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The skinny on the 2008 naked short-sale restrictions

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Abstract

On July 15, 2008, the US Securities and Exchange Commission announced temporary restrictions on naked short sales of the stocks of 19 financial firms. The restrictions offer a unique empirical setting to test Miller's (1977) conjecture that short-sale constraints result in overpriced securities and low subsequent returns. Consistent with Miller's overpricing hypothesis, we find evidence of a positive (negative) market reaction to the announcement (expiration) of the short-sale restrictions. Announcement returns are higher for firms that appear to be subject to more naked short selling in the days immediately preceding the announcement of the restrictions. The restrictions are successful in eliminating naked short sales for the restricted stocks, but naked short sales increase dramatically for a closely matched sample of financial firms during the restricted period. We also find that the restrictions negatively impact various measures of liquidity, including bid-ask spreads and trading volume. From a public policy perspective, our findings suggest that, at a minimum, policymakers should pause when considering further short sale restrictions.
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> *The SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than it has ever been. Today's Commission action aims to stop unlawful manipulation through "naked" short selling that threatens the stability of financial institutions.*
> Christopher Cox
> Chairman of the U.S. Securities and Exchange Commission[1]

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[1]US Securities and Exchange press release 2008-143 (http://www.sec.gov/news/press/2008/2008-143.htm).

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1. Introduction

In the third quarter of 2008, a wave of international markets introduced restrictions on short selling.[2] With a financial crisis sweeping through the world's capital markets, the restrictions were intended to protect firms from short sellers, who were singled out as exacerbating the quick and steep stock price declines many firms were experiencing. Although short sales have long been controversial, the actions of market regulators stand in contradiction to the general consensus in academic research that short-sale constraints reduce market efficiency, damage market quality, and result in security mispricing. For example, Miller (1977) argues that short-sale constraints can lead to overpriced securities and low subsequent returns, and Diamond and Verrecchia (1987) predict that short-sale constraints can damage market quality. We leverage the first of several recent short-sale restrictions to test the impact of short-sale constraints on stock prices and market quality in an empirical setting not available to prior studies. We find that the restrictions temporarily inflated the prices and negatively impacted the market quality of the stocks they were designed to protect.

The recent wave of short-sale regulations began on July 15, 2008, when the US Securities and Exchange Commission (SEC) announced an Emergency Order restricting naked short sales of the stocks of 19 publicly traded financial firms. The Emergency Order was in effect from July 21 to August 12, 2008. On announcing the Emergency Order, the SEC pointed to "a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets."[3] We exploit the Emergency Order as a natural experiment to study the impact of short-sale constraints on stock prices and market quality by comparing stock returns and market quality changes for the restricted firms with a matched sample of unrestricted firms.

Miller's (1977) overpricing hypothesis suggests that short-sale constraints dampen the incorporation of negative information into prices, resulting in overpriced securities. Lamont (2004, p. 1) notes, "[Short sale] constraints are difficult to measure, however, and researchers have struggled to find appropriate data to test the overpricing hypothesis." Previous tests of the overpricing hypothesis have employed a variety of proxies for short-sale constraints, including short interest or the change in short interest (Figlewski, 1981; Desai et al., 2002; Asquith et al., 2005), the introduction of options (Figlewski and Webb, 1993; Danielson and Sorescu, 2001), stock loan supply and fees (D'Avolio, 2002; Geczy et al., 2002; Jones and Lamont, 2002), breadth of ownership (Chen et al., 2002; Asquith et al., 2005; Nagel, 2005), and legal threats, investigations, or lawsuits (Lamont, 2004). An alternative approach, found in Charoenrook and Daouk (2005) and Bris et al. (2007), leverages cross-country differences in short-sale regulations to test the relation between short-sale restrictions and stock returns. Although tests of the overpricing hypothesis generally support the notion that short-sale constraints result in overpriced securities and low subsequent returns, each of these proxies previously used for short-sale constraints has limitations. For example, Chen et al. (2002) note that using short interest to proxy for

[2]Countries that introduced restrictions included Australia, Belgium, Canada, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Russia, Singapore, Switzerland, Taiwan, the United Kingdom, and the United States.

[3]SEC, Release no. 58166/July 15, 2008, p. 2.

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