

Short Selling: Costs and Benefits

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- Financial economists and practitioners generally have a positive view of short selling, a view on evidence at CenFIS's conference on short selling.
- The ban on short sales in some firms did not increase trading in options, an effect that might have been expected.
- Short sales might be made more efficient by a centralized listing of stock that can be borrowed and sold short.
- Policy changes that are quick responses to financial difficulties can create uncertainty about future policies.

Short selling was much in the news in the heat of the financial crisis in September 2008 even if no one thought it was central to the crisis. Short selling was banned in financial stocks for a time, and some thought short sales were contributing to the dramatic decreases in financial firms' stock prices. Naked short selling—selling stock without having prearranged to acquire the stock—also hit the front pages even though the practice was relatively obscure before the crisis. The name “naked short selling,” if not the actual practice, even sounds nefarious. And selling stock when an investor is not sure that the stock can be borrowed somewhere may not sound like a best practice to some.

To shed some light on the topic of short selling, the Center for Financial Innovation and Stability (CenFIS) held its inaugural conference on October 9, 2009, on the topic of short selling. The purposes of the conference were to review some of the best current research on the topic, subject the work to comments by other knowledgeable researchers, and try to advance the state of knowledge somewhat. The conference was a great success.

Restrictions on short selling and policy uncertainty

Erik Sirri, who was the director of the Division of Trading and Markets at the U.S. Securities and Exchange Commission from 2006 to 2009, gave an informative presentation about the SEC's deliberations concerning short selling in the fall of 2008. Financial economists generally have a positive view of short selling. As Sirri pointed out, the history of legislation against short selling indicates that public attitudes are quite different. Short selling often is associated with charges of price manipulation—in particular, attempts to drive stock prices down at least temporarily.

The reasons for economists' more positive view of short selling are simple. First, prices are likely to better reflect informed opinion about a company when people can sell short. Allowing people to sell a stock short allows even those who do not own stock to register their opinion by staking some of their personal wealth on that opinion.



A typical short seller?

Second, shorting a stock can be part of a more general trading strategy. Consider a hypothetical example: One can buy stock in Google (going long) and sell stock in Yahoo (going short). This position will yield profits if Google stock increases in value more than Yahoo's. While holding the long position in Google alone also can generate profits, it may have losses if stock prices in general decline or prices of Internet stocks decline. Buying Google and shorting Yahoo means that decreases in the prices of Internet stocks or stocks in general are likely to have little effect on the value of the investor's position. Losses in the long position are offset by gains in the short position. The position becomes an investment in Google that is hedged against changes in prices of similar shares.

While Sirri discussed the process leading to the restrictions on shorting stocks, Robert Battalio and Paul Schultz (2009) talked about their research into the effects of those restrictions. They focus on the options market, where it is possible to take positions that are similar to the effects of shorting the stock. They find that the restrictions were associated with substantial uncertainty about what policies would be put in place and their duration. This uncertainty translated into much less efficient trading of options at a time when many market participants likely wanted to reduce their risk by trading options.

The importance of this policy uncertainty in the midst of a crisis perhaps is too little appreciated, as Battalio and Schultz's results indicate. From a policymaker's perspective, it can be hard to know what is the best thing to do while in the crisis; from others' perspective, it also can be hard to know what to do, and uncertainty about policy responses exacerbates that indecision. This policy uncertainty was an issue in other financial markets besides the stock and options markets (Dwyer and Tkac 2009).

The economics of short selling

Adam Reed (Kolasinski, Reed, and Ringgenberg 2009) presented a nice paper on the economics of the market for stock to sell short. Reed and his coauthors find that a search model in which the short seller searches for stock at nontrivial cost is the best way to understand the market. They suggest that a central repository of information, as existed until the 1930s, might well lower or eliminate much of these search costs. It is indicative of financial economists' generally positive view of short selling that such a change surely would increase the amount of short selling.

John Standerfer made a very informative presentation about short selling from a practitioner's perspective. He pointed out some of the many financial strategies in which short selling is merely part of the strategy. He left no doubt that he perceives short selling to be an important part of a well-functioning financial market.

Thomas Boulton (Boulton and Braga-Alves 2009) looked at naked short selling and its effects on financial markets. While it seems straightforward to define naked short selling as selling stock short when the acquisition of the underlying stock has not been arranged, the problem is trickier than that. Many short sales last less than a day, and the underlying stock never trades hands. Many shorts sales are a continuing activity, and the investor knows where the stock usually can be acquired. Is that a naked short sale? Boulton and Braga-Alves decide to look at failures to deliver stock and the effects of these failures as a reasonable way of examining naked short sales. Their evidence provides little support to the notion that naked short sales magnify changes in stock prices.

Short selling on material, nonpublic information

On a very different line, Nadia Massoud and Anthony Saunders (Massoud, Nandy, Saunders, and Song 2009) examine the informativeness of short sales in a specific context in which they may not be benign. Hedge funds participate in syndicated loans, sometimes to troubled firms, and renegotiation of those loans often is associated with the borrowers' financial distress. Announcement of the renegotiation is associated with decreases in the borrowers' stock prices, suggesting that the announcement is bad news. Massoud, Nandy, Saunders, and Song present clear evidence that short sales of borrowers' stock typically increase before announcements of renegotiated terms of loans from hedge funds. This finding is consistent with apparent trading on the basis of material, nonpublic information. So, while short selling can be consistent with more informative stock prices, this informativeness may not always be consistent with rules about trading on the basis of nonpublic information.

Overall, the conference covered quite a bit of policy ground and revealed some new insights into the development and effects of recent short sale restrictions.

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References

Dwyer, Gerald P., and Paula Tkac. 2009. The financial crisis of 2008 in fixed-income markets. *Journal of International Money and Finance* (forthcoming).

Papers and presentations at the conference "Short Selling: Costs and Benefits," sponsored by the Federal Reserve Bank of Atlanta's Center for Financial Innovation and Stability, October 9, 2009:

- Battalio, Robert, and Paul Schultz. 2009. Regulatory uncertainty and market liquidity: The 2008 short sale ban's impact on equity option markets.
- Boulton, Thomas, and Marcus Braga-Alves. 2009. Naked short selling and market returns.
- Massoud, Nadia, Debarshi Nandy, Anthony Saunders, and Keke Song. 2009. Do hedge funds trade on private information? Evidence from syndicated lending and short selling.
- Sirri, Erik. 2009. Short selling: Economics and regulation.
- Standerfer, John. 2009. Short selling in the real world.