Time to Widen the Self-regulatory Mechanism of Short Selling

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The Secondary Markets Advisory Committee (SMAC) of the Securities and Exchange Board of India (Sebi) has in the recent past come out with a paper on modifying the rule which regulates short selling of securities in India. The current regulatory scheme allows non-institutions to short sell securities in the market. On the other hand, insitutions are not permitted to short sell even intra day. Thus an institution cannot sell in the morning and buy the same security in the evening. This regulation is bolstered by another one which mandates that all institutional trades must result in delivery, thus obviating any netting intra-day i.e. no netting, whether short or long.

The committee has made a good attempt to re-introduce broad based short selling and Lending/Borrowing of securities in India. To begin with the definition of short selling is highly appropriate and replaces the deeply flawed definition brought out by the 2003 SMAC in its paper then on the same subject which confused short selling with default. The 2003 committee sought to define short selling as 'failure to deliver securities at the time of settlement'. This is of course the definition of default in delivery rather than a definition of short selling. Short selling is defined by the new SMAC as the sale of a security one does not own at the time of the trade.

The committee recommends that institutions should be allowed to short sell though the current restriction on intra-day settlement would be retained. The recommendation allowing institution to short without allowing them to do intra day settlement is welcome as it not only creates a level playing field but also paves the way for more efficient markets without converting institutions into day trading punters. While allowing institutions this level playing field, the regulator must also mandate margins on institutions in the cash market as it creates an unnecessary presumption of 'too big to fail'. Today institutions do not need to place margins for trades in the secondary markets creating a non-level playing field with other players and creating a large risk management problem based on the presumption that institutions are good as gold with their orders.

The present committee defines short selling as selling securities which one doesn't own. To simply define, short selling is the sale of securities before their purchase and just as it is legitimate to buy in expectation of gains and of subsequent sale, so is it legitimate to sell expecting gain from a fall in securities price and subsequent purchase at a lower price. Arguments have been exchanged over the years in many countries that allowing unfettered short selling could be a means to hammer prices down by bear cartels and thus implicitly encourage manipulation of stock prices. Unfortunately, such arguments fail to point out that short selling is one of the most powerful tools *against* manipulation. Shorting not only does not increase manipulation, but it increases fear of shorts in the minds of manipulators. Thus a (say) promoter thinking of inflating his company's shares would think twice before doing so in the fear of a short sale by people ready to puncture the bubble created by him.

The committee suggests introduction of shorting only for the most liquid (around hundred and twenty) securities in which derivatives trading is permitted. This is erring on the side of caution. In fact the securities most in need of the shorting protection are the mid/small cap securities where it is easy to inflate prices of securities without the fear of short sellers. Shorting is thus most needed in mid and smaller stocks and experimenting with only the largest stocks may not provide the market with the remedy it most requires and instead provide it where it least requires.

There is an excellent US case on short selling (*Sullivan v. Scattered*) where the court held that a person who short sold more shares of a company than existed did not manipulate the market. The person in fact burst a bubble instead of creating an artificial market. The details of the case were that a company had gone into bankruptcy restructuring and its shares had become nearly worthless but were yet trading at dozens of times its true value. Unlike in a normal situation where valuation of a company is difficult, here it was relatively easy to ascertain 'true value' of the share.

A short seller finding the huge bubble created by some investors decided to short sell massive quantities of the stock and was hauled up for manipulation by those people who were buying the stock, specifically a large trader on the other side. Obviously, people buying the stock were very unhappy with the falling prices as they were on the losing side of the bargain. The court found the shorts not liable and in fact commended them for puncturing the balloon brought into existence by less sensible people i.e. the buyers. The court also found if at all, it was the buyers who were inflating and distorting the price of the securities. Thus the presence of short selling provided an economic equilibrium where securities reach more accurate prices and manipulation becomes more difficult. Having said that, it is important that the regulator understands the subtle nuances of manipulation in the

short selling context. Without such understanding, the regulator may prosecute shorts who decide to take a large position and brand them as manipulators.

The committee recommends providing for additional penalty for non delivery of securities if a short does not deliver securities. After all short selling should not interfere with the trade settlement on exchanges and shorts must borrow securities to deliver on their sale position since they don't own them. This is again venturing into an over-regulatory mode as the usual settlement mechanisms on default and pay out auctions or the proposed system of clearing corporation borrowing to effect delivery will take care of such naked shorts. No additional or special penalties or further regulations are required for the purpose. There is sufficient economic disincentive against defaulting on delivery built into the system and there are adequate safeguards in the system including capital requirements and margining system to ensure there is no systemic risk. A broker will ensure that naked shorts do not occur because it is in his self interest to do so.

The committee recognizes that short selling cannot occur unless a system of securities borrowing and lending mechanism is in place. This is of course fundamentally correct, it is nearly impossible to expect a market in short selling unless the short has a way of borrowing securities. Since India does not have the system of 'holding in street name' as in the US where brokers access their clients account for lending or any other form of institutional means of borrowing securities, short selling even if allowed would be a damp squib.

The committee has not considered one fundamental problem in the lending of securities market. And that is the obstinately cautious role of the central bank in limiting the hand of banks with exposure to the equity markets. With the result that even though banks are permitted to lend, they are averse to any form of lending of funds (based on securities). Thus though banks theoretically agree to lend money based on any collateral, few banks will actually lend funds based on collateral of securities. Similarly, banks will refuse to get into the business of lending securities for the same reason based on the RBI diktat on exposure limits. Unless banks are allowed to take a more liberal exposure to a secure securities lending system, securities lending may be more difficult to bring to fruition as one whole sector of the financial sector i.e. the banks, will not be able to participate in the scheme.

Finally, the concept of providing counter party risk elimination in securities borrowing and lending as well as electronic match making for borrowing securities are both brilliant suggestions made by the exchanges (which are part of the committee) and they must be commended for their willingness to push the limits of innovation into new areas of the securities markets.

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