Wachtell Lipton Calls for Urgent Action on Short Selling

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But the signatories fail to give evidence why, following a disturbing trend.

Earlier this week, many European regulators banned short selling. The European Securities and Markets Authority (ESMA) issued an official opinion agreeing with the prohibitions. [1] Spain, Belgium, Italy, Greece, and France now restrict various forms of the practice. The U.K. was forced to follow on certain securities listed in those markets.

Renown New York law firm Wachtell Lipton just called on US regulators to consider the same. [2] In a memo to clients, signed by five of its partners, the firm cited "long-term failures in securities regulatory regimes ... to properly address short selling" and a "lack of accountability for market-moving propaganda attacks – poses risks to companies." They also reiterated their prior views for reinstatement of the great depression era uptick rule.

Conspicuously absent from the memo was evidence.

To be fair to the firm, the memo didn't call for an outright ban on short selling. But it takes a second read to realize this. The tone is one of complete agreement with recent European actions. And although they do not call on US regulators do to the same, they cite the turmoil currently gripping the US as a basis for an urgent need for regulatory action.

The memo may not come as a surprise to some market observers. Wachtell Lipton is the inventor of the poison pill. They represent incumbent management at firms subject to takeovers and the advances of activist investors. Consistent with this, their memo quickly refers the reader to other reforms that would advantage their clients.

The danger is that this slippery type of client advocacy, coming from a reputable firm, adds to the chorus of uninformed voices calling for draconian actions that will harm markets, not help them.

Short sale bans impair capital formation

For firms seeking new capital, issuing equity is a non-starter in the current environment. And for many firms, imperiled future earnings don't support the coupon payments required to issue straight debt. In the public issuance market, this leaves convertible bonds. These instruments embed a future equity conversion option in exchange for lower immediate interest payments. That makes them popular among financially stressed firms, particularly in times like these.

Convertible bond issues provided more than $50 billion in financing to corporations during 2018 and 2019. And as of the end of February, projections by one firm estimated it would be nearly

$60 billion in 2020. [3]

A ban on short selling will turn off this important capital raising method. This is because the vast majority of buyers hedge out the equity risk by short selling the underlying stock. Taking offsetting positions in the bond and stock minimizes the volatility of their portfolio strategy. And it also serves to minimize pricing errors between the issuer's bond and stock prices. Most notably, the shorting is done as stock prices increase, which is not predatory.

Convertible bonds become too risky when buyers cannot short the underlying security. We learned this from the last financial crisis. After Lehman failed, and the SEC enacted a short sale ban on financial stocks, the market dried up. There were no more issuances by financial firms. And that was bad for banks, who had until then relied on these instruments to shore up their balance sheets.

Short sale bans also impair market quality

Financial researchers have had a decade to study the effects of the short sale bans enacted during the 2008 financial crises. The overwhelming evidence is that the measures did not achieve intended goals. To the contrary, liquidity deteriorated, volatility increased, and price discovery slowed. [4] The effects were particularly acute among smaller firms, and those without traded options.

It is also true that the ban may have temporarily propped up prices among companies where there was a lot of uncertainty. [5] This made them over-valued relative to other firms, which persisted until the ban was lifted.

While a potentially appealing prospect to some firms, particularly those in industries most affected by the coronavirus, the same research also showed a significant deterioration in market quality that lasted even after the ban was lifted. This adversely affected many other firms. That is, the ban caused a distortion that benefited some companies at the expense of others.

In general, studies show that short selling improves price efficiency, and restrictions impair market quality. [6] And returning to short-selling attributed to the issuance of convertible bonds, research shows that it improves liquidity and decreases return volatility of the issuer's traded stock. [7]

But everyone's doing it

This seems to be the predominant rationale for a ban. And this is what happened last time. The SEC caved to pressure during the 2008 financial crisis. After the U.K. Financial Services Authority (now the Financial Conduct Authority) announced a ban, the U.S. followed suit. But here is what the former SEC Chairman, Chris Cox, said about that decision in an interview with Reuters:

"*While the actual effects of this temporary action will not be fully understood for many more months, if not years, knowing what we know now, I believe on balance the commission would not do it again," followed by, "The costs appear to outweigh the benefits*."

The preponderance of peer-reviewed academic research overwhelming supports what former Chairman Cox had already realized just a couple of months after the ban was lifted. Short sells bans don't help. They hurt.

A great deal of credit goes to the current SEC Chairman, Jay Clayton, for resisting pressure to follow other regulators, or listening to voices that reflect a poor understanding of markets. While each bad market day will make it harder to say no, for now he is standing on the right side of history.

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[1] See the following statements (1) https://www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-bans-net-short-positions-belgian-fsma-and-greek; (2) https://www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-italian-consob-1; and (3) https://www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-french-amf

[2] The memo was not yet posted on their website at the type of writing, but if follows an earlier memo found here: https://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.26823.20.pdf

[3] https://www.calamos.com/globalassets/media/documents/product-literature/investmentprofessional/us-convertible-market-snapshot.pdf

[4] Beber, Alessandro and Marco Pagano, 2013, "Short-selling bans around the world: Evidence from the 2007–09 crisis." The Journal of Finance, found at: https://ssrn.com/abstract=1502184

[5] Autore, Don, Randall Billingsley, and Tunde Kovacs, 2011, "The 2008 Short Sale Ban: Liquidity, Dispersion of Opinion, and the Cross-Section of Returns of U.S. Financial Stocks." Journal of Banking and Finance, found at: https://ssrn.com/abstract=1422728

[6] See, e.g., Saffi, Pedro, and Kari Sigurdsson, 2010, "Price Efficiency and Short Selling." Review of Financial Stucies, found at: https://ssrn.com/abstract=949027; and Fox, Corbin and Eric Kelly, 2018, "Causal Effects of Short-Selling Supply on Market Quality." Working paper found at: https://haslam.utk.edu/sites/default/files/files/Fox%20and%20Kelley-%20Short%20Selling%20Supply%20on%20Liquidity.pdf

[7] See, e.g., Choi, Darwin, Mila Getmansky, and Heather Tookes, 2009, "Convertible bond arbitrage, liquidity externalities, and stock prices." Journal of Financial Economics, found at: https://ssrn.com/abstract=891657

[8] Rachelle Younglai, "SEC chief has regrets over short-selling ban," Reuters, December 31, 2008, found at: https://www.reuters.com/article/us-sec-cox/sec-chief-has-regrets-over-short-selling-ban-idUSTRE4BU3GG20081231