

Corpsec Hotline

November 18, 2008

SHORT SELLING: WAS THE REGULATOR'S APPREHENSION MIS-FOUNDED?

Short selling (sale of a security that the seller does not own) is one of the long-standing market practices, which has often been the subject of considerable debate and divergent views in most of the securities market across the world. The votaries of short selling consider it as a desirable and an essential feature of a securities market. The critics of short selling on the other hand are convinced that short selling, directly or indirectly, poses potential risks and can easily destabilize the market.

Even recently, short selling practice was accused to be the main culprit behind the sharp falls across global stock markets, as a result of which many countries, specially US, have temporarily banned the practice in respect to certain stocks relating to financial sector companies.

The Indian regulators were not far behind with the Securities and Exchange Board of India ("SEBI") imposing a fictional curb by disapproving of overseas short selling by foreign institutional investors ("FI") in pursuance of offshore derivative instruments ("ODI") issued by them (please refer to our hotlines [SEBI disclosure on overseas securities lending: Falling 'short'? dated October 16, 2008](#) and [P Notes- Almost Full Circle dated October 8, 2008](#)), which they apparently thought was the reason behind the steep fall of Indian stock markets. However, a newspaper report in [The Economic Times dated November 15, 2008](#) suggests that there is no link between ODI induced short-sales overseas and the market fall in India. As per the report, a senior official in the Finance Ministry (name was undisclosed) stated that only 0.2% of the total 10,000 crore shares in 224 companies (19.2 crore shares) were lent by them abroad till October 9, 2008; besides, price movements in 10 biggest price losers in the domestic market had no relation with the overseas lending activity in their scrips. The official further affirmed that in ninety percent of the cases where prices fell steeply, at most only about 0.01-0.02 % shares were lent offshore and also avowed that the non-promoter holding in the 10 firms which saw the largest fall in prices was just 0.58% of their total paid-up capital.

A conspectus of the factual matrix of the above suggests that the stock market crash may not be a direct result of short selling of stocks overseas in pursuance of ODIs issued by FIIs. It may have been a measure that SEBI imposed in a hurry to prevent the percolation of the financial crises into Indian market despite of the fact that short selling may have had no role to play in the stock market crash in India.

However, SEBI still believes that ODI induced short-sales overseas was the main reason behind the recent stock market collapse in India. An article in [Indiaainfoline.com dated November 18, 2008](#) provides that SEBI has announced that it would come up with new rules for stock lending and borrowing by next month. The article provided that this move by SEBI is aimed to curtail ODI induced short-sales overseas and to monitor the lending and borrowing by overseas investor.

Keeping in view the above analysis and the current crunch in the inflow of the foreign currency, we believe that SEBI must relax its stand on the short selling of stocks overseas as it may enhance the liquidity in the domestic market. While international securities market regulators have recognized that short selling can exacerbate market falls and lead to manipulative activities, most of the jurisdictions have also recognized short selling as a legitimate investment activity that has contributed significantly to market liquidity. Thus, this relaxation may be done sparingly and with utmost care and caution, as the same if misused in current market conditions, could translate into an unprecedented financial turmoil.

- Vedant Shukla & Divaspati Singh
You can direct your queries or comments to the authors

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