Which financial stocks did short sellers target in the subprime crisis?*

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\textbf{A B S T R A C T}

Tracing the SEC ban on the short selling of financial stocks in September 2008, this paper investigates whether such selling activity before the 2008 short ban reflected financial companies’ risk exposure in the subprime crisis. Evidence suggests that short sellers sold short stocks that had the greatest asset and insolvency risk exposures, and that the short selling of financial firms’ stocks was not significantly greater than that of non-financial firms after we match them on firm size and insolvency risk. When the short ban was in effect, the market quality of financial stocks without subprime assets exposure had deteriorated to a larger degree than that of financial companies with subprime assets exposure. The findings imply that such a regulation may mute the market disciplining effects of investors and may also be seen as a counterweight to any perceived macro or systemic risk reduction benefits resulting from such a ban.

\section{1. Introduction}

Short sellers such as hedge funds were accused of using short sale strategies to push down the prices of financial company equities below their fundamental values during the 2007–2009 crisis. Indeed, a sequence of actions taken by the SEC seems to be consistent with this belief. On 15 July 2008, the SEC issued an emergency rule to limit certain types of short selling,\textsuperscript{1} namely, the “naked” short selling of 19 major financial firms. On 17 September 2008, the SEC announced that this rule was to be extended to all publicly traded financial firms. On 18 September 2008, the SEC announced a ban effective immediately on all types of short selling of the stocks of 797 public financial companies, which continued until 8 October 2008. At the time, the SEC’s Chairman, Christopher Cox, claimed that this short selling ban was an effort “to combat market manipulation that threatens investors and capital markets.”\textsuperscript{2} Within a week, the prohibition on short selling had spread to markets overseas, including the United Kingdom, Australia, Taiwan, and the Netherlands.\textsuperscript{3}

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\textsuperscript{1} See SEC Press Release 2008-143 on 15 July 2008.

\textsuperscript{2} See SEC Press Release 2008-211 on 19 September 2008.

\textsuperscript{3} According to a recent BBC news article from 12 August 2011, the European Securities and Marketing Authority (ESMA) issued a statement that France, Italy, Spain, and Belgium were set to ban short selling on select stocks, including large banks and insurers such as BNP Paribas, Crédit Agricole, and Natixis.
The 2008 short ban triggered significant controversy. A number of hedge fund managers and other investors actively opposed the ban, arguing that regulators were actually punishing short sellers for the mistakes made by financial companies that had exposed themselves to risky asset investments, such as subprime mortgage-backed securities and other credit derivatives. Richard Baker, head of the Managed Funds Association, a hedge fund lobbying group, argued that hedge funds short because they identify fundamental problems with a company. "If in fact a company does fail, it will have nothing to do with the fact that someone on the outside noticed these deficiencies." Additionally, financial economics researchers commonly believe that short sellers are active, rational, and even informed traders that help facilitate the price discovery process (Boehmer and Wu, 2013) and keep price in line with the fundamental or intrinsic values (e.g., Dechow et al., 2001). Short-sale constrained stocks, on the other hand, may be traded at a price above their fundamental values, and therefore may underperform in the future (e.g., Miller, 1977; Boehne et al., 2006; Asquith et al., 2005).

This paper investigates whether investors rationally anticipated and traded on certain types of fundamental information that affected future returns, and we are specifically interested in overinvestment in risky assets and overall insolvency risk exposure. Given the controversies regarding the short ban, this is an important research question for both researchers and regulators. First, financial institutions' excessive exposure to risky assets—specifically subprime assets—is believed to have been one of the major causes of the 2007–2009 crisis. The question of whether and how these types of risk exposures affected short selling activity remains unanswered in the literature. Second, if companies with greater exposure to risky assets were actually sold short to a greater degree, then opposition to the SEC's ban on short selling would have been reasonable. Indeed, as has been shown in a more general context, short selling activity enhances the informational efficiency of asset prices (e.g., Boehmer et al., 2008; Boehmer and Wu, 2013). That is informed traders inject additional information (and potentially more accurate information) into the marketplace by short selling. Thus, banning short selling could have had unfavorable informational consequences. Stock prices, for instance, might no longer be an accurate reflection of the full information set in the marketplace, especially with regard to a financial company's investment in subprime assets. Such "inefficiency" effects may be perceived as offsets to any potential macro policy or systemic risk reduction benefits from such a ban.

There have been a number of papers that investigate the impact of the short ban on different markets. For example, Boehmer et al. (2013) show that the ban lowered market quality as measured by spreads, price impact, and intraday volatility for affected stocks. Gagnon and Witmer (2009) have demonstrated—via a natural experiment crafted around cross-listed stocks between the Canadian and U.S. markets—that the 2008 short selling ban actually caused stock prices to trade above their fundamental values. Beber and Pagano (2013) find that short bans around the world during the 2007–2009 crisis were detrimental for liquidity, slowed price discovery, and failed to support prices. Kolasinski et al. (2013) find that short bans result in more informed trading. Battalio and Schultz (2011) and Grundy et al. (2012) focus on the impact of the option market. Danciulescu (2009) and Choi et al. (2010) examine the impact on the bond market. However, the heterogeneity of market quality deterioration within stocks affected by the short ban has been relatively under-researched. This paper further investigates whether financial firms with greater subprime asset expo-

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5 See Desai et al. (2002), Asquith et al. (2005) and Diether et al. (2009), for example.
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