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SHORT SELLING AND ITS REGULATION IN INDIA IN INTERNATIONAL PERSPECTIVE

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Executive Summary

Need for study

In India, the need for introducing regulation of short sales has been felt for many years but no tangible progress has been made in evolving such regulation. In order to understand the regulatory problem, one needs some foundational knowledge. The concept of short selling, its desirability or otherwise, its effects on the market and the economy and its appropriate regulation, are matters which are not generally understood in India. This study begins by providing a theoretical foundation for understanding the various aspects of short selling in a systematic way distinguishing between its legitimate uses from abusive uses. Its regulation has to be designed to prevent the abusive uses.

Approaches to regulation

A short sale is a sale of securities which the seller does not *own* at the time of effecting the sale. The U.K. and the U.S. represent two diametrically opposite approaches to the regulation of short sales. The U.K. never had, nor felt the need for, any regulation of short sales till now. In the U.S., on the other hand, the need for short sales regulation was felt very acutely in the depression period after the October 1929 stock market crash. The U.S. Securities and Exchange Commission (SEC), established in 1934, introduced short-selling regulation in 1937 as a very crucial component of its securities market regulation.

The U.K.'s approach

The study brings out the distinctive characteristics of the London Stock Exchange (LSE), specially in order to understand why it felt no need to regulate short selling.

Upto early 1994, London had a fortnightly settlement system. India too had a fortnightly system. Many people are mistakenly under the impression

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that India's and U.K.'s fortnightly settlement systems were similar. It was not so. *All trading on LSE was always delivery-based* even when it had fortnightly settlements before adopting rolling settlement in 1994. In contrast, in India, deliveries were only about 10% of the trading volume. Such a huge difference explains why the Indian stock market had recurrent crises throughout, but it was nothing like that in the U.K. Further, while London was able to change to rolling settlement system since 1994 smoothly and without resistance from brokers, the rolling settlement was stiffly opposed by the broking community in India.

Our analysis brings out that the quality of stock exchange's governance is the most important differentiating factor among the stock markets of the world. In the U.K., apart from the London Stock Exchange's traditional conservatism, the usual surveillance and disciplinary measures by exchange authorities themselves have sufficed to stop abuses, like price manipulation and over-speculation. On the other hand, in India, the governing bodies of broker-controlled exchanges have been extremely lax throughout. The comparison of the historical evolution of stock markets of U.K., U.S. and India made it clear that the most critical factor, which made all the difference to the regulatory structure and its effectiveness, was the quality of governance of the stock exchanges.

The U.S. before 1930s and India even today represent failure of governance of their exchanges. After the creation of the Securities and Exchange Commission (SEC) in 1934 in the U.S., the New York Stock Exchange (NYSE) and other exchanges were brought under SEC's supervision. Among the first acts of the SEC was to change NYSE's governance structure. India is still struggling with this problem.

The U.S. approach

The study goes into the evolution of short-selling regulation in the U.S. The SEC, which was created in 1934, designed its short-selling regulation to achieve the objective of allowing relatively unrestricted short selling in an advancing market but preventing short sellers from accelerating a declining market.

The SEC Rule 10a-1 prescribes that short-selling is permitted at a price as defined below:

(1) At a price **above** the price at which the immediately preceding sale was effected (plus tick), or

(2) at the last sale price if it is higher than the last different price (zero-plus tick).

This rule, known as "tick-test", is linked to the last reported market price. *In no case is any short sale permitted below the* ***last (i.e. latest) reported*** *price.* A short sale is permitted if it passes the "plus tick" test or the "zero-plus tick" test. The "plus tick" test means that the short-sale price has to be *above* the reported price at which the immediately preceding sale was effected in the market. The "zero-plus tick" test means that the short-sale is allowed *at the last* reported sale

price if such price is higher than the last *different* price. The tick-test is a kind of formula which is supposed to automatically distinguish a declining market from a rising market. As the wording of Rule 10 a-1 is not easily understood by many, we have explained it in the study by giving a practical example.

The SEC rule also requires that *every short sale transaction has to be disclosed upfront* to the dealing broker who is held responsible for ensuring that the transaction does not violate the tick test. This prevents surreptitious short selling.

No proof of intent needed

An important merit of the U.S. system of short selling regulation is that the *regulator is not required to prove short seller's intent* or motive of abuse, even though it is designed specifically to strike at the abuse. Proving intent is always difficult, often impossible. The administrative discretion is also entirely excluded under the tick test.

What India needs

In India, the High Powered Committee on Stock Exchange Reforms (1984-85) for the first time expressly stated that *India needed short selling regulation on the U.S. pattern because of serious weakness of the governance of stock exchanges.* This supports our point about the critical importance of the quality of stock exchange governance. The Committee found that *speculative activity in Indian stock market was excessively high on both bull and bear sides.* This is indicated by the fact that only a minute fraction (around 10-15%) of the total trading volume in India is delivery-based. Strangely, as per NSE data, deliveries continue to be almost at the same low level even after the adoption of rolling settlement system. There is need for looking into the persistence of such a low level of deliveries in India.

In late 1996, due to prolonged depression in the stock market, the need for controlling bear-side speculative activity began to attract special attention. The SEBI appointed the B.D. Shah Committee to recommend a suitable system for regulating short selling. The Committee came up with the idea of "differential margins", i.e. charging a *higher margin during market's declining phase on daily outstanding short sale positions than on long purchase positions* and doing the opposite during a bull phase. Our detailed examination shows that the Committee's recommendations were perfunctory and of not much value.

On the basis of our detailed examination of the provisions of the U.S. short selling regulation and its long history of working for over 60 years, we are convinced that the tick-test of the U.S. type would be the ideal way of regulating short selling in India. To improve it further and simplify its implementation without reducing its effectiveness in the least, we are suggesting an important change in the bench-mark price to be used for its application in India. The proposed change is explained below.

Base the tick-test on preceding day's closing price

We suggest the use of *closing price* of the *preceding day* as the bench-mark for applying the tick test in India instead of the last reported price available at the time of short sale on the transaction day itself. The use of preceding day's closing price would make the regulation more effective and simpler.

There are two weighty reasons in favour of our suggestion. Firstly, it becomes difficult to apply the tick-test on the basis of the *last reported price* at the time of short sale in an environment of quick, and sometimes violent, up and down intra-day price movements. Secondly, it can be argued that the successive intra-day price movements cannot really be regarded as indicating a declining or rising market trend, which the tick-test formula is intended to distinguish.

Upfront identification of every short sale

From the viewpoint of ensuring compliance and preventing manipulative use of short selling, we consider that the upfront identification of every short sale transaction is absolutely essential, as in the U.S. It is not at all valid to argue that such upfront disclosure is not possible in India. If the U.S. could implement it over 60 years ago when modern technology was not even available, why can India not do it today with state-of-the-art technology? The study has also suggested a regular system of reporting "short interest", i.e. scripwise aggregate outstanding short sale positions on daily basis.

We suggest that the short selling regulation should apply generally to all listed shares subject to certain practical considerations, like availability of trading price and traded volume data on regular basis. The Shah Committee scheme arbitrarily covered only 15 most actively traded scrips.

What about regulation of bull-side excesses?

Undoubtedly, the absence of short selling regulation in the speculatively surcharged atmosphere of the Indian stock market has been a critical regulatory gap. This should be filled. At the same time, we feel that without regulating the bull-side excesses also, not much can be achieved by short-selling regulation alone. The Indian stock market has suffered because it had no forward-looking and systematic regulation of both bull and bear-side excesses. We must plan to regulate both on a consistent and well thought out basis and not haphazardly on ad hoc basis from day to day, as till now.

It is absolutely necessary that the *short-selling regulation should be operated along with margin trading regulation*. In our opinion, the minimum initial margin for margin trading should be 50%. While the short selling regulation would help to control bear-side (down-side) speculative excesses, the initial margin for margin trading in shares will be instrumental in controlling the bull-side (up-side) speculative excesses. A regulatory system designed in this manner can acquire the automatism of thermostat control.

Chapter 1 : Introduction

Objective of study

In this study, we have undertaken a comprehensive examination of short selling and its regulation. Short selling refers to the trading practice of selling stocks which you do not own at the time of sale. The study is intended to provide a foundation for deeper understanding of such practice in both its positive and negative aspects. It considers its potentiality for making a positive contribution to the market's pricing efficiency as well as its potential for abusive use, like price manipulation and, therefore, the need for its regulation.

It attempts to present a balanced and objective view. We have argued that given the poor state of governance of the broker-controlled stock exchanges in India and an environment surcharged with excessive speculation, the absence of short-selling regulation is a critical regulatory gap in our system of market regulation. At the same time, we have also argued that it is equally necessary to have a strict system of margin trading regulation with minimum initial margin of 50% so that speculative excesses on both bear-side and bull-side can be brought under control. Controlling only one side will not achieve an orderly and economically efficient market.

Our exploration brought out a very significant but little-known fact that the U.S. and U.K., both of which have stock market-dominated financial systems, have adopted diametrically opposite approaches towards short-selling regulation. The U.K. has no such regulation whereas the U.S. has it as a very well-known and crucial component of its stock market regulatory system. We realised that this difference between the U.S. and U.K. told a very important story, and had relevance to the regulatory policies needed in India. We have investigated the reasons for such difference as it was found to be extremely illuminating. The study has been structured around a comparison covering the U.K., U.S. and India.

Chapter scheme

Following this introductory chapter, Chapter 2 provides an overview of short-selling, including the necessary theoretical foundation for understanding the subject. Chapter 3 is based on our exploration as to why the U.K. never had, nor felt the need for, any short-selling regulation. We bring out the implication that regulation through legislative provision is not the only way to deal with the short selling abuses or other kinds of abuses, and that we should not lose sight of the other ways which can help in controlling speculative abuses. Chapter 4 is devoted to the evolution of short-selling regulation in the U.S. and presents a detailed explanation about how its "tick-test" works, keeping in view its possible adoption in India. Finally, Chapter 5 is focused on evolving an appropriate system for regulating short sales in India. It traces the historical background and examines the characteristics of our market's environment. It also critically examines the earlier proposals about regulating short sales. It recommends the adoption of the tick-test type of regulation with some important modifications.

Chapter 2 : An Over-View Of Short Selling

Central issue: the market's pricing efficiency

The regulation of stock market should aim at achieving the ideal "market in which prices provide accurate signals for resource allocation."[1] In India, in the last few years, the Securities and Exchange Board of India (SEBI) seems to have come so much under the influence of the stockbroking interests that it began to focus mainly, or rather exclusively, on stimulating speculative trading volumes even by undesirable methods (like allowing different settlement cycles on different exchanges) in the name of enhancing market liquidity. It almost forgot that its main focus should have been on enhancing pricing and allocational efficiency, as universally emphasized in economic literature on securities markets. It is no surprise that the Indian stock market's development got completely derailed in the last few years.

In theory, speculation, whether in the form of short selling or long buying, is supposed to contribute to the market's pricing efficiency. Both over-valuation and under-valuation of stocks reflect market inefficiencies. Hence, any processes or institutional mechanisms which help to rectify over-valuation and under-valuation, or to control abuses like bear raids and corners, will also help to make the market pricing more efficient. Many kinds of market abuses have a long lineage dating back to the early years of securities trading.[2]

[1] See E. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," in *The Journal of Finance, May 1970,* specially p.383. See also Joseph E. Stiglitz, "The Role of State in Financial Markets," in *Proceedings of the World Bank Annual Conference on Development Economics,* 1993, specially p. 20.

[2] Government regulation of the stock market, in the sense in which we know it today, arose long after the emergence of stock exchanges. However, reckless speculation in the form of time bargains (i.e. settlement of trades by payment of differences) flourished both in U.K. and U.S. in the early years of their stock market. Courts in the U.S. declared time bargains as "wagering" contracts and, therefore, not enforceable. That is how the rolling settlement system was adopted in the U.S. in the securities market's relatively early stage but in the U.K. in 1994 only. Bear raids and corners (short squeezes) were also rampant. So were fraudulent company promotions which led the British Parliament to enact the Bubble Act of 1720. For early history, see Walter Werner and Steven Smith *Wall Street* (Columbia University Press, New York, 1991, pp. 98-101). See also Charles Geisst, *Wall Street: A History* (Oxford University Press, New York, 1997), specially Chapter 1. For India, the rampant practice of bear raids and corners was reported by the Atlay Committee of 1923 (see Chapter 5 below).

The theory of speculation mentioned above is based on certain assumptions which may diverge from reality to various extent in different environments. We must, therefore, understand the conditions under which the theory holds good. The single most important condition is that no individual or group can manipulate the price artificially, i.e. price is fair.

Under-valued stocks

If some stocks are *under-valued*, and if there are market participants who are able to identify such stocks correctly and follow the strategy of buying them, the price of these stocks will tend to rise with the result that the under-valuation will gradually disappear. As per theory, such market participants will make profits and the market's pricing efficiency will also improve.

Over-valued stocks

Similar logic applies to *over-valued* stocks. If we have market participants who can identify such stocks and follow a strategy of short-selling them, not only will they make profits but their activities will also enhance the market's pricing efficiency. Of course, a short-selling strategy is not as straight-forward as the strategy of buying under-valued stocks because the short seller has to borrow the stocks sold short till the entire process, including the return of borrowed stocks, has been completed.

Normal equity strategy

Buying under-valued stocks is a popular well-established equity strategy and is followed by innumerable individual and institutional investors. The constant search for under-valued stocks by so many investors makes the availability of under-valued stocks rather scarce, at least among large-company stocks.

The reverse "investment strategy"[3]

The reverse strategy involves identification of over-valued stocks and selling them short in order to earn a return in the form of profit from short selling[4] . It has been called reverse investment strategy because, instead of first buying and then selling, the order is reversed. The short selling strategy envisages first selling and then buying the same stock later in the expectation that the price will fall in the meanwhile and

[3] Bruce I. Jacobs and Kenneth N. Levy, "Long/Short Equity Investing" in *Journal of Portfolio Management,* Fall 1993, pp. 52-63. The authors recommend the incorporation of short-selling into equity strategies to earn return from over-valued stocks. They discuss the various issues involved.

[4] See Kenneth S. Nicholas Choie and S. James Hwang, "Profitability of Short-Selling and Exploitability of Short Information in *Journal of Portfolio Managemne,* Winter 1994, pp. 33-38. The authors provide empirical evidence showing that short-selling activity provides fairly attractive returns to short-sellers and also enhances market efficiency.

the short seller will be able to buy at a lower price than his sale price, thereby making a profit. There is nothing immoral about such a strategy.

Short-seller's risk

Short selling could result in a loss if the price goes up instead of falling in the subsequent period. In the case of investment made in the ordinary way (first buying and then selling), the potential loss is limited to a maximum of 100 per cent of the original investment. However, the potential loss in short selling can be much higher because there is no limit to price rise. Sometimes, bulls may generate the price rise artificially by cornering the floating stock. This happens frequently whenever there is large-scale short selling and bulls know that short sellers would need to make purchases to cover their short sales.

A *short squeeze* arises when bulls are able to corner the supply of the stock and artificially push its price very high. The short sellers then find it difficult to buy or borrow the stock from anybody, except the bulls to whom they may have sold. The short sellers are thus "cornered". They are at the mercy of bulls who may demand exorbitant price. The opposite case is when bulls are over-extended because of accumulated large positions financed by short-term borrowings, and the bears, having come to know about it, engage in bear hammering, causing market price to tumble and imposing losses on the bulls. Manipulative episodes of both kinds have been occurring in India.

Thus, the battle between bulls and bears sometimes takes undesirable forms of price manipulation by fraudulent methods, including rumour-mongering, planting false stories in newspapers, secretly cornering supply of stocks, etc.

Market-crises due to short selling

Corners may result in a market crisis if short sellers are left with no option but to default. Default by even one large trader has a chain reaction, causing many other defaults and market panic. Corners are sometimes resolved by the exchange governing body by fixing prices but such intervention is a debatable issue as it may incidentally encourage short sellers to become even more daring. What we have said above means that large-scale short selling, concentrated on single stocks is a cause of market disruption or breakdown.

"Diversified" short-selling

In the case of investors who have diversified portfolios and who follow the diversification principle for short-selling also, the risk of short selling is much less and takes on a different character.[5] If there is a general rise in market prices, such investors may incur loss on their "portfolios" of short sales but this would

[5] See Jacobs and Levy, op. cit.

be ordinarily compensated by the gain on their actual investment holdings, provided that these investors are not engaging in large-scale concentrated short selling in one or two stocks but in diversified short selling, i.e. short selling distributed in small amounts over several stocks. This kind of investment strategy by diversified investors towards short selling can be beneficial to the market.

Many investors, specially institutional investors, churn or reshuffle their portfolios, discarding over-valued stocks and purchasing under-valued ones. By doing so, they are, in fact, helping to improve the stock market's pricing efficiency as well as their own return. They may also lend such stocks to short sellers and thereby facilitate the process of improving the market's pricing efficiency.

Passive holding of stocks by some investors will lower the returns for these investors, but it may not necessarily come in the way of the market's pricing efficiency as long as the market has a sufficient number of active and sophisticated investors. Short sellers' presence promotes a more active or aggressive search for over-valued stocks and more speedy adjustment of market prices to company performance. It can be argued that *short-sellers' presence is not necessary, and may not make much difference to the market's pricing efficiency if there are a sufficient number of active and informed investors in the market.*

Scarcity of empirical studies

There is scarcity of empirical studies relating to how short selling affects market efficiency in declining and rising phases of the market and whether and to what extent short selling restrictions (like the tick-test in the U.S.) help or hinder the market's efficiency[6] . To the best of our information, there are no such studies on India as no regular data on short selling has been available.

Abusive and non-abusive uses of short-selling

Short-selling (i.e. selling something which you do not at that time own) has a legitimate place in investment strategy. Conceptually, short selling can be a part of a sound investment strategy, based on the expectation of earning a return by correctly identifying substantially over-valued stocks and selling them short. So long as no fraud or manipulation is involved, short selling is a perfectly legitimate activity, beneficial to the market's pricing efficiency. In our discussion, we have tried to draw a distinction abusive and non-abusive uses of short-selling and to provide a conceptual basis for its proper regulation.

Our discussion has made it clear that while short selling is not necessarily an undesirable speculative activity (in fact, it can be beneficial), it is capable of

[6] See U.S. SEC, "Concept Release on Short Sales" (Release No. 34-42037, dated 20 October, 1999). See also A.J. Senchack, Jr. and Laura T. Starks, "Short-sale Restrictions and Market Reactions to Short-Interest Announcements" in *Journal of Financial and Quantitatie Economics,* June 1993, pp. 177-94.

great abuse and has, in fact, been frequently employed for sinister purposes, causing great harm to the market, the innocent investors and the economy of the country. There are many historical episodes of short selling of dramatic type which received wide attention in the press and which gave it a bad name. Descriptions of 'bear raids' or 'bear hammering' are found in many official enquiry committee reports on the Indian stock market. The evils occurred were conspicuous in the more permissive or lax type of market environments, such as on the Wall Street before the 1930s or in India till recently but not in the London Stock Exchange, as the subsequent chapters will show. There exits extremely rich literature about manipulative and abusive short selling episodes. We have extensively drawn on such literature.

Pricing efficiency in the absence of short selling

We strongly believe that a well-designed restraint on short selling will, on balance, improve the market's efficiency, strengthen the investors' confidence and create a more favourable market environment. At the same time, as we have mentioned above, the market's pricing efficiency need not necessarily be less in the absence of short selling provided the market has a sufficient number of active and well-informed investors. There is thus a strong case, on practical grounds, for not allowing unrestricted short selling and bringing it under a regulatory system.

Chapter 3 : The U.K. : Never Needed Short-Selling Regulation

U.K.'s trading environment

Nearly all trading on the London Stock Exchange was always delivery-based even when it had fortnightly settlements and its tradition has been relatively conservative. That is why its change to rolling settlement system in 1994 was smooth and met no opposition. It required short sales to be settled by delivery and not by squaring up. The fact that the U.K. never had any regulation of short-selling, nor felt any need for it, intrigued the author and induced him to explore and verify it carefully. To a recent query to the London Stock Exchange in January 2002, for the purpose of verification, the author was told that "the London Stock Exchange imposes no restrictions on a firm's capacity to short sell.[1]" The author has been in correspondence with the London Stock Exchange since 1991 for studying its trading practices compared to India's.

Why did the U.K. feel absolutely no need to regulate short selling whereas the U.S. felt strong need for it and introduced an elaborate system as long ago as 1937? Why such diametrically opposite approaches have existed in two stock-

[1] Letter dated 15 January, 2002, from the London Stock Exchange to the author.

market dominated financial systems in the world? Understanding the factors behind such difference was important. It has helped to identify factors which determine regulatory structures in different environments.

In 1993 also, the author had received a confirmation that "there are no London Stock Exchange regulations or U.K legislative provisions which specifically relate to short-selling"[2]. The reason given was the existence of competing market makers in London. The market-making obligation meant that the market maker had many times to sell securities which, at the time of trade, he did not have. This system helped to enhance the London market's liquidity. The market-maker had to borrow the stock in order to deliver because delivery was a must for settlement. Such borrowing was generally from institutions through the so-called system of 'money brokers' The Exchange affirmed that it did not see any need to introduce short selling restrictions.

London's approach towards short-selling should be seen against its over-all approach towards ensuring that the trading practices adopted are fundamentally sound. Upto early 1994, London had a fortnightly settlement system. In India, people think that India's and U.K.'s fortnightly settlement systems were similar. The author discovered that the two operated so differently that while Indian stock market had recurrent crises throughout, the U.K.'s market had no such problem. Why it was so became clear after learning from the London Stock Exchange directly the exact manner of its operation.

To the author's detailed queries about how its fortnightly settlement system actually operated at that time, the London Stock Exchange provided the following information in a written reply to the author:[3]

(1) *Delivery, either physical or electronic, took place for all trades executed.*

(2) Only a minute fraction (about 5%) of the customer business was of squaring up type, i.e. a purchase (sale) followed by a sale (purchase) of the same stock within the settlement period. It is noteworthy that in London even such trades required the selling market-maker to deliver stock electronically to the buying market-maker.

(3) Contangos, i.e. the number of *trades being carried forward from one settlement to another by paying contango charges (the so-called Badla in India) by the buyer to the seller were "negligible".*

(4) Any trades which remained unsettled on the settlement day got settled mostly within the next few days because of the buying-in provision to enforce delivery of unsettled stock to buyers. The London Exchange had other mechanisms also to ensure that firms settle their business in a timely manner.

(5) The member firms were responsible for honouring the clients' trades and had their own safeguards in place to ensure that the clients did not speculate beyond their means and to minimize the firm's exposure.

[2] Letter dated 6 July 1993 from London Stock Exchange to the author.
[3] Letter dated 5 July 1991 from the London Stock Exchange to the author.

Contrast with India

As we have said earlier, London Stock Exchange's system was always a delivery-based system and this was the reason why its change over to rolling settlement system since 1994 was smooth and met no resistance from brokers or others. What a contrast that in India the rolling settlement was opposed tooth and nail by the entire broking community and speculative operators simply because our exchange community was not used to a delivery-based system and were against its adoption!

Another point to note is the highly disciplined way in which the London Stock Exchange operated its fortnightly settlement system. There were no recurrent market crises, like those in India. Speculative excesses on both buy and sell sides remained under control almost automatically by the observance of the normal business rules of prudence by the exchange members under the exchange's supervision.

Contrast with the U.S.

Some very interesting light on the traditional conservatism of the London Stock Exchange is thrown by Keynes, who, in his *General Theory,* published in 1936, made a comparison between the U.S. and U.K. stock markets in the following memorable words:

> In one of the greatest investment markets in the world, namely, New York, the influence of speculation is enormous…. Americans are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market. It is rare… for an American to invest, as many Englishmen still do, 'for income'; and he will not readily purchase an investment except in the hope of capital appreciation…. i.e., that he is, in the above sense, a speculator. *Speculators may do no harm as bubbles on a steady stream of enterprise. But, the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.* The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield cannot be claimed as one of the outstanding triumphs of *laissez-faire*…capitalism….
>
> "That the sins of the London Stock Exchange are less than those of Wall Street may be due, not so much to differences in national character, as to the fact that to the average Englishman Throgmorton Street is, compared with Wall Street to the average American, inaccessible and very expensive". (Emphasis added)

Exchange governance

Thus, we find that, in the U.K., instead of enacting laws for preventing trading abuses or excesses by exchange members, or by others who transact through exchange members (because all trading in stocks had to go through members), the normal operating system of the London Stock Exchange (via its governing body, as well as rules, regulations, etc.,) was, on its own, able to prevent the kind of speculative excesses which have characterized the U.S. markets as well as the Indian markets.

It is also worth noting in this connection that London had a long tradition of voluntary codes. It had evolved its takeover code very long ago and a corporate governance code about ten years ago. It is, therefore, not surprising that U.K. did not need short-selling regulation. Surveillance and disciplinary measures by exchange authorities sufficed to stop abuses, like price manipulation and over-speculation. It is in this context that the so-called demutualisation of the hitherto broker-controlled Indian stock exchanges acquires urgency because the broking community in India has failed to throw up enlightened and socially sensitive leadership.

Chapter 4 : The U.S. : Originator Of Short-Selling Regulation

Wall Street's early history

Bear raids and corners prevailed in the U.S. from the early days of its securities market and have been described in some excellent histories[1]. Short-selling regulation originated in the U.S. This chapter examines the circumstances which gave birth to short-selling regulation. It also explains how the regulatory rule, the so-called "tick-test", works and what are its important merits.

Upto the 1930s, the Wall Street in the U.S. was no less a rowdy place than Dalal Street in India. The difference was that whereas the stock market had an insignificant influence on the Indian economy which was largely agrarian, the influence of the U.S. stock market on the U.S. economy was extremely powerful as it was an industrial country.

Why the 1929 market crash originated in U.S.?

It is not an accident that the October 1929 stock market crash originated in the U.S and shattered the U.S. economy the most in the whole world. The U.S. stock market's history had been boisterous and full of wheeling-dealing. A Wall Street historian, Charles Geisst, has noted that almost from its beginning in the eighteenth century, the Wall Street "has been a symbol of the best and worst

[1] See Walter Werner and Steven Smith, *Wall Street* (Comumbia University Press, New York, 1991) and Charles R. Geisst, *Wall Street: A History* (Oxford University Press, 1997).

(that) finance has had to offer. It has become known for its scandals, avarice, and greed on the one hand and ingenuity and even patriotism on the other"[2].

The American political leaders and government authorities had begun to recognise in the 1930s their financial system's grave afflictions. There cannot be a more damning statement than the observations of William O. Douglas, Chairman of SEC, in a speech delivered around 1938:

> "The financial and industrial world has been afflicted with termites as insidious and destructive as the insect termites. Instead of feeding on wood they feed and thrive on other people's money… these financial termites are those who practice the art of predatory or high finance. They destroy the legitimate function of finance and become a common enemy of investors and business… one of the chief characteristics of such finance has been its inhumanity, its disregard of social and human values"[3]

Wall Street blamed

During the debates in the U.S. after the October 1929 stock market crash and the subsequent prolonged depression, the Wall Street's trading practices attracted much public criticism. Many political leaders and independent thinkers blamed the Wall Street for the economic chaos. The then U.S. President, Herbert Hoover, denounced short selling as harmful to the economy[4]. He asked the U.S. Congress to investigate short selling practices. This was described as 'bear hunt' in those days[5].

Short-selling notorious in U.S.

Short selling had earned great notoriety in the U.S. and had gone on unchecked since long. It was often found to take organised and malicious form of bear raiding to drive down prices artificially. Many Wall Street firms had perfected the art of forming "pools" or syndicates for rigging stock prices upwards or downwards[6].

The Congressional investigations into short selling during Hoover's Presidency did not produce any concrete regulatory steps. It was much later after Democratic Party's candidate, Franklin Roosevelt, had snatched the U.S. Presidency from the Republicans in the 1932 elections that the enactment of new regulatory legislation gathered speed. Roosevelt was advised by three Columbia University Professors, dubbed as the "brain trust", which included Adolf Berle who, alongwith G.C. Means, achieved fame for their monumental work, *The Modern Corporation* and *Private Property,* published in 1933.

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[2] See Geisst, op. cit., Preface to the book.
[3] Cited by Geisst, op. cit., p.248
[4] Ibid., pp.198-206.
[5] Ibid., p.209.
[6] Ibid., p.182.

Roosevelt's new legislation

Roosevelt introduced sweeping changes in the financial system by quickly enacting the following Acts:

(a) The Securities Act, 1933
(b) The Glass-Steagall Act, 1933
(c) The Securities Exchange Act, 1934

The Securities Act, 1933, was aimed at enforcing fuller disclosure about new issues of securities and the accountability of issuers and investment bankers. The Glass-Steagall Act, 1933, separated investment banking from commercial banking and introduced deposit insurance. The Securities Exchange Act, 1934, created the Securities and Exchange Commission (SEC).

Since the Congressional leaders had earlier recognized short selling as an important problem area, the Securities Exchange Act gave specific authority to the SEC to regulate short-sales of exchange-listed securities in order to stop the abuses in short-selling. It left the SEC free to decide the best way of doing it. The short-selling regulation was evolved by the SEC in 1937 after it had conducted much inquiry into the effects of concentrated short-selling during the market break of that year.

Explanation of U.S. short selling regulation

It is worth examining in detail the system finally evolved in the U.S. for regulating short-selling because it has some excellent features which are unique and have worked well for over 60 years. India has not been able to evolve any satisfactory system in this regard so far.

Objectives

The SEC designed its short-selling regulation after observing the effects of short-selling and the behaviour of speculators in downward moving markets. Its short selling regulation is designed to achieve the following three clearly defined objectives which are relevant to the Indian situation also:

(i) allowing relatively unrestricted short selling in an advancing market;
(ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and
(iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.

The "tick-test"

The SEC's regulation of short-selling uses the so-called tick-test. The tick-test is, in reality, a practical way or formula for defining the price for *permissible* as well as *non-permissible* short selling. *The defined price automatically takes into account* *the prevailing market condition.* No discretion is involved in such definition.

As per SEC regulation, short-selling is permitted at a price as defined below:

(i) at a price **above** the price at which the immediately preceding sale was effected (plus tick), or

(ii) at the last sale price if it is higher than the last different price (zero-plus tick).

Example of tick-test application

The wording is not easily understood and its interpretation looks daunting. An example will make the application of the tick-test clear under varying market conditions. Assume that the last reported price (at time t_0) in each of the following cases was Rs. 20 for a share and the preceding prices (at times $\mathbf{t_{-1}}$, $\mathbf{t_{-2}}$, $\mathbf{t_{-3}}$ were as given below:

	latest	**earlier**		
	$\mathbf{t_0}$	$\mathbf{t_{-1}}$	$\mathbf{t_{-2}}$	$\mathbf{t_{-3}}$
Declining market when "plus-tick" applies:				
Case 1:	20	20	20	21
Case 2:	20	22	22	23
Ascending market when "zero-plus tick" applies:				
Case 3:	20	18	17	16
Case 4:	20	20	20	19

In the first two cases (declining market), the "plus-tick" condition will apply and short-sale price will be allowed only at a price above Rs.20, the last reported price. In the last two cases, the "zero-plus tick" condition will apply and the short sale can be at Rs. 20. In all cases, the short sale is not allowed to be below Rs.20 (i.e. minus tick).

As the example given above shows, the tick test is linked to the last reported market price. In no case is any short sale permitted below the last reported price. A short sale is permitted if it passes the "plus tick" test or the "zero-plus tick" test. "Plus tick" test means that the short-sale price has to be above the reported price at which the immediately preceding sale was effected in the market. "Zero-plus tick" test means that the short-sale is allowed at the last reported sale price if such price is higher than the last different price. It can be readily seen that the tick-test automatically distinguishes a declining market from a rising market.

Requirements

A little reflection will indicate that this kind of regulation for short selling is possible only if the following conditions are fulfilled.

(a) *Every short sale transaction is disclosed upfront;*

(b) There is a dependable system of market quotations with reference to which plus-tick or zero-plus tick is determined;

(c) Stock borrowing facility is available because short sales have to be settled by delivery in every case and not by squaring up through subsequent purchase transaction.

The core provisions of the short sale regulation were so well-conceived that they have worked extremely well in the U.S. and there has been no need to change them till now. The SEC has attempted, from time to time, to assess whether the short selling restrictions have, on balance, been beneficial to the markets. In October 1999, its Concept Release on Short Sales (Release No.34-42037) sought comments from the public on diverse issues relating to short selling restrictions whether they need to be modified, extended, diluted or eliminated altogether. We down-loaded from the SEC site a large number of comments received by it. By and large, the comments have appreciated the usefulness of such regulation.

Balancing the bear/ bull regulations

It is noteworthy that *the U.S. had adopted mechanisms for restraining bull-side excesses as well as bear-side excesses.* This is indicative of a deep understanding of the over-all problem of regulating speculative activity. This is something which India has to learn.

While the tick-test took care of bear side speculative abuses and excesses, margin trading regulation was used to restrain bull-side excesses. The margin requirements for such trading were made uniform and were prescribed by the Federal Reserve at a much higher level of 50% compared to the earlier practice of 10-20% margin only. In the U.S., even such margin requirement has been kept stable for decades, unlike the Indian habit of changing the margins every now and then.

The combination of short-selling restrictions and the margin trading requirements were designed to prevent gross speculative abuses of the past from flaring up again[7] .

The U.S. short-selling regulation is a very carefully crafted piece designed to strike at the potentially *abusive types* of short-sales but leaving the *benign type* of short-sales free.

[7] Geisst, op. cit., p. 234

Special merits of the U.S. short-selling regulation

From the viewpoint of its adoption in India, we consider that its most attractive features are the following:

(i) First, the *regulator is not required to prove short seller's intent* or motive of abuse, even though it is designed specifically to strike at the abuse. In India, we have many anti-fraud and anti-manipulation provisions in SEBI regulations which are supposed to take care of abusive use of short selling but they are ineffective because they require proof of intent and proving intent is always difficult, often impossible.

(ii) Second, the restrictions on short selling are defined so precisely after taking a long view that *administrative discretion is entirely excluded in enforcing the regulation* and no frequent changes have been necessary.

The SEC in its Concept Release on Short Sales (Release No. 34-42037 dated 20 October 1999), sought public comment on the regulation of short sales of securities by raising many specific issues. It has done so earlier too. There have been attempts in the U.S. to assess the relationship between short-selling and price movements and also to investigate how short selling regulation has impacted the market prices and whether the regulation had achieved its objectives. We have scanned the comments received by the SEC and available on its website. They convey the impression that the short selling regulation has on the whole worked well since its introduction.

Chapter 5 : India : In Search Of Short Selling Regulation

India's stock market environment

Because of the badla system, India's stock market environment till recently had been conducive to excessive speculation and all kinds of speculative abuses. The badla system promoted a wholly spurious kind of share trading in which neither the buyer had the money to pay for the shares at the time of settlement nor the seller had the shares to deliver but "settlement" took place by payment of differences along with carry forward of outstanding positions.[1] Only about 10 per cent of the trading volume was settled by delivery.

The High Powered Committee on Stock Exchange Reforms (1984-85) was highly critical of the prevailing trading system, observing:

[1] L.C. Gupta, Stock Exchange Trading in India: Agenda for Reform (Society for Capital Market Research and Development, 1992), p. 85.

> "…*the present pattern of trading where there is no prior commitment to compulsorily make payment for shares purchased and to give delivery of the shares sold, leads either to excessive buying by bulls or unwarranted large selling by bears.*"[2] (Emphasis added)

The Committee also felt that the Indian trading practices encouraged short selling. It observed:

> "This mechanism of short sales provides free facility to the seller to sell shares and hold on to the transactions as long as he wants without any thought of completing them till the price comes down to enable him to buy back from the market and complete delivery or square up the transaction and pocket the difference. For doing so, *he (seller) is, in fact, paid contago (badla) charges by the purchasers of shares,* apart from keeping his sales position open in subsequent settlements…."[3] (emphasis added).

As a result of excessive speculativeness, the Indian stock market had a very troubled history throughout its long existence of nearly 125 years and right till recently, as indicted by the market crisis of March 2001. The decade since the setting up of SEBI has seen no respite from such speculative bouts and recurrent market crises.

The reports of the many official enquiry committees, appointed at different times since 1923, provide a long historical and panoramic view of the Indian stock market and its fundamental weaknesses. An understanding of this historical background is of great help in understanding today's situation also.

We shall be quoting extensively from official reports because they are the most authentic source of information on happenings and problems. Readers may find it useful to familiarize themselves with this goldmine of information. These reports may not always be easily accessible.

A panoramic view from official reports:

The earliest available official report on the Indian stock market is the *Report of the Bombay Stock Exchange Enquiry Committee* (known as the Atlay Committee) published in 1924, i.e. 78 years ago. The Committee observed that the members of the Bombay Stock Exchange had evolved the practice of *settlement of trades merely by payment of differences* rather than by delivery and that this was the root cause of market crises, because, under this system of trading, the outstanding positions of traders frequently exceeded the number of shares available for delivery.[4] In the Committee's opinion, such trading was nothing but gambling in differences. *The Committee drew a contrast with the London Stock Exchange where*

[2] *Report of the High Powered Committee on Stock Exchange Reforms* (Ministry of Finance, Government of India, 1986), para 7.66

[3] Ibid., Para 7.67.

[4] *Report of the Bombay Stock Exchange Enquiry Committee, (*Government Press, Bombay, 1924), specially pp. 13 and 17.

all trades had to be completed by delivery and the system operated without crisis.[5]

The most relevant fact for the purpose of the present study is the frequent occurrence of short selling and bear raids in India during those early times. In many cases, the bear raid was met with its opposite, i.e. "*bear squeeze*" or "*corner*" by bulls. The reverse type of case is that bulls initially pushed the prices too high by making huge purchases and then bears "hammered" the prices down by pressing huge sales, making the purchasers suffer huge losses. The events leading to market crisis of March 2001 were of the latter kind. All such episodes resulted in frequent market crises. The Atlay Committee described many types of manipulative practices. It also observed that the exchange members carried on their nefarious games without any fear because the exchange authorities tolerated these, even connived at them.

The undesirable trading practice of settlement by payment of differences (facilitated by carry forward of trades) continued till recently, except during 1994 and 1995 when carry forward was banned.

A flavour of what the Indian stock market has been like over the last three quarters of a century is provided by extracts from the various committee reports (See Box 1).

After economic liberalization, which envisaged more reliance being placed on the stock market, the old practice of badla began to be challenged by economic reformers.[6] The broking community started justifying the badla system as an indigenous innovation, even though it was not beneficial for the mass of investors nor for the market's health but extremely profitable for brokers and speculators. Short-selling also prospered under the badla system. The High Powered Committee on Stock Exchange Reforms expressed its concern for *both bull-side and bear-side excesses*, observing that at times the markets were pushed up by bull operators without due regard to the actual performance of the companies or intrinsic value of their shares and, at other times, the markets were pushed down by bear speculators by hammering down prices. *Hence, the stock market prices were often not linked to corporate performance nor to the real economy's performance.*

The Committee felt that India needed short selling regulation on the U.S. pattern because even though the stock exchange governing bodies in India were empowered to regulate short-selling, they had been ineffective. The Committee observed:

> *"There are no special rules for governing short selling though the Governing Bodies are vested with discretionary powers to prohibit such short selling in emergencies in the markets. Such being the position, large scale short selling is often resorted to by the operators to depress the prices with a view to making quick profits. Short selling has a role to play in moderating excessive speculative rises in prices. However, in narrow markets as ours, short selling, on a large scale, often leads to crises when deliveries are demanded by the bull operators and the sellers are not in a position to give the same. The Committee is of the view that there should be specific parameters fixed for short sales limiting them to the price ranges in a security for the day on the U.S. model".*[7] *(Emphases added)*

[5] Ibid. See also Chapter 3 above.

[6] See *Stock Market Trading in India: Agenda for Reforms, op. cit, pp. 85-90.*

The worst characteristic of Indian trading

The Committee found that only about 10% of the trades were settled by delivery, and the rest represented settlement by payment of differences. This has remained as the worst characteristic of the Indian stock market throughout. *One can now understand why there was so much opposition to rolling settlement by broking community in India whereas U.K. (which always had a delivery-based system) witnessed no such opposition.*

Indian trading system: perennial features

The perennial features of the Indian stock market are noteworthy as indicated below:

(a) Speculative activity is excessively high on both bull and bear sides. Only a minute fraction (around 10-15%) of the total trading volume in India is delivery-based, the rest being settled by payment of differences. It continues to be so even after the adoption of compulsory rolling settlement system, as per a recent report by the *Economic Times*.[8]

(b) Manipulative activity is high. Prices are rigged up to dizzy heights at one time and then driven down steeply at another time, resulting in wild fluctuations and frequent market crises. The market is dominated by a few big non-member speculative operators, working in collusion with exchange members and company promoters.

(c) There is over-concentration of trading in a handful of around 10-12 scrips which typically account for over three-fourths of the trading volume.

(d) The stock exchange administrations in India have not been used to ensuring the strict observance of rules, regulations etc., by the members.

Prolonged bear phase since 1996

Our discussion has clearly thrown up the fact that speculative excesses and abuses existed in India on both bull and bear sides and harmed the market's efficiency. In late 1996, the need for controlling bear-side speculative activity began to attract special official attention because of continuing market gloom. The SEBI appointed the B.D. Shah Committee to recommend a suitable system for regulating short selling. The Committee came up with the idea of "differential

[7] See Committee's *Report*, para 7.68

[8] See *The Economic Times,* 11 February, 2002. See also National Stock Exchange, *NSE News,* January 2002, p. 40.

margins", i.e. charging a *higher margin on daily outstanding short sale positions than on long purchase positions* and doing the opposite during a bull phase. The Committee suggested that 15 most actively traded scrips be brought under this regulatory scheme and further that stock exchanges should regularly compile data on aggregate outstanding short-sale positions scripwise for 60 actively traded scrips at the end of each trading day and publicize such data.

Earlier in 1997, the Dave Committee had also suggested differential margins in the ratio of 3:1 respectively on bears and bulls in a falling market and in a reverse ratio in a rising market. Still earlier, the High Powered Committee on Stock Exchanges (1984-85) had also made a similar kind of suggestion to "deal appropriately distinguishing between the bullish and bearish trends in the market"[9] .

Recommendations of the kind made by the Shah Committee failed to go to the root of the problem. *So long as the trading system was not made a delivery-based system, speculative excesses on both bull and bears sides were bound to continue. Short-sale regulation by itself would be able to achieve little.* A second reason why this kind of approach has never been effective is that the *margins are decided by administration discretion* and have to be constantly changed as market conditions change. The reliance on administration discretion in such matters has been the bane of the Indian regulatory method.

Shortcomings of Shah Committee approach

The Shah Committee on short selling failed to come to grips with the problem. Its approach was very perfuntory. For example, the Committee mentioned that there was lack of transparency in the Indian exchanges about short-selling, as no information in this regard was being collected and disseminated by stock exchanges. Hence, the investing public remained in the dark about the existence and scale of short-selling. However, the Committee's recommendations about disclosure of information were very inadequate.

The Committee had recommended that each stock exchange member should disclose to the exchange scripwise "net short-sale position at the end of each trading day" separately for his clients as a whole and for himself. What the Committee did not realize was that disclosure at the *end of the trading day* and that too on a *net basis* (after all squaring up has taken place) is like bolting the door after the horse has run away.

What was required was *upfront disclosure of every short sale.* Had there been such a system, the bear hammering and the parties responsible for creating the market crisis in March 2001 would have been quickly identified. The JPC is still struggling with the question "who did it?" The reason given by the Shah Committee for not requiring upfront disclosure was that there were difficulties

[9] High Powered Committee Report, para 7.70.

in obtaining such data. The point is that *if the U.S. SEC was able to enforce upfront disclosure of every short-sale transaction as long ago as 1937 without today's technology, why we in India cannot enforce such disclosure today with state-of-the-art technology?*

The Shah Committee's scheme involved too much ad hocism and discretion on the part of those who have to administer it. The scrips to be covered and the rates of differential margins would have to be constantly adjusted as the market conditions change from bearish to bullish or vice versa. Such discretion leaves too much room for lobbying by vested interests and also the possibility of judgemental error regarding market conditions. The Shah Committee's scheme does not seem to have been of any use, as proved by the market crisis of March 2001, which was allegedly caused by bear hammering.

None of the official committees in India, which have enquired into the need for regulatory improvements ever made a detailed examination of the U.S. system of short-selling regulation, except mentioning it casually. Even the B.D. Shah Committee (1996), which was specifically charged with the responsibility of suggesting regulation for short selling, did not care to look at the U.S. system. The High Powered Committee (1984-85) suggested the adoption of the U.S. system[10] in India but did not go into details about its adoption. We have looked at the U.S. system minutely from the viewpoint of its adoption in India.

Detailed explanation of the tick-test and how it is applied in practice has been given, along with an example, in the preceding chapter on the U.S. system. Hence, in this chapter, we shall be discussing only the modifications required and the implementation problems.

Designing the "tick-test" system for India

There are three practical problems to be resolved in order to apply the tick-test type of short-sale regulation in India. These are:

(1) What should be the *reference price* for applying the tick-test?

(2) How do we ensure *compliance of every short-sale transaction* with the regulation? and

(3) How do we guard against *fudging of reference price* by short sellers

The reference price: use preceding day's closing price

In the U.S., the tick-test is applied in relation to the *last reported price"* at the time of short sale on the trading day itself. Our suggestion is to base the tick-test on the *closing price of the preceding trading day.* This will have important advantages.

Firstly, it is difficult to apply the tick-test on the basis of the *last reported price* at the time of short sale in an environment of quick, and sometimes violent, up and down intra-day price movements.

[10] See Para 7.68 of the Committee's Report.

Secondly, the successive intra-day price movements cannot really be regarded as indicating a declining or rising market trend. In the U.S. also, the SEC has raised the issue whether the previous day's closing price would be a preferable benchmark than the last reported price on the trading day.[11] As the tick-test is based on the assumption that we can distinguish between a declining market from a rising market and as intra day successive price movements may be upwards at one time and downward at another time, our opinion is that the use of intra-day movements for tick-test can create unnecessary confusion and its effectiveness will be reduced to some extent. It may even defeat the very objectives of the tick-test.

For monitoring purposes also, the use of previous day's closing rice on the exchange on which the short sale is being executed will be simpler.

Let us keep in mind that the objective is to *prevent abusive use of short selling* by artificially driving prices down in a cascading fashion. Now, if the intra-day price on a particular day are below the previous day's closing price, no short-sale at the reduced price will be allowed. Thus, short sellers (i.e. those who do not already own the shares) would be restrained from destabilizing the market further but investors holding the stock would be freely allowed to sell at any price.

For ascertaining whether the market is rising or falling, we would take the closing prices of the last few days, as when zero-plus-tick applies.

The task of implementing a tick-test type of regulation has been made easier as a result of rolling settlement and uniform settlement cycles in all Indian exchanges.

Upfront identification of every short-sale and reporting system

From the viewpoint of ensuring compliance and preventing manipulative use of short selling, the upfront identification of every short sale transaction is absolutely essential. This would enable the stock exchange authorities to know promptly who the parties involved are in each short-sale. Without upfront disclosure, the tick-test cannot even be implemented. There should be no dilution of upfront disclosure requirement *to prevent surreptitious short selling*.

In the case of short selling by non-members of exchange (i.e. by clients of stockbrokers), the upfront disclosure of short sale should be made to the broker through whom the transaction is being executed. Such broker member should be held responsible for ensuring that the transaction being put through him complies with the tick-test regulation before executing it. The broker should be required to keep a separate record of all short sale transactions executed through him.

In the case of proprietary transactions by stockbrokers on their own behalf, they should report these upfront to the stock exchange concerned. Clients' transactions beyond a certain size should also be reported upfront by the dealing broker to the stock exchange immediately. This will ensure that any abusive use of short selling does not go undetected till a crisis, like that of March 2001, has occurred. If daily upfront reporting of short sales is enforced, market crises due to short selling will become a thing of the past.

[11] See SEC's "Concept Release on Short Sales" (Release No. 34-42037 of 20 October 1999)

"Short-interest" daily reports

In addition to the disclosure and reporting requirements mentioned above, each stock exchange should compile data on daily basis regarding scripwise aggregate amount of gross short sales and also the *net aggregate outstanding short sale positions (called "short interest")* in respect of transactions executed on the particular exchange. Information on changes in the aggregate outstanding short sale positions (i.e. short interest) is important from the viewpoint of investors as well as regulatory authorities.

Coverage of short selling regulation

The Shah Committee's scheme for regulating short-selling covered just a handful of actively traded scrips, numbering 15. As abusive use of short selling is not necessarily confined to a few of the most active scrips and has been found to occur in many less known shares, we would like that the short selling regulation should apply to listed shares generally, the only requirement being the availability of reliable and regular trading price and traded volume information. In the U.S., the SEC's tick-test rule covers short-sales in any security listed on a national securities exchange if trade was reported pursuant to an "effective reporting plan" and if information regarding such trades is made available on a real-time basis to vendors of market transaction information.

Watch against closing price manipulation

The regulatory authority should ensure that under no circumstances the closing prices of scrips are manipulated by anybody in any way. The short sale regulation can be rendered ineffective in preventing bear hammering if the short sellers can manipulate the reference prices for the tick-test.

Exemptions from tick-test

Short sales conducted exclusively for the purpose of establishing a bona fide hedge do not involve manipulation and should be exempted from short sale regulation, as in the U.S.

In India, we have not yet succeeded in creating a system of market-makers. If any stock exchange members undertake the obligation of providing market-making service by giving two-way quotations, they should be exempted from short sale regulation in respect of short sales undertaken in fulfilment of their market-making obligations. As there have been some complaints in the U.S. about market-makers misusing their privileges and doing a kind of "front-running", their short sale activities would have to be kept under watch.

Undoubtedly, the absence of short selling regulation in the speculatively surcharged atmosphere of the Indian stock market has been a critical regulatory gap in the scheme of market regulation. This gap should, of course, be closed as early as possible.

Concluding comments

The short-selling regulation should be operated along with margin trading regulation with substantial initial margin requirement. We would prefer the minimum initial margin to be fixed at 50%. While the short selling regulation would help to control bear-side (down-side) speculative excesses, fixing a reasonably high margin for margin trading in shares can be instrumental in controlling the bull-side (up side) speculative excesses. A regulatory system designed in this manner can acquire the automatism of thermostat control through all phases of the stock market, including booms and depressions.

Without regulation of the bull-side excesses, the regulation of bear-side excesses alone may not be able to achieve market stability. Discretionary day-to-day changes in the margins add to market uncertainty and have not worked well. A stable, almost non-discretionary margin regime for margin trading should be evolved.

Box 1: Extracts from Enquiry Committee Reports on Stock Exchanges in India.

Atlay Committee (1924)

In all Exchanges of repute it is recognised that the basis of all business on the Exchange is the principle that the seller who sells must be prepared to give delivery and the purchaser must be prepared to pay. The recklessness or unwisdom of a bargain is not regarded as good cause for departure from this principle which distinguishes the legitimate business of a Stock Exchange from gambling in differences.... It is generally recognised, that the evils resulting from the failure of those who have sold recklessly that which they do not possess are of less public moment than those resulting from the failure to insist upon the principle that all bargains freely made must be fulfilled by actual delivery and purchase.

W.B. Morison Committee (1937)

We are satisfied, from the evidence which has been placed before us, that, **of the total business transacted on the Bombay Share Bazaar, too high, indeed much too high, a proportion is of a speculative nature—** several witnesses estimated such business at anything between 80 and 90 per cent — and of that speculative business, a very high proportion has degenerated into a mere gamble in differences, thus constituting an ever present threat to the continued existence of the Bazaar as a serious place of business... (Emphasis added) (p.2)

The first and fundamental principle of Stock Exchange practice and administration .... is that every bargain must be regarded as a contract to deliver or to take delivery of a stated amount of stock at a stated price and within a stated time ...... (p.2)

P.J. Thomas Committee (1948)

The principal charge is that owing to **excessive speculation, wide and wild fluctuations in stock prices have taken place frequently**....

There is no doubt that outside operators, whether free-lance brokers and speculators, and influential syndicates of them, have also been instrumental in carrying out the manipulations.... **Manipulations cannot have been possible without the co-opration of the stock exchange members....** (Emphasis added) (pp. 68-9)

Legally each contract is to be fulfilled by delivery of scrips and payment of price.... But it is easier to make a settlement of contracts by payment of differences in price, and this is what too frequently happens.... It is this that serves as the main facility for over-speculation. As no delivery or payment is needed, people can speculate to any extent without having the means....

J. J. Anjaria Committee (1970)

In the first place, it cannot be said that the stock market under conditions of forward trading always provides an objective appraisal of investment propositions.... (p.8)
Secondly, experience in India shows that **speculators tend to concentrate their attention on a few securities and to indulge in excessive activity in them.** Such "milling and churning" around a few scrips cannot help investment activity to

broaden and extend to all the listed securities.... (Emphasis added) (p.8)....

....the most disturbing aspect of the trading has been the heavy concentration of business in respect of these few scrips in the hands of a few operators.... They create unusually feverish activity in the market and rig up prices to unduly high levels....

The market would be healthier if trading could be broad-based.... (p.15)

G.S. Patel Committee (1984-85)

It is estimated that about **90 per cent of the transactions which take place in "specified shares"** are settled through payment of differences without taking or giving delivery of shares.

Forward trading, properly regulated, is necessary for imparting necessary liquidity and price continuity in shares. However, in the conditions prevailing in some of our markets, this **often results in excessive speculation, leading to frequent payment crisis, disruption of market activities, defaults of stock brokers and creation of a feeling of instability and uncertainty in the minds of the genuine investors** shaking thereby their confidence and faith in the institution of the Stock Exchanges.

Joint Parliamentary Committee
on the Securities Scam (JPC 1992-93)

The then Minister of Finance acknowledged vide his letter dated 26 August, 1982 that the **BSE had developed payment crisis on account of excessive speculative activities** and that efforts would be made to streamline its functioning....

The Committee are actually not the least surprised to find that even after a decade, functioning of Stock Exchanges are still characterised by the very same malpractices that had been prevalent earlier. (p.104)

Dave Committe, 1987
The Informal Working Group on current system
of restrictions on trading in stock exchanges

A major cause of destabilisation in the market is the building up of positions either by a single operator or a syndicate of them acting in concert....

A sustained fall or rise in price of a share could be a hunting ground for specualtive operations. We, therefore, feel that whenever the price of a share falls or rises continuously for two consecutive settlements by the levels stipulated for a settlement, the share must automatically be shifted from the specified group to the non-specified group and its restoration to the specified group may be made only after one or few settlements during which period the price of the share should stabilise...

The Group is of the opinion that punishment meted out to the erring members at present is rather lenient.... Serious offences like non-reporting of transactions, evasion of margins, non-fulfilment of arbitration awards, etc., should be penalised with suspension of at least 3 days.... any misbehaviour of a member with a client by way of delay in payment and delay in delivery of securities, mis-appropriation of funds, etc., should also be brought within the disciplinary ambit of the Exchange.