Short Sell Ban

The Impact of Recent Short Sell Regulation on the Marketplace

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Over the past few days we have seen a number of new regulations imposed on short sellers, and we would like to take this very early opportunity to look at the impact these new regulations are having on the marketplace. We will summarize the timing and actual regulations put into place and look at a variety of liquidity factors for each of the UK, U.S. and Canadian marketplaces and see what early indicators we can detect.

The U.S. Market

The SEC started the ball rolling by issuing an emergency order before the open of trading on Thursday September 18 that forced broker dealers to enforce pre-borrow on any short where they had a fail as a result of an existing short trade, even if said trade was affected by a different client. We would argue that due to administrative logistics the SEC really ended up forcing the dealers to enact pre-borrow on all shorts but was able to do so without looking like the bad guy. At the same time they also removed options market makers exemptions from Reg SHO and informed the street that deceiving your broker dealer regarding stock locate was now a jailable offense.

Then on Friday morning, after watching the U.K.'s FSA ban shorting on 32 financial sector stocks, the SEC issued a second order banning short sales on 799 financial stocks. It all issued an order requiring "All hedge funds and asset managers with at least $100 million under management" - (which means all asset managers of size but we really want to bad mouth those hedge guys) – disclose weekly their short positions to the SEC, for public disclosure two weeks later. (This is the SECs attempt to shame market participants out of shorting stocks…it will be interesting to see what effect this has on retail facing asset managers that run legitimate long-short or short extensions funds...will they endure the shame of making the list or simply shut down any strategy involving shorts to avoid being tainted?)

On Monday Morning the SEC delegated responsibility for identifying financial sector stocks to the primary listing exchanges (NYSE and NASDAQ) and as a result the list of stocks covered grew by a few dozen names.

When all is said and done the SEC has banned short selling in over 800 financial services stocks, and banned trading in put options on these stocks as well as naked writing of call options on the names. They have included a number of exemptions the most important of which are for block facilitation and OTC derivative market makers being able to affect any trade which hedges delta. All of these rules (with the exception of the rule making deception around stock locate a jailable offense) are set to expire at midnight October 2nd.

The Canadian Market

The Canadian regulators issued a statement late Friday night (Sept. 19th) banning the short sale of 13 inter-listed (with the U.S. market) financial services stocks. The ban, which was effective as of Monday morning and expires at midnight Oct. 2nd, didn't ban put options or writing naked calls. The original OSC order didn't include exemptions for block facilitation or delta hedging – but they have revised that this morning to allow block facilitation and hedging of any position that existed before the order was released. The original order also banned the shorting of preferred stock and debentures issued by affected financial services firms – this ban was lifted last night such that only common stock shorting is banned.

The key difference in the Canadian and U.S. rules are:

1) Canadian exemption for market makers only includes those market makers designated by the exchange. The U.S. rule exempts anyone who is acting as a market maker regardless of exchange designation.

2) The U.S. exemption allows for OTC derivative market makers to delta hedge any positions while the Canadian rule only makes an exemption for delta hedging any position taken before the order became effective.

3) Canadian rule has not restrictions on trading options, U.S. rule bans puts and naked short calls on the financial names.

4) The Canadian exemption allows for program trades (baskets of cash equities traded against derivatives) which allows for index and ETF arb. The U.S. exemption is less clear on this point.

The London Experience

The UK regulator (FSA) announced last Thursday, Sept. 18th, that they would be banning short sells on 32 financial services stocks. The major difference with the UK rule is that it is in effect until January 19th, 2009. The UK rule did not ban trading on puts or writing of calls and also included exemptions for delta hedging and program trading.

So What Does this all mean for the Market?

While the sample set of trade data since the new rules is incredibly small we still think it is instructive to take an early look at how markets are reacting to these news rules, and attempt to explain the reaction. We would caution that not only is the sample set small but there is an incredible amount of other 'noise' in the market with the treasury bailout, exploding overnight borrow rates, the U.S. election rhetoric and more.

The first data points we have chosen to look at are average spreads of stocks in the S&P 500 and TSX/S&P 60 indices.

The S&P 500 index had an average spread during the week of September 8th -12th of 7.22 basis points. This number is fairly consistent with the spread levels we have observed over the past several months for this index. Last week (Sept 15th – 19th) that spread blew out to 10.8 basis points – an increase of 49% and on Friday the average spread was 14.54 basis point – a 100% increase from 2 weeks ago. Yesterday the average spread came back to 9.34 basis points.

The TSX/S&P 60 index had an average spread during the week of September 8th – 12th of 7.59 basis points. This is also consistent with observed values over the past several months. Last week this number increased to 8.98 basis points, with an average spread of 8.52 basis points last Friday. It is notable to see the difference between the spreads in the S&P 500 and TSX/S&P 60 last Friday when only one marketplace (U.S.) was banning shorts in financials. Yesterday after the Canadian ban on shorts was announced spreads in the 60 index blew out to 11.19 basis points.

We have also looked at spreads in affected and non-affected financial stocks to compare spreads. We randomly chose TD bank to represent the banned short stocks and National Bank to represent the non-banned names. 2 weeks ago TD's average spread was 6.01 bps. It increased to 7.42 bps last week with the lowest spread of the week on Friday at 5.14 bps. It then blew out to 13.33 bps yesterday after the ban. National has always had a slightly higher average spread – 7.17 bps 2 weeks ago, 13.51 last week and 8.53 bps on Friday. Yesterday NA's spread was 13.59 bps – almost identical to TD's spread.

Table 1: Summary Table

	2 Weeks Ago	1 Week Ago	Friday	Monday
SP60	7.59	8.98	8.52	11.19
SP500	7.22	10.80	14.54	9.34
TD	6.01	7.42	5.14	13.33
NA	7.17	13.51	8.53	13.59

The second factor we have looked at is volume. During the week of Sept. 8th – 12th the S&P 500 components traded 1.3 billion shares on their primary exchanges. That number increased to roughly 1.9 billion shares last week with a high water mark of 2.6 billion last Friday. The number that jumps out is yesterday's volume fell sharply to just over 1 billion shares. We witness similar patterns in Canada with the TSX trading 831 million shares on Friday – up from an average of just over 430 million – and then falling back to 410 million shares yesterday.

Looking at this very limited data set we would argue that the introduction of the short sell restrictions has resulted in widening spreads and lower volumes – after an initial reactionary burst of activity. We

would suggest that the inability of derivative desks to hedge any newly created positions will greatly limit their market activity over the next several days, negatively affecting market liquidity. While this trend may not do any long term damage to our marketplace, if this order were to be extended we would certainly be concerned about the longer term repercussions. We will be following the spread and volume data over the next few days to fewer determine the net effect of these new regulatory bans.

Ideally we would like to see the regulators allow any trading that does not inflict a net short delta onto the marketplace. This would include granting derivative market makers the ability to put on new positions that are delta neutral of delta long and dynamically hedge these strategies.

The intention of the regulators is to thwart predatory short selling of financial stocks. To that end any strategy that results in a delta neutral position is not a threat to market integrity and can only help increase market liquidity and efficiency. We believe the locate and borrow regulations imposed by the SEC were better aimed at the predatory shorts without negatively effecting legitimate arbitrage strategies.

Finally we would suggest to all those that are clamouring for the return of the tick rule that this ship has sailed. Most if not all of the trading venues around the globe have undergone software updates in the many months since the tick rule was abolished in the U.S. and it is safe to assume that these upgrades paid little or no attention to the tick feature. Any attempt to rush back a tick rule – despite a lack of evidence that it would help at all – would only tempt a significant technology disaster in the marketplace.

If you have any questions regarding these changes please contact the BMO Quantitative Execution Desk at 416-359-5743.

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