TRANSACTIONANALYSIS

Market Structure Research

October 2011

Short Sale Bans: How Effective Are They?

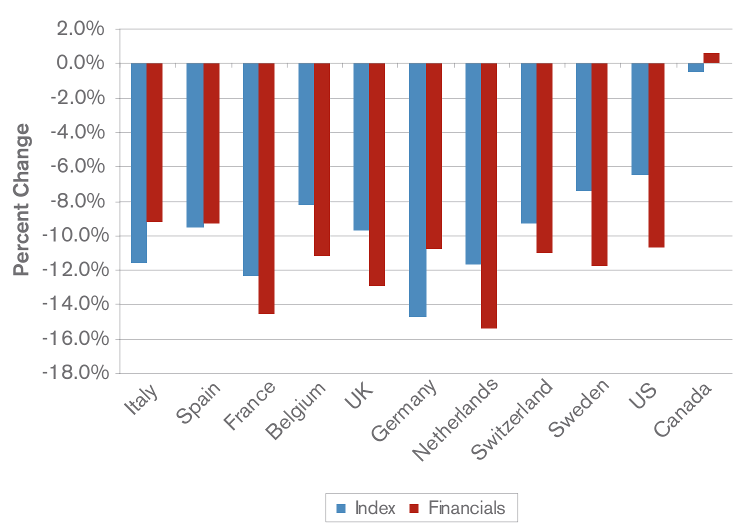
Summary

- On August 12, 2011, France, Belgium, Italy and Spain banned the short selling of financial names after the market's significant move lower in the first half of August.
- Since the decision, volumes in the banned names dropped dramatically, while financial names in other countries continue to trade actively.
- Average daily price moves in countries both with and without the ban increased during the volatile period and fell after the ban took effect, with no significant difference between the two groups.
- Bid-ask spreads in countries both with and without the ban generally increased during the volatile period and fell after the ban took effect, with no significant difference between the two groups.
- Academic research on the 2008 short sale bans generally found that they adversely affected market quality and did not support prices.
- Our data agrees: short sale bans depress liquidity and do not provide demonstrably positive effects. They should not be an knee-jerk reaction to market volatility.

In the Autumn of 2008, amidst massive volatility, price declines and high emotions, the regulators in both the US and most European countries banned the short selling of financial names. On August 12, 2011, France, Belgium, Italy and Spain, **on the prompting of the European Securities and Markets Authority** (ESMA), moved to ban the short selling of financial names after the significant move lower seen in the "volatile period"[1] during the first half of August (Figure 1).

Regulators were concerned that short sellers were contributing to the extreme volatility. Short sellers are often characterized by their detractors as predatory, and these bans clearly reflect regulatory intervention in the midst of uncertain times. Our research and that of the academic community, however, finds that bans on short sales have historically had a negative impact on market quality and therefore should not be a reflexive recourse whenever market volatility occurs. The existence of arbitrageurs is crucial to liquidity, which has an explicit link to market valuation.

Figure 1: Market Performance Aug 3 - 11

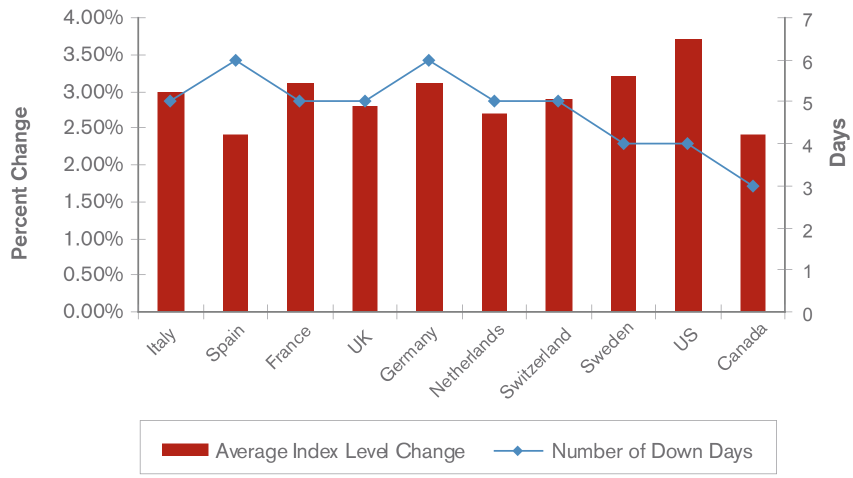


[1] "Volatile Period" defined as August 3-11, 2011.

Setting the Scene

In Europe, the market moved lower (i.e., a "down day") on five or six (depending on the market) of the volatile period's seven days, while the US market saw large swings in both directions during the period (Figure 2). In terms of performance, Italian and Spanish financials actually outperformed their country's primary blue chip indices while in France and Belgium financials underperformed. Finally, during the volatile period, volume in the banned names was higher in all countries studied except for Spain (Figure 3), which was due primarily to a decline in volume in Banco Santander.

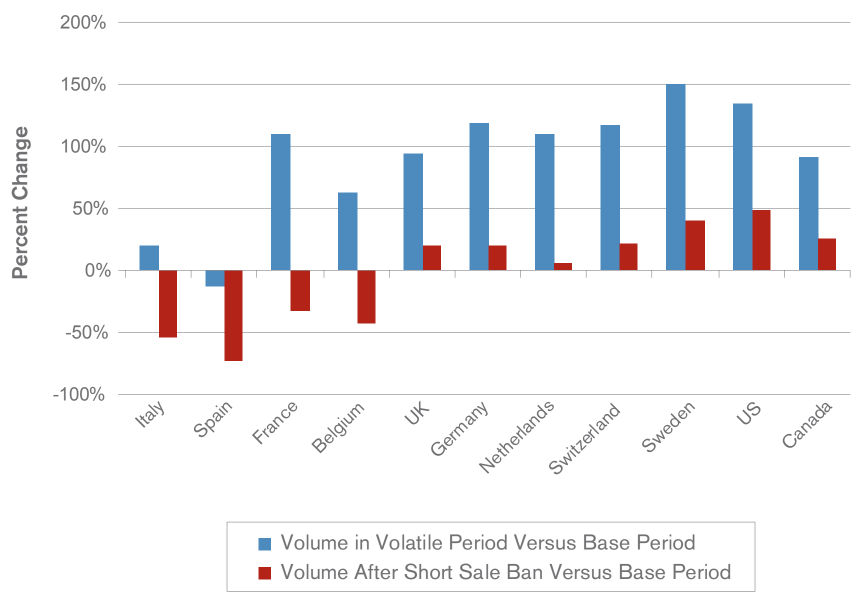
Figure 2: Average Price Changes (Absolute Value) and Number of Down Days August 3-11



Impact of the Short Sale Ban

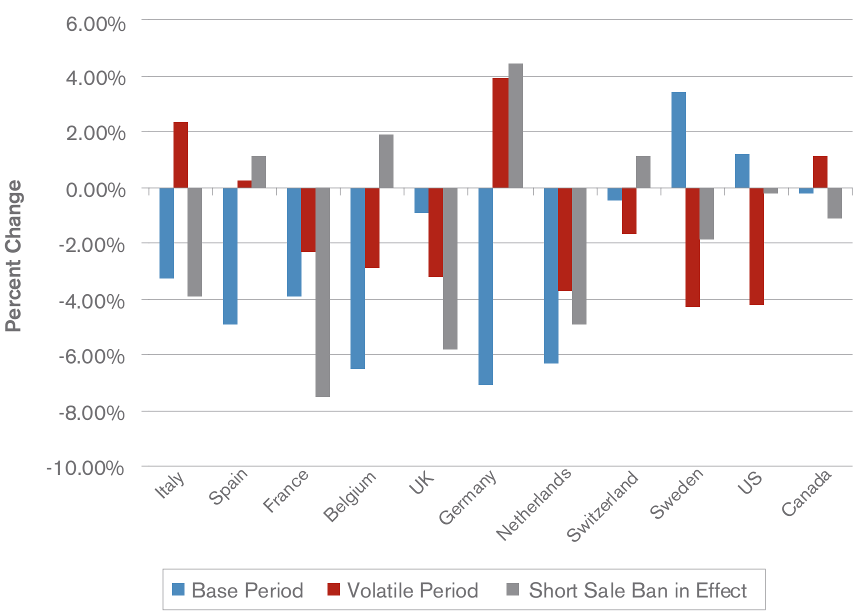
When France, Belgium, Italy and Spain implemented the short sale ban on August 12, trading volume in financial names in those markets decreased dramatically. Volume in financials in markets without the bans continued to be elevated, though not to the extent that it was during the "base period"[2] prior to the volatile period (Figure 3).

Figure 3: Volume in Financials during Volatile and Short Sale Ban Periods Compared to the Base Period



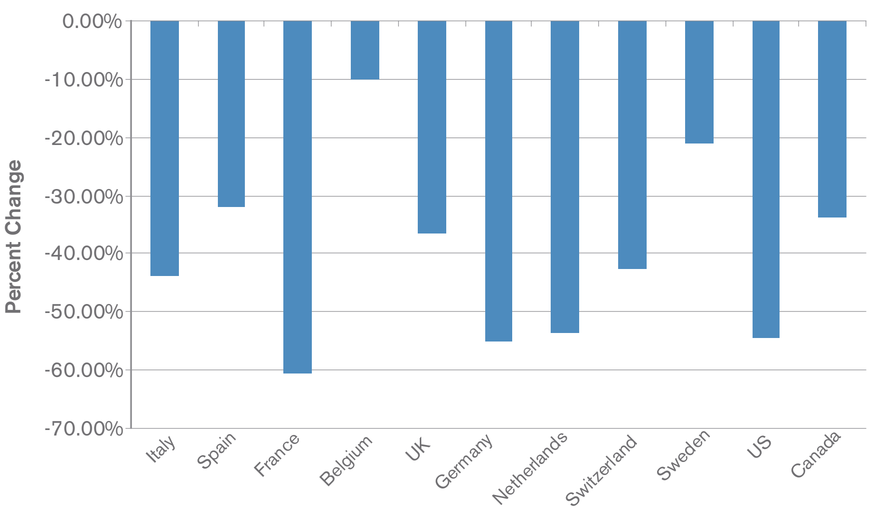
[2] "Base Period" defined as July 21-August 2, 2011.

Figure 4: Performance of Financials versus Market Index



Since the short sale ban, financial names in the countries with the ban have performed similarly to financials in countries with no ban. Comparing the performance of financial names in a particular country to the performance of that country's market overall, we also see no distinguishable difference between countries with the ban and countries without (Figure 4).

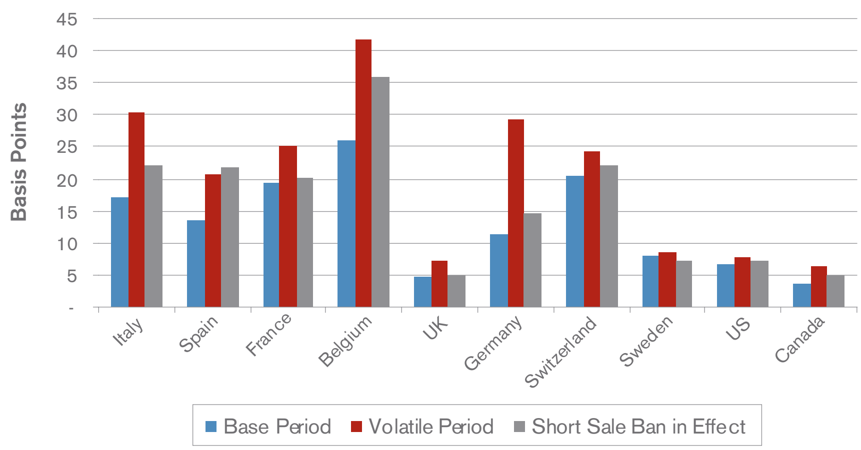
Figure 5: Average Change in Size of Price Moves in Financials After Ban



In all the countries studied, the degree of average daily price moves (in either direction) increased over the volatile period and fell during the short sale ban period. If the short sale bans succeeded in reducing volatility, one would expect the reduction of price volatility to be greater in countries with the ban than without. In fact, the reduction in volatility between the two groups is similar. Figure 5 shows the change in the size of price moves in the banned period compared to the volatile period. The changes are negative, indicating that the average absolute price move decreased after the volatile period.

Bid-ask spreads in financials increased in the volatile period and decreased in the "post-volatility period"[3] in every country except Spain (Figure 6). There is no consistent difference between the decrease in the banned countries and the decrease in the other countries and thus no indication that the short sale ban was negative for spreads.

Figure 6: Bid Ask Spreads in Financial Names



Finally, we note that several pieces of academic research support our hypothesis that the recent short sale bans have harmed liquidity without lessening volatility:

- **Beber and Pagano** (2009) examined the varying regulatory constraints globally during the 2008 crisis and found that short sale bans harmed liquidity, did not support price discovery and did not generally support stock prices.
- **Boehmer, Jones, and Zhang** (2009) examined the impact of the SEC's 2008 ban on the short selling of financial names in the U.S. They found that the ban harmed market quality by increasing spreads and volatility, and found inconclusive evidence of the impact of the ban on prices.
- **Harris, Namvar, and Phillips** (2009) looked at the 2008 bans globally and found evidence that they reduce negative skewing at a market level but do not make a difference at an individual stock level. The group also found positive abnormal returns for US financial names under a short sale ban. The ambiguity between these two studies may be attributable to the difficulty of separating the impact of the ban from the impact of the announcement of the US bank bail-out program.

The clearest evidence from the data is that volume falls dramatically when a short sale ban is in effect, while names in markets without a similar ban trade actively. This is a concern as it implies that liquidity has been dramatically inhibited, possibly because many of the short sellers were providing liquidity using market-making strategies. There is no indication that price performance is protected under the bans. Ultimately, we do not believe that the recent short sale bans have succeeded in protecting markets from extreme volatility and if anything have harmed market quality.

A Note on Methodology

Stocks analyzed in this study were weighted by average daily value traded (composite) during the review periods, and spreads were weighted by market capitalization.

[2]"Post-Volatility Period" defined as August 12-29, 2011.

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