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Banning short sales – the way to go?

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Christian Schlag: The coronavirus triggered a worldwide sell-off on the stock markets. Banning short sales to stop falling prices, however, is too short-sighted



The corona pandemic has severely affected stock markets around the globe. Compared to early February, the Dow Jones index has lost around 30 percent as of March 21, and the same is true for the DAX index in Germany. This is a time of pronounced uncertainty on financial markets, and many market participants currently expect even further declines in stock prices in the future.

Almost like a reflex, there is the call for a ban of short sales to stop investors speculating on falling stock prices. In fact, this ban has already been implemented in some countries (e.g., Italy and Spain) in various forms. Even if short selling seems detrimental for stock prices, a total ban of short sales would be too

myopic.

The mechanics of short sales

An investor can implement a trading strategy called a short sale to benefit from a downward price movement, in case their expectations indeed materialize. To sell a stock short means that the short seller borrows shares from a lender and then sells them to a third party at the current market price. Assuming the short sale is executed on March 26 at a current stock price of 30 euro, the short seller has to return the borrowed shares to the lender at a fixed date in the future. Therefore, the seller needs to buy them back on the stock market at the then prevailing price. Let us assume in our example that the stock has to be returned on April 26. This transaction generates a profit when the stock price on April 26 is lower than on March 26 (for the sake of simplicity, we are going to abstract of any fees and other costs associated with short selling). If the stock price on April 26 is, e.g. 25 euro, the short seller has made a profit of 5 euro per share. On the other hand, if the stock price on April 26 is 34 euro, the short seller will incur a loss of 4 euro per share.

Short sale bans in times of crises

Since in a short sale the investor benefits from falling prices and in this sense from the misery of others, this type of transaction suffers from a rather negative perception in public and sometimes considered unethical. Especially in times of market turmoil, one can read statements that sound as if short sales were the actual cause of the observed decline in prices.

Views may differ whether it is a good thing that certain market participants benefit from a decline in stock market valuations, but there are a few economic issues one should keep in mind when discussing the matter. The most important rule is that one should not shoot the messenger (i.e., the short seller) when bad news are delivered (i.e., falling stock market prices).

The economics of short sales

First, to start with the simplest point, every seller needs a buyer. The short sale can only happen if the short seller finds a counterparty to buy the shares she wants to sell. It seems highly unlikely that in times of such severe negative market shocks, other market participants would lightheadedly buy large quantities of shares, unless they have expectations of higher prices in the future. A popular reaction to this simple point is the argument that short sellers “always have superior information” and thus “know that prices will fall further in the future”, as opposed to the uninformed other party in the trade. Does this really sound credible? If anything, we would assume that in a panic scenario, unsophisticated investors become very cautious and would rather consider selling their shares than buying new ones. However, if the counterparty to the short sale is a professional investor, it seems reasonable to assume that such an experienced market participant will soundly form her expectations.

Second, and related to the first point, short sales are of course risky and deliver by no means sure profits. There have been numerous episodes on financial markets (e.g., the sudden price spike in Volkswagen shares in October 2008) where short sellers were hit dramatically by rising stock prices, and in some cases, the market participants having sold short even got wiped out. In the Volkswagen example, the losses by short sellers (mostly hedge funds) are estimated at around 15 billion euro over a very short period, a quite substantial number.

To be clear, an “honest” short sale based on a market participant’s expectations has to be distinguished sharply from market manipulation or insider trading. In the latter cases, there is indeed an illegal advantage on the part of the short seller, such that their profits are not a legitimate compensation for risk,

but simply the result of fraud.

The information in short sales

Finally, there is a deeper, probably not so obvious point. On financial markets, investors meet to trade with each other so that they can allocate their funds to their respective preferred portfolios. The balance of supply and demand, then, results in a price. In this process, information is generated (often labeled “price discovery”) and liquidity is provided to market participants, since they can convert assets into cash and vice versa.

There is academic research on whether short sale bans actually help to support prices, i.e., to prevent them from falling further. For example, in a recent paper, Alessandro Beber and Marco Pagano discuss the effectiveness of short sale bans during the financial crisis. They find that these bans introduced by various countries and in various forms during the 2007-2009 period “(i) were detrimental for liquidity, especially for stocks with small capitalization and no listed options; (ii) slowed price discovery, especially in bear markets, and (iii) failed to support prices, except possibly for U.S. financial stocks.” At the very least, one can conclude from these authors’ work that a short sale ban has a major negative impact on the way financial markets aggregate and process information, admittedly probably not always the kind of information that we like to see, but nonetheless information.

A complex decision

Rapidly declining stock prices are bad news for most market participants. Some investors believe that prices have not reached their low and will fall further, and to benefit from a situation where these expectations materialize, they would like to sell shares short. In case they are right, they will make a profit, but they may just as well be wrong, which means they may incur potentially substantial losses. Banning short sales takes away a significant part of the informational role of financial markets, which reflects investors’ diverging opinions about the future evolution of stock prices. These bans and their potential effectiveness should thus be seen with a healthy dose of skepticism.

As a point on the side, selling shares short is not the only way to express a negative opinion about the future stock price. Buying put options is economically similar to a short sale, since the holder of the option also benefits from falling prices. Consequently, if the concern is that some investors benefit from falling prices, one would have to ban put option trading as well.

References

Beber, A.; M. Pagano (2013): *Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis*, *Journal of Finance* (68), 343-381.


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