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Short selling - a South African perspective:

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1. Background

During October 2008 the US and UK regulators temporally banned short sales on certain financial stocks. This controversial topic has become relevant again recently when the German Government **banned naked short selling** on euro-zone government bonds, Credit Default Swaps ("CDS's") and 10 financial stocks on **18 May 2010**. Subsequently the European Parliament's Economic and Monetary Affairs Committee proposed a total ban on naked short selling and argued that the European Securities and Markets Authority, a proposed pan-EU body, should be given powers to **restrict all forms** of short selling "in exceptional circumstances or in order to ensure the stability and integrity of the financial system".

2. Definition

Short-selling in general involves traders profiting from falling share/asset prices. The technique works when investors sell shares that they do not own, hoping the price will fall. The aim is then to buy back the asset at a lower price and as such pocketing the difference between the higher sale price and the cheaper purchase price. There are basically two forms of short selling:

- **Conventionally**, the trader will "borrow" securities from a current shareholder, typically a bank or prime broker, agreeing to return them on demand. The seller delivers these shares to a buyer, who takes full ownership and likely does not know that he is participating in a short sale. When the seller wants to "unwind" the position, he buys back equivalent shares in the market and returns them to the lender. It is not possible to sell more stock than there is in issue.

- **Naked short selling** is the practice of selling a stock short without first borrowing the shares or ensuring that the shares can be borrowed as is done in a conventional short sale. When the seller does not obtain the shares within the required time frame, the result is known as "fail-to-deliver". However, the transaction generally remains open until the shares are acquired by the seller or the seller's broker, allowing a trade to occur when the order is filled. Naked short selling therefore creates the potential to sell more of a stock than there is in issue.

3. How does naked short selling on CDS contracts work?

The FT (20 May 2010) offered the following explanation:

"Why is a naked CDS different from a naked short sale of bonds and stocks? Buying a credit default swap in effect buys insurance against the risk of a default by either a company or country. This is essentially a short sale, since the holder profits from the contract if the entity does default. Even before that happens, the CDS holder benefits if the outlook for the entity deteriorates, because the insurance premium for that default risk will rise and the holder can profit by selling the insurance and closing out their trade. Some investors holding debt issued by an entity, buy credit insurance to protect their portfolios from such a risk, but most buying comes from investors who simply want to express a negative bet. As such, buying credit protection without owning any of the entity's debt is a "naked short bet."

Thus the writers (usually investment banks) of CDS contracts will either have to warehouse the risk of the underlying credit risk (like AIG did until 2006) or hedge themselves with other CDS writers (other investment banks) or sell the underlying bond short (either naked or conventionally).

4. Why has it become a concern?

In times of severe financial turmoil when prices of shares and bonds are under pressure, speculators tend to enter the market. They may inflame the situation by building up short positions in already distressed securities, depressing prices even further. Recent examples are the Asian crisis in 1998, the Global Financial crisis during 2008 and lately the Greek Bond crisis.

- ***Example 1: Bear Stearns***

    The collapse of Bear Stearns, Lehman Brothers and AIG as well as market anxiety over Morgan Stanley and Goldman Sachs in 2008 raised serious concerns regarding the effect of *short selling* in the listed equity markets.

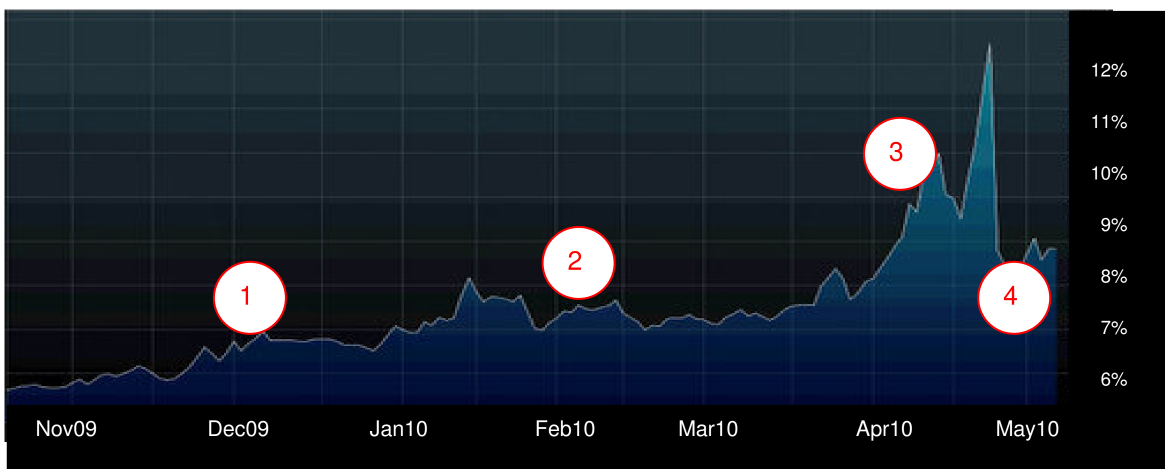
    Many market commentators blamed malicious ***naked*** short selling as the main cause of panic in the sell down of investment banking shares. As an example - it is alleged that certain hedge funds took naked short positions in Bear Stearns and then started false rumours that Bear was struggling to fund itself. This is akin to shouting "fire" in a crowded theatre. These rumours triggered panic selling in the market and Bear's share price was pummelled to $5 from $80 in just a few days. The sharp drop in share price made the headlines and together with the negative

press became a self-fulfilling prophecy. Bear experienced rapid and massive outflows of clients' funds. The rest is history and Bear was eventually bought by JP Morgan for $10 per share.

The effect of **naked** short selling may be seen at the time of the Bear Stearns collapse:

Bear Stearns had 241 million shares in issue at the end of February 2008. For the 3 trading days between 14 and 18 March 2008 a whopping 500 million shares (twice the shares in issue) were traded. It was reported that Joe Lewis (7% -10%) and Management (25%-30%) combined had between 30% and 40% of the shares in issue. This block of shareholders will not have made their shares available for lending purposes. This means that it is highly unlikely that the majority of the selling activity came from current holders or *conventional* short sellers. The only explanation for the extraordinary volume had to be as a result of *naked* short selling.

- ***Example 2 : Greek Bond Crisis***



1. The 10year Greek government bond yield traded below 5% until December 2009 when its credit rating was downgraded to the lowest in the Eurozone due to fears about its deteriorating public finances.
2. During the next 4 months concerns escalate due to increasingly poor economic indicators, higher than expected budget deficits and warnings of further rating downgrades from credit agencies.
3. A full blown crisis develops during April/May 2010 as Greece's unemployment figures jump to six year highs and budget deficits are revised upwards again. As a result S&P downgraded Greece's rating to junk and followed it up with a downgrading of Greece's commercial banks. The systemic influences in play are escalating the crisis globally. Many European banks are holding Greek Government bonds for capital purposes. The ratings downgrade made Greek bonds ineligible for capital purposes and these institutions were forced to liquidate their holdings – fuelling the sell-off. This resulted in deteriorated balance sheets of European Banks that forced global banks to increase their collateral requirements from European Banks. The seeds for another spectacular banking crisis have been planted and speculators increased their short positions against the Euro, Greek-, Portuguese- and Spanish bonds as well as European- and Global Banks.
4. The immediate crisis is averted when the European Central Bank and the IMF announce a €750bn bailout package that includes Government backed loan guarantees and a commitment to buy European Sovereign bonds.

The role of short selling is not as obvious in the Greek bond example as in the Bear Stearns case but many European government officials blamed short sellers for the extreme price movements of Greek bonds during April/May 2010. *"Mr Papandreou claimed the surge in spreads …was the result of sustained shorting of Greek bonds by unnamed speculators and hedge funds" (FT 20 May 2010).*

A senior deputy in the governing Socialist Party supported by another 10 deputies alleged that an extension of the settlement period (from T+3 to T+10) and the abolition of penalties for failed bond trades had made it easier for speculators to short Greek bonds on a naked basis. This certainly gave naked short sellers a longer window of opportunity to push down the price of a bond before delivering it on settlement date. There are also no severe consequences if a short seller failed to settle on due date – the trade is simply rolled to the next settlement date.

5. Reaction by the regulators

In light of this it is understandable that regulators would like to prohibit **naked** short selling:

- After the 1997-98 Asian financial crisis, Hong Kong outlawed naked short selling and the ban has remained in force ever since. Hong Kong permits only the short selling of liquid stocks, on the grounds that thinly traded stocks are vulnerable to manipulation.
- The US Securities and Exchange Commission temporarily banned all short selling with effect of 19 September 2008. Hedge funds and investors managing more than $100mil in securities would be required to begin public reporting of their daily short positions. The SEC imposed the ban on short selling from the 3rd of October through till the 19th of October 2008.
- The Financial Services Authority (FSA) banned short selling in 29 financial shares and it lasted until 16 January 2009.
- China launched a pilot programme for short selling for the first time in April 2010, but naked short selling is strictly forbidden.
- The German Government bans naked short selling on euro-zone government bonds, Credit Default Swaps and 10 financial stocks on 18 May 2010.

6. The JSE approach to short selling

In contrast to the situation in the USA the JSE have followed a **strict ban on naked short selling all along**. This is as a direct result of the Union Wine bear squeeze in the 70's when in a matter of hours the share price collapsed when word leaked that there was a naked short sale in the market. There is a number of factors that differentiate the JSE from the UK and US in this regard. They are:

- The JSE's equities rules regulate against naked short selling in that they provide:
  - *A member may only enter an order on the JSE equities trading system or report a trade to the JSE equities trading system if the member has appointed a CSDP, has SWIFT connectivity as prescribed by directive and has taken reasonable steps to satisfy itself that, **in respect of a sell order:***
  - *a controlled client has evidenced to a member that they own the equity securities to be sold in uncertificated form and that such securities will be available for settlement on settlement date; or*
  - *another transaction has been concluded which provides for an equivalent amount of equity securities being available for settlement on settlement date; or*
  - *a satisfactory borrowing arrangement is in place which provides for an equivalent amount of equity securities being available for settlement on settlement date.*

- the settlement procedures on the JSE, which are contractual, also make it unlikely that there could be naked short selling, because if no commitment is made by the settlement agent by noon on T+3, the trade would have to be covered by the member who effected the trade. In the US and the UK, settlements are rolled where necessary for long periods of times, while the JSE has a near faultless record in respect of failed trades.

- the limited extent of the impact of the credit crisis on the South African financial services sector at this stage;

- the JSE's surveillance capabilities which allow it to scrutinize trades down to client level.

On 8 October 2008 the FSB and JSE stated that they have **no reason** to believe that taking the same action in any of its markets as that taken by the FSA and SEC would be appropriate as naked short selling was already banned. The situation will be closely monitored by the JSE and should circumstances change, the situation will be revisited.

7. What are the consequences if short selling is banned from the JSE?

As mentioned before naked short selling is already prohibited on the JSE. Banning conventional short selling will have a serious impact on the Securities Lending industry. In the early 2000's Genesis Analytics produced a detailed research paper on the benefits of securities lending for the Financial Services Board. As conventional short selling and securities lending go hand in hand, the benefits of securities lending may be extrapolated to the advantages of short selling.

Herewith an extract of the findings of that report:

- **Liquidity:**

  - Securities loans [conventional short selling] contribute to liquidity, by some measures accounting for 40 percent of market liquidity for the typical ALSI40 share. The liquidity on the JSE lags the rest of the developed world. Liquidity for the JSE expressed as the annual turnover divided by market capitalisation averages at around 60%, while those in the developed world is greater than 100%. Banning conventional short selling will further dampen local liquidity.

- **SAFEX : Futures, Option trading and Indexation**

  - Short selling has become integral to the development of equity derivatives that play a vital part in the market today. Institutional investors look to derivative providers (usually banks) to manage and protect their equity exposures. Many banks and brokers sell the underlying stocks conventionally short and buy futures from option writers. Option writers generally use the futures market to trade their delta hedges. As their delta hedges require them to be short on day 1, option writers turn to SAFEX for efficiency. It is far easier for option writers to sell a futures contract in one trade than trading in the underlying basket of shares.
  - Arbitrage between index futures traded on SAFEX and underlying securities on the JSE is strongly present in our market. The effect of this arbitrage activity leads to efficient indexation and this increases liquidity. Consistent and fair prices on listed derivatives enable institutional investors to hedge effectively via index and single stock futures as well as option strategies on them.
  - Statistical analysis of intra-day trading data found that price discovery in South African equities takes place on SAFEX: price changes in futures contracts are reflected in JSE prices with a lag of up to a maximum of forty minutes. This pattern is consistent with markets in advanced economies, and reflects the lower trading costs of a futures exchange.
  - Three crisis periods in South African equity markets were analysed by Genesis: October 1997, May-June 1998 and August 1998. In all three periods futures prices consistently led spot prices. These findings refute the theory that securities lending and index arbitrage jointly created a vicious spiral of falling prices during the crisis periods. For that view to hold, ‘feedback’ effects from the JSE to SAFEX had to be observed. There were no such effects during the period under review or during the crisis periods. Instead, it was found that, during the period, arbitrage led to a convergence of futures and spot prices, thereby stabilising markets.
  - Exhaustive statistical testing found no positive link between securities lending and volatility on the Johannesburg Stock Exchange for the period.

8. Conclusion

Although the ban on short selling during September 2008 brought temporally relieve to the spiralling panic in **international** financial stocks, the dire long term consequences should not be underestimated. In an interview with the Washington Post in late December 2008, Christopher Cox the Chairman of the SEC said that his agreeing to the three-week ban on shorting of financial stocks was the biggest mistake of his tenure and he acknowledged that the ban was not productive.

Conventional short selling and securities lending provide an important link between spot and futures markets. In the absence of short selling and securities lending, liquidity on both the JSE and SAFEX would drop and prices between the two exchanges become uncoordinated. It would become difficult for institutional investors to manage and hedge their exposures in a professional way, ultimately with negative consequences to market participants and institutions.

A ban of *naked short selling* as is currently in place **on stocks and bonds** in South Africa, Hong Kong, China and, more recently, Germany (18 May 2010) is sensible and prudent. To have a stock borrow in place, before being able to go short has an automatic damping effect on the market and should shelter the market against extreme behaviour from speculators.

One can only speculate what the contribution of naked short selling was to the Greek crisis, but speculators will definitely take advantage of legitimate opportunities to do so. It is doubtful that a ban on naked short selling on CDS's (Germany – 18 May 2010) can work, as these trades are not conducted on exchanges and are basically contractual obligations between two counterparties. A ban on the naked short selling on the *underlying bond of the CDS* contract will limit the ability of counterparties writing credit insurance as they won't be able to hedge themselves by going short the conventional way without a stock borrow or repurchase agreement in place.

***Given these benefits and the absence of negative effects, conventional short selling and securities lending ought not to be curtailed in South Africa*.**