MFA

An introduction to short selling

Table of contents

I. An introduction to short selling

Short selling is important to a variety of market participants. Investors use short positions to express a view that a security, such as a stock, is overvalued or to hedge against risk. Pension funds, mutual funds and endowments earn returns by lending stocks to short sellers, and market makers facilitate the buying and selling of stocks. Short selling is a big part of the market, accounting for nearly 50 percent of the volume of trading in listed equity shares[1]. Short selling is employed widely. It contributes to overall market quality, dampens volatility, and promotes fraud detection and capital formation.

Short selling is subject to a robust regulatory regime to guard against abusive practices. It is also subject to reporting requirements in the United States that allow the public to see how much of a public company's shares are held in short positions. As a critical component to a healthy market, whenever governments have sought to ban or restrain short selling it has invariably led to lower trading volumes, increased transaction costs and more—not less—volatility. Changes to rules that would require individual investors to disclose short positions would lead to these same results, hurting investors and ultimately the competitiveness of U.S. markets.

What is a short sale?

A short sale is a trade in which an investor borrows a security from a lender and sells it with hopes to buy it back later at a cheaper price before returning the borrowed security to the lender. For example, an investor believes that the stock price of Company A is overvalued at $60 per share. The investor borrows a share of Company A via a lender and immediately sells it for $60. If the investor is correct about Company A being overvalued, the stock price will decline overtime. Assume the share price drops to $50—the investor then buys the share back at $50 and returns it to the lender. Since the price is lower, the investor profits the difference —$10 per share—minus the transaction costs and interest paid to the lender. However, if the price of Company A's stock goes up, the investor must buy back shares at a higher price and will lose money.[2]

[1] See Study on Short Sale Position and Transaction Reporting, SEC Division of Economic and Risk Analysis (June 2014) ("SEC Staff Study") at 4, available at: https://www.sec.gov/files/short-sale-position-and-transaction-reporting%2C0.pdf. [2] See Key Points About Regulation SHO, Secrities and Exchange Commission, available at: http://www.sec.gov/investor/pubs/regsho.htm.

II. How does short selling benefit the market and investors?

Short selling promotes market quality by increasing price efficiency,[3] providing market liquidity,[4] promoting capital formation, detecting fraud and potentially reducing economically-damaging price bubbles. The SEC and the academic community have long acknowledged these important benefits to investors, companies, and markets. SEC Staff found that, "[t]he potential benefits of short selling are not trivial…given the prevalence of short selling as a proportion of all sales," which they estimated to be as high as 49% of listed equity share volume.[5] Following is a discussion of those benefits.

Short selling makes stock prices more accurate

Stock prices are accurate to the extent that they best correspond to the fundamental value of the company issuing shares. That value is determined by the collective opinion of all market participants—the more opinions the better. When an investor engages in fundamental research and determines that a stock is underpriced, they buy it. If it is overpriced, they sell it. But even if an investor does not own the stock they can express the view that a share is overpriced by way of a short sale, thereby adding information to the market and improving stock price accuracy. In this way, fundamental investors such as hedge funds, some mutual funds, and others, contribute to price efficiency through the use of short selling.[6] Additionally, a 2004 study demonstrated shorting constraints allow stocks to become overpriced. When firms take anti-shorting positions, their stock returns are significantly low for a while thereafter. In extreme cases, when short sellers look to take a short position but cannot, overpricing can be particularly prevalent.[7]

Studies conducted over the past ten years demonstrate that short selling bans damage the price discovery process by increasing information delay, that is, it takes longer for the market to reach consensus on the accurate price of a given stock.[8] A 2012 study of the United Kingdom's 2008 ban on short sales found that the ban impaired price discovery. Unsurprisingly, lifting bans improve price discovery.[9] A 2014 study of China's 2010 pilot to lift a ban on short selling and margin-trading on a designated list found lifting such bans increased price efficiency.

Short selling makes markets more liquid and less volatile for the benefit of investors

Short selling contributes to liquidity and dampens volatility. Market liquidity describes the relative capacity of the market to trade significant volumes of stocks at or near the prevailing market price. The more buying and selling, the more liquid the market. Short selling allows market makers to better fill customer orders for securities. It helps offset imbalances in the flow of buy and sell orders, when the demand to buy a certain stock would otherwise exceed supply.[11] A liquid market also has lower transaction costs, which accrues to the benefit of investors.

[3] See, e.g., Ekkehart Boehmer & Julie Wu, Short Selling and the Informational Efficiency of Prices, (Working Paper, Aug. 16, 2010), available at: http://ssrn.com/ abstract=972620. [4] See SEC Staff Study at Appendix E ("The academic literature provides ample theoretical support for, and empirical evidence of, the importance of short selling for liquidity."). [5] SEC Staff Study at 15. [6] See SEC Staff Study at 11. [7]Lamont, Owen A., Go Down Fighting: Short Sellers vs. Firms (July 2004). NBER Working Paper No. w10659, Available at SSRN: https://ssrn.com/abstract=579806. [8] Baki Cem Sahin, Fatih Kuz, The effects of short selling on price discovery: A study for Borsa Istanbul, Borsa Istanbul Review, 2020. [9] Ian W. Marsh, Richard Payne, Banning short sales and market quality: The UK's experience, Journal of Baking & Finance, Volume 36, Issue 7, 2012, Pages 1975-1986. [10] Eric C. Chang, Yan Luo, Jinjuan Ren, Short-selling, margin-trading, and price efficiency: Evidence from the Chinese market, Journal of Banking & Finance, Volume 48, 2014, Pages 411-424. [11] See SEC Staff Study at 12-13.

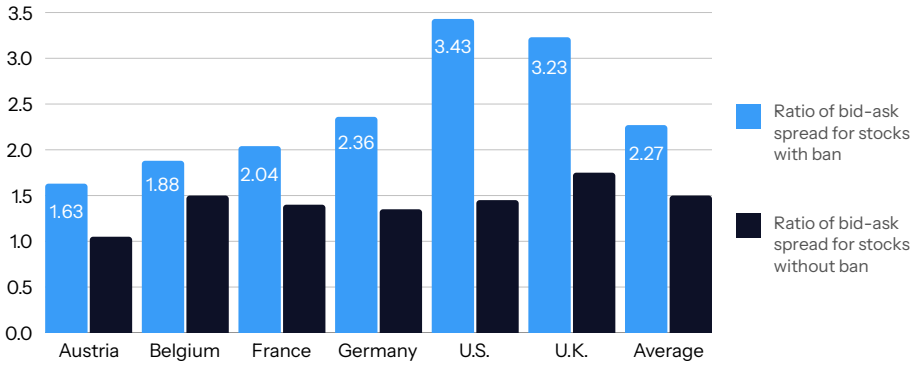
It is a misconception that short selling increases market volatility and leads to accelerated declines in prices. In fact, evidence shows that during a price decline, short sellers will often sell less, or close out of their short positions by purchasing shares of the security, which offsets sales by long position holders.[12] Recent experience in several European countries demonstrates that where short selling is restricted the result is more volatility.

Short selling boosts market liquidity and lowers transaction costs for all investors.

In response to COVID-19 related market downturns, Austria, Belgium, France, Greece, Italy, and Spain imposed temporary short selling restrictions. Studies that have analyzed the effects of these bans found that banned stocks had lower liquidity, higher volatility, higher transaction costs and abnormal returns when compared to non-banned stocks.[13] Separate studies show that stocks, on which short selling bans are imposed, ultimately had an increased likelihood of default.[14] Short selling boosts market liquidity and lowers transaction costs for all investors; when it is restricted, market makers charge buyers more and sellers receive less for those stocks covered by the short sale ban.

Similar results were observed during the 2008 financial crisis. In response to claims that short selling was responsible for significant declines in financial companies' share prices, the SEC adopted a temporary ban on short sales of a list of such companies. The result was a less efficient market. Bid-ask spreads increased 3.43 times for U.S. stocks that were subject to the ban, which again means that buyers paid more and sellers got less. Notwithstanding the ban, shares of these companies continued to decline and did not appear to be supported by the ban.[15]

Increase in median bid-ask spreads after 2008 short selling restrictions



Source: Beber, A., & Pagano, M. (2012). Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis. The Journal of Finance, 343-381.

Following the ban, SEC staff analyzed short selling activity during the volatile period. They found short selling activity did not cause episodes of extreme negative returns. Consistent with past experience showing that short selling mitigates volatility, the analysis concluded that short sale volume was actually higher for periods of positive returns than for periods of negative returns.[16]

[12] See, e.g., Daniel Aromi and Cecilia Caglio, Memorandum from SEC Office of Economic Analysis to SEC Chairman Christopher Cox on Short Selling Activity During the First Weeks of September 2008 (Dec. 16, 2008), ("SEC Memorandum") available at: http://www.sec.gov/comments/s7-08-09/s70809-369.pdf. [13] Siciliano, Gianfranco and Marco Ventoruzzo. "Banning Cassandra from the Market? An Empirical Analysis of Short-Selling Bans during the Covid-19 Crisis." European Company and Financial Law Review 17, no. 3-4 (2020) 386-418. [14] See Whitmore, Travis, "The Effectiveness of Short-Selling Bans," Securities Financial Research, State Street Associates, 2020. [15] See, e.g., Robert Battalio, Hamid Mehran, and Paul Schultz, Market Declines: What Is Accomplished by Banning Short-Selling?, Federal Reserve Bank of New York, Current Issues in Economics and Finance, vol. 18, no. 5 (2012) ("The preponderance of evidence suggests that the bans did little to slow the decline in the prices of financial stocks.") ("Federal Reserve Short Selling Paper"), available at: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci18-5.pdf. [16] See SEC Memorandum ("We find that for all but one subgroup, short selling is higher during periods of extremely positive returns than in periods of extreme negative returns . . .These findings indicate that, on average, short seller's intraday activity is contrarian. On average, short sales seem to decrease intraday volatility by selling relatively more during periods of positive returns.").

Short selling boosts market liquidity and lowers transaction costs for all investors.

Short selling improves the allocation of capital to its most productive uses by promoting the accuracy of stock prices.[17] If a stock is overvalued, too much capital may be allocated to the company. The result is that overvalued companies may fund less profitable or less sound projects, while profitable projects could go underfunded by companies whose stock is undervalued. The liquidity that flows from short selling likewise enhances capital formation. Investors prefer to invest capital in liquid markets with low transaction costs and one in which they can quickly establish and liquidate positions.

Reduces the risk of market bubbles

From a long-term perspective, stocks that are overvalued present a problem for the economy. The market will eventually correct the mispricing, but in the meantime, real resources may flow to the overvalued stock or industry. The correction can be swift and disruptive. Short selling helps reduce the risk of market bubbles by providing selling pressure and market indications to overvalued stocks.

[17] See SEC Staff Study at 13.

How and in what ways are short sales used?

Express a view about the value of a company

Investors engaging in fundamental research analyze and interpret public information to develop a view whether a stock is under or overvalued. If they believe a stock is undervalued, investors purchase the stock. If they already own the stock and come to believe it is overvalued, they sell their stock. If investors do not already own the stock and determine it is overvalued, they can sell it by means of a short sale. Without the ability to short stocks, investors would have no reason to apply their expertise to companies they believe are likely overvalued.

Reduce risk in positions in the same company

In a convertible bond arbitrage strategy, an investor purchases convertible bonds of a company and also sells short the company's stock. A convertible bond can be converted into stock at a pre-determined time and price. In this strategy, the investor uses short sales to reduce some of the risk of holding the convertible bonds.

Hedge different types of market investments

For example, an investor with a long position in the stock of Beverage Company A may also take a short position in the stock of Beverage Company B. The short position is designed to eliminate the risk in the long position of Beverage Company A that the beverage industry underperforms the market. It is not an indication that the investor believes Beverage Company B is overvalued, only that Company A is undervalued compared to Company B.

Balance investments

An investor with a short position in a company may later take a long position in the company. An investor engaged in fundamental research may develop a view that a company has become undervalued and change from a short position to a long position.

Reduce the total exposure of a long portfolio to the broader market

By taking short positions in a basket of stocks, an index, or an ETF, short sales allow investors to minimize the general risk that markets will go up or down.

Manage portfolio risk

In the alternative, an investor could take a short position in the stock of Consumer Goods Company A (or multiple consumer goods companies) to reduce the risk in the long position of Beverage Company A. Again, the short position does not indicate that the investor believes the companies are overvalued; rather the short position is an insurance policy against market downturn in that sector.

Facilitate market making

Market makers are broker-dealers that stand ready to buy and sell stockson a regular basis at a quoted price. Market makers sell short when filling customerorders for stocks that they do not already hold in their inventory. Market makers also use short sellingto facilitate customerorders in othertypes of securities, such as equity-based options. Market makers have been found to account for about 35 percent of short sales.

Wirecard

Short selling as fraud detection and the perils of government intervention

The collapse of Wirecard demonstrates the important role that short sellers play in detecting fraud.

Wirecard was a leading German fintech company. When allegations of accounting inconsistencies arose in 2015 and later claims of money laundering and fraud in 2016, some investors engaged in fundamental research began to take short positions in Wirecard. These investors were signaling to the market their view that Wirecard had internal problems or worse and was overpriced. Despite questions about Wirecard's accounting practices and other claims, Germany's market regulator BaFin instead launched investigations against short sellers for suspected market abuse.[18]

In January 2019, after a journalist published an investigation into Wirecard's sales and profits, BaFin requested the Financial Reporting Enforcement Panel conduct an investigation into Wirecard's financial statements.[19] Understandably, short sales crested again in February 2019, yet BaFin's response was to ban shorting of Wirecard's stock for two months citing volatility that was "a serious threat to market confidence…in Germany."[20] BaFin also filed criminal complaints against short sellers and the journalist who published the January 2019 investigation.[21]

In October 2019, Wirecard hired KPMG to conduct a forensic investigation.[22] After several delays, KPMG published a report in April 2020 stating effectively that €1 billion in foreign bank accounts might be missing.[23] In June 2020, BaFin filed a criminal complaint against Wirecard and a few days later, the company acknowledged that €1.9 billion was missing and filed for bankruptcy.[24]

A November 2020 report commissioned by the European Parliament found that the short sale ban on Wirecard, instituted between February and April 2019, harmed investors who bought Wirecard stock at excessive prices.[25] The report also found some investors may have mistakenly inferred from BaFin's intervention that the regulator had private information that the short sellers were wrong.[26] After reviewing the Wirecard case, the report recommended that supervisory authorities "respect whistleblowing and short selling as important potential gateways for information flow and treat them accordingly."[27]

The German regulator, by first intimidating short sellers from expressing the view that Wirecard was in trouble, shielded the company from scrutiny and artificially propped up the company's stock. Ultimately, the government's intervention to ban shorting of Wirecard stock allowed the company to continue to perpetrate a fraud on investors and the market.

Wherever they have been tried, short sale bans prevent critical information from being reflected in stock prices and handicap market participants and management from access to accurate valuations.

A common short selling myth

Issuers sometimes claim that short sellers take short positions to manipulatively drive down stock prices, but the Wirecard case among others shows this to be false. Taking a short position does not in and of itself drive down prices. In fact, short sellers are engaged in a waiting game––they believe the shorted stock is fundamentally overpriced and anticipate the rest of the market eventually coming to the same conclusion. Once the price of a shorted stock gets close to its fair value, short sellers do not typically add more short positions, because it is too late to turn a profit from new positions. Instead, short sellers simply buy the devalued stock and return it to the securities lender, closing out their short position and realizing their profit.

[18] See Germany's long, lonely, campaign: Battling Wirecard's short sellers, Reuters, July 16, 2020. [19] See What are the wider supervisory implications of the Wirecard case? Published by the European Economic Governance Support Unit, 13, November 2020. [20] See Opinion of the European Securities and Markets Authority of 18 February 2019, See also Germany bans Wirecard 'shorting' as prosecutors probe FT journalist, Reuters, February 16, 2019.[21] See What are the wider supervisory implications of the Wirecard case? Published by the European Economic Governance Support Unit, 13, November 2020. [22] Id. [23] Id. [24] Id. [25] Id. [26] Id. [27] See What are the wider supervisory implications of the Wirecard case? Published by the European Economic Governance Support Unit, 13, November 2020.

III. How investors borrow shares for short selling and institutional investors profit

Securities lending is an important part of the short-selling process and benefits institutional investors, such as pensions. The institutional investor lends securities to a broker-dealer borrower for a fee. The broker-dealer then relends the securities to an investor for short selling. The short selling investor will secure its obligation to return the borrowed security to its broker-dealer lender by posting the short sale proceeds and an additional amount (called margin) with the broker-dealer.

The broker-dealer borrower secures its obligation to return the borrowed security to the institutional lender by pledging cash or non-cash collateral. Institutional investors receiving cash collateral typically reinvest it to generate interest income in addition to the stock borrowing fee. In 2023, pension funds earned more than $700 million from securities lending.

Pension name	Income from securities lending (in millions)
California PERF	$94.16
Wisconsin RDS	$56.33
NY State & Local ERS	$38.59
Arkansas PERS	$35.27
Ohio PERS	$32.00
San Franciso City & County	$29.31
Virginia RS	$26.06
New York City ERS	$23.35
Texas Teachers	$23.34
Pennslyvania School Employees	$23.09
Florida RS	$18.45
Mississippi PERS	$15.26
Maryland Teachers	$14.34
LA County ERS	$14.10
New York City Police	$13.38
Colorado School	$11.54
TN Political Subdivisions	$9.99
Louisiana Teachers	$9.24
New York City Teachers	$9.24
Illinois Municipal	$9.16
Other pensions	$215.03
Total in 2023	**$721.20**

Source: Public Plans Data, https://publicplansdata.org/public-plans-database/download-full-data-set

IV. How is short selling regulated in the U.S.?

The SEC regulates short sales primarily through Regulation SHO, which went into effect in 2005. That regulation has been effective in preventing potentially abusive short sale activity. In fact, the SEC has noted that short selling abuse is far less common than other types of market abuse.[28] It also has been effective at addressing concerns about failures to deliver, which occur when one party to a transaction fails to meet their contractually obligated delivery before the settlement date or if there is a technical problem in the settlement process. In 2011, for example, the SEC's Division of Economic and Risk Analysis found that since 2008, failures to deliver had declined by approximately 66 percent across all securities, and failures to deliver had declined by 85 percent for threshold stocks (shares with persistent failures to deliver).[29]

Under Regulation SHO, a broker may not accept a short sale order from a customer to effect a short sale for its own account, unless the broker has:

- Either borrowed or made bona fide arrangements to borrow the security;
- Reasonable grounds to believe the borrower can locate, borrow, and deliver the security to the buyer by the date delivery is due (Rule 203(b)(1) an (2)) and;
- Documented compliance with these requirements.

In addition to Regulation SHO, those engaged in short selling are subject to broad anti-fraud provisions of the federal securities law, including Rule 10b-5 under the Exchange Act, which prohibits any manipulative conduct, including intentional dissemination of false information. The SEC has extensive authority to investigate and punish fraudulent conduct.

How are short sales reported?

In addition to Regulation SHO, the SEC oversees short sales through an extensive system of reporting. A substantial amount of information about short sales is publicly available, and more information is readily available to regulators. Several self-regulatory organizations provide on their websites daily aggregate short selling volume information for individual securities and monthly disclosures for individual short sale transactions in all securities with respect their venue. In addition, the SEC discloses fails to deliver data for all equity securities on its website twice-monthly.

Taken together, this information gives regulators quick, easy access to aggregate, market-wide short sale information and allows for healthy transparency in the short selling market.

[28]See SEC Staff Study at page 74 ("There were 273 Commission enforcement actions from 2004 through 2010 than involved market manipulation. Of these, only 14% involved short-side manipulation while 86% did not involve short selling.") [29]See Memorandum from SEC Division of Risk, Strategy and Financial Innovation, Impact of Recent SHO Rule Changes on Fails to Deliver (Apr. 25, 2011), available at: http://www.sec.gov/spotlight/shortsales/failsmemo042511/pdf/

V. Why individual short sale disclosure would be detrimental to the market and investors

Markets in which short sellers are active have more informed stock prices, lower transaction costs and less volatility —this benefits all investors.[30] Where short selling has been discouraged through public disclosure of individual investor positions or outright banned—stocks are mispriced, and both transaction costs and volatility increase.[31] Promised benefits of public disclosure (as distinguished from disclosure to regulators to protect against manipulation and fraud), have been illusory where tried while injury to the market and ultimately investors has proven real.

Meaningful transparency flows from investor scrutiny of public companies to best ensure that stock prices accurately reflect their fundamental value. This transparency is only possible when investors are incentivized to do fundamental research and ask hard questions. Certain types of public disclosure can promote accountability and efficiency and provide investors with understanding of broader trading activity in the market. However, disclosure of individual investor short positions offers none of these benefits. Such disclosure discourages short selling and even under current rules has sometimes put investors in personal, physical jeopardy.

Reasons why individual short sale disclosure would be detrimental

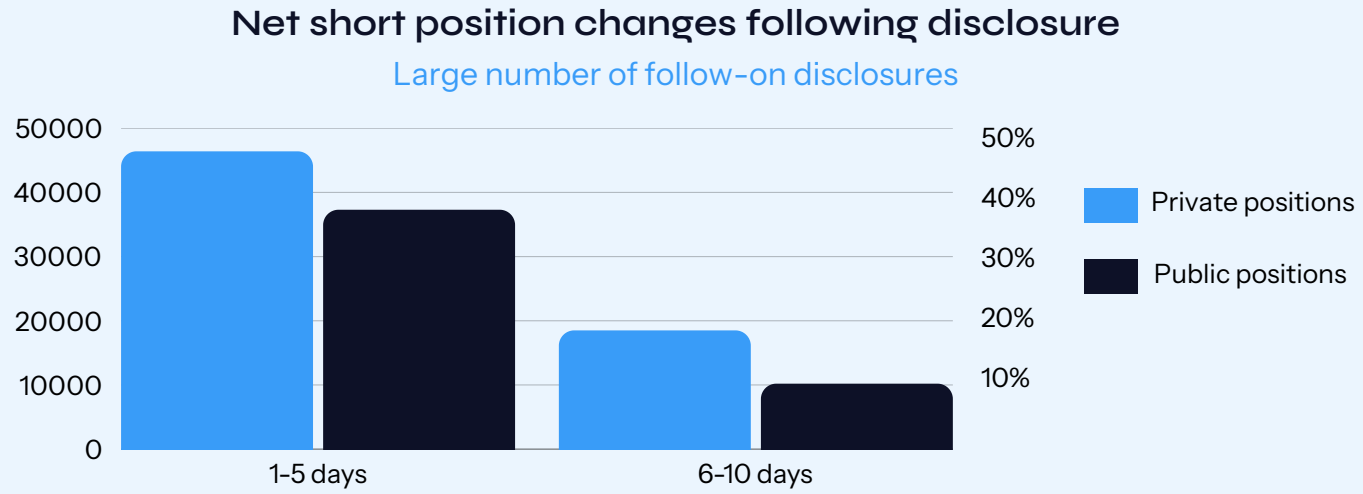
Public disclosure of individual short interests would provide regulators no additional material information.

The SEC has developed an extensive system of reporting to oversee short sales that helps inform markets. As mandated by the Dodd-Frank Act, the SEC studied the feasibility, benefits, and costs, of adding a real-time short position reporting regime in 2014 and found the net effect to be unclear.[32] The SEC noted concerns that public reporting could "facilitate copycat and order anticipation strategies that could discourage liquidity supply, fundamental analysis vital to price efficiency, and hedging that facilitates capital formation."[33] The SEC also warned the risk of these effects "may be amplified" if public reporting identifies short sellers.[34] The SEC concluded real-time short position reporting would "provide regulators with little additional information."[35]

Public disclosure of individual investor positions causes market distorting behavior

Mandated public disclosure may require investors to disclose their active investment strategy, which could risk disclosing investors' proprietary trading strategies, compromise their ability to manage their market risk exposure, lead to retaliation, or, as the EU experience has shown, result in an investor deciding not to fully express their view. The European Securities and Markets Authority (ESMA) reviewed the data collected pursuant to the 2012 EU regulation on short selling that requires positions above a certain threshold to be disclosed. ESMA found that the public reporting thresholds appeared to reduce price discovery and encourage market-distorting herding behavior.[36] ESMA also found that when a short position is disclosed publicly, there is a 15 percent increase in the likelihood that other investors will likewise exceed the public disclosure threshold.[37] In either case, the distortion caused by the public disclosure threshold led demonstrably to less informed stock valuation.[38]

[30] Boehmer, E. and Wu, J., (2013) "Short Selling and the Price Discovery Process," The Review of Financial Studies, Vol. 26, Issue 2, February 2013, pp. 287-322. [31] Jones, C., Reed, A., and Waller, W., (2016) "Revealing shorts: An examination of short position disclosures," The Review of Financial Studies, Vol. 29, Issue 12, August 6, 2016, pp. 3278-3320 (examining the EU short sale disclosure regime and concluding, "there is less shorting… and prices are not as informative, consistent with the idea that some informed trading is being discouraged by the disclosure requirements."). See also Boehmer & Wu, (making the "empirical finding is that short sale constraints, or barriers to short selling, lead to stock overvaluation.") [32] "Short Sale Position and Transaction Reporting," Securities and Exchange Commission, 2014, p. vi, (available here). [33] Id. at iv. [34] Id. [35] Id. at v. 36] Id. at 5. [37] Id. [38] Jones, C., Reed, A., and Waller, W., (2016) "Revealing shorts: An examination of short position disclosures," The Review of Financial Studies, Vol. 29, Issue 12, August 6, 2016, pp. 3278-3320 (examining the EU short sale disclosure regime and concluding, "there is less shorting… and prices are not as informative, consistent with the idea that some informed trading is being discouraged by the disclosure requirements."). See also ESMA at 64 (citing Jank, Roling and Smajlbegovic (2016) for the proposition investors that wish to keep their strategy non-public are "prevented by the threshold from fully acting on their information and beliefs due to the constraint imposed on short selling, resulting in less informational efficiency.").



Note: Number of private and public net short position changes in the days following public disclosures of a net short position on the same ISIN, and share of public positions (right axis) in % of total. Private positions are net short below public disclosure threshold.

Source: "ESMA's Report on Trends, Risks and Vulnerabilities" (No. 1, 2018).

Rationale for public disclosure of long positions does not hold for short positions

Public disclosure of long positions is important because stock owners have voting rights and can affect corporate control. There is no analogous rationale for requiring public disclosure of short positions because short sellers do not exercise voting rights or pursue strategies to acquire control of companies.[39] The bare assertion that there is potential for abusive short selling that the SEC is not sufficiently motivated or resourced to interdict is not supported. Current data reporting provides regulators access to short sale transaction information with only a one-day lag. All of which begs the question—what public benefit could flow from disclosure of individual investor positions? The SEC did identify a potential harm with such disclosures suggesting that retail investors could misinterpret disclosed data in ways that may result in "poor trading decisions."[40]

Public disclosure of individual investor positions could subject all investors and companies to higher risks and costs

The effort to develop an informed decision to take a short position is substantial, and unlike purchasing a stock, the trade itself is costly to execute. Short sellers pay fees to borrow stock, they are generally required to collateralize the stock loan, and they are potentially exposed to unlimited losses. Mandated public disclosure would effectively cause short sellers to disclose their active investment strategy, which undermines the value of their fundamental research or, as the EU experience has shown, results in an investor deciding not to fully express their views (and not getting the full benefit of their views if correct).

[39] See Conference Report to the Securities Acts Amendments of 1975 at 80 (stating that reporting would help issuers identify their holders of record in order to communicate regarding corporate decisions.). [40] "Short Sale Position and Transaction Reporting," Securities and Exchange Commission, 2014, p. 45 (available here).

To the extent that short sale disclosures have the effect of making such trades less economic, there will be fewer short sales, which will harm market quality.[41] More importantly, managers may trade their active investment strategies, which help soften market distorting behavior, for passive investment strategies, which would reduce market efficiency.[42] During the financial crisis starting in 2008, at least 18 countries, including the United States, implemented restrictions on short selling. In analyzing the data from these periods, restrictions on short selling were found to reduce liquidity, slow price discovery, increase risk aversion, and generally failed to support stock prices.[43]

If an inference can be drawn from the experience of short sale bans, reduced short-selling should likewise be expected to result in increased transaction costs in the form of wider bid-ask spreads and longer times to fill orders. Public companies would face higher costs of capital as a result of less efficient prices and impaired capital formation. And all investors and companies would be subject to the increased risk of price bubbles and higher market volatility.

Public disclosure of individual investor positions increases the risk of short squeezes

Proponents argue increased public disclosure of short sales could reduce abusive trading, but such public disclosure could also facilitate abusive trading. Public disclosure of short positions may subject market participants to the risk of a short squeeze, that is, when the price of a security is pushed upward or the availability of stock to borrow is restricted with the intent of forcing short sellers out of their positions. As the price of a shorted stock rises sharply, short sellers must add cash to their margin accounts or close out their short positions at the increased stock price. Investors with short positions that are publicly disclosed would be more vulnerable to a short squeeze. The GameStop squeeze, for example, occurred because a short, via a listed put option, was made public in an SEC filing.

Public disclosure of individual investor positions could facilitate issuer retaliation

Even under current rules issuer retaliation against short sellers has been manifested in short squeezes, harassment, intimidation, false claims of price manipulation, and threats of violence. Already, short sellers face hostility and are often wrongfully blamed in times of crisis or major price declines in the market.[44] If management knows who the individual short sellers are, they know who to retaliate against. In an interview with ProMarket, Fahmi Quadir, short seller, founder and CIO of Safkhet Capital, said short sellers already run the risk of lawsuits, harassment, and even "mortal threats." In her view, "most fundamental short sellers have already been wiped out" due in large part to the risk of retaliation.[45] Most recently, we saw short sellers targeted during the GameStop short squeeze. In his written testimony for the House Financial Services February hearing on the GameStop short squeeze, Gabriel Plotkin, Founder and Chief Investment Officer for Melvin Capital Management, testified that he had been subject to antisemitic slurs by Reddit platform users as a result of his firm's short positions.[46]

[41] See Jank, S., Roling, Christoph, and Smajlbegovic E., "Discussion Paper: Flying under the radar: the effect of short-sale disclosure rules on investor behavior and stock prices" (2016). [42] See Wermers, Russ. 2019. "Active Investing and the Efficiency of Security Markets." SSRN Electronic Journal. (available here). [43]See Beber, A. and Pagano, M. (2013), "Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis;" Felix, L., Kraeussl, R., and Stork, P. (2013), "The 2011 European Short Sale Ban on Financial Stocks: A Cure or a Curse?;" "Short-Selling Bans and Bank Stability" (2018), ESRB Working Paper Series No 64; "ESMA's Technical Advice on the Evaluation of Certain Elements of the Short Selling Regulation" (2017); "ESMA's Report on Trends, Risks, and Vulnerabilities" (No. 1, 2018). [44] Lamont, Owen A., Go Down Fighting: Short Sellers vs. Firms (July 2004). NBER Working Paper No. w10659, Available at SSRN: https://ssrn.com/abstract=579806. [45]See Kasperkevic, Jana, "Fahmi Quadir: Short Sellers are Always an Eager Boogeyman," ProMarket, February 22, 2021. [46] SeeGabriel Plotkin, Founder and Chief Investment Officer for Melvin Capital Management testimony for House Financial Services Committee February 18, 2021 hearing, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide"(available here).

Public disclosure of individual investor positions could cut off the free flow of information

Public disclosure of short positions could lead to issuers refusing to meet or excluding short sellers from discussions in which issuers discuss their public disclosures with investors.[47] SEC Commissioners[48] and business leaders[49] alike have recognized the importance of shareholder engagement. Any chilling of the free flow of information between investors and issuers can hamper the benefits provided to the market by well-informed short sellers.

Institutional investors may avoid alternative investment classes

Many institutional investors – such as pension funds, endowments, and foundations – invest in investment vehicles that engage in short selling as a means to mitigate overall risk to their portfolios. They are likewise sensitive to reputational risk and incremental cost increases. Public disclosure requirements for short sales could lead institutional clients to disfavor investments vehicles engaged in short selling to avoid adverse publicity. As a result, institutional investors may lose the risk management benefits of short sales in the long run, which could ultimately erode returns to these investors.

[47] Lee, Joanna, "Activist Short Sellers: Market Manipulators or Market Protectors?," 32 Review of Banking & Financial Law 274, 2014, Part C (available here). [48] See Public Statement of SEC Chairman Jay Clayton, "Statement Announcing SEC Staff Roundtable on the Proxy Process", July 30, 2018. (Former SEC Chairman Jay Clayton called shareholder engagement "a hallmark of our public capital markets," noting the "SEC's rules governing the proxy process are at the center of investor participation in, and influence over, corporate governance at U.S. public companies.") Daniel M. Gallagher, Comm'r, Sec & Exch. Comm'n, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College, June 23, 2015. (Former SEC Commissioner Daniel Gallagher argued for management and boards to be as responsive to shareholders as politicians are to their constituents.) [49] "Commonsense Principles of Corporate Governance," July 2016, Section II.a (available here) (Corporate governance principles endorsed by prominent leaders of U.S. public companies encouraged "[r]obust communication of a board's thinking to the company's shareholders" and recommended that asset managers, on behalf of their clients, "actively engage…with the management and/or board of the company, both to convey the asset manager's point of view and to understand the company's perspective.")

VI. Conclusion

Short selling contributes significantly and demonstrably to healthy capital markets, which ultimately profits pension beneficiaries and supports job creation. Short sellers support reporting to the SEC and the disclosure of aggregate short positions in the market. Short sellers do not, however, want public reporting of individual investor positions. As starkly demonstrated by the Wirecard collapse, government efforts to restrain or ban short selling may actually shield the exposure of fraud and, in all cases, such intervention leads to deterioration of market quality. Changes to rules that would require individual investors to disclose short positions would lead to the same results, hurting investors and ultimately the competitiveness of U.S. markets.