The Nature and Impact of Short Selling in the Hong Kong Stock Market

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1. Background and aims of project

Since the formation of the earliest stock markets, an ongoing debate has taken place as to the morality and fairness of shorting the market. On the one hand, short sales are argued to be essential to the efficient processing of information in asset markets. On the other hand, a pejorative view exists that argues short selling causes excessive volatility and, in the extreme, destabilises markets.

These different points of view on short selling have very different regulatory implications. On the one hand, the eulogistic suggests that short selling is both legitimate and necessary to ensure the efficient workings of the market. On the other hand, the pejorative view casts a far more sinister shadow over the role of short selling and suggests that short selling should be tightly controlled and monitored, at the very least, if not banned outright.

It is interesting to note that the academic literature has very little to say on this issue. This is most likely a function of the fact that only a very limited amount of very low frequency (monthly) data is available, often with significant lags.

2. Significance and innovation

The aim of this project is to provide some unique and original insights into the nature, impact and regulatory implications of short selling. Specifically, this research will focus on enhancing our understanding of short selling in two different areas. The first issue relates to the orderly conduct of the market. Although volatility is most frequently thought to be the primary source of concern with short selling, our discussions with the SFC indicate that it is in fact, the potential for disruption to the settlement process that is of greater concern. When a short seller fails to deliver on a contract, the exchange will invoke its buy-in rules and settle the trade. Usually some form of penalty is imposed on the defaulting party (for example in the case of the LSE, a dealing fee, daily penalty and interest charge are imposed). Naked short selling may impose significant delays to the settlement process where the exchange has to invoke the buy-in rule causing great disruption to the market. Very little is known about this aspect of short selling and to the best of our knowledge, this study will be the first to investigate this issue. The SFC is able to provide detailed information on daily buy-ins for the Hong Kong market. In particular, information over the highly volatile August, 1998 period is available, which was a time of unprecedented short selling the in Hong Kong market. Market buy-in procedures are a primary concern of stock market regulators and this study will provide detailed information which has direct implications for the regulation of short selling activity.

A second issue which this study will consider relates to the cost of short selling (see D'Avolio, 2002, Falkner**,** 2006). Where the exchange imposes vesting rules, the short seller must borrow the stock prior to initiating the trade. The short seller must pay a fee for this service, which varies over time. The aim of this part of our project is to establish the nature of the costs of stock lending and document the variability of these costs in relation to the conditions in the market. In Hong Kong, the Pan Asia Securities Lending Association (PASLA) is a collective group representing some of the major suppliers of hypothecated stock to the market. Discussions are currently underway with PASLA to secure data that would allow a detailed study on the cost of stock lending. Information as to the costs of short selling and how these costs respond to market conditions will prove invaluable to market regulators in understanding market dynamics.

3. Description of Approach

Through a strategic alliance with the SFC, this study is uniquely positioned to provide some highly original insights into the issue of short selling in the areas of the nature of short selling trading strategies, the costs of short selling and the potential for short selling to disrupt the settlement process. This highly innovative project aims to not only investigate information available on short selling for the Hong Kong market, but also to create information as to the nature of short selling trading strategies. This latter initiative will be undertaken in conjunction with the SFC and has their full support.

References

D'Avolio, G. (2002) "The Market for Borrowing Stock" Available at SSRN: http://ssrn.com/abstract=305479

Falkner, M.C. (2006) "An Introduction to Securities Lending" 3rd Ed., SpitalFields Advisors