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Short Selling in India: The History, Current Scenario, and Way Forward

Pranjal Shah[1], Chahak Kanojia[1,*]

Abstract

Short selling refers to the sale of securities which are borrowed in essence and the seller does not own them at the time of selling. The seller sells the securities when their price is high and then buys them back when their prices drop, making a profit from the price difference. Traditionally, it has been viewed as a boon by investors and regulators around the world due to the volatility it infuses into the market. But this perception is changing with the benefits of short selling coming to light. Essentially, short selling aids in increasing liquidity and determining the price of securities. In India, it has always been viewed with suspicion and reluctance due to the involvement of short selling in various scams. Therefore, in this paper, the position of short selling has been analysed, starting with the beginning of the millennium and how it has shifted in the last decade with changing regulations. In the context of this discussion, several loopholes in the Indian regulation of short selling have been critically examined, and recommendations have been given in a bid to update the regulations in light of the modern changes. The chief arguments of the paper are based on the perception that short selling could be truly beneficial in the development of the Indian securities market, with India becoming an attractive location for investment.

Keywords: COVID-19, Harshad Mehta, Ketan Parekh, SEBI, Short Selling

INTRODUCTION

Short selling is the sale of securities that the seller has borrowed, indicating that they do not own those securities. Short selling permit investors who do not own the stock to have their lower valuations reflected in the asset's equilibrium price [1]. Those prices for which there is anticipation of a decline would be sold by the brokerage on the open market. After repaying the initial loan, short sellers intend to repurchase the stock, preferably at a lower price than what they sold it for and pocket the difference. In the typical stock loan agreement, the lender can demand the return of the shares at any time. This gives the lender the flexibility to sell the shares at any time [2].

A considerable body of literature is available at length on the function of short sellers in the financial marketplace. One school of thought contends that short sellers are knowledgeable investors who play a vital role in price determination, stock market efficiency, and the discipline of corporate managers because they collect data from a range of public and private sources [3]. Contrary to this is another view point that short sellers are uneducated and predatory traders who harm society by manipulating stock prices, producing market volatility, generating undesired selling pressure, and reducing market efficiency [4]. Authentic short selling could aggravate a price decrease, but without additional evidence of market manipulation, it cannot be considered a manipulative practise. However,

***Author for Correspondence**
Chahak Kanojia
E-mail: chahak.k25@gmail.com

[1]Student, Gujarat National Law University, Koba, Gujarat, India

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abusive short selling techniques designed to manipulate the price of a company continue to be viewed as market misconduct and be subjected to regulatory action [5].

The merits of short selling entail that it helps to keep derivative prices in line with the underlying cash market and permits liquidity providers to add liquidity to the market. The demerits include that some short sellers allegedly engage in smear campaigns that spread false or misleading information about their target, it increases the volatility in the market, and it gives manipulators a tool to depress prices.

It has a high-risk association and is extremely risky when a large number of investors, short-sell shares of the same firm, and the price unexpectedly rises. At that moment, everyone rushes to repurchase their shares, leading the stock to rise even higher. It is known as a "short squeeze", and it may easily become a vicious cycle that is extremely costly for short-sellers [6].

When an investor shorts a stock, margin calls are expected if the stock's value moves in the opposite direction. When margin calls are received, investors are expected to deposit additional funds with their broker in order to maintain their position. The broker will square off the trade without the investor's authorization if this additional amount is not deposited. Due to these continual margin calls, only active investors with the time and motivation to observe price fluctuations and make judgments can engage in short selling. Typically, retail investors are inactive. This indicates that they do not have the time to consider these choices throughout the day. This is why short selling is not appropriate for them.

Short transactions are extremely volatile. This is because investors have relatively little influence on the traded stock. For example, even if you are willing to pay interest on the stock, the lender of the stock may suddenly demand its return. This is referred to as a buy-in. These circumstances compel short sellers to liquidate their bets and reimburse the lender. Similarly, other parties could refuse to sell you the shares, despite your willingness to pay a reasonable price. In such a case, you will be unable to repurchase the stock and return it to the lender. This is referred to as a brief squeeze. It is known to increase costs over a short period of time. All short sellers are rushing to cover their bets, resulting in overwhelming demand.

The given discussion on the benefits and risks of short selling raises the question of whether short selling would be beneficial in the Indian market. The perception with regard to short selling has seen a favourable shift in the last decade with several benefits coming to light. Therefore, in this paper, the position of short selling in India has been critically examined. After analysing the Harshad Mehta scam and the Ketan Parekh scam, which eventually led to the prohibition of short selling in the Indian securities market, the paper moves on to a discussion of the current scenario of short selling in India, the present regulations, and the prohibition on short-selling during the COVID-19 lockdown. Thereafter, several recommendations have been discussed to make the short selling activity in India more robust as an aid to the development of the Indian stock market.

HISTORY OF SHORT SELLING

In 1996, SEBI formed a committee under the leadership of Shri B.D. Shah, the chairman of GIC, to examine the issue of short sales for the first time. To address the issue of the stock exchanges' lack of transparency, effective November 29, 1996, all member brokers of stock exchanges were required to submit their scrip-by-scrip net short sale position for 60 actively traded scrips at the end of each trading day.

While SEBI mandated disclosure of scrip-by-scrip net short sale positions, it did not agree to the use of the margin mechanism to deal with a short sale on the grounds that the margin was intended to ensure solvency, not market regulation. In contrast to its previous stance, SEBI on June 16, 1998 imposed a 10% additional margin on the total net outstanding sale position by scrip at the end of each trading day due to the market turmoil at the time. The disclosure was subsequently expanded to include net long positions subsequently, as a result of market volatility in 1998. On June 17, 1998, SEBI enacted a temporary ban on short sales and mandated that the net outstanding sale position at the end of each trading day must result in delivery. This restriction was subsequently lifted [7].

Harshad Mehta Scam (1992)

The Harshad Mehta fraud totalled ₹ 24,000 crores, making it one of the most significant frauds. After the liberalisation in 1991, the banks were supposed to retain a minimum quantity of government fixed-interest bonds. Governments used to issue these bonds to improve the nation's infrastructure. Banks were strictly prohibited from participating in the stock market. Consequently, they could not reap the benefits of the stock market's rise in 1991 and 1992. Harshad Mehta promised the banks higher rates of interest, while asking them to transfer the money into his personal account, under the guise of buying securities for them from other banks. Therefore, these banks issued receipts and sold securities that they did not own, thus leading to short selling.

He stole an enormous amount of money from the government securities market during a brief period. Techniques used by Mehta involved having corrupt officials signing fake cheques, misusing market loopholes, and fabricating to drive the price of stocks up to 40 times their original price. He used to invest this money in a few carefully chosen assets, causing their prices to skyrocket. Thus, leading to an increase in the Sensex, or the Bombay Stock Exchange index, from 1,000 to 4,500 [8].

Ketan Parekh Scam (2001)

The Ketan Parekh fraud was the second most significant fraud in terms of short selling, as it resulted in a complete ban on short selling by SEBI on March 8, 2001. Ketan Parekh is a chartered accountant by profession and had worked as an intern for Harshad Mehta's business. After the development of the dot-com boom, his stock portfolio was mainly concentrated on the technology, communication, and entertainment industries, also known as the ICE sector. He invested in low-liquidity IT and telecom firms as he was interested in corporations with little market capitalization and liquidity, and low visibility. He used to raise funds through different promoters in the form of loans and pay orders without providing sufficient securities. The stocks were named 'K-10 stocks' as he used to invest in 10 particular stocks regularly.

He was able to control the pricing of such businesses by employing the "pump and dump" method. He was also rumoured to have engaged in insider trading by manipulating the stock prices of companies who would bribe him to do so in order to take advantage of investors' emotions as the price increased. In the initial phase of the pump and dump strategy, stock prices were artificially inflated. He invested in K-10 stocks by purchasing 20–30% of the company's stock, which was less well-known on the stock market, thereby inflating the price of the shares, which eventually became overvalued, thereby luring institutional brokers and investors to invest in the shares. Then he would sell the shares, causing the stock price to plummet. A direct consequence of his actions was that investors interested in short selling would buy his overvalued shares and then them when their prices crashed, leading to increased volatility.

He also took part in circular trading, in which mutual traders trade among themselves to increase the trading volume; this makes the investors show interest in them who focus on the trading volume of the stocks. The investors start buying this stock which makes the prices go high, and then he used to sell these stocks. This is also called the Badla System.

These two scams and the crash of the stock market due to the allegations against Anand Rathi (who was then the president of the Bombay Stock Exchange) for his indulgence in insider trading led to the banning of short selling by SEBI in 2001.

INDIA’S CHANGING DYNAMICS WITH SHORT SELLING

Following the mentioned ban on short selling of securities enforced in 2001, only retail investors were allowed to sell short. Institutional Investors were debarred from shorting stocks. However, short selling has its own advantages, with it playing a crucial role in efficient markets [9]. Firstly, short selling has been linked to greater transparency in the securities market, with the same assuring that both positive and negative information being released [10]. This has led scholars to argue that short selling has ensured that the prices of the securities of a company reflect its reality and are not overpriced or underpriced. Secondly, short selling has also been shown to improve market liquidity due to its impact on bid-ask spreads and price. Thirdly, it serves as an external watchdog on the management activities of companies, thereby enforcing corporate governance regulations.

In the context of these advantages along with pressure from foreign as well as domestic investors, the Indian regulator, SEBI decided it apt to reintroduce short selling in the Indian security markets. Thus, in July 2007, new guidelines for short selling were released by SEBI [11]. These guidelines sought to put retail and institutional investors on an equal footing by allowing both the sets to trade short. However, naked short selling is still barred; therefore, all investors have to mandatorily deliver the transacted securities at the time of settlement. Institutional and retail investors have been distinguished on some aspects. Institutional investors have to disclose a short sale transaction upfront at the time of placement of the order while retail investors can make such a disclosure at the end of the trading day.

Additionally, in the spot market, short sales have to be strictly intra-day [12]. Thus, all such sales have to be settled by the end of the day. The same restrictions do not apply on short selling in future markets. Furthermore, it has been clubbed with a scheme for securities lending and borrowing (SLB) to provide the required framework for short selling. SLB is an automated, order-matching platform to ensure that traders adhere to their transaction. Additionally, short selling is only allowed in those securities which have been approved by SEBI. Another thing to note here is that foreign portfolio investors (FPI) are not allowed to sale short at all.

The COVID-19 pandemic once again saw SEBI impose a ban on short selling. However, it was temporary, from March 2020 to October 2020 [13]. Panic selling and other concerns regarding some fundamentals of the Indian economy resulted in a crash in the stock market. To prevent the same from escalating into a full-blown crisis, however, whether this restriction was actually helpful is a question yet to be answered. There have been mixed responses, with several experts such as Mr. D. K. Aggarwal, Chairman and MD of SMC Investments and Advisors supporting the restriction propagated by SEBI [14]. Co-founder of Zerodha, Mr. Nikhil Kamath, was against the ban, taking the view that such a ban would hurt the market in the long run [15]. The latter perception is apt, for, there is still no clarity whether the ban actually helped the Indian stock market, but, on the other hand, retail investors were left vulnerable when the restrictions where finally lifted in October 2020.

In light of the discussion here, it becomes important to analyse and understand the existing loopholes in the regulation of short selling in the Indian stock market and seek more effective solutions because the reality, as it stands, shows that short selling is unlikely to go out of fashion and therefore, the Indian regulator has to be ready for several unlikely scenarios.

CRITICISMS AND RECOMMENDATIONS

Several criticisms have been levelled against the Indian regulation of shorting stocks. Some of them are quite relevant when we consider the changing nature of the economy, and therefore, solutions have to be devised to address them. While it is true that directly importing regulations from other countries is not effective due to the differing realities of countries; we certainly can look at their regulations and draw inferences from them in order to devise our own.

One of the most recent criticisms levelled against SEBI is the ban imposed on short selling during the COVID-19 lockdown. This action of SEBI and other regulators across the world have been alleged to be 'traditional'. Regulators in most countries have been historically reluctant to allow short selling, attributing increasing volatility and vulnerability, and decreasing integrity of the market to shorting of stocks. However, this traditional approach fails to appreciate a fundamental element of short selling. It increases cash flow in the market, thereby improving liquidity in the market, which is much needed at the time of crisis. Another disadvantage of such a ban is the precarious position which retail investors are left in when such a temporary ban is lifted. Therefore, such temporary bans on short selling should not be allowed to become the norm every time the stock market faces a crisis. Instead, short selling should be allowed with increased restrictions. Thus, the benefit of short selling can be taken to increase the liquidity in the market while preventing its volatility from further impeding the market.

A very good example of this is Belgium. It indeed banned short selling, however, when the European Securities and Market Authority decided that such bans cannot be extended beyond 18th May 2020, the Financial Services and Markets Authority (FSMA) of Belgium had to seek other alternatives [16]. Therefore, FSMA allowed short selling, however, placed some restrictions on it. Stocks that lost 10% or more value in one day were restricted from being sold short [17]. This approach allowed Belgium to achieve market stability without compromising on the benefits of short selling.

A second criticism faced by the regulations of SEBI is that the mandatory requirements of upfront disclosure by institutional investors when engaging in short selling. Short sellers prefer maintaining anonymity because of the risk of revealing their trading strategy, thereby increasing their cost; fear of potential suit by the company whose shares were sold short; and potential loss of access to the company's management. Therefore, mandatorily requiring institutional investors to disclose their short sales upfront could prove to be costly for them. However, it is true that some form of disclosure is required due to the chilling effect it has on short sales. Therefore, instead of upfront disclosure, institutional investors should be allowed to disclose at the time of settlement of the transaction. Due to the SLB scheme framework, transactions will be recorded, therefore, SEBI will have a platform to monitor the activities of short sellers.

A third loophole, or rather, an inference from the acts of SEBI is that the Indian regulator is afraid of short selling activity contributing to a crash or crisis by facilitating decreasing prices of shares. Therefore, SEBI is quick to restrict short selling when the market is declining to prevent its acceleration. However, a ban is not always the way forward, as is evident from the discussion earlier. There are various other mechanisms to control short sellers from agitating a crashing market.

The United States of America (USA) is a good example for looking at the price controlling activities of the Securities and Exchange Commission (SEC). Considerable freedom has been given to short sellers in USA. However, the SEC uses a tick-test for regulating the price of short selling [18]. Acceptable and unacceptable prices are defined keeping in mind the corresponding market conditions. General guidelines have been put in place to determine what the acceptable price for short selling is. SEC permits short selling at a price higher than that of the immediately preceding sale, called as plus tick or the last sale price, provided that it is higher than the last different price, defines as zero plus tick [1, 6, 7, 8, 11, 18, 19, 20, 21, 22, 23, 24]. However, the USA is a quote driven market while India is an order driven market. Therefore, such a framework can only be adopted within a framework of comprehensive regulations and strong relationship between the key market regulators, in essence, SEBI and the stock exchanges. Significant updates to the SLB framework could help incorporate such a mechanism into the fundamental procedure of short selling itself, and with vigilant monitoring through the SLB, borrowing and lending of securities could be restricted when prices drop below the acceptable level.

CONCLUSION

Short selling can prove beneficial because of its twin benefits of increasing liquidity and regulating price determination. However, as with all aspects of the securities market, it cannot be overregulated nor underregulated. SEBI has to strike the right balance between the two. The regulation of short selling is particularly cumbersome because of its unique nature, and its involvement in many market shaking scams have left the regulator with no very cordial perception towards short selling. The participants of the securities markets are divided on the compatibility of short selling with the Indian stock market. On the other hand, the undeniable benefits of short selling, if precisely regulated, cannot be denied.

Thus, after an analysis of short selling in the Indian context and its regulation by SEBI, it is found that short selling in India faces the following hurdles. One is the eagerness of SEBI to ban short selling the moment the market starts heading towards a crash. This indicates that the Indian regulator has yet to appreciate the aid short selling could provide in increasing market liquidity. It is not denied that short selling is volatile and leaves the market vulnerable. However, both of these can be combated with well thought out restrictions falling short of a total prohibition of short selling.

Another issue in the Indian regulation of short selling is the requirement to make upfront disclosures when engaging in short selling. This is applicable to institutional investors only. Disclosures, by their very nature, become a difficulty for all short sellers because they run the risk of exposing their commercial strategy and thereby, increasing the cost of short selling. Further, there is always the danger of litigation from the shorted company. Due to the ease and benefits which such disclosures bring to the regulator, they cannot be done away with. Therefore, instead of such upfront disclosure, institutional investors should be allowed to disclose short sales at the time of settlement. The SLB scheme has been so far an effective framework for borrowing and lending securities, maintaining a precise record of borrowing and lending transactions, which are keys to short selling. Therefore, SEBI will have ample resources to cross verify in case of discrepancies.

To implement such measures, practices of stock market regulators in other countries can be drawn upon. While regulations of other countries should not be blindly adopted, since the political, economic, and social environments of the donor as well as recipient countries need to be studied, inferences can be derived from such regulations. The independence and expertise of SEBI have been lauded across the world; therefore, there is little doubt that the regulator is equipped with the tools to formulate such regulations for the Indian stock market. What requires a change is the approach of SEBI, which still views short selling in the traditional sense, regarding it as a boon for the securities market. With the correct regulations, short selling could assist in the development of the Indian securities market.

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