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The costs and benefits of short sale disclosure

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ABSTRACT

In this study, we examine the impact of a market-wide mandatory disclosure policy on short selling on the Tokyo Stock Exchange. We find that average short selling slightly declined while investors' shorting strategies changed significantly in response to the disclosure. Previously highly shorted stocks were shorted less and shorting activity shifted toward smaller and riskier stocks, suggesting that retail investors became the more likely short sellers. Short sales became more trend-chasing, prices became less informative, and short-term price volatility increased. Overall, the pricing efficiency benefits of short selling declined after the mandatory disclosure policy.

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1. Introduction

During the Global Financial Crisis (GFC) of 2007 to 2009, short sellers were blamed for increasing price volatility, intensifying price drops, and distressing share prices (Culp and Heaton, 2008; SEC, 2008). Numerous exchanges deemed short sale practices to be too aggressive resulting in temporary or permanent bans on naked shorting and mandated reporting for large short sales in an effort to curb them. After the collapse of Lehman Brothers, such measures were mostly aimed at stabilizing volatile financial stocks, so the initial reporting requirement of large short positions focused on those stocks. For example, following European exchange

disclosures of large short financial stock positions, permanent price effects suggest increased information from large shorts improved pricing efficiency (Jones et al., 2013).

However, the reporting requirements have spread worldwide and across different asset classes since the financial crisis. More recently, in 2012, the European Securities and Market Authority (ESMA) introduced a standardized, market-wide reporting and disclosure procedure for short sellers in all EU markets, covering stocks and treasuries. The standardization likely benefits all market participants in terms of reducing the administrative burden of dealing with different disclosure requirements across the member states. Although markets worldwide have implemented similar disclosure policies for large short positions, no studies have examined the impact of such policies. To our knowledge, our study is the first to analyze the impact of market-wide short sale disclosure policy. We provide new insights into the impact of short sale disclosure on shorting activity, stock returns, and market quality, which are major concerns for regulators. Thus, our study contributes to the regulatory debate on the costs and benefits of mandatory disclosure policies.

We study a well-developed market, the Tokyo Stock Exchange (TSE), around the GFC, during which the Financial Services Agency of the Japanese government implemented a mandatory disclosure

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¹ Following the collapse of Lehman Brothers, regulators introduced disclosure measures on large short sales in Australia (Sept. 2008), Belgium (Sept. 2008), France (Sept. 2008), Germany (Sept. 2008), Greece (Sept. 2008), Hungary (Sept. 2008), India (Oct. 2008), Ireland (Sept. 2008), Japan (Nov. 2008), the Netherlands (Oct. 2009), Portugal (Sept. 2008), Spain (Sept. 2008), United Arab Emirates (Oct. 2008), and the United Kingdom (Sept. 2008). For a full review of disclosure regimes, see Gruenewald et al. (2010).

of large positions for all listed stocks on its exchange. The mandatory disclosure policy (hereafter MDP) requires traders to report within 24 h to the exchange all short positions in excess of 0.25% of the shares outstanding. The information is then publicly disseminated within 24 h.² Since short sellers may behave differently when providing information to regulators than they would when disclosing information to the public, it would be difficult to distinguish between the two behaviors. Thus, the Japanese MDP is especially suited for examining the impact of public disclosure on market quality. Specifically, we examine shorting demand and the role of short selling on pricing efficiency for TSE stocks from July 2006 to July 2010, focusing on changes after November 7, 2008, when the MDP was introduced.

Although regulators hope to support stock prices, curtail volatility, and improve overall pricing efficiency with disclosure (FSA, 2009), its impact is *a priori* unclear because of possible market participants' strategic reactions. Mandatory reporting is required only above a specific threshold, so the policy mostly affects active institutional traders.³ Consequently, institutional investors worldwide protested that the disclosure policy would add additional reporting costs, reveal trade secrets, and allow other investors to free-ride on private information. Industry studies questioned the benefits of mandated reporting by showing that disclosure policies constrain liquidity and increase volatility (e.g., Oliver Wyman Financial Services, 2011). They also suggested that short sellers stay below the reporting requirements or divert investments to other markets because institutional traders face direct administrative costs of reporting and indirect costs from revealing private information.

Moreover, short sellers are generally considered to be relatively informed investors (Diamond and Verrecchia, 1987) whose trades are widely viewed as beneficial for price discovery and market efficiency (Boehmer and Wu, 2013). Mandatory disclosure of large positions is expected to affect the behavior of both informed and uninformed investors: retail or noise traders can obtain valuable information from the disclosure of large institutional short positions and trade on such information, while informed short sellers (e.g., hedge funds) may attempt to disguise their positions by changing their trading strategies or moving to a less transparent market (Easley et al., 2014). Therefore, policies that reduce or affect short sellers' behavior call for regulatory and academic attention.

We document a large drop in the aggregate shorting activity at the onset of the GFC, likely as a result of the increased risk aversion in the market. While we find evidence of some recovery in the shorting volume, the aggregate level remains still significantly lower during the MDP period compared to the pre-crisis period. To better understand the MDP implications, we examine short selling changes by comparing stocks in the cross-section before and after the introduction of the MDP. Specifically, after the MDP, although shorting demand declined for heavily shorted stocks, it increased for riskier and poorly performing stocks. These suggest that short seller composition might have shifted from institutional investors to retail investors because of the disclosure, consistent with theoretical predictions (Easley et al., 2014). Informed investors are naturally averse to transparent markets (Fishman and Hagerty, 1995; Madhavan, 1995), so institutional investors might

have reduced their trades, while small, uninformed investors might have increased their trades since they can trade on the disclosed information.

We also examine the pricing efficiency of short sales around the MDP implementation and find that pricing efficiency deteriorated after the MDP was introduced. Although previous studies documented contrarian trading behavior of short sellers, we report that short sellers showed more trend-chasing after the MDP introduction. We also find that price volatility increased for large and heavily shorted stocks, which are more likely to cross the threshold level for the disclosure requirement. In sum, our study highlights that the MDP might have indirect costs that negatively impact market quality, which concerns both institutional investors and policymakers.

During the GFC, the Financial Services Agency also banned naked short sales on November 4, 2008, just 4 days before the MDP implementation. In line with theoretical predictions (Diamond and Verrecchia, 1987), if a ban on short sales increased short selling cost, we would expect a higher concentration of informed short sellers after the ban because a higher cost would discourage uninformed traders and in turn should improve market quality. Although we find increased lending fees for large and highly shorted stocks, contrary to Diamond and Verrecchia's (1987) prediction we document deteriorating market quality for these stocks. Therefore, our results imply that the MDP's impact on market quality dominates the ban on naked short sales. We also find that average lending fees decreased after the ban, so our overall results suggest that the ban might have failed to have a market-wide effect on short selling during the period.

The rest of this paper is organized as follows. In Section 2, we discuss the relevant literature and the development of our research hypotheses. In Section 3, we describe our data and present the empirical analyses on the role of disclosure policy in relation to short selling and pricing efficiency. We draw conclusions in Section 4.

2. Literature review and hypotheses development

We contribute to the literature on market transparency in relation to short selling. Previous literature on market disclosure shows that strategic trading behaviors of both informed and uninformed traders in response to disclosure are important in determining market quality. On the other hand, studies on short selling have suggested that short sellers are relatively informed institutional investors who make markets more efficient (Diamond and Verrecchia, 1987; Boehmer and Wu, 2013). In this section, we summarize the relevant literature and present our research hypotheses for the impact of the MDP. As our sample covers the GFC, a naked short sale ban, and an MDP, we also discuss implications of these different and economically important overlapping events in the context of the Japanese stock market.

2.1. Short selling and pricing efficiency

Short sellers are generally viewed as informed traders because the higher costs and risks of shorting likely discourage uninformed traders from active shorting (Diamond and Verrecchia, 1987). Empirical evidence has consistently shown that short sellers forerun important firm announcements such as analyst downgrades, earnings revisions, insider trading, and disclosures of aggressive accounting practices (e.g., Chakrabarty and Shkilko, 2013; Christophe et al., 2010). Ample evidence shows that short sellers are either informed traders or efficient information processors able to identify and load on overvalued stocks while identifying and avoiding undervalued ones (e.g., Blau et al., 2012; Boehmer et al.,

² In early 2013, Japan's Financial Services Agency (FSA) announced changes to these short sale reporting requirements. Short sellers must now report all net short positions in excess of 0.2% of shares outstanding, but only positions in excess of 0.5% are disclosed to the public, as with the new European ESMA reporting. The series of measures that the FSA implemented in 2008 during the financial crisis were temporary. In 2013, the FSA revised the temporary measures to permanent status, in line with similar measures in other countries.

³ Most countries require short sellers to report their short exposure once it exceeds a certain threshold. Originally, in 2008, Ireland, the Netherlands, and Japan introduced similar thresholds, requiring short sellers (both individuals and institutions) to report aggregate short positions that are greater than 0.25% of the total shares outstanding.

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