STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

January 2021: GameStop and Short Selling

SBai
Standards Board for Alternative Investments

Introduction

Retail trading increased during 2020 and has continued to do so in 2021, aided by the popularity of commission free trading tools and social media platforms, such as Reddit's r/WallStreetBets chatroom. In late 2020 and early 2021 this forum was used to drive up the price of certain stocks. The increase in the share price contributed to a short squeeze of GameStop shares resulting in significant losses to some hedge funds who held large short positions in the stock (as well as losses to some retail investors who entered the trade at the top).

Resulting coverage has been negative on hedge funds in general and specifically on short selling. The SBAI argues that short selling is an important tool in portfolio risk management and contributes to efficient price discovery, increased liquidity, and mitigation of market bubbles, to the benefit of all investors. The SBAI also notes that the public disclosure requirements of short positions in some jurisdictions can potentially have a negative impact on market integrity.

Short Selling

Short sellers borrow[1] stocks to sell them in the market, with the view to buying them back cheaper at a future point in time (to return to the stock lender). When the stock price rises, short sellers incur losses and may be forced to repurchase the stock at a higher price. When the price of the stock declines, short sellers can repurchase the stock at a lower price and profit from the price differential.

Short selling is a risk management technique that enables investment managers to:

- Express a negative view on a particular company[2],
- Generate returns from relative mispricing of assets, and
- Construct market neutral portfolios by combining long and short positions to hedge the overall portfolio against broader market fluctuations.

Short selling can be risky as potential losses are theoretically unlimited. Therefore, this technique is usually reserved for sophisticated investment managers and requires robust risk management practices, including stress testing, scenario analysis and liquidity monitoring as set out in the SBAI's Alternative Investment Standards[3]. As seen in the recent events, public disclosure requirements for short positions can expose managers to the risk of (concerted) short squeezes.

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[1] In all major trading jurisdictions selling securities that are not owned or borrowed ("naked short selling") is prohibited

[2] Short selling may be an effective tool in Responsible Investment frameworks allowing investors to express a negative view on the ESG practices of issuers.

[3] https://www.sbai.org/standards/

What are the benefits of Short Selling to the broader market?

Short sellers typically conduct rigorous financial research on target positions to develop well informed investment views, using methods such as fundamental research and statistical models. The presence of well-informed investors (including hedge fund managers) in financial markets benefits all market participants, in particular passive index, and retail investors.

Well-informed investors act as "market detectives", identifying over-valuations which can result from unfounded optimism in future earnings or fraudulent activity (for example the Wirecard scandal). Short selling can therefore help to mitigate valuation bubbles and prevent investors from overpaying for an asset. Recent academic research has confirmed that short selling and negative activism are "a substantively desirable, albeit perhaps intuitively unappealing, disciplining forces in the market"[4].

In summary, short selling contributes to market integrity, including supporting effective price formation, enhancing market liquidity, and enabling better risk management.[5,6]

The Impact of Short Selling Disclosures

In Europe, following the financial crisis, the public disclosure thresholds for short positions were set at 0.5% of issued share capital, requiring investment managers to notify authorities and publicly disclose their positions.

For individual managers, the disclosure requirement reduces the incentive to be "informed" by reducing an investor's return on its research effort by publicly disclosing it) and can also result in a deterioration of the relationship of managers with underlying issuers, making fundamental research and engagement more difficult. As a result, managers often cap their short positions just below the 0.5% threshold to avoid disclosure.

This behaviour negatively impacts markets by reducing market liquidity, widening bid ask spreads, increasing intra-day volatility and increasing pricing inefficiencies[7] when pricing corrections happen more slowly (with risk of investors overpaying). Reduced activity of "informed investors" (due to short selling bans or public short selling disclosure requirements) should be a warning signal to retail and index investors, as it removes a mechanism for sanctions on poor or reckless corporate management, increases the risk of investors overpaying for assets and accentuates market booms and contractions during major crises.

Temporary restrictions of market activity (e.g., via temporary short selling bans) may also signal regulatory concerns about market integrity and result in more investors withdrawing from the market and exacerbating liquidity issues.

The SBAI's Position[8]

Does enhanced disclosure of short positions convey important information to the market?

The SBAI believes that it is an arbitrary decision to enhance disclosure on the grounds of "additional valuable information" and that this might lead to market distortions or less efficient price discovery:

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[4] https://corpgov.law.harvard.edu/2021/03/26/the-long-term-effects-of-short-selling-and-negative-activism/
[5] See FCA statement on 17 March 2020 in context of EU short selling bans https://www.fca.org.uk/markets/short-selling/statement-short-selling-bans-and-reporting
[6] Reference to EDHEC 2010 paper on short selling https://risk.edhec.edu/sites/risk/files/1328885973950.pdf
[7] https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/archive/2010/OW_EN_FS_2010_ShortSelling_PublicDisclosureRegimes.pdf
[8] See SBAI consultation responses to:
a) SBAI response to the European Commission Consultation on Short Selling (07/2010):
https://www.sbai.org/wp-content/uploads/2016/04/hfsb_response_-_eu_commission_consultation_short_selling_final.pdf
b) SBAI response to the ESMA Public Consultation on Short Selling (03/2012):
https://www.sbai.org/wp-content/uploads/2016/04/esma_short_selling_consultation_paper-esma-2012-9_march_final.pdf

- All information is reflected in the current market price, irrespective of whether short selling has occurred or not. The aggregate impact of short selling might have reduced the price, but this information is included in today's market price.
- It could equally be argued that for every short sale, there is a buyer that is equally conveying important information to the market (e.g., that the stock is undervalued). Therefore, the "net- signal" is not indicative of whether the stock is over- or undervalued.
- If regulators argue that short selling can convey a signal that a security is over-valued, they implicitly tell market participants that short sellers have better information. This may encourage herding behaviour based on short selling disclosures where more weight is given to the fact short selling occurs than the valuation of the asset.

In contrast, for long positions, the rationale for public disclosure (above certain thresholds) is that they grant voting rights and control of companies and as such there is a valid public interest. Therefore, it could be argued that short position thresholds should not be lower than the long position thresholds (e.g., 3% in the EU), and could be calibrated at a higher level.

Does short selling pose particular risks to the market?

The SBAI argued in its response to the European Commission's Public Consultation on Short Selling that the "risks" of short selling had not been sufficiently identified to provide justification for the proposed disclosure regime.[9] The SBAI suggested these "risks" should be defined precisely, and classified according to common regulatory objectives, such as market integrity, systemic stability and (retail) investor protection. The table in the Appendix A draws on the potential issues the European Commission alluded to and seeks to categorise them in this way.

What about non-public disclosure to regulators?

The SBAI is in favour of non-public disclosure of short positions exceeding certain thresholds to regulators (to inform regulatory analyses) but has highlighted in prior consultation responses that there is no justification for a public disclosure regime of short positions from a financial stability, market integrity or efficiency perspective.

What about aggregate disclosure of short interest?

While there is limited rationale for public disclosure that identifies individual short position holders, aggregated and anonymised short positions in companies could be valid information for market efficiency.

[9] p. 2-3 https://www.sbai.org/wp-content/uploads/2016/04/hfsb_response_-_eu_commission_consultation_short_selling_final.pdf

Appendix A

This table takes the potential issues the European Commission alluded to in its paper and seeks to categorise them according to common regulatory objectives (market integrity, systemic stability and (retail) investor protection). It also provides observations on the "risks" that are mentioned.

Potential failure	Category	Observation
Driving down prices in an abusive fashion and contribute to disorderly markets	Market integrity?	The less liquidity in the market, the more likely it is that any large transaction can move the market (positively or negatively). This is also called market impact. However, for every short sale, there is a buyer, who will benefit from a lower acquisition price for the asset than in a situation where short selling has not occurred. A falling price might provide an incentive for other market participants to start buying. **Ultimately, this is precisely what markets are all about, price discovery by balancing supply and demand.** Therefore, the quicker disorderly (e.g., falling) markets find a level where buyers are willing to step in, the better. If the regulators were to seriously pursue this "failure", it would have to first establish what constitutes a disorderly market and distinguish it from justified price corrections. Many issues would arise in such an approach: • It assumes superior knowledge of the "right price". • Regulatory intervention can give rise to "first order errors", whereby a market intervention prevents a justified price correction from happening (i.e., hurting market integrity). • It is also important to keep in mind that intervention or restriction of market activity (e.g., temporary short selling restrictions) might exacerbate the distress: The regulator signals that there are concerns in relation to market integrity, resulting in more investors withdrawing from the markets
Amplifying price falls	Market integrity?	There is only weak evidence to support the view that short selling constraints help to prevent financial panics. As seen in the banking crisis in 2008, a short selling ban did not prevent banking stocks from further falling. It merely resulted in a brief artificial rally, and ultimately only postponed the market correction to a sustainable level (-> the ban hurt market integrity!) There was a real underlying cause for falling stock prices of banks during the banking crisis in 2008. In such instances, regulatory focus should not be on short selling restrictions ("shooting the messenger"), but on measures which enhance real confidence in the banking sector (i.e., initiating recapitalisations). Short selling helps price corrections to happen in a much quicker fashion. This ensures that investors do not overpay, therefore, **short selling enhances the attractiveness of a marketplace** for all investors (and in particular long only or index investors). It should not come as a surprise that assets, companies, banks or governments that manoeuvre close to the brink of bankruptcy will face severe volatility and will end up trading at a discount. But this severe sanction is exactly what provides the incentive for responsible

Potential failure	Category	Observation
		management and serves as a strong deterrent to wasteful behaviour or excessive debt. **Trying to ease this market sanction merely increases moral hazard.**
Adverse effects on financial stability	Financial stability	The SBAI is not aware of any cases where short selling has adverse effects on financial stability. On the contrary, the knowledge that markets can sanction waste and reckless behaviour enhances the discipline of those using capital. The quicker that markets sanction wasteful or reckless behaviour (whether by corporates, banks, or governments) by withdrawing (or selling that asset), the better. Short selling can therefore contribute to smoothing bubbles and help to reduce the risk of even larger price corrections and more severe distress.[10]
Resulting in information asymmetries	Unclear	Short selling does not result in information asymmetries but can be a reflection of information asymmetries in the market. An investor who completes thorough research may well gain insights that other market participants might not have, and short selling (or buying) allows this investor to capitalise on this “research effort”. The quality of the marketplace increases with increasing number of “informed” investors. At the same time, such a marketplace becomes more attractive for “uninformed” investors as well, since the risk of mispricing is significantly reduced. However, it is important that the incentive to be “informed” remains intact (i.e., an investor has a return on his research effort), otherwise, such information acquisition would be discouraged (e.g., if investors had to publicly disclose their short or long positions at very low thresholds).
Risk of settlement failures	Market integrity	Settlement failures damage a marketplace, and sanction is the best mechanism to avoid this from happening.

Sources

SBAI response to the European Commission Consultation on Short Selling (07/2010):
https://www.sbai.org/wp-content/uploads/2016/04/hfsb_response_-_eu_commission_consultation_short_selling_final.pdf

SBAI response to the ESMA Public Consultation on Short Selling (03/2012):
https://www.sbai.org/wp-content/uploads/2016/04/esma_short_selling_consultation_paper-esma-2012-9_march_final.pdf

[10] Several Hedge Funds shorted Greek and Portuguese government debt several years ago, precisely because they felt that their finances were not sustainable. They might have dampened the narrowing of spreads on these sovereign bonds, but failed to make any money, because the markets did not follow them. This shows two things: 1.) Short selling has only limited capacity to influence prices; 2.) If they had succeeded, the prices would have adjusted, investors would have observed the signal and the crisis would have stopped much earlier, with the appropriate measures taken before things got really out of hands. The lesson is that more active investors are needed, and that restrictions on short selling can result in slowing down price discovery, prolonging imbalances and ultimately making crises worse.