We investigate the aggregate market quality impact of equity shares that fail to deliver (hereafter “FTDs”). For a sample of 1,492 NYSE stocks over a 42-month period from 2005 to 2008, greater FTDs lead to higher liquidity and pricing efficiency, and their impact is similar to our estimate of delivered short sales. Furthermore, during the operative period of a Security and Exchange Commission (SEC) order mandating stock borrowing prior to short sales, the securities affected display relatively lower liquidity and higher pricing errors. Finally, we do not find any evidence that FTDs caused price distortions or the failure of financial firms during the 2008 financial crisis.

1. Introduction

Trades in US stock markets are settled on a three-day cycle: for trades on day \( t \), if the net delivery obligations of a clearing member are not fulfilled on day \( t+3 \), any undelivered position becomes a “failure-to-deliver” (or FTD).

Regulators and financial journalists have widely perceived FTDs, and specifically “naked” short sales, as having a very negative impact on markets. For example, a report in *Time Magazine* (“Watch out, they bite,” November 9, 2005), quoting estimates by former Under Secretary of Commerce Robert J. Shapiro, alleges that naked short selling has “cost investors $100 billion and driven 1,000 companies into the ground”; and an article in *Euromoney* (“Short selling: the naked truth,” December 2008) claims that, “Fails to deliver in the US equity market have exacerbated the sharp declines in share prices of financials. Although the SEC is clearing up the mess caused by naked short selling, more drastic measures might be needed to restore confidence.” In this context, this paper investigates the overall net impact (on day \( t+1 \)) of the change in the open interest of undelivered positions (i.e., the change in FTDs) generated...
collectively by trades on day $t$ (and observed on day $t + 3$). First, we analyze the effect of FTD changes on pricing efficiency and liquidity. Second, we examine whether FTD changes played a causal role in the major price declines or the demise of financial institutions during the 2008 financial crisis.

Settlement on US stock exchanges is done electronically through the Depository Trust and Clearing Corporation, its subsidiaries, and associated agencies (hereafter collectively referred to as the DTCC). Ownership records are largely held, tracked, and transferred electronically through the DTCC, with more than 99.9% of all trades involving only electronically held securities (Morris and Goldstein, 2009). The DTCC becomes the central counterparty of all duly-owned stock electronically held, tracked, and transferred electronically through the Depositary Trust and Clearing Corporation, its subsidiaries, and associated agencies (hereafter collectively referred to as the DTCC). Ownership records are largely held, tracked, and transferred electronically through the DTCC, with more than 99.9% of all trades involving only electronically held securities (Morris and Goldstein, 2009). The DTCC becomes the central counterparty of all duly-owned stock electronically held, tracked, and transferred electronically through the Depositary Trust and Clearing Corporation, its subsidiaries, and associated agencies (hereafter collectively referred to as the DTCC). Ownership records are largely held, tracked, and transferred electronically through the DTCC, with more than 99.9% of all trades involving only electronically held securities (Morris and Goldstein, 2009). The DTCC becomes the central counterparty of all duly-owned stock electronically held, tracked, and transferred electronically through the Depositary Trust and Clearing Corporation, its subsidiaries, and associated agencies (hereafter collectively referred to as the DTCC). Ownership records are largely held, tracked, and transferred electronically through the DTCC, with more than 99.9% of all trades involving only electronically held securities (Morris and Goldstein, 2009). The DTCC becomes the central counterparty of all duly-owned stock electronically held, tracked, and transferred electronically through the Depositary Trust and Clearing Corporation, its subsidiaries, and associated agencies (hereafter collectively referred to as the DTCC). Ownership records are largely held, tracked, and transferred electronically through the DTCC, with more than 99.9% of all trades involving only electronically held securities (Morris and Goldstein, 2009). The DTCC becomes the central counterparty of all duly-owned stock electronically

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