SHORT SALES REGULATION IN SEASONED EQUITY OFFERINGS: WHAT ARE THE ISSUES?

Emilios Avgouleas∗

I am indebted to Harry McVea and Joe McCaherry for very constructive comments to an earlier draft of this chapter.

5.1 Introduction

Short selling normally describes the market practice whereby securities, the seller does not own at the time of the trade, are sold as part of a transaction or series of transactions.1 In the most common scenario, the seller borrows the securities concerned and engages in relevant transactions against a commitment to buy the securities back later at a lower price, returning also any borrowed shares to the lender.2 Any form of share capital increase of a public company with public subscription (normally called seasoned equity offerings (SEOs)), whether or not in the form of a rights issue, clearly provides a very fertile ground for insiders to trade and speculators to spread rumours to manipulate the market. The best way to reap the rewards of inside information or otherwise abuse the market is through short sales. A massive volume of short sales around a SEO can destabilize the share price. Such de-stabilization could lead the shares to be offered at steep discounts, prejudicing the success of the SEO.

The negative view that society and the press have of this practice is reinforced by the fact that short selling is one of the preferred trading strategies of hedge fund managers, who, sometimes, are seen as the ugly face of ‘casino’ capitalism. Yet a large number of empirical studies indicate that short selling is an important factor of market efficiency. In general, it allows all buying selling interest in the market,

1 IOSCO submits that short sales should generally be understood as transactions characterized by the presence of two factors: ‘(i) a sale of stock that (ii) the seller does not own at the point of sale’. IOSCO, Technical Committee, Regulation of Short-Selling – Consultation Report, Appendix III, 24, (March 2009). [Hereinafter, IOSCO Report]. IOSCO’s Report suggests that a trader should be regarded as owning the securities in which she trades when: ‘(i) the seller has purchased or entered into an unconditional contract to purchase the stock but has not yet received delivery; (ii) the seller has a title to other securities which are convertible into or exchangeable for the stock to which the order relates (and has tendered the application to convert or exchange); (iii) the seller has an option (and has exercised such an option) to acquire the stock to which the order relates; (iv) the seller has rights or warrants (and has exercised such rights or warrants) to subscribe to and to receive the stock to which the order relates; (v) the seller is making a sale of a stock that trades on a ‘when issued’ basis and has entered into a binding contract to purchase such security, subject only to the condition of issuance of the security; and (vi) the seller has bought the stock in one market and then sells the same stock in another market (regardless of whether it is an overseas market).’ Ibid.

2 If short sales are covered the chain of transactions is normally as follows: (i) the short normally borrows the shares that are for sale so that they can be delivered to the buyer at settlement, (ii) he sells the shares short, (iii) at some point in the future, he buys the same number of shares so as to return them to the original lender (preferably at a lower price), (iv) replacement shares are returned to the original lender and the chain of transactions is complete.
including trading interest based on inside information, to be revealed and be better reflected into security prices. The International Organization of Securities Commissions (IOSCO) has recognised that short sales may bring significant efficiency gains especially with respect to: (a) efficient price discovery, because short-selling facilitates ‘a more rapid re-pricing of over-valued securities than would otherwise be the case’, (b) mitigation of price bubbles, because it helps ‘contrarian investors’ to mitigate, through rapid sales, steep, temporary price spikes (mini ‘bubbles’), (c) increasing market liquidity, and (d) facilitating hedging and other risk management activities. In addition the link between short sales and market abuse is far from being firmly established, even in the case of SEOs.

Traditionally, the regulatory treatment of short sales has been either hesitantly heavy-handed, such as the US uptick rule under Rule 10a-1, which, in a modified form, was in force since 1938 and was repealed in July 2007, or quite relaxed, relying on convoluted disclosure arrangements of stock-lending data, as was the case of the UK regime. The main area of concern that had been identified was the role of short sales in the context of SEOs. The Securities and Exchange Commission (SEC) through the various forms of Rule 105 of Regulation M (which covers both Initial Public Offers (IPOs) and SEOs), first prohibited traders from covering short sales made within five days of the seasoned offer with shares purchased through a subscription to the offer, and, since the October 2007 amendment, from purchasing any security sold short from the newly offered shares.

The watershed moment in the regulation of short selling was the market price collapse of listed financial sector stocks, following the bankruptcy of Lehman Brothers and the revelation of the losses of American International Group (AIG), in the first two weeks of September 2008. During that period stock markets witnessed a massive increase of short selling orders in financial sector stocks, which

---

3 IOSCO Report, supra note 1, 5, 22.
4 Rule 10a-1(a)(1) provided that, subject to exceptions, a listed security could be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it was higher than the last different price (zero-plus tick). Short sales were not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. This was the ‘tick test’. In the case of NASDAQ, instead of the last reported sale price, the ‘tick test’ was based on the last bid. NASD Rule 5100.
7 Ibid.
8 SEC 17 CFR Part 242 [Release No. 34-56206; File No. S7-20-06] (Short Selling in Connection with a Public Offering) (effective 9 October 2007). According to the SEC, the goal of Rule 105 is to maintain the integrity of the offering price by ensuring that is based on market forces and not “artificial forces” (market manipulations). In the SEC’s view, pre-pricing short sales that are covered with offering shares artificially distort the market price. Id.
9 ‘[I] it shall be unlawful for any person to sell short (as defined in Rule 242.200(a)) the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period (“Rule 105 restricted period”) that is the shorter of the period: 1. Beginning five business days before the pricing of the offered securities and ending with such pricing; or 2. Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.” Ibid. According to the SEC: ‘Rule 105 is prophylactic. Thus, its provisions apply irrespective of a short seller’s intent’. Id.
was held to be the main reason for the amplification of downward price pressures in what was already a falling market.

Following a serious public backlash and strong pressure by the management of big banks, the SEC, the Financial Services Authority (FSA), and most European and other developed market regulators issued orders banning short selling in financial sector firms, which came into effect on 21 September 2009. These orders had been preceded by FSA and SEC orders in July 2008, in an attempt to stem the tidal wave of short sales around SEOs. As it will be explained in section 3 short sales had been, wrongfully, castigated as the main reason behind the failures of rights issues conducted by major financial institutions such as the Halifax Bank of Scotland (HBOS).

However, the global ban was more of a ‘knee-jerk’ reaction to the precipitous price falls and less a comprehensive regulatory response to the challenges posed by short selling. Thus, given the failure of the September 2008 short sales ban to curb market volatility, most developed market regulators have consulted on the best way to regulate short selling. The Commission of European Securities Regulators (CESR) and IOSCO have, in the meanwhile, released a final set of high level principles for the regulation of short sales, and the SEC has reinstated the uptick rule. However, the issue of short sales around SEOs has been largely overlooked as a separate issue, although it had, in the past, dominated the policy agenda concerning the regulation of short sales.

The regulation of short sales during SEO periods is a very important issue because of its ability to affect capital formation in the internal market. As a result, it should be dealt with on a Pan-European basis, preferably by means of an EU directive creating a consistent framework for short sales during SEO periods. Such pan-European approach is also consistent with EC company law regulating rights issues in order to protect existing shareholders and capital formation in the EU.

---


In this context, the chapter argues that a ban on ‘naked’ short sales in the context of SEOs, combined with properly calibrated disclosure requirements and a sophisticated circuit breaker system, applying to short sales in general, would be sufficient to control the undesirable effects of short selling around SEOs, seriously restraining speculative depreciation attempts (‘bear raids’). The introduction of the suggested pan-European regime would reduce the incentives of insiders to trade and restrict manipulators’ room to profit from ‘bear raids’ facilitated by the spreading of false rumours. It would also deepen and make more efficient the internal capital market in the EU.

This Chapter is divided in five sections beginning with this introduction. Section 5.2 explains the mechanics of short selling in contemporary securities markets, which are viewed as ‘adaptive’ markets that incorporate in their workings elements of both modern finance theory and behavioural finance. Section 5.3 examines short-selling in the context of SEOs. It explains the efficiency gains that short selling brings and it considers the potential of short sales to destabilize orderly markets. Then, it discusses the risk that short sales present to issuers in the context of seasoned equity offerings, including rights issues. Section 5.4 provides an outline of the current proposals for the regulation of short sales set out by IOSCO and CESR and discusses the optimal regulatory framework for short sales during SEO periods. It explains why a prohibition of ‘naked’ short sales complemented by a dual strategy of disclosure and short trading halts is superior to the imposition of any other restriction. Section 5.5 concludes.

5.2 Short Sales in Contemporary Financial Markets

Modern finance theory and its offspring Efficient Markets Hypothesis (EMH) have been the predominant analytical to interpret of market behaviour for the past four decades. EMH, as the brainchild of rational choice theory, assumes that asset prices are set by hyper-rational actors. Thus, market prices take a ‘random walk’, reflecting fundamental value; prices tend change on the basis of new information.

Most of the assumptions of EMH have been assailed by behavioural finance that

---

Siemens v Nold Case C-42/95 [1996] ECR 1-601, ECJ. For the standards applicable to various member states see Herbert Hirte, ‘Issuing New Shares and Pre-emptive Rights, Recent Issues in European Corporate Statutes’ (2007) 30 Rivista Delle Societa 733. Arguments have been put forward against the entrenchment of shareholder pre-emption right in mandatory company law, but this view has not won wider endorsement. See Eilis Ferran, ‘Legal Capital Rules and Modern Securities Markets – the Case for Reform as Illustrated by the UK Equity Markets’, in Klaus J Hopt and Eddy Wymeersch, Capital Markets and Company Law (OUP, 2003), ch 5.

19 Naked short sales’ is a term used to describe transactions in securities the seller does not hold at all. The Namely, it is the market practice where: ‘the participant, either proprietary or on behalf of a client, enters an order in the market and do not have in place arrangements for delivery of the securities.’ Lecce et al., infra note 52.


incorporates insights from so-called psychology of choice and judgement\textsuperscript{23} into analysis of market behaviour.\textsuperscript{24} According to behavioural finance many of the market phenomena that cannot be explained by EMH (‘anomalies’) can be attributed to individuals’ cognitive properties, whether cognitive processes, such as heuristics,\textsuperscript{25} or outcomes of cognitive processes: so-called cognitive biases.\textsuperscript{26} One of the core assumptions of EMH is that in an efficient market no investment strategy can yield average returns higher than the risk assumed and no trader can consistently outperform the market or accurately predict future price levels, as new information is continually absorbed by market prices. Therefore, since in efficient markets transaction costs are relatively low, ‘professionally-informed traders’ have the opportunity to quickly observe and exploit through arbitrage trading any price deviations from fundamental value. The result of arbitrage activity is that prices reach a new equilibrium, which reflects more accurately the traded asset’s value, and corrects any mis-pricings.\textsuperscript{27} In fact, the best tool for arbitrage trading is short selling. However, when what calls for correction is not a price spike but precipitous price falls, arbitrageurs will have to engage in the much more expensive (than unrestricted short sales) share purchases. Thus, in this case, the corrective power of arbitrage trading is limited due to higher transaction costs. It follows that, if arbitrage activity fails to ‘correct’ a precipitous price fall caused by short selling, the majority of market actors may feel compelled to imitate short sellers’ trades adding further downward pressure on prices. Furthermore, the corrective influence that EMH attributes to arbitrage is strongly disputed by behavioural finance, because, apart from transaction cost restrictions,\textsuperscript{28} the EMH also assumes that all market players are rational.

Behavioural finance assumes two kinds of investors in the market: (a) rational speculators or arbitrageurs who trade on the basis of information and (b) quasi-rational investors, called ‘noise’ traders. As a result, a number of investors (‘noise’ traders) act on imperfect information\textsuperscript{29} and may cause prices to deviate from their equilibrium values. This framework, combined with the fact that upwards arbitrage


\textsuperscript{25} ‘Heuristics’ are cognitive processes which allow individuals to reduce the complex tasks of assessing probabilities and predicting values to simpler judgmental operations. For this reason, they are also called ‘mental shortcuts’. In general, these heuristics are quite useful, but sometimes they lead to severe and systematic errors. See Kahneman and Tversky, Judgment under Uncertainty, supra note 23.

\textsuperscript{26} Cognitive biases are the results of the use of heuristics, when they lead to: (a) systematic errors in estimations of known quantities and statistical facts and (b) systematic departures of intuitive judgments from the principles of probability theory. Ibid.


trading may have limited corrective power, can explain why sometimes short sales can trigger investor herding and cause widespread market price falls. However, even more convincing explanation of why short sales could trigger strategic trade behaviour might be offered by theories intending to replace EMH and behavioural finance.

Despite the powerful and ultimately successful challenge that behavioural finance has posed for EMH, it may not serve as the successor to the EMH orthodoxy, since sometimes investors do behave rationally and prices take a ‘random walk’. It seems that hybrid and more nuanced theories, which view markets as evolutionary and adaptive systems that are also susceptible to irrational behaviour, due to: (a) investors’ cognitive limitations and limited self-control and (b) to strategic trade behaviour (herding), caused by socio-psychological or narrow self-interest factors, provide a better understanding of actual market conditions and investor behaviour.

Professor Andrew Lo of MIT has offered the best, so far, alternative to the battling rivals of modern finance theory and behavioural finance. Lo’s theory called Adaptive Capital Markets Hypothesis (ACH)\(^{30}\) incorporates several of the assumptions of both theories in an evolutionary framework. Lo submits that markets often can be efficient, but with strong deviations caused by behavioural factors. These are caused by the fact that market actors’ computational ability is limited and cognitive biases do play a role in their investment decisions. The predominant theme of ACH is that market actors ultimately struggle not for optimal returns (as the EMH holds) – optimization is costly - but for survival, like all living species in an evolutionary framework. Namely, ACH holds that market actors behave sometimes rationally and other times irrationally, depending on which strategy suits best their struggle for survival. For the reasons explained in the next few paragraphs, herding may easily become the only survival strategy in a falling market even for professional (rational) investors.

If the more accurate assumption is that markets are complex adaptive systems that encompass both rational and quasi-rational investors,\(^{31}\) and the latter cause prices to deviate from their equilibrium values, and for the aforementioned reasons upwards pressure through arbitrage trading is either not strong or fast enough, then the majority of investors may just follow the herd of short sellers. Namely, even rational investors may resort to the safest short-term survival strategy either because they assume that short sellers have inside information or because it pays off to join the ‘momentum’ game in the short run.

The assumption that herding could merely constitute a survival strategy abides well with recent research that herding does not have to be the result of irrational panic. Peer pressure, or attachment to short term gains for career, and other reasons relating to the reputation and compensation of traders or fund managers, are also sufficient and likely factors,\(^{32}\) because of the agency relationship in financial markets, so-called ‘separation of brains from capital’. The agency relationship means that fund managers’ and investor (clients’) interests may be misaligned. Agents’ reputations, salaries and career progress are often determined


on the basis of short term profit and comparability with competitors’ returns.\textsuperscript{33} As a result, fund managers, in fear of the irrational behaviour of ‘noise traders’ which may force further market price falls, making them to post losses, are likely to decide that foregoing arbitrage opportunities through purchases in a falling market and following the herd is the safer option for them.\textsuperscript{34} This behaviour may of course lead to a serious destabilization of the market. If it occurs during the period that a SEO is priced, it practically forces the issuer to offer the shares at a steeper discount and raise less capital for the same amount of equity sold. Such an outcome will, of course, prejudice the success of issuer’s investment plans.

Yet, for reasons discussed below, even this extreme, but not rare, form of market behaviour does not justify a blanket ban on short sales. As argued in section 5.4, this effect may be countered through a combination of a ban on ‘naked’ short sales and more generally applicable circuit breaker and disclosure regimes.

5.3 Should Short Sales in the Context of SEOs be Banned?
A Cost Benefit Analysis

5.3.1 The Efficiency Benefits of Short-Selling

Economic theory has highlighted the welfare gains short sales bring with regard to pricing efficiency.\textsuperscript{35} A significant number of empirical studies confirm this view. These studies show with emphasis that short selling can facilitate better valuation of securities by controlling overpricing,\textsuperscript{36} enable the market to adjust faster to bad news,\textsuperscript{37} and enhance pricing efficiency.\textsuperscript{38} In addition, there is some evidence that lack of short selling restrictions may boost liquidity, because short traders and their counterparties find it easier to trade and also pursue hedging strategies based on short selling. This translates into a bigger number of trading parties for a specific stock, higher trading volume, and lower bid ask spreads.

A number of empirical studies indicate that an increase in short positions also signals genuine bad news for the stock\textsuperscript{39} and heavily shorted stocks tend to exhibit,  

\textsuperscript{36} In fact, there is evidence that stocks can be overpriced when securities are subject to short sale constraints. See Charles M Jones and Owen A. Lamont, ‘Short Sale Constraints and Stock Returns’, 66 Journal of Financial Economics 207 (2002).
\textsuperscript{38} Arturo Bris, William N. Goetzmann and Ning Zhu, ‘Efficiency and the Bear: Short Sales and Markets Around the World’, 62 Journal of Finance 1029 (2007) (providing ‘evidence that prices incorporate negative information faster in countries where short sales are allowed and practiced’).
following the trades, negative returns.\textsuperscript{40} The latter finding suggests that short sales probably convey negative information about a stock which feeds into its valuation for a considerable period.\textsuperscript{41} Boehmer, Jones, and Zhang examined NYSE short sale order flow data in the period January 2000 to April 2004. They showed that short sellers as a group tend to be well informed and trade on fundamentals. Furthermore, they found that those engaging in higher volume of short sales (5,000 shares or more) were very well informed unlike those entering a lower volume of short sales (500 shares or less) who tended to be less well informed.\textsuperscript{42}

Arguably, the most convincing evidence of short sales’ beneficial impact on market efficiency is supplied by the results of several studies that measured the impact of the SEC and FSA bans on price volatility and trading liquidity, both among the most important indicators of market efficiency. From the studies conducted by the US Office of Economic Analysis (OEA), it is evident that the price impact of the short selling ban was minimal\textsuperscript{43} and that long sellers were more responsible for price declines during the period under consideration.\textsuperscript{44} Another study on the impact of SEC’s ban by Boehmer, Jones, and Zhang compared a selection of NYSE-listed stocks on the restricted list with comparable NYSE-listed stocks not subject to the ban. The study showed that stocks on the restricted list experienced a share price increase at the start of the ban and a temporary share price decline when shorting resumed after the end of the ban. However, market quality for these stocks, as measured by spreads, the five-minute price impact of trades, and intraday volatility, decreased. Namely, the ban gave a temporary boost to the share prices of financial companies in the restricted list, which proved to be short-lived.\textsuperscript{45}

An independent study, commissioned by the London Stock Exchange to evaluate the impact of the ban on market quality (defined as market volatility and liquidity) for the stocks affected by the ban, also produced very interesting findings that strongly argue against such a measure.\textsuperscript{46} In specific, Clifton and Snape (the authors of the study) compared quality of trading in 15 FTSE 100 stocks from the restricted list (affected stocks) and in 78 stocks that did not belong in the restricted list (control stocks) during three separate thirty day trading periods: two prior to the FSA ban and one after the ban. They found that liquidity in affected stocks, measured by reference to the size of bid ask spreads, order depth, number of trades, and trading volume, deteriorated.

\textsuperscript{43} Office of Economic Analysis, Analysis of Short Selling Activity during the First Weeks of September 2008, 16 December 2008.
The results of the above studies are further corroborated by independent research conducted by Marsh and Niemer, who examined the impact of the September 2008 short selling restrictions in a number of countries, including the UK, US, France, and Germany.\(^47\) Marsh and Niemer found no strong evidence that restrictions on short selling in the UK or elsewhere changed the behaviour of stock returns.

In summary, the overwhelming majority of recent empirical studies show that short selling brings considerable efficiency gains to the market. On the other hand, short selling prohibitions failed to stabilize securities markets and bring about reductions in price volatility. At the same time, they seem to have adversely affected liquidity and thus pricing efficiency in the securities concerned and the market’s information efficiency.

5.3.2 Destabilization of Orderly Markets and Settlement Risk

The most potent of the perceived threats that short-selling presents is its ability to destabilize orderly securities markets. Due to their large volume and speed of implementation short sales may create downward price spirals.\(^48\) These may be both the result of other traders’ inability to insert buying orders in a rapidly falling market or unwillingness to take a long position, since the market’s continuous decline may accrue big losses to such long positions. Furthermore, short selling that causes a significant price falls may also force long traders to liquidate their positions because of funding pressures, e.g. margin calls, feeding further downward price spirals, or in order to avoid losses due to strategic trade behaviour, namely, herding.

A free falling share price affects issuer’s standing among investors and impairs issuers’ ability to raise fresh capital or obtain credit. Also, the precipitous collapse in the market price of a security may have implications for the wider market in terms of investor confidence. Namely, a precipitous collapse in the market price of a stock, due to short selling, may have a contagious effect spreading downward price pressures to the rest of the market and destabilizing market prices in all stocks of the same sector or the market as a whole.\(^49\)

The aforementioned study by Bris, Goetzmann, and Zhu tried to ascertain whether short sales have a destabilising impact on securities markets. The study analysed cross-sectional and time-series information from forty-six equity markets around the world for the period 1990-2001.\(^50\) Its results suggest that short sales do

\(^{48}\) IOSCO Report, supra note 1, 22.
\(^{49}\) FSA, Discussion Paper, supra note 14, 12.
\(^{50}\) Bris et al., supra note 38.
not affect the frequency of extreme negative returns. However, without short selling restrictions, extreme returns become even more negative. Also, the Bris, Goetzmann, and Zhu study found evidence that short selling amplifies price swings, which means that downward price pressures are fed faster to the market and may be stronger.\textsuperscript{51}

On the other hand, there is strong evidence that ‘naked’ short-sales do not lead to more efficient prices, increasing instead the volatility of stock returns and creating a serious settlement risk.\textsuperscript{52} They may also lead to a deterioration of liquidity through wider bid-ask spreads, decreased order depth, and reduced trading volumes, and to an increase in volatility of stock returns.\textsuperscript{53}

Short selling, especially ‘naked’ short selling, can maximize the risk of non-settlement. Namely, ‘naked’ short sales, where the short seller has not arranged borrowing ahead of the sale, may lead to settlement default, if either the short seller does not have strong incentive to settle or the stock lending market has become illiquid not allowing the seller to borrow the shares she sold short to fulfil her settlement obligations. A settlement failure is a serious matter, because it may cause serious disruption to the orderly operation of the market in the securities concerned. In addition, it might trigger a chain of defaults among highly leveraged market participants threatening the stability of the system.\textsuperscript{54} Even more serious is the risk to the buyer, who may wish to exercise voting rights from the securities concerned, or to meet obligations in respect of an onward chain of transactions, and is prevented from doing so, because the shares sold short were not registered in a timely manner.

5.3.3 The Impact of Short Sales on SEOS

The perception of short selling as a destabilizing factor in the context of seasoned equity offerings, including rights issues, is very well entrenched. The pricing of SEOs is based, inter alia, on the prevailing market price of the security, and is generally set at a discount to that price. Consequently, parties expecting to receive an allotment of securities in the SEO may seek to capture the difference between the current market price and the discounted offering price without market risk by selling securities short at the current market value, and using securities acquired in the offering to cover that short sale. Therefore, SEOs are particularly vulnerable to short selling, as short sellers, who attempt to drive down the share price, can later cover their positions at profit.\textsuperscript{55}

This view may be given added credence by the travails of the rights issue of HBOS in the summer of 2008,\textsuperscript{56} which seemed to involve substantial short selling

\begin{footnotes}
\item\textsuperscript{51} Ibid.
\item\textsuperscript{53} Ibid.
\item\textsuperscript{54} IOSCO Report, supra note 1.
\item\textsuperscript{55} FSA, Discussion Paper, supra note 14, 11-12.
\item\textsuperscript{56} This is how Ferran describes the fate of HBO’s rights issue in July 2008: ‘The rights issue was approved by shareholders at an extraordinary general meeting on 26 June 2008. The period for nil-paid trading of rights began on 27 June. On 21 July 2008, after closure of the offer, HBOS announced that just under 8.3 per cent of the rights had been taken up by existing shareholders. This outcome triggered a great deal of media coverage
activity. However, the same steep discounts were observed in similar bank rights issues (cash calls) in the same period, although there was no evidence of significant short-selling activity. In addition, the rumours circulating about HBOS financial condition proved in the end to be discounting rather than exaggerating the bank’s terrible financial condition.

Furthermore, relevant empirical studies provide a mixed view regarding the impact of short sales on SEOs. A study by Christophe et al. examined transactions involving short sales in the 5 days prior to earnings announcements of 913 Nasdaq-listed firms, provided ‘evidence of informed trading in pre-announcement short-selling’, which would justify wide price movements before the announcement of seasoned equity offerings. In another study Safieddine and Wilhelm examined whether short selling around seasoned equity offerings for NYSE and Amex-listed firms, during the period 1980-1991, led to issue discounts. They also examined the effects of the SEC’s adoption of (former) Rule 10b-21 in 1988. The study found that seasoned equity offers were, indeed, preceded by abnormally high levels of short selling. It also showed that higher levels of short selling were associated with lower offer prices and thus reduced proceeds from the equity issue. Safieddine and Wilhelm concluded that (former) Rule 10b-21 constrained short selling activity prior to seasoned equity offerings and therefore reduced the cost of seasoned offerings.

A more recent study undertaken by Kim and Shin also examined the effects of the introduction of Rule 10b-21, using a larger sample of US equity offerings, describing the issue as a “flop” or a “failure” which could be said to be a technically inaccurate assessment of the position given that HBOS did successfully raise the capital it had sought because the issue had been underwritten . . . Since the HBOS share price dropped below the rights issue price during the offer period, there was no incentive for rational investors to take up the offer. ’Eilis Ferran, ‘Limits of Private Sector Solutions for Banks: Recent UK Rights Issues’, ECGI Law Working Paper N°.115/2008, October 2008, 6. (Notes omitted).

57 See newspaper reports cited in supra note 13.
58 Ferran, supra note 56, 7-8.
59 After a near death experience in September 2008 the UK government lobbied Lloyds Bank to buy HBOS in a deal that was later regarded as detrimental to the Lloyds Bank shareholders, although Lloyds management offered a sharp discount over market price for the takeover, a price that was discounted further in October 2008. Both banks had to be subsequently bailed out by Treasury through a capital infusion of £11.5 billion for HBOS and £5.5 billion for Lloyds in October 2008. Even after the bailouts this is how newspapers reported on the deal: ‘The stock market seems still to fear that Lloyds is paying too much for its rival, which just three months ago was on the verge of collapse . . . With the Government determined to ramrod through a deal, some Lloyds shareholders clearly fear that their bets on the Black Horse are about to be HBoshed. HBOS’s business model is broken: it is over-reliant on wholesale funding, the window for which is barely open. Worse still, it is heavily exposed to a fast-deteriorating commercial property market. Not surprisingly, some Lloyds die-hards are asking: why are we over-paying for this rubbish?’ Jeff Randall, ‘What’s Wrong with Lloyds’ Takeover of HBOS? Just Follow your Nose’, The Telegraph, 11 November 2008, available at <http://www.telegraph.co.uk/finance/comment/jeffrandall/3442788/Whats-wrong-with-Lloyds-takeover-of-HBOS-Just-follow-your-nose.html> (last visited on 18 July 2010).and Nick Goodway, ‘Counting the Cost a Year after Lloyds’ Takeover of HBOS’, London Evening Standard, 17 September 2009.
62 This Rule originally prohibited short sales where the short position was covered by purchasing shares from the new offering, if the short position was established between the filing of the registration statement and the beginning of the distribution of the offering. See supra note 5.
covering the period 1983 to 1998, and reached an opposite conclusion. Kim and Shin study postulated that the observed significant seasoned equity offer discounts that became distinguishable post 1988, the year (former) Rule 10b-21 went into effect, were the result of ex ante uncertainty about the offer price. Since (former) Rule 10b-21 restricted short sales, it reduced the informativeness of seasoned equity offer prices, raising levels of uncertainty and thus causing greater discounts.

Another major study on the impact of short sales on seasoned offers’ discounts was conducted by Autore in 2006. Autore compared price discounting in US traditional and shelf-registered seasoned equity offerings during the period 1982-2004. This comparison could provide useful conclusions, because shelf-registered seasoned equity offerings were exempt from (former) Rule 10b-21, unlike traditional seasoned equity offerings, enabling Autore to use shelf-registered offers as a control group. His study showed that (former) Rule 10b-21 did not lead to an increase in seasoned offer discounts contradicting the conclusions of Kim and Shin’s study.

The mixed view provided by the above studies shows that it is hard to quantify the impact of short sales on the pricing of SEOs and determine whether this is beneficial or not. Furthermore, other factors may be affecting the success of the offer, which are not related to short sales. Such factors are: (i) the flotation method; (ii) the conditions that lead issuers to select uninsured rights or rights with standby underwriting over a firm commitment underwritten offer; (iii) the direct and indirect flotation costs across flotation methods. Finally, as regards rights issues, the period during which the offer is open, and the presence of firm commitments by strategic investors, as opposed a traditional underwritten with no firm commitments rights issue, may be more important factor with regard to offer price stability than short selling. Therefore, while a total ban of short sales would affect the liquidity of the issue and possibly pricing efficiency, it would do nothing to address the above issues that are equally critical in determining the price of a SEO.

5.3.4 Does Short Selling Around SEOs Amount to Market Abuse?

One of the main rationales offered by the FSA and the SEC for the short-selling ban of September 2008 was its role in the perpetration of market abuse. First, short

---


66 In the UK the offer period for rights issues is 21 days, a week longer than the minimum provided in the Directive. Companies Act 2006, s. 562. Ferran has suggested that such an extended period clearly endangers a pricing risk. Thus, the period should be shortened to the Directive’s minimum, in accordance with the recommendations of the relevant Myners’ Report (DTI, ‘Pre-emption Rights Final Report: A Study by Paul Myners into the Impact of Shareholders’ Pre-emption Rights on a Public Company’s Ability to Raise New Capital’, February 2005 (URN 05/679) activating the relevant power given to the Secretary of state under s. 562(6) (a) of the Companies Act 2006. See Ferran, supra note 5, 12-13.

67 For the differences between the HBOs issue and the Barclays issue, which also had low taking up levels but presented the firm commitment of a strategic investor, see Ferran, ibid. 9.
selling may help insiders to profit from information they possess, which if made public, would have an adverse impact on the price of the issuer’s securities. Second, it may be used as an implementing tool in the context of a wider scheme to manipulate the market through spreading of false rumours. Finally, ‘naked’ short sales may in some cases become an effective way to manipulate downwards market prices,\(^{69}\) a possibility that seems quite serious in the case of SEOs.

As regards the relationship of short sales to insider dealing, Christophe, Ferri, and Angel conducted a study of short selling in a period (5 trading days) leading to earnings announcements in the autumn of 2000 for 913 firms listed on NASDAQ. The hypothesis they tested was that if short sellers possess inside information, short selling activity should increase prior to negative earnings announcements and increase before positive earnings announcements. Their tests found that there is a negative relationship between short selling prior to an announcement and the post-announcement change in share prices and that abnormally large changes in short selling volume are often followed by substantial post-announcement share price movements. This shows that short sellers are overall better informed evidencing the existence of insider dealing in short selling before earnings announcements.\(^{70}\)

As regards SEOs, the SEC has noted that ‘short selling with the intention of covering the sale with securities purchased in an offering, thereby locking in a profit, may act as an artificial depressant on the security’s market value.’ Even bigger concern is raised by the spreading of false rumours during SEOs; a practice that was supposed to accompany the disastrous rights issue of HBOs in the summer of 2008. Yet subsequently the FSA dropped the case for lack of evidence,\(^{71}\) and if anything any rumours circulating about HBOs, however, menacing could not possibly describe the truly disastrous financial position of the highly leveraged bank.

The most recent study is by Henry and Koski,\(^{72}\) who examined whether short sales around seasoned equity offerings were the result of informed or manipulative trading. Henry and Koski examined a sample of US seasoned equity offers in the period 2005-2006. However, unlike other studies they used daily short-selling data. Their study found evidence of manipulative short selling in traditional seasoned offers, which could not be fully contained by SEC Rule 105,\(^{73}\) which replaced (former) Rule 10b-21. Henry and Koski argue that the wide discrepancy between the

\(^{68}\) See SEC Order and FSA Instrument cited in note 11 supra.

\(^{69}\) Lecce et al., supra note 52.

\(^{70}\) See Christophe et al., supra note 60.


\(^{73}\) SEC Rule 105 prohibited traders from covering short sales made within five days of the seasoned offer with shares purchased through a subscription to the offer.
findings of their study and those of other studies is explained by the fact that they used daily rather than monthly short selling data. 74

However, artificial depression of the market price through short sales may prove a very risky exercise and thus self-deterring. Short sellers with overextended positions may become vulnerable to a price upsurge or a squeeze75 by the long traders, as was the case with the Volkswagen shares. 76

Yet even this mixed view does not justify a full ban on short sales before rights issues and other forms of SEOs. Rather it calls for increased disclosure and a ban on ‘naked’ short sales during SEOs. ‘Naked short sales’ remain a suitable means to perpetrate a downwards price manipulation. Thus, they pose a very real risk to the stability of the market within and outside SEO periods. Arguably, the general laws prohibiting market manipulation combined with a regime of strict penalties for non-settlement should be a sufficient deterrent in a more general context. However, during periods of SEOs it may be a sensible strategy to impose a ban on ‘naked’ short selling.

5.4. How Short Sales in the context of SEOs should be regulated?

5.4.1 IOSCO Principles

In June 2009, IOSCO’s Technical Committee issued the final set of Principles for the regulation of short sales.77 According to IOSCO the main objectives of the regulation of short selling should be to protect the beneficial role short selling plays in capital markets especially with respect to (a) efficient price discovery, (b) mitigating price bubbles, (c) increasing market liquidity, and (d) facilitating hedging and other risk management activities.78

74 Henry & Koski, supra note 72.
75 The FSA describes this risk to short sellers as follows: ‘Short sellers must, at some point in the future, buy back an equivalent number of shares to those that were sold short. This would be true whether they were to replace the number of borrowed shares in the case of covered short selling or simply close out the short position in the case of naked short selling. In either scenario, the short seller is exposed to the risk that the shorted shares will go up in price. If the price rises while the short position is open, then the short seller will be required to either close out the position at a loss or to pledge more cash to keep the position open. Stock prices may rise for any number of reasons and if this occurs quickly and is sustained for a period of time then short sellers are caught in what is called a ‘short squeeze’, with the covering of short positions driving up prices further.’ FSA, Discussion Paper, supra note 14 above, 7, para. 2.5.
76 See Armin J. Kammel, ‘The Dilemma of Blind Spots in Capital Markets – How to Make Efficient Use of Regulatory Loopholes?’ 10 German Law Journal 605 (2009). This article describes the VW ‘squeeze’ as follows: ‘On a Sunday late in October 2008, on the 26th to be precise, Porsche published a statement in which it informed the public that it had raised its stake in VW to 42.6 percent from before 35 percent, and that it held options for another 31.5 percent. In case of exercising those options Porsche would be put within spitting distance of the 75 percent threshold, which it could control every major decision at its much larger rival, Volkswagen . . . This statement had tremendous effects: VW shares shot up to a momentary high of $ 1,276, making it for one moment the most expensive share worldwide on Tuesday, 28 October 2008.’ (notes omitted). Id. at 605-606.
77 IOSCO Principles, supra note 16.
78 Ibid, 5.
At the same time, regulation must ensure that, especially in extreme market conditions, certain types of short selling or the use of short selling in combination with certain abusive strategies do not contribute to disorderly markets. Thus, the 'principles have been developed with a view to striking a balance between realising the potential benefits of short selling and reducing the adverse impact on financial markets that may arise from abusive short selling'. Following consultation, IOSCO published its four high level general principles on the regulation of short-selling in June 2009. These provide that short sales must be regulated by means of:

- appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets
- a reporting regime that provides timely information to the market or to market authorities
- an effective compliance and enforcement system
- allow appropriate exceptions for certain types of transactions for efficient market functioning and development

According to IOSCO, the first principle mostly refers to appropriate arrangements for the settlement of short selling transactions, including strict settlement requirements (such as compulsory buy-in) for failed trades. Yet much more is required than preventing settlement failures to ensure that short-selling does not disrupt the ‘orderly and efficient functioning and stability of financial markets’ and IOSCO’s interpretation here is markedly light touch, possibly in order to secure international consensus. IOSCO clarifies that the objectives of the second principle, i.e. provision of ready access to information on short selling to improve insight into market dynamics must be far reaching intending to: (a) deter market abuse, (b) contain the potential of aggressive short selling to disrupt the orderly function of the market, (c) provide regulators and the market with early warning signs of the building up of large short positions and alert regulators to promptly investigate suspicious activities that may be potentially abusive or disruptive to the orderly functioning or stability of the markets, and (d) provide evidence to assist post-event investigations and disciplinary actions. As regards, the third principle, IOSCO suggests that regulators should:

- monitor and inspect settlement failures regularly;
- consider whether they are able to extend the power to require information from parties suspected of a breach, beyond the scope of licensed or registered persons if they lack such power;
- establish a mechanism to analyse the information obtained from the reporting of short positions and/or flagging of short sales to identify potential market abuses and systemic risk; and
- review whether their existing cross-border information sharing arrangements are sufficient to facilitate cross-border investigation.

Evidently the conflicting attitudes towards short selling of IOSCO members have prevented it from producing a more concrete and detailed set of principles. However,

---

79 Ibid. 6. It should be noted here that IOSCO does not take a position for or against short selling, the high level principles are addressed to jurisdictions where a decision has been made to allow short selling. Id.

80 IOSCO Principles, supra note 16, 4, 6.
81 Ibid, 8-10.
82 Ibid, 9-12.
83 Ibid, 16-17.
it is doubtful whether the objective of international harmonization may be achieved by means of very high level principles. Furthermore, although a short settlement cycle combined with severe monetary penalties for failure to settle may successfully contain the settlement risk posed by ‘naked’ short sales, it may not prove sufficient, to prevent market instability in the event of a ‘bear raid’, especially where the trader can cover its ‘naked’ short sales from the new offer. Thus, a strict settlement framework should be supplemented by a prohibition of ‘naked’ short sales at around SEOs, enhanced disclosure requirements and trading halts.

IOSCO’s model is, arguably, the product of compromise, given how diverse and often irreconcilable are the regimes its members have in place to regulate short sales in their securities markets. Of course, this observation explains the very high level that its Principles are formulated. Thus, while a very useful departing point, it is very doubtful that IOSCO Principles may truly serve as a harmonisation model, due to their striking level of generality. As regards SEOs, a more detailed regulatory model is discussed in section 5.4.3.

5.4.2 CESR Proposals

CESR has proposed to the European Institutions a pan-European short selling regime ‘based on a two-tier model for disclosure of significant individual net short positions’ in all shares that are admitted to trading on an EEA regulated market and/or an EEA alternative trading systems so-called Multilateral Trading Facilities. First, at the lower threshold, positions would be disclosed to the relevant regulator once they reached the of 0.2% threshold. Second, at the higher threshold, positions would be disclosed both to the regulator and the market as a whole once they reached the of 0.5% threshold. All changes of position would be reported at increments of 0.1%, first to the regulator (from 0.3% until 0.4%) and then to the regulator and the market. In calculating whether a disclosure was required, market participants need to take account of any transaction which provided an economic exposure to a particular share. Hence transactions in exchange-traded and OTC derivatives would be covered as well as short positions in the cash markets. All disclosure reports of short positions – whether to the regulator or the market – would be made on the trading day following that on which the relevant trigger threshold had been crossed, a requirement that could greatly reduce the value of relevant information.

CESR’s Recommendations are a major step towards the establishment of a consistent Pan-European disclosure regime governing short selling. Yet its disclosure standards may not be sufficient to counter the destabilization effect of aggressive speculation by means of naked short sales during the period SEOS are priced.

5.4.3 A Model for the Regulation of Short Selling Around SEOs

As said earlier, short selling carries valuable information to the market and increases liquidity. Thus, it enhances, in some measure, market efficiency. The possibility of


85 See CESR Report, supra note 15.
short sales leading to a massive downward price spiral, in contexts other than new rights issues, is, arguably, the combination of two factors: rational investor response to bad news and socio-psychological reactions to falling prices, especially if the volume of short sales is significant, triggering herding behaviour by non information seeking ‘noise’ traders. Therefore, the true challenge financial regulators face is not how to ban short-selling, if it is agreed, in principle, that the ethical concerns short selling creates are outweighed by its beneficial impact on market efficiency.

Arguably, EU policy-makers and regulators should consider how to best achieve three objectives. First, they must create a transparent market which allows traders to have information on the volume of short sales with respect to a tradable stock and its potential price impact. Second, they must check the socio-psychological factors that would potentially cause a market over-reaction, which would destabilize the price formation mechanism. Third, in the context of short sales during SEOs, they must protect the EU capital formation mechanism and issuer’s interests against the whims of aggressive speculators. Arguably, all three objectives may be met through the implementation of a Pan-European regime that combines can be achieved through increased disclosure, circuit breaker halts on short trading, and a prohibition of ‘naked’ short selling during the period that SEOs are priced.

To put it simply, a regulatory strategy that merely focuses on disclosure, such as that endorsed by CESR, will provide unsatisfactory results. As explained above, the presence in the market of ‘noise’ traders and of high transaction costs for actual stock purchases means that arbitrage trading on the demand side, triggered by increased availability of information on the volume and price limits of short sales, may not materialize in such a quantity as to provide a counterbalance to the downwards price trends initiated by sizeable short-sales and especially ‘naked’ short sales. The inability of the market to provide stabilizers to unnecessary downwards price movements, inspite of increased availability of information, will trigger further sales due to herding with professional joining the herd to strengthen downward pressures. Therefore, a circuit breaker halt rule that operates on the basis of a sophisticated price threshold, is a necessary supplement to disclosure and possibly the only way to keep in ‘check’ the destructive ‘animal spirits’ preventing price falls from destabilizing the market.

The price limits incorporated in a circuit breaker halt rule should not exclusively calculate the fall in the market price of a specific stock just by reference to the previous day’s closing price or on the basis of intra-day price fluctuations. It is fairer to all market participants if the threshold also incorporates relatively longer term price trends. Moreover, if the circuit breaker rule is to act as a proper market stabilizer, then, the price threshold must be set in such a way as to also take into account levels of liquidity, which are different for stocks composing a developed market’s main index and for those in the periphery, as well as for stocks traded OTC. I have described this system elsewhere and thus I make reference to that publication for a detailed description.88

86 See section 5.3.1 supra.

87 See Section 5.3.2 supra.

88 See Avgouleas, supra note 84.
A thorny issue in the context of disclosure of short sales data is whether individual short selling positions should be disclosed to the market. The FSA’s Discussion Paper, accurately notes that ‘disclosure of individual significant short positions and of the identity of significant short sellers to the regulator or to the market can facilitate detection of short selling that is connected to market abuse’.\(^89\) This is because such disclosure allows the regulator to identify in a timely manner who holds the significant positions and ‘as necessary follow up any enquiries with that market participant’,\(^90\) stopping on its tracks any attempt to manipulate the market or profit from inside information. It also allows the market to reflect on the meaning of such trades and expose manipulators by taking opposite positions. Therefore, disclosure of individual short positions above a set threshold is an effective way to address the risk of market abuse through short sales.

On the other hand, the disclosure of individual significant short positions on real time or nearly real time basis ‘may dissipate the liquidity benefits of short-sales’.\(^91\) As the market may take opposite positions frustrating short seller’s investment strategy, it is possible that short traders may switch to other strategies in order to minimize this risk. Short traders will be particularly careful not to reveal their strategies. As a result, they might be hiding short sale orders in order not to reach the disclosure threshold. Thus, the volume of short sale orders entered into the market may be lower leading to substantial liquidity losses and even to have an adverse impact on the price formation mechanism and the information efficiency of the market.

The FSA notes that on balance: ‘[t]he benefits of reducing disorderly markets and abusive short selling can outweigh the costs associated with impaired market efficiency which may occur through any reduction of liquidity.’\(^92\) However, this need not be the case. Although it is not a low cost exercise, disclosure of aggregate short positions several times throughout the day, instead of publication of this data just once in the beginning of trading day, would be sufficient to serve the public interest objectives of disclosure based regulation of short sales without having to disclose on a real time or nearly real time basis individual significant short positions. On the other hand, real time or nearly real time disclosure of short positions to the regulator is not affected by any concerns of the short sellers being squeezed and gives the regulator the ability to monitor real time market activity and intervene in a timely manner, if suspicious activity is taking place. Subsequently, data about individual short positions may be released to the market by the regulator or the securities exchanges (on an anonymous basis) with a two or more hours’ lag. This time lag would be large enough to allow short traders to unwind their trades without any fear of the market taking an opposite position.

Finally, while short sales may be implicated in market abuse, this is usually an implementing strategy in the context of wider schemes to manipulate the market through the use of false rumours. It is, then, the latter area where regulatory efforts should concentrate on. Only ‘naked’ short sales have the potential to manipulate market prices without the aid of false rumours. Therefore, the best option is to allow

---

\(^89\) FSA, *supra* note 14, para 5.28.
\(^90\) Ibid.
covered short sales, \textit{i.e.}, where the short trader has already borrowed the shares, even if she expects to ultimately cover her position from the new issue, and only prohibit ‘naked’ short sales during SEOs. A ban of ‘naked short sales would restrict aggressive speculation aiming to drive the price of a new issue down. At the same time, this ban would not eliminate arbitrage activity, which may lead to a better pricing of the new issue: short sales may indicate that the shares are overvalued or that the purchase options are undervalued correcting observed mispricings.\footnote{Commissione Nazionale Per Le Societa E La Borsa (CONSOB), ‘Position Paper on Short Selling’ 27 May 2009, 20.}

5.5 Conclusion

Short selling is a source of major concern with regard to pricing of SEOs. It could also be used by insiders and manipulators to profit from the discrepancy between the prevailing market price and the offer price. Yet short selling may also be a significant source of market efficiency. The results of recent studies on the impact of the September 2008 ban show that the huge falls in the price of financial stocks were more due to a rational reaction to bad news, funding pressures, and irrational loss-aversion, fuelled by herding behaviour, and less the result of short selling \textit{per se}. Therefore, what is required is a regulatory strategy that assists rational traders to profit from arbitrage trading, while it also protects issuers from aggressive speculation and market irrationality. The same strategy must ensure that short sales are unlikely to be used to perpetrate market abuse.

This chapter has suggested that the best way to regulate short sales during SEOs in the EU is through: (a) the consistent implementation by member states of a ban on ‘naked short sales and (b) the introduction of Pan-European disclosure and circuit breaker regimes, which should cover short selling activity within and outside SEO periods. It is submitted that the adoption of these recommendations would facilitate capital formation in the EU by reducing the cost of raising new capital and containing price volatility, while safeguarding the price efficiency benefits that short selling may bring.