ABSTRACT: This article analyzes the effectiveness of the short selling ban, and questions it with critiques from comparative empirical data. Authors have argued that the ban on short selling hit trading volumes but did not necessarily reduce market volatility. Today market regulators are seeking to rebuild a short selling policy that allows covered short selling while reducing the risk of market abuse. The reinforced framework must include rules and regulations that increase market efficiency, enhance the visibility of short selling to regulators and to investors, improve regulators’ responsiveness to market failures and periods of extreme volatility, and enforce anti-abuse laws consistently and judiciously. Although most regulators have allowed their short sale bans to lapse and seem to be thinking constructively about the form of future regulation, the dust has not settled on the short sale debate. As the events of the year 2010 outline, short selling regulations tend to mirror the capital markets they oversee. The author questions if the capital market in Montenegro is ready to lift the short selling ban and to allow speculative trading again.

KEY WORDS: Government regulation, short selling, securities lending

JEL CLASSIFICATION: G10, G18
1. INTRODUCTION

The Securities Commission of Montenegro has published changes in its rules with the aim of enabling margin trading, which previously securities regulations had not allowed. Authorized participants in the securities market put forward and publicly announced an initiative to the Securities Commission, asking them to adopt rules which would enable margin trading as soon as possible and explaining that the adoption of these rules would stimulate the capital market.

The proposed Commission Rules regulate the conduct of margin business in the most basic form. However, the same rules ban short selling, i.e. trading with securities that the owner does not have in his account at the moment of issuing the order.1 On the other hand, the borrowing/lending of securities is not regulated in Montenegro. In practice there was borrowing/lending and frequent trading of securities in Montenegro during the stock exchange boom. The Commission took a number of measures against brokers who, without their client’s knowledge, traded with securities that were in the client’s ownership account. Since the Commission Rules stipulate that securities can be traded only when there is a client’s order, any trading of securities without a client’s order, and thus also borrowing/lending securities without the client’s knowledge, is not allowed. On the other hand, the Commission Rules banning short selling were primarily aimed at explicitly banning this practice, since trading with securities that the broker did not have in his account or in his client’s account resulted in a large number of cancelled transactions. After the adoption of these rules there was no cancellation of transactions caused by brokers’ incapacity to close positions on open sale orders. Two years later the Commission adopted the draft and put the rules enabling margin trading up for public discussion.

With changes in the rules aimed at enabling margin trading, changes enabling short selling or borrowing/lending of securities were not envisaged. However, they are planned, in order to have shares trading in the Montenegro market. But if we look at international experience, the basic goal of margin trading, apart from

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1 See Article 19 paragraph 2 Rules on the Method of Conducting Business of Authorized Participants in the Securities Market ("Official Gazetate of the Republic of Montenegro", no. 78/09 and 87/09) stating: “An authorized participant may insert a sale order into the stock exchange trade system and execute a sale order for certain securities on his behalf and for the client’s account, or on his behalf and for his account, if the securities are registered in the ownership account of the person issuing the order or on whose behalf the order is given, in the amount stated in the sale order.”
the commission obtained by the broker and interests, is to borrow the securities that are in the margin account to close positions on other accounts.

Short selling is betting on the price of shares falling. The seller uses borrowed securities which he sells in the market. At some point he has to buy the same number of securities as he has sold in order to ‘cover’ his positions; that is, to substitute the previously borrowed shares. Profit or loss is the difference between the price for which the shares were borrowed and the price for which the positions were ‘covered’. A profit is made if the price of shares goes down. A loss is made if the positions are ‘covered’ for a price higher than the price for which the shares were previously borrowed and sold.²

Standard margin trading contracts contain a clause according to which the dealer/broker has unlimited rights to borrow securities that the clients keep in the broker’s account for margin trading.³ However, American authors have shown that brokers do not include clauses in contracts clearly informing the client that s/he thereby gives authorization to the broker to borrow securities that the client keeps in the broker’s account. In fact these clients never find out that their shares were used for trading, or that they have lent their securities. The reason for this, according to the authors, is the fact that the most often borrowed securities are the ones being actively traded.⁴

The USA Depository Trust Clearing Corporation (DTCC) and National Stock Clearing Corporation (NSCC) put together the so-called “Easy to Borrow” list (a list of securities that are easy to borrow) which is then used by brokers.⁵

In USA market practice securities that are not in the “easy to borrow” list are much more difficult to borrow. Experienced brokers state that one of the greatest problems they face is to borrow shares that are not often traded.⁶ Several reasons are given for this in the literature: some shares are still in founders’ and families’

hands, or in accounts with brokers that are not margin accounts. Shareholders of some companies wish to be long-term shareholders who keep their shares in a registered name, and not in margin accounts.7

Since it is difficult to locate securities that can be borrowed, many financial service providers have formed special divisions dealing only with borrowing securities and developing programmes for borrowing securities. Such programmes provide the owners with higher than average revenues (8% to 10% interest) and other benefits if the owner agrees to lend his securities. An attractive characteristic is that these contracts are usually for a short period, so that the investor/lender is entitled to withdraw his shares at the end of any month.8

The programme of borrowing securities does not include information that the borrowed securities will be ‘short sold’, and that such trading most often results in reduction of the price of the securities traded in such a manner. According to many authors the US Securities Commission (US SEC) should use its authority to impose sanctions on brokers and dealers, demanding that each programme for borrowing securities include a document/prospectus, which explains in clear, colloquial language the risks of short selling to each investor being offered participation in the programme of borrowing securities.9

2. THE CAMPAIGN AGAINST SO-CALLED ’NAKED SHORT SELLING’ – THE ROAD TO THE SHORT SELLING BAN

The sale of securities by investors who do not own them and the intention to borrow securities are practices known as ‘naked short selling’. Many people with knowledge of the securities market and the US SEC claim that, whether independently or in combination with other tactics, sellers use ‘naked’ short selling in order to manipulate the price of securities, causing the reduction of these securities’ prices to a level that has no connection to economic reality. The former US SEC President, Christopher Cox, said that “distort and short” campaigns had “drastic consequences”, leading the Commission to focus on them for special control programmes. In 2004 US SEC adopted the SHO Rule, which entered into force at the beginning of 2005, and which is considered the first action of US SEC against naked short selling. This rule requires the broker/dealer not to accept

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7 See: Branson, op.cit.
8 See: Branson (2010).
9 Ibid.
more ‘short sale’ orders if the seller does not have shares or a reliable contract to 
borrow those shares. In September 2008 this rule was expanded to apply to all 
shares, and brokers were required to cover the deliveries at the opening of the 
first day after the transaction closing day.\(^\text{10}\) In other words, through this rule 
the Commission requires that market participants close uncovered positions 
for delivery of securities until the following trade opening day T+3, while in the 
previous rules it was the thirteenth day from the transaction conclusion day.

Since 2004 SEC increasingly advocates reduction of the pressure on participants to 
lend shares. Both through regulatory efforts and constant sanctioning activities, 
US SEC strives not only to impose sanctions but also to completely eliminate 
’naked short selling’ and the incapacity of brokers/dealers to close positions on 
securities.

Many participants in the market consider that ‘naked short selling’ practice is 
not good.\(^\text{11}\) Theoretically, if sellers do not have the obligation to, or simply do 
not deliver shares they intend to sell, the short-term interest for those securities 
can exceed the total number of available securities. Practically, when ‘naked 
short selling’ occurs the short-term interest for shares grows fast, which results 
in pressure on the price reduction of those shares. Combined with false news or 
organized campaigns known as ‘distort and short’, naked short selling can lead 
to a significant reduction of the price of those shares. Buyers of those shares, to 
whom they are not delivered, are not entitled to dividends or voting rights for the 
shares they have purchased. According to almost every participant in the market, 
naked short selling is not considered to be good business practice.\(^\text{12}\)

3. SHORT SELLING BAN – AMERICAN ACADEMY COMMUNITY CRITICS

Since July 2000 US SEC Rules have required that the potential short seller either 
borrow shares he intends to sell or has a formal agreement with the lender to 
have the requested shares delivered for short selling on or prior to the closing day 
(T+3).\(^\text{13}\)

\(^{10}\) Ibid.
forbes.com/2006/06/20/naked-short-selling-overstock-cx_lm_0621short.html;
\(^{12}\) See: Branson (2010).
\(^{13}\) See: SEC Enhances Investor Protections Against Naked Short Selling, SEC Press Release 
It is important to point out that as a consequence of adopting this rule share prices fell significantly. SEC considers that short selling contributed to this fall, or to the speed of it.\textsuperscript{14} Criticism of SEC’s efforts was almost universal. Professor Owen Lamont described it as a “ridiculous but harmless effort”\textsuperscript{15}. Believing that one of the key contributions to the failure of Bear Stearns and Lehman Brothers was precisely short selling, the Commission adopted a number of temporary rules through which it increased sanctions for short sellers who do not meet requirements for delivery of securities on T+3, and temporarily completely banned short selling.

The new US SEC Rules which entered into force on 18th September, 2008, led to a drastic reduction of unclosed positions.

As a direct consequence of the US short selling ban, the practice was banned by many other regulators across the world.\textsuperscript{16} This step resulted in much criticism of the regulators. “It seems that we have a lot of amateurs [in the Commission] who do not know what they are doing… Banning short selling shows regulators’ despair”, said Professor James Angel from Georgetown University\textsuperscript{17}. “SEC decided that we need time-out, but there are a lot of us wondering what the Commission was thinking, whether they lost their tracks…”, said Professor Charles Jones from Columbia University.\textsuperscript{18}

A large number of academic studies on short selling regulations point out the advantages of short selling and show concern over the ban. Akbas et al concluded that “our evidence shows that short sellers act as specialized controllers generating value-relevant information to the stock market.”\textsuperscript{19} Balasubramanian and Cyree pointed out that short sellers reliably control banks through their market behaviour,\textsuperscript{20} and Boehmer et al stated that “short sellers represent a significant contribution to efficient market prices”\textsuperscript{21} Lamont and Stein wrote that aggregated

\textsuperscript{17} Ibid. quoted according to: Branson (2010)
\textsuperscript{18} Ibid.
\textsuperscript{21} See: Boehmer & Zhang (2008a).
Short selling tends to increase market fall, making it easy for people to blame the messenger. However, according to their interpretation of the evidence, the problem is not in having too much short selling when the market is falling, but more in too little short selling when the market is growing, and any effort of the regulator to limit short selling is likely to be misdirected.  

Jones (2008) wrote that empirical analyses almost certainly show that, in aggregate, short sellers trade based on good information on fundamentals, and they make exceptional profits. When short seller’s information is not included in the price because short selling is expensive, difficult, or banned, the evidence show that shares can be overestimated. 

Other short selling studies also lead to similar conclusions. Ekkehart Boehmer et al studied the influence of the temporary short selling ban on almost a thousand shares in 2008. Comparing banned share trading to control group share trading, they concluded that the trading ban lowered market quality, measured according to spreads, price influence, and daily volatility.

Analysis sponsored by the International Securities Lending Association, the Alternative Investment Management Association, and the London Investment Banking Association estimated the influence of the 2008 short selling ban in several countries. According to this analysis, short selling limitations did not alter share return. Both for the shares whose short selling was limited, and for these shares compared to control group shares whose trading was not limited, a conclusion was made that regulatory limitations were not harmful, and any changes were effected by the circumstances characteristic for the sector, and not short selling limitations.

Credit Suisse also analyzed the effects of the 2008 short selling ban, and concluded that the share trading volume was significantly reduced, market spreads grew more, and the costs of trading increased, compared to shares whose trading was

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26 Boehmer et al. (2008b).
28 Ibid.
not limited. Credit Suisse attributed about 20 points to the increase of spreads due to short selling limitations.

4. RESEARCH TOPICS AND CONSIDERATIONS OF SHORT SELLING REGULATIONS

As stated above, many countries introduced short selling limitations as a response to the market crisis, usually temporarily. Many of these temporary measures were removed in May 2009. On 25th May 2009, when Australia lifted its eight-month short selling ban, the Financial Times commented that this step placed Australia in the ranks of the most developed market countries, which had already lifted temporary bans on the practice.

The Australian Securities & Investments Commission (ASIC) warned that it would immediately reintroduce the ban if it appeared that market conditions required such a step. Although the effectiveness of the short selling ban was questioned and criticized due to its effect on trade volumes, analysis showed that ASIC’s warning was likely to result in the future absence of short selling in Australia.

In March 2009 the International Organization of the Securities Commission (IOSCO) stipulated four draft principles to regulate short selling. This document pointed out the significance of regulatory mechanisms to prevent the inability of delivering securities. IOSCO also demanded more publishing of information on short selling and reporting to regulators and the market, as reporting balances regulatory, economic, technical, and ownership issues. IOSCO pointed out that regulators should implement regulations they adopt, particularly to prevent cancelling of transactions, and should collect the necessary information. They also pointed out that “short selling regulations should enable adequate exceptions for certain types of transactions for efficient functioning and market development”.

29 McCaffrey (2010).
30 Ibid.
31 Ibid.
34 Ibid.
The IOSCO document stated a number of regulatory mechanisms for short selling, such as price limitations, marking of short sale transactions, limitations of the type of transactions which can be ‘shorted’, and margin conditions. It was pointed out that all these measures can have a different efficiency level depending on specific local conditions and the nature of the existing market infrastructure. Also, the introduction of some of these measures in some countries can be connected to operational difficulties and can include significant expenses for regulators and participants in the market.\textsuperscript{35}

Broadly speaking, stock exchanges strongly support establishing strict rules for balancing transactions as a priority solution, as this produces regular and efficient functioning of market processes compared to other initiatives such as price limitation. A regulatory framework for short selling should include provisions to cover fraud, manipulations, and requirements regarding delivery of securities and closing of transactions.\textsuperscript{36}

The World Federation of Exchanges questioned the IOSCO stipulations and pointed out that the “reporting regime should be based on key benefits for fair and regular market functioning with due attention to costs. The primary goal of any short selling reporting regime should be a contribution to efforts for preventing market abuse. We suppose that IOSCO still claims that in certain circumstances, public publishing of information can contribute to prevention of market abuse. However, data on all or most short positions is not considered a precondition for a fair, efficient and regulated market. World Federation of Exchanges considers that the primary goal can be reached through reporting to the regulator, rather than with public reporting in the market.”\textsuperscript{37}

According to the World Federation of Exchanges, IOSCO should have pointed out that the system of mandatory reporting should be regarded by the regulators as an additional system directed at controlling and sanctioning short selling, and not as a system to provide information or assist the investor in making decisions on the sale of shares.\textsuperscript{38}


\textsuperscript{36} Ibid.

\textsuperscript{37} See more in: McCaffrey (2010), p. 183 et seq.

\textsuperscript{38} Ibid.
The World Federation of Exchanges also commented that, if price limitations are part of the whole regulatory scheme, they should include adequate exceptions that provide efficient and effective market functioning, and they should include exceptions for market makers with both derivative and cash instruments, particularly when there is a significant obligation for development of both market segments.39

The United Kingdom’s Financial Services Authority published a discussion paper on short selling in February 2009. This document also highlighted both regulator and market reporting. However it added that the FSA discarded price limitation as a regulatory measure.40

Richard Whitney, the NYSE President, pointed out the effect of short selling on market stabilization. He explained that short selling is often used not only for speculative purposes but as a method of loss prevention due to price fluctuations.41 Also, he claimed that “fall in share price was not caused by short selling but unsatisfactory business conditions and liquidation of securities that were owned or margin held. Whitney also described economic reasons forcing institutional investors, well known as long-term investors, to sell securities (relatively liquid assets) in order to obtain cash.42

Perkins, a lawyer from New York, described short selling as a manipulator’s means in the market and the cause of market volatility. Perkins gave a number of suggestions and demanded “thorough questioning of short selling” to analyze the effects of short selling on the market. Perkins then recommended the draconian suggestion to stipulate a special tax on profit made through short selling, with no loss deduction allowed.43

The debate demonstrates public criticism of traders and speculators. But while “several regulators, public companies, and many nervous individual investors have fears caused by the manipulative tactics of short selling applied by large investors, many financial experts and industrial leaders defended short selling as a critical means for stabilization of market prices and maintenance of market

39 Ibid.
40 Ibid.
41 See: Whitney, R. Short Selling, in: Short Selling, For and Against 1, 6 (1932); quoted according to: McGavin (2010), p. 201.
42 Ibid.
efficiency. Indeed, the consensus of financial experts, including US SEC President Christopher Cox and a hedge fund manager, showed that the benefits of short selling legalization largely exceed the damage it can cause.44 However a basic characteristic of the short selling debate is that even those advocating short selling admit that damage due to naked short selling can cause and foster efforts to control this trading.

Comparative data show that those who advocate short selling are right to question and criticize regulatory policy based on a short selling ban, but these preliminary results fail to resolve the continuous political debate on short selling that marked the financial crisis. While most analyses were based on the naked short selling ban, the regulators must also consider further empirical data on the limitations of short selling when developing further regulatory regimes.

For example, the study published by Cass Business School showed that the short selling ban did not affect market volatility. Financial economists widely researched the effects of short selling and limitations on market efficiency, and this research, well known for its consistent conclusion that short selling increases market efficiency, should be the basis for the future regulation of this issue by US SEC.45

Several economists pointed out the “hypothesis of price increase”, according to which short selling limitations can lead to shares being overestimated, because the possibility of short sellers to correct the increased prices and the reaction to negative information is slowed down.46 This hypothesis shows, as does much empirical research, that, in the interest of preservation and promotion of market efficiency, short selling should not be banned. Market research shows that the existence of short selling liquidity benefits the existence and enabling of safe short selling. This hypothesis shows that one of the most important issues for which regulators should seek an answer in developing a new regulatory system is not whether to allow short selling, but how to allow short selling and to control the risk of abuse.47 Short selling is not a flawless mechanism for market efficiency and will not function without effective regulation and monitoring in order to identify and prevent abuse.

45 See: Jones & Lamont (2002).
47 Ibid.
5. CONCLUSION

Although most regulators lifted their temporary short selling bans and have started to think constructively about the form of future legal regulation, there is still a lively discussion on short selling regulation. As 2010’s events show, short selling regulation is only a reflection of the capital market.48 In years of market growth the risk of market manipulation by short sellers is low, and there is less need for regulation, which becomes unpopular as it imposes costs for investors and investment managers and reduces market liquidity and the price stabilization effect produced by short selling. In times of market fall and financial crisis greater regulation or suspension and banning of short selling seem like a fast remedy for an unhealthy market,49 and it becomes necessary to reduce the influence of pessimistic rumours.

Under these conditions the challenge the regulator faces is finding an adequate balance between control and interfering with market conditions, and development of a regulatory system that responds efficiently to market fluctuations. A very low level of confidence in capital markets across the world showed that sudden, stricter regulations do not calm either the market or the nerves – and that market regulators must respond to the calls for urgent regulation with knowledge and resistance.50

To make the final decision on whether short selling practice should be banned permanently in the Montenegro market it is necessary to understand the role that short sellers play when the market is growing, and the connections between market disturbances and short sale transaction volume. The regulators’ aim should be to punish those who abuse the practice, while avoiding punishing the whole market through inefficient limitations. When the market is stabilized regulations should follow market developments. There is enough evidence to support regulators enabling short selling, if they can provide strict controls and suspend aggressive short sellers.

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48 Ibid.
49 Ibid.
50 Ibid.
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Received: February 9, 2011
Accepted: May 18, 2011