for 15 days now, as they are being affected by sovereign debt and the risk premium traded on the over-the-counter market of Credit Default Swap (CDS). Although someone less aware may not notice, in reality this market provides an idea of the risks and losses of the banks investment portfolios, while CDS trading on the banks debt gives an idea about the implicit risk of the financial institution. Therefore the pressure on listed securities is focused according to this market. Thus, one can easily see that the ban on short selling will not avoid the existing risk perception on the institutions concerned. It can happen that instead of hedging their long positions with short positions, the participants will do it with a synthetic position, if possible ? for example, buying puts and selling calls on assets, or simply selling the whole position to reduce risk exposure.

This suspension may cause the market to recover briefly, with the short sellers forced to buy back their positions and pushing up the market in the short term. However, it can have a wicked effect (an increase in volatility and more instability, as in China where short selling is forbidden) and may precipitate a further decline in the medium term with investors selling their shares, since there is no longer a mechanism to stop market distortion, as it would be possible by creating a synthetic position that involved the short selling of shares.

It is important to remember that someone who sells his/her shares is not obliged to buy them back, but the short seller will be a buyer at some point, since he/she must replace the shares sold. Therefore, he could be one of the few traders to hold the market in a moment of panic selling.

It should be noted that this ban was imposed only in 4 countries and without coordination from the board of



regulators, transmitting the idea that there is something fundamentally wrong in the financial sector in such countries and that these governments are more schizophrenic than with the Greek crisis.

In September 2008, the U.S. Securities and Exchange Commission (SEC) also surprised the market by temporarily banning short selling for more than 1,000 shares of the financial sector, exactly for the same reasons that are now evoked to justify this dysfunction of the regulators. However, according to Boehmer, Jones & Zhang (2009), the shares subject to this restriction suffered a severe deterioration in terms of market quality, as measured by spread, price impacts and intraday volatility, further concluding that there were no positive effects on the shares price.

Short selling was also banned in Singapore, between 1985 and 1986, during the Pan Electric Industries crisis, and according to Ho (1996) volatility increased significantly.

Last but not least, to ban short selling makes so much sense as to allow only buy orders; that is to say, it makes no sense at all. This is easy to understand if we realize that in short selling the investor can only sell when he/she has the effective ownership of the shares obtained through a loan. This means that whoever lent these shares can not sell them while they are borrowed, thus preventing the creation (from nothing) of sell orders. It can be said that the short seller is just selling what someone else did not want to sell, but could have sold without anybody pointing fingers, creating exactly the same selling pressure created by the short seller. In addition, this mechanism allows the lender to receive a fair remuneration for the shares given as a loan, an amount that he/she would not receive if they were immobilized into an account.

In any case, I believe the suspension will not prevent short selling, since it is very difficult for regulators to intervene in private legal transactions freely established between stakeholders, as it is the case with stock loan agreements, despite the underlying be under the jurisdiction of the regulator.

Take notice:

A) Arbitrage, which is an important mechanism for market efficiency, since it allows the correction of price distortion for similar assets intra- and inter-markets, is only possible if there is short selling. An example of a distortion that lasted for days, due to the (technical) failure to do short selling in American Depositary Shares (ADS) of France Telecom, between May and June 2006, was seen as they were quoted in the U.S. at a price (in dollars) much higher than the price (in dollars) of shares (with the same rights as ADS) quoted in France, which is bizarre.

B) When prices are rising investors tend to buy more, accelerating the movement and, as the movement accelerates, investors also accelerate their purchases. So this mechanism feeds on itself, often creating large bubbles. The same is true when prices fall, since the big falls also feed on themselves, resulting in precipitous declines. From this perspective, we can say that a strong upward trend in prices discourages sellers (further increasing the trend and not necessarily the volume traded) and a strong downward trend discourages buyers (further increasing the trend and not necessarily the volume traded), leading to a huge mispricing and decrease of liquidity. In such cases, most of these extreme movements are made by uninformed traders, who are investors less informed about the fair value of the assets they are trading. Accordingly, it can be said they are “buying (or selling) a pig in a poke”.

It is interesting to note that the situation is reversed with short selling, because short sellers are informed traders, as a rule, a well-supported evidence in the literature. Dechow et al. (2001), Cohen, Diether & Malloy (2007) and Boehmer, Jones & Zhang (2008) show that in aggregate the short sellers seem to negotiate based on fundamental right information, holding a more informed assessment on the fair value of the securities they intend to trade. In this way, as the price falls and moves away from its fair value, worsening the ratio risk/reward of the operation, they will not open new short positions, covering instead their open positions by buying shares, at a time when few traders may want to buy, thus helping to prevent the crash.



On the other hand, when the security goes up too much and stays far from its fair value, short sellers, as informed traders they usually are, sell the shares preventing bubbles from forming.

According to Diamond & Verrecchia (1987) and Reed (2007), restrictions on short selling result in a slower adjustment of prices to negative information and create price asymmetries in response to information about earnings. Boehmer & Wu (2008) also concluded that short selling reduces the deviation of the post-earnings announcement, leading to more efficient prices due to information.

This shows that short selling is a very important mechanism to mitigate mispricing, since prices adjust quickly to new information, and to avoid extreme situations of overvalued or undervalued assets, making the market more efficient.

Short selling is not a free lunch:

1) Short selling shares directly is more difficult than buying shares, because it requires a variety of mechanisms, such as to get the borrowed shares, as well as the maintenance margin, paying fees for the loan and a possible forced closing due to a short squeeze that withdraws the short seller margin.

2) Mathematically, a short position is much riskier than a long position, since in the second one the risk of loss is limited to the capital invested, while in the first one the risk can be the amount invested “infinitely” multiplied, because any share may only fall until the price is 0, while there is no price limit on the rise.

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