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Should short-selling be reintroduced?

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Short-selling curbs help rig share prices

Removal of all restrictions on short-selling would be the single most important step towards making Indian capital markets cleaner, safer and more efficient. All institutions (including banks, FIs, MFs and FIIs) are prohibited from short-selling in the Indian capital market. This long-standing restriction has become more serious with the progressive institutionalisation of the capital market in the '90s.

Almost all the scandals in our stock market involve alleged attempts by the companies and their promoters to rig up the share prices of their own companies. In a free market, aggressive short-selling by rational investors would be a powerful weapon against them. With short-sale restrictions, however, the best that rational investors can do is to sell all their holdings. Once they have done so, they make no further contribution to price discovery. Market prices are then determined by the alleged manipulators and less rational investors (momentum investors and passive or indexed investors).

Short-sale restrictions constitute an open invitation to promoters and managements to rig up the share prices of their own companies. Perhaps inadvertently, the regulatory regime has come to fulfil the fondest dream of these market manipulators.

The US also has short-sale restrictions introduced in the '30s as a misguided knee-jerk reaction to the great depression. The Enron and other debacles there have demonstrated that continuing with these archaic restrictions was a big mistake. These scandals tarnished the reputations of the SEC and all other regulators. The one group that came out with flying colours was the short-seller who kept pointing at the skeletons in Enron's cupboard. It is time for even the US to allow free short-selling.

If our markets are more susceptible to market manipulations than the US market, we should move faster than the US to remove these restrictions. We must create an effective and viable mechanism of securities lending and allow both institutions and individuals to short-sell without restriction.

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Yes, it'll help make price discovery efficient

Contrary to popular perception, there is at present no ban on short-selling of shares. Any person having a bearish view can be short in the futures segment or can buy put options or can sell call options. What is prohibited currently is the activity of share borrowing and lending for the purpose of short-selling in the cash segment of the equity market.

Many perceive short-selling to be the cause of market crashes and hence short-selling is tarnished. However, banning short-sales does more harm than good. The premise that short-sellers cause a permanent fall in the share prices is suspect. Any security which is short-sold has to be bought back and there is no permanent supply of shares by short-sellers.

There are three types of participants in the stock markets. These are investors, arbitrageurs and speculators. Investors buy and sell shares according to their investment or fund requirements. Arbitrageurs do not have any net short or long position. If they are short in one segment of the market, say the cash segment, they have a corresponding long position in some other segment like the futures segment. Speculators take a view on the movement of stock prices and accordingly go long or short.

On account of prohibition of share borrowing and lending, investors are deprived of the opportunity to make additional returns on their holdings by lending shares to short sellers. Arbitrageurs can only go long in cash and short futures. They cannot go short in cash and long in futures. This distorts the futures market as many futures trade at a discount to the cash market. This is a sign of an inefficient market. Also speculators who wish to take a bearish view are put at a disadvantage as many a times futures trade at a discount to the cash market.

In my view removal of the prohibition on share lending and borrowing will help in making price discovery more efficient without affecting the basic course of the market. It may also curb volatility by giving an equal opportunity to both the bulls and bears.

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