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The impact of naked short selling on the securities lending and equity market ☆

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Abstract

This paper examines the impact of naked short selling on equity markets where it is restricted to securities on an approved list. Consistent with Miller's (1977) intuition, stocks with the highest dispersion of opinions and short sale constraints are the only stocks to exhibit significant and negative abnormal returns in the post-event period. We also find slightly higher stock return volatility and a small reduction in liquidity when naked short sales are allowed. Overall, it impairs market quality (liquidity and volatility), although there appears to be some improvement in price efficiency in stocks with high short sale constraints.

JEL classification: G10; G14

Keywords: Short sale constraints; Liquidity; Naked short selling; Australian Securities Exchange; Regression discontinuity design

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1. Introduction

In an effort to stop unlawful stock price manipulation, on July 9, 2008 the Securities and Exchange Commission (SEC) in the United States announced an emergency order to immediately curb naked short selling on nineteen financial firms.[1] On September 19, 2008, regulators in the United Kingdom also acted by banning short selling (both covered and naked) on leading financial stocks. The SEC subsequently moved to ban short selling on financial stocks from September 22, 2008 until October 9, 2008. Other markets soon followed and announced their own bans: Australia temporarily banned all forms of short selling and later placed an indefinite ban on naked short selling; Germany, Ireland, Canada, Indonesia, and Greece banned short selling on leading financial stocks; Korea banned short selling on all stocks; France, Italy, Portugal, Luxembourg, The Netherlands, and Belgium banned naked short selling on leading financial stocks; and Japan and Switzerland banned naked short selling on all stocks.

Although short selling has long been a contentious issue (Chancellor, 2001), this latest series of bans on short selling serves to highlight a common concern among market participants over the use of short selling and, in particular, naked short selling. It is interesting to note that while most markets have reinstated covered short selling as a legitimate trading activity, naked short selling remains largely outlawed.[2] This is an interesting development as, despite the apparent assumption that naked short selling is detrimental, relatively little or no empirical evidence is available on the impact that naked short selling has on financial markets.

The literature examines changes in the rules governing either covered short sales (Chang, Chang, and Yu, 2007), or changes to short sale constraints that affect both naked and covered short sales (Boehme, Danielsen, and Sorescu, 2006). The purpose of this paper is to bridge this gap in the literature by directly examining the impact of allowing *naked* short selling on returns, volatility, and liquidity. This opportunity is provided by a unique feature of the Australian Securities Exchange (ASX), which allows naked short sales for certain securities on an approved short sale list that is revised over time.[3] The addition of a security to the designated list of eligible stocks represents a shift from *only* allowing covered short sales to allowing *both* covered and naked short sales, thus allowing an isolation of the impact of allowing naked short sales on financial markets.

This shift to naked short selling may circumvent the fee charged by the stock lender, which represents a significant cost associated with covered short selling.[4] In addition to this direct cost, there are several risks associated with covered short selling, including the risk

[1]The emergency order took effect on July 21, 2008 and ended August 12, 2008.

[2]Naked short sales are not permitted on all stocks in Australia, Japan, Hong Kong, China, Switzerland, Spain, Russia, Luxembourg and Korea. Naked short sales are not permitted on certain financial stocks in the Netherlands, Portugal, Italy and France. In the U.S., naked short sales are restricted by requiring that sellers deliver securities by the settlement date. If violated, the broker-dealer acting on the short seller's behalf will be prohibited from further short sales (for all customers) in the same security unless the shares are not only located but also pre-borrowed (www.sec.gov).

[3]Securities are added or removed from the list based on market capitalization, shares issued, and liquidity. See Section 3.1 for further detail.

[4]In Australia, naked short sellers at the time of sale have not borrowed or entered into an agreement to borrow the stock and may repurchase the stock without incurring the borrowing fee. The Australian Securities Lending Association Limited estimate that these costs can range between 25 and 400 basis points, representing a significant barrier to covered short sales. See Section 3.2 for further detail.