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## The folly of demonizing short-selling

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Japan has imposed stricter restrictions on short-selling in the aim of stemming the equity market's decline. However, even with such restrictions, equity prices have no prospect of rising unless the consensus economic and corporate earnings outlook improves. Moreover, short-selling restrictions pose a risk of diminishing liquidity and impairing the market's price formation mechanism.

## Clampdown on short-selling in Japanese market

The financial market turmoil triggered by US subprime mortgage woes has escalated into an international financial crisis likened to a hundred year storm. Fortunately, markets are regaining stability by virtue of major countries' closely coordinated policy responses. Nonetheless, the outlook remains fraught with risk, particularly vis-à-vis the real economy.

Against such a backdrop, even Japan, whose financial institutions are seen as largely unscathed by the crisis, has unveiled a series of economic and market stabilization measures since October. One such measure is short-selling restrictions aimed at stabilizing the equity market.

Short-selling is a trading strategy whereby one sells borrowed shares in the aim of buying them back later at a lower price. It is a legitimate economic activity that enhances market efficiency and liquidity and shapes prices to reflect the investment views of investors that do not own the stock in question. However, some blame short-selling for exacerbating market selloffs. Cases of market manipulation through intensive short-selling of certain stocks have in fact been reported overseas.

Even during the current financial crisis, financial institutions rumored to be of dubious creditworthiness were allegedly targeted by short-sellers in the aim of market manipulation. In response, the US and UK imposed more stringent restrictions on short-selling from September, including a complete ban on short-sales of designated stocks.

Japan initially refrained from following suit because its short-selling regulations (e.g., uptick rule) were stricter than most other countries' to begin with and its financial institutions' stocks had not been targeted by mass short-selling. After the Nikkei 225 had fallen to new post-bubble lows, however, calls for measures to support stock prices grew louder from late October. In response, the regulatory authorities tightened restrictions on short-selling. Japan now has the most stringent short-selling regulations of any major country (see table).

Exhibit. Comparison of short-selling regulations in Japan, US, and UK

| | Japan | US | UK |
|---|---|---|---|
| Prohibitions against short sales | Through March 31, 2009, short sales of all stocks are prohibited without prior confirmation that the shares have been borrowed | Brokers that have failed to delivered shares by the start of trading on the day after the scheduled settlement date are generally prohibited from further short-sales of the same stock unless the shares have been pre-borrowed* | Short sales of 34 financial institutions' stocks are banned through January 16, 2009 |
| Price restrictions on short sales | Short-selling on downtick or zero-downtick is prohibited | Prohibition against short-selling on downtick or zero-downtick was repealed in July 2007 | No restrictions |
| Duty to report short positions | Short positions in any stock equivalent to 0.25% or more of the outstanding shares must be reported to the applicable exchange (reports are published on the exchange's website) | On the first business day of every week, institutional investors with assets under management of $100mn or more must report short positions as of the previous week-end (reports are generally not made public) | For stocks subject to the short-selling ban, short positions of 0.25% or more of the outstanding shares must be reported |

*The US imposed a blanket ban on short-selling of all financial stocks from September 18 through October 8, 2008.
Source: NRI, based on data from various sources

## Short-selling restrictions do not boost share prices

If restrictions are to be imposed on short-selling, their purpose should be limited to preventing market manipulation. If excessive restrictions that go beyond this limited purpose are imposed on trading, they could detract from market liquidity and impair the price formation mechanism. From such a perspective, the US and UK have been careful to avoid overregulation.

In Japan, by contrast, short-selling tends to be widely "demonized," with sharp equity market selloffs often blamed on short-selling (e.g., by foreign hedge funds). There is also a strong sense of confidence in short-selling restrictions' capability to boost equity prices. These perceptions appear to have gained credence from the equity market's sharp rebound on October 28, when the revised short-selling restrictions were rushed into effect ahead of the initially announced schedule.

However, such confidence in short-selling restrictions' efficacy is, alas, essentially groundless. Even if short-selling is banned, stock prices will fall if shareholders sell their stock cheaply in response to a heavily bearish outlook for economy or corporate earnings. A case in point is the US and UK short-selling bans' failure to halt the selloff in the financial stocks subject to the bans. In the Japanese market, hastened effectuation of the tightened short-selling restrictions triggered an equity market rally, but the rally proved to be merely a brief spike fueled by short-covering among certain investors averse to the new restrictions.

Since the tightened short-selling restrictions took effect, the Tokyo Stock Exchange's average daily trading value has fallen from over ¥2trn to around ¥1.5trn, with daily trading value as low as ¥1.2trn on some days. This trend raises concern that investors may have started to quietly exit the market.

## Lamentable Japanese markets

While a declining or depressed equity market is certainly undesirable, equity prices have no prospect of rising without improvement in the consensus outlook for corporate earnings and the economy. Makeshift measures to prop up share prices are senseless.

Moreover, such regulatory meddling has previously had unintended detrimental consequences. In the early stages of the Japanese equity market's downturn from 1990, Nikkei 225 Index futures trading on the Osaka Securities Exchange was demonized as the main culprit behind its decline. Regulators intervened by raising transaction costs to curb trading in index futures. Trading in Nikkei index futures consequently shifted from Osaka to Singapore. Needless to add, the clampdown on futures trading utterly failed to boost share prices in the cash market.

Even if the short-selling "boogeyman" is banished from the market, share prices will not rise as anticipated amid mounting concern about the economic outlook. Instead, liquidity is likely to dry up and the price formation mechanism atrophy as investors abandon the market. An active OTC market for Japanese stocks could even emerge offshore (e.g., Hong Kong, Singapore).

Equity prices are a barometer of economic conditions. Tampering with the barometer will by no means improve the economic conditions that it reflects. It is lamentable that this truism still eludes Japanese markets nearly 20 years after equity index futures trading was futilely demonized.

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