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Regulators struggle to agree on short selling

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Short selling seems to bring out the worst in regulatory confusion.

Two years ago in the middle of the financial crisis, governments from Hong Kong, Europe and the US jumped into falling markets to protect what were seen as vulnerable stocks from bearish investors.

The bans on selling shares to be delivered at a future date varied in breadth and detail, creating a compliance nightmare. Regulators promised to come up with a more uniform approach when they returned to the issue once the crisis passed.

Committees were created, meetings were held. Everyone agreed that shorts have their place in damping bubbles and most regulators decided they wanted to know more about large short positions than they did before the crisis.

Then the unanimity disappeared. While the UK and Japan require public disclosure of individual positions, Hong Kong and the US do not. Some countries ban so-called "naked" short selling, where the seller has not yet arranged to borrow the necessary shares.

In early March, the Committee of European Securities Regulators brought out a draft for what they hope will be an EU-wide standard, which requires public disclosure for any short position greater than 0.5 per cent of shares outstanding.

But two days later, the Germans went their own way – their plan asked only for disclosure to the regulator, BaFin, not the public, and was limited to shares of just 10 companies.

"Despite all the talk there is still a lack of joined-up thinking," says Will Duff Gordon from the short-selling research group Data Explorers.

Martin Wheatley, who heads the Hong Kong regulator and chaired a global regulatory committee that looked at the issue, downplays the differences among the various regimes. "We've all moved in the right direction but at a slightly different pace," he says. Differences on disclosure levels and whether they are made to the regulator or the public "don't really matter. It's not an area of regulatory arbitrage".

Industry groups beg to differ, arguing that public disclosure of short positions will dry up liquidity and hurt all investors, both long and short.

They point to a study commissioned by the US-based Managed Funds Association that found that the bid-ask spread for disclosure stocks in the UK widened by 45 per cent last year, versus a 2 per cent widening for stocks not subject to disclosure. Trading volumes also fell 13 per cent for the disclosure stocks.

"Investors have reacted to public disclosure rules in the UK quite predictably, by staying below disclosure thresholds. Any expansion of the rules would simply further reduce short selling, leading to lower market liquidity for long and short sales and higher transaction costs for all investors," says Stuart Kaswell, MFA's general counsel.

A recent study by Data Explorers found that short selling has dropped 38 per cent globally in the past 12 months.

While most of that decline stems from rising market confidence, concerns about disclosure and regulation have played a part in dampening interest.

"There is a hysteria surrounding short selling, so why wouldn't firms shy away from breaching a disclosure threshold," says Kevin McNulty, chief executive of the International Securities Lending Association, which represents institutional investors who allow their shares to be borrowed to cover short sales.

Industry groups say that, while they recognize that regulators need to know more about short selling than they did before the financial crisis, they object to imposing tougher public disclosure rules on bearish investors than on those who help push share prices up.

"The authorities seem to disapprove of aggressive short selling but not of aggressive buying. We think they should be treated equally," says Rob McIvor, spokesman for the Association for Financial Markets in Europe.

"Forcing individual investors to disclose short positions publicly would expose them to unfair risks and wouldn't actually help. It would be far more useful to investors for the disclosure to be made privately to the regulators, who would then publish aggregated short positions," he adds.

That argument and the MFA study helped convince some US regulators not to push for public disclosure instead imposing a "circuit breaker" making it more difficult to sell a stock short after it has fallen more than 10 per cent in a day.

The mish-mash of regulations leaves industry in a confusing position. So should industry groups press regulators for uniformity, to limit compliance costs, or exploit the differences?

Mr Kaswell see advantages in the second course. "Data show that public disclosure of short positions hurts markets. We'd prefer differing policies among markets, understanding the greater compliance burden that would entail, over one uniform policy that hurts investors," he says.

But Mr McNulty worries that high compliance costs could be as bad for short selling as disclosure. “It’s looking very messy in terms of different regimes. We would strongly favor harmonization.”

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