

Now we know: the shorting ban was a mistake

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While UK regulation of hedge funds has much to commend itself in comparison with other financial centres, notably the US, the specific approaches taken to short selling – specifically the four-month ban and the subsequent proposals on disclosure – do nothing to enhance our credentials for global leadership. On the contrary.

The one great benefit of the UK's [ban on short selling financial stocks](#), which ended on January 16, is that it provided the perfect laboratory in which to assess the policy's merits. The conclusion is unequivocal – it was a mistake.

The London Stock Exchange commissioned an independent analysis of the ban's impact on the 15 affected stocks within the FTSE 100. Liquidity in the restricted stocks fell by about 10 per cent compared with a rise of 50 per cent in trading volumes in the control sample, and transaction costs rose by 150 per cent compared with the control sample. A separate study by Cass Business School found that volatility of restricted stocks rose significantly more during the ban than volatility of unrestricted stocks.

For those who saw the purpose of the short selling ban as a means of shoring up share prices, the evidence is equally painful. During the course of the ban, the price of [Royal Bank of Scotland](#) fell 78 per cent, [Lloyds](#) 59 per cent and Barclays 66 per cent.

But there was a further impact, perhaps more serious in its implications for the broader market, and that lay in the unintended consequences for the hedge fund industry.

Short selling is the main risk management tool for hedge funds in their quest to preserve clients' capital. Banning them from shorting is akin to asking Formula One drivers to operate without brakes. Without proper protection, they will simply withdraw from the race. Thus, funds with strategies particularly dependent on short selling had no choice but to withdraw, leaving markets that rely on their participation, such as the convertibles market, paralysed. The ban was an example of extreme "regulatory hazard", undermining the foundations of an industry and of a number of markets that are critical to capital provision.

It was disappointing that the UK ban was more severe in scope and length than in any other market except Australia. The US ban was similar in scope (only financial stocks) but lasted just three weeks. Many European markets applied the ban only to "naked" short selling – where the vendor has not borrowed the stock in advance – (Belgium, France, Netherlands, Germany), or not at all (Spain, Scandinavia), while most parts of Asia did not apply a ban.

None of this is to belittle the concern for financial stability that lay behind the ban. However, the relationship between short selling and financial stability is much better addressed by a sensible policy on disclosure. Last week, the Financial Services

Authority invited consultation on a new policy to require disclosure by individual funds of short positions above 0.5 per cent. But the FSA's position lacks logic.

There are three arguments for disclosure of individual positions: control, market abuse and financial stability.

The control argument is the main basis for the current disclosure of long positions in excess of 3 per cent. To the extent that issues of "control" apply to the same extent on the short side, one could argue for "symmetrical" disclosure of 3 per cent. Concerns about market abuse also apply as much to the long side as the short side, and to the extent that they justify the 3 per cent rule, that too should be symmetrical.

Which leaves financial stability. It is fair to argue that short selling poses issues of financial stability that are less applicable on the long side. However, the threat to market stability is not posed by individual funds so much as the aggregate of the marketplace. So surely the answer is for the FSA to monitor aggregated data on short positions, rather than at the individual fund level. This can be achieved either by requiring prime brokers to aggregate the positions under their custody, or by requiring all short positions to be flagged with the stock exchange such that aggregate short positions can be reported by the exchange.

The sensible policy on disclosure, therefore, is to combine individual fund disclosure on the same basis as long positions (ie 3 per cent) with aggregate disclosure (at a level to be determined by the interests of financial stability).

It is important that the UK recovers leadership in this debate if we are to retain our status as one of the world's leading financial centres. At least we now have the evidence to set sensible policy.

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