Clients&FriendsMemo

COVID-19 Update: Restrictions on Short Selling in the UK and European Union - An Update

22 April 2020

Introduction

Five EU member states have extended their temporary bans on short selling imposed in line with the emergency process permitted by the EU Short Selling Regulation, despite increased pressure from hedge funds to remove the current restrictions.[1] Regulators in Austria, Belgium, France, Greece and Spain have now extended the bans (which were due to expire in the coming days) until mid-May, arguing that the restrictions are necessary to stabilise stock prices. Italy's ban will also continue until mid-June.

These are extensions to the temporary bans on the short selling of shares in response to the extreme volatility in equity markets caused by the COVID-19 pandemic described in our recent memo.

UK & U.S. Regulators – A Different Approach and Attitude to Short Selling

As noted previously, the UK (as well as Germany in the EU) have not banned short selling and appear disinclined to do so. The UK Financial Conduct Authority ("**FCA**") continues to monitor market activity and has stated it will not rule out a ban if it considers such a prohibition necessary, but for the moment notes that "*net short selling activity […] is low as a percentage of total market activity [and there is] no evidence that short selling has been the driver of recent market falls*".[2]

In the U.S., the Securities and Exchange Commission ("**SEC**") continues to push back against any suggestion that short selling should be banned during the COVID-19 crisis. Jay Clayton, the current SEC Chairman, recently stated that short selling is critical "*in order to facilitate*

[1] European stocks dropped by around 30% in March, but a recovery of around 15% had led a number of funds to claim that further extensions would be damaging and push up the all-in costs of trading.

[2] See Financial Conduct Authority, '*Statement on UK Markets*', accessible here: https://www.fca.org.uk/news/statements/statement-uk-markets.

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ordinary market trading".[3] While emergency orders were issued by the SEC during the 2008 financial crisis prohibiting short selling in a wide array of financial stocks (and requiring institutional money managers of a certain size to report short sales to the SEC on a weekly basis), the SEC stated that such orders were issued only because investors were aggressively short selling financial institution stocks which created sudden price declines in securities that were unrelated to true price valuation. Following the short sale ban, the former SEC Chairman, Christopher Cox, expressed regret with the decision, which would seem to indicate his scepticism that stock market prices had become disconnected from real values,[4] and noted that he believed the SEC would not ban short sales again as the costs "*appear to outweigh the benefits*".[5]

Discussion

UK and U.S. market regulators have a different attitude towards short selling as compared to some EU countries. They believe the ability to take "long" and "short" positions is particularly important in many investment and risk management strategies and can benefit a wide range of investors (including pension funds for employees of companies and local government). In addition, a significant number of hedge fund investors maintain balanced long and short positions; if they are unable to increase or were required to reduce short position it would have a corresponding effect on their ability to increase or maintain long positions. Further, short selling is generally seen by UK and U.S. market regulators as a critical underpinning of the provision of liquidity by market makers,[6] the loss of which they will carefully balance before intervening to restrict or prevent. Consequently, it seems likely that regulators in both jurisdictions will resist the implementation of temporary bans on the short selling of shares in response to the COVID-19 crisis, despite the action taken (and extension of restrictions imposed) by other European countries. Both regulators have, however, confirmed their commitment to monitoring the situation and taking action if they deem necessary in the coming weeks.

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3 See P. Kiernan, '*SEC Chairman: Government Shouldn't Ban Short Selling in Current Market*', Wall Street Journal, accessible here: https://www.wsj.com/articles/sec-chairman-government-shouldnt-ban-short-selling-in-current-market-11585568341.

4 It is not in fact clear how one would demonstrate such a disconnect or if the disconnect really existed. While among major firms, only Lehman became insolvent, other firms were saved from failure only because of government intervention in one form or another.

5 See R. Younglai, '*SEC chief has regrets over short-selling ban*', Reuters, 31 December, 2018.

6 The SEC note, for example, that short selling "*contributes substantially to overall market quality through its positive effects on price efficiency and market liquidity*". See Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission, '*Short Sale Position and Transaction Reporting*', accessible here: https://www.findknowdo.com/sites/default/files/2014/06/05/00/short-sale-position-and-transaction-reporting.pdf

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