

Authorities Restrict Short Sales during COVID-19 Crisis

By Greg Feldberg and Adam Kulam

The COVID-19 pandemic has created extraordinary uncertainty; it is too early to predict how bad it will get or how it will impact the world economy. This uncertainty has substantially elevated the volatility in bond and equity markets. In response, several countries have placed restrictions on short sales. In short sales, an investor sells a security she doesn't own, hoping to profit when its price falls. Economists generally find that the benefits of short selling to market efficiency and liquidity outweigh the potential costs, most of the time. But authorities argue that short sales amidst extreme uncertainty can excessively deflate market prices and lead to further market contagion in a crisis.

We discuss:

- (i) short-sale restrictions during the COVID-19 crisis,
- (ii) similar actions in earlier crises, and
- (iii) key design decisions that authorities face in restricting short sales.

Note that, while we focus here on short-sales bans, they are not the only tools authorities have used to address market volatility in the current crisis. Authorities have expanded the mandatory disclosure of net-short positions (Europe), introduced new circuit breakers to halt trading as prices fell (Thailand), and even briefly banned all trading for a few days (Philippines).

2020 Actions

In the COVID-19 crisis, several European countries, such as Spain and Italy; South Korea; and three Gulf States have banned short-selling. The Stock Exchange of Thailand (SET) and Securities and Exchange Commission of Pakistan (SECP) imposed uptick rules, which only allow short sales to occur just after a stock price has risen. Turkey's Capital Markets Board and Indonesian authorities adjusted domestic circuit-breaker rules, which temporarily halt trading on an exchange if a specified index significantly declines in price. The Johannesburg Stock Exchange (JSE) Settlement Authority raised settlement obligations, and pledged to force short-sellers to borrow securities in the open market if it appeared that their short-sales would fail.

Actions in Earlier Crises

For as long as stocks have traded, authorities have blamed short-sellers for market stress and periodically banned their activities ([McGavin \(2010\)](#), p. 207). Bans can be instituted either by a [financial regulator](#) or a self-regulating organization (SRO) such as a stock exchange.

During the Global Financial Crisis, the United States' Securities and Exchange Commission (SEC), in concert with the United Kingdom's Financial Services Authority (FSA), banned short-selling of nearly 1,000 financial stocks in 2008. At the same time, the SEC introduced a temporary requirement that all money managers publicly report any short sales. Amidst the Eurozone debt crisis, several countries banned short selling [for three weeks](#) in August 2011. When China's stock market suffered from turbulence in 2015, the Securities Regulatory Commission imposed a [new rule](#) requiring short sellers to wait one day before covering their short positions and paying back loans used to buy shares.

Studies of historical uses of short-sales bans haven't found them to be very successful ([Battalio et al. \(2012\)](#), p. 4). Scholars argue that short-sales banning bans decrease market efficiency, impede price discovery, and bring unintended negative effects, such as price inflation ([Hendershott et al. \(2013\)](#), p. 6). One study found that the US ban in 2008 did succeed at significantly reducing shorting activity. But the ban worsened market quality, as measured by quoted and effective spreads, price impacts, and realized spreads ([Boehmer et al. \(2013\)](#), p. 1398, 1399).

Key Design Decisions

Regulators face the following key design decisions in restricting short sales:

- Communicated Purpose – How will the authorities explain the ban?
- Nature of the Ban – Will the ban cover all shorts, or just uncovered or “naked” shorts? Will the authority use other tools, like an “uptick” rule?
- Scope – Will the ban cover shorts on all stocks, or selected companies or sectors?
- Exemptions – Will some market participants, particularly market-makers, be exempt from the ban?
- Timeframe – Will the ban be for a short term, longer term, or indefinite?
- Coordination of Measures – Will the ban apply to other types of bearish activity, and will other countries cooperate?

Communicated Purpose

Authorities' documents and press releases suggest an attempt to curb price decline, control volatility, or bolster market confidence. Authorities typically express the concern that excessive short-selling might misrepresent a company's true value and eventually damage the fundamentals of the underlying company – especially for companies whose counterparties treat the stock price as a proxy for long-term financial health. So they use short-sales bans to avoid a “[crisis of confidence](#),” as the SEC said in 2008.

Short-sales bans in 2008 focused on shares of financial institutions “whose health may have an impact on financial stability” ([IOSCO](#), 2008). Regulators in that crisis were concerned about financial contagion, as counterparties took falling share prices to indicate weakness in these companies. “In the context of a credit crisis, where some entities face liquidity challenges but are otherwise solvent, a decrease in their share price induced by short-selling may lead to further credit tightening for these entities, possibly resulting in bankruptcy” ([IOSCO](#), 2008).

The SEC's September 18, 2008 prohibition of short sales was the first of several around the world. South Korea's Financial Supervisory Service (FSS) banned short sales of all South Korean stocks on September 30, 2008, citing “malignant rumors” in its financial markets ([Bohl et al. \(2014\)](#), p. 265). Germany, France, Australia, and the United Kingdom followed similar policy agendas soon after.

Nature of the Ban

In some cases, authorities have banned all short sales. In other cases, they have banned only “naked” or uncovered short sales. In a “[naked](#)” short sale, the short seller neither borrows nor arranges to borrow the underlying security by the settlement date. This introduces a settlement risk that the seller will fail to deliver the security when it is due. If a trade fails, the short seller will not receive any cash, and the buyer will not receive any security. These “failures to deliver” (FTDs) are a key measure of naked short-selling, and scholars suggest that naked short sales result in higher levels of volatility than covered short sales ([McGavin \(2010\)](#), pp. 204-6).

Authorities also have to make judgments about how a short sale can be covered ([Howell \(2016\)](#), pp. 15-6). During the “close-out” portion of the short sale, the short seller “covers” their position by re-obtaining the security and returning it to the original lender by the date of settlement. Regulators can set the degree of ownership that satisfies minimum “coverage” thresholds. Authorities may require a short seller to wholly possess the security, to obtain a legal contract entitling the short seller absolute ownership of the security, or use a “locate” requirement, which is more or less a promise from the short seller that they reasonably expect to obtain the security from a third party before the settlement date. There is [some evidence](#) that stringent covering requirements can increase the ratio of informed to uninformed short-sellers.

Another way to regulate short-selling is through [uptick rules](#), which permit traders to short-sell securities only at prices above the current market price. Simply put, short-sales can't go through

until the security's price rises. Authorities aim to limit the contribution of short-selling to [market abuse or bear raids](#), which may result in steep and sudden price declines ([McGavin \(2010\)](#), p. 214). Authorities also rely on uptick rules to communicate that there are active buyers in the market ([Howell \(2016\)](#), p. 34).

Uptick regimes have re-entered both the [public discussion](#) and the active macroprudential toolkit in the current crisis. The [Stock Exchange of Thailand \(SET\)](#) employed a temporary, three-month uptick rule “to cope with high uncertainties” and volatility related to the COVID-19 outbreak. The [Securities and Exchange Commission of Pakistan \(SECP\)](#) imposed an uptick rule on 36 shares listed on its futures market “in the wake of COVID-19 and its unprecedented effect on global stock markets.”

Also, rather than restrict short sales, authorities have on some occasions sought to limit the possible negative impacts by requiring more disclosure. The UK FSA argued that disclosure-induced transparency would prevent market manipulation and ward off speculation and market overreaction ([McGavin \(2010\)](#), p. 237).

Scope

A short-selling ban can span groups of securities, indexes, or country-wide stock markets and exchanges. In 2008, the SEC first banned short sales on the stocks of the two mortgage government-sponsored enterprises in July. It later extended the ban to 799 financial companies' stocks. In announcing the expanded list, the US SEC noted that it had focused on financial institutions because of “the essential link between their stock price and confidence in the institution.”

Of course, short sales are not the only way for investors to take bearish positions on equities. Some authorities have more broadly prohibited all net-short positions, thereby extending the ban to derivative securities and other “[bearish operations](#)” that profit from the problematic securities' price-decline. Several European countries such as [Spain](#) and [Italy](#) recently banned net-short positions, but exempted credit default swaps, corporate debt instruments, and balanced hedging activity.

One study of the 2008 short-sales bans in the US noted that options markets continued to function. The authors were able to [show](#) that banning short-selling slowed the flow of negative information into stock prices, relative to the options markets that weren't covered.

Participant Exemptions

Rather than ban all short-selling, authorities may prohibit or exempt specific market participants. One academic paper classified short-sellers as algorithmic traders, market-makers, or long-term profiteers ([Battalio et al. \(2012\)](#), p. 2). [Market makers](#) are participants that facilitate the purchase and sale of stocks “on a regular and continuous basis at a publicly quoted price.” Expansive prohibitions have made it difficult for specialists such as market makers to provide liquidity by short-selling ([Jones \(2012\)](#), p. 27). When the NYSE banned all market participants from short-selling in 1931, it included market makers and “provoked something akin to a short squeeze” and accidentally permitted short-term buyers to ratchet up prices ([Boehmer et al. \(2013\)](#), p. 1367). In 2008, the SEC included algorithmic traders in its ban; some saw this as a mistake, because those traders could not act as informal market makers while the ban was in force. With less competition, the exempted formal market makers collected greater

rents from those demanding liquidity. In most recent cases, authorities have [exempted market makers](#).

Timeframe

Temporary short-selling and net-short bans might function as extreme macroprudential tools if they could limit panic selling. During the Global Financial Crisis, “Temporary short selling restrictions were imposed as a means to try and restore financial stability: the constraints could be swiftly introduced; they were easy to sell to the public; and they demonstrated the regulators were taking action to try and control the situation” ([Howell \(2016\)](#), p. 10). Still, temporary bans can cause uncertainty because market participants do not know what is included in the ban ([Howell \(2016\)](#), p. 28-9). Recently, international regulators have clarified the length and scope of their short-selling restrictions by publishing answers to frequently asked questions (FAQs) on their websites.

Coordination of Measures

In some instances, authorities have coordinated short-sales restrictions across jurisdictions. On September 18, 2008, the Securities and Exchange Commission (SEC) and the Financial Services Authority (FSA) consulted one another before prohibiting the short-sale of domestic financial stocks ([Boehmer et al. \(2013\)](#), p. 1366-7). After the GFC, the European Securities and Markets Authority (ESMA) was established to promote supervisory convergence across the European Union. Recently, the ESMA ensured that the short-sales bans of foreign securities were consistent across markets in multiple nations ([France](#), [Belgium](#), [Greece](#), and [Italy](#)). Regulators coordinate to make their policies transparent and harmonize them with the policies of other regulators. In another recent example, ESMA strengthened the EU’s short-sale disclosure requirements, and the UK’s Financial Conduct Authority (FCA) imposed [a reciprocal rule](#) to avoid the migration of share-specific short-selling from one market to another. Coordination can be essential to prevent regulatory arbitrage or exploitation by short-sellers ([McGavin \(2010\)](#), p. 238).