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## Changing the rules again: Short selling in connection with public equity offers

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## ABSTRACT

We study the impact of two recent regulations that impose restrictions on short selling. First, since October 2007 any investor that short sells a firm's stock is prohibited from purchasing shares in the firm's seasoned equity offering (SEO) if the short occurred in the five days prior to the offering (pursuant to an amendment to Rule 105). Previously Rule 105 only disallowed investors from covering a pre-issue short sale with shares purchased in the offering. We hypothesize that the amended rule has the unintended consequence of greater discounting for overnight offers, which are not announced in advance, because the rule excludes some potential buyers and thereby forces underwriters to set lower offer prices to fully distribute the offer. The evidence supports this hypothesis. Second, we examine the impact of the SEC's 2008 Emergency Order that greatly curtails naked short selling on all stocks under its jurisdiction. We find that the Emergency Order is associated with large increases in discounting for offers announced in advance, suggesting that the removal of naked short sellers is associated with reduced pre-SEO pricing efficiency. Taken together, the results imply that recent restrictions on short selling have significant unintended effects on the capital raising process.

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## 1. Introduction

We study the impact of two recent regulations that impose restrictions on short selling. The first is the 2007 amendment that significantly strengthens Rule 105, and the second is the 2008 Emergency Order that dramatically curtails the prevalence of naked short selling. We particularly focus on how these restrictions impact the pricing of seasoned equity offers (SEOs).

Rule 105 prohibits short sellers from covering short positions with shares purchased in an SEO if the position was established in the five business days prior to the offer date.<sup>1</sup> Rule 105 is intended to prevent manipulative short selling that can artificially distort prices and lower the expected offering proceeds to the issuer or selling shareholders. A number of articles examine the effect of pre-issue short sale constraints imposed by Rule 105 on the pricing of seasoned offers, with mixed results (e.g., Gerard and Nanda, 1993; Safieddine and Wilhelm, 1996; Corwin, 2003; Kim and Shin, 2004;

Henry and Koski, 2010; Autore, 2011).<sup>2</sup> No study to date, however, examines the impact of a recent rule change that substantially strengthens Rule 105. This study provides such an examination.

Effective October 9th, 2007, the SEC amended Rule 105 to eliminate the covering element of the former rule.<sup>3</sup> Under the amended rule, any person who opens a short position in the five days prior to issuance is prohibited from purchasing shares in the offer, regardless of whether the purchased shares would be used to cover the short. Prior to this amendment, Rule 105 only prohibited a person from covering a short position with newly offered shares; an investor was able to short a stock during the restricted period and then buy shares in the offering, as long as the offered shares were not used to cover the short. The intent of the amendment is to eliminate trading strategies that evade the former rule. However, as we elaborate,

<sup>2</sup> More specifically, Gerard and Nanda (1993) argue that the rule could restrict informationally motivated pre-offer short sales, compromising market efficiency and leading to greater SEO discounting. Safieddine and Wilhelm (1996) find that the rule, where binding, reduces discounting and thus lowers the expected costs of issuance, as intended. However, Corwin (2003) and Kim and Shin (2004) find that discounting increases after the implementation of the rule. Henry and Koski (2010) argue that the rule does not effectively eliminate manipulative short selling around the issue date. Autore (2011) finds that the rule has no effect on SEO discounting.

<sup>3</sup> The final rule can be seen here: <http://www.sec.gov/rules/final/2007/34-56206.pdf>.

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<sup>1</sup> Rule 105 was originally adopted by the Securities and Exchange Commission in 1988 (then known as Rule 10b-21).

the amendment has the potential to cause unintended consequences for certain issuers.

In adopting the amendment to Rule 105, the SEC cited the use of cross-trading strategies to evade the former rule. An example is a scenario whereby a short sale during the restricted period is followed by a purchase of shares in the offering, and two open market trades, a sale and a purchase, which occur nearly contemporaneously. A similar scenario is one in which an investor uses post-offering crossed limit orders and market orders at identical or nearly identical prices.<sup>4</sup> These evasive strategies are less effective under the amended rule because any investor that short sells during the restricted period is prohibited from purchasing shares in the offering.

Despite this potential benefit, the amendment to Rule 105 could adversely impact issuers that conduct offers with little advanced notice. For example, if an offer is announced two days before issuance, any investor that opens a short position during the three days prior to the announcement would be prohibited from buying shares in the offer even though that investor reasonably had no knowledge of the offer when the short position was opened. This scenario could make it more difficult for underwriters to locate eligible investors to purchase offered shares, possibly resulting in lower offer prices, *ceteris paribus*. To address this concern, the amendment to Rule 105 includes a provision that allows restricted-period short sellers to purchase offered shares if they cover their short position at least one business day prior to the pricing of the offer (i.e., bona fide purchase exemption). This provision, however, is of little benefit in “overnight” offers in which the issuing firm provides no advanced notice of the offering.<sup>5</sup>

More specifically, in overnight offers a short seller does not have adequate time to satisfy the one day requirement for the bona fide purchase exemption and can be prohibited from buying offered shares without ever having knowledge of the approaching offer. When investors (who may include favored clients of the underwriting firm) are excluded from buying offered shares, placing all the offered shares is more difficult and as a result the underwriter is more likely to set a lower offer price to ensure complete distribution. Based on these arguments, we hypothesize that overnight offers are associated with greater offer price discounting after the amendment to Rule 105 takes effect.

Rule 105 is unlikely to affect discounting for non-overnight offers because an investor that wishes to buy primary market shares has time to satisfy the bona fide exemption by covering a restricted-period short sale before the offering takes place. We take advantage of the fact that our hypothesis is specific to overnight offers by using a difference-in-difference approach that compares the difference in discounting in overnight offers before and after the rule to the difference in discounting in non-overnight offers before and after the rule.

We find that the amendment to Rule 105 is associated with a large increase in the discounting of overnight offers. For example, before the amendment (January 2005–October 8th, 2007), the average discounting in overnight offers is 3.62%, whereas after the amendment (October 9th, 2007–September 17th, 2008) the average discounting is 6.24%. The respective median values are 3.40% and 6.05%. The increase in discounting from pre- to post-amendment is highly significant and does not represent a general time trend; the results are similar if we examine only offers in narrower time frames around the effective date. Thus, the amendment

appears to have the unintended consequence of greater discounting in overnight offers.

These findings are not driven by a market-wide increase in SEO discounting. During the same pre- and post-amendment windows the average discounting in non-overnight offers increases from 2.46% to 2.62%. The respective median values are 1.86% and 2.16%. These changes are statistically insignificant. In regression estimates that control for many known determinants of discounting, the difference-in-difference estimate suggests that the amendment is associated with a change in discounting for overnight offers that is a significant 1.66% higher than the change for non-overnight offers. This difference is large in magnitude given that discounting typically ranges from 2% to 4%. In economic terms a typical overnight issuer that raises \$200 million incurs an additional discounting cost of \$3,320,000 after the amendment compared to before, *ceteris paribus*. This evidence suggests that the SEC’s strengthening of Rule 105 significantly lowers offer proceeds for issuers that conduct overnight offerings. Our findings remain strong when we restrict the analysis to shelf offers (which include both overnight and non-overnight offers), and when we control for whether the offer is issued on an accelerated basis.

We address the possibility that the increased discounting in overnight offers after the amendment to Rule 105 is due to lower quality firms self-selecting into overnight offers as opposed to our premise that it is due to an artificial lessening of demand resulting from restrictions on short sellers. In particular, we examine abnormal stock returns on the issue date and the following five days. We find no evidence of larger permanent stock price declines after the amendment compared to before, suggesting that, in investors’ view, overnight issuer quality does not deteriorate after the amendment.<sup>6</sup> This evidence further supports our hypothesis that increased discounting after the amendment stems from an artificial lessening of demand due to restrictions on short sellers.

A potential concern with our analysis is whether investors who express pessimism via a short position would have any interest in SEO allocations soon after initiating the short. There are at least two reasons why a short seller of a particular stock may nevertheless be willing to purchase shares in the stock’s offering. First, short positions are often opened for reasons associated with hedging or market making as opposed to pessimism. Second, an investor who is somewhat pessimistic about the secondary market price may nevertheless be willing to purchase newly issued shares at the discounted offer price. In our sample, the average discount equals 3.57%. This represents a relatively large \$1 dollar discount of the offer price from the prevailing market price for a typical sample offer that priced at about \$24. While there is no way to be certain of the intentions of short sellers, it seems reasonable that a non-trivial portion of investors holding short positions would be interested in buying newly offered shares.

The second regulatory event we study is the SEC’s Emergency Order, effective as of September 18, 2008, which largely removes naked short sellers from the market. A naked short sale of a security occurs when a short seller does not borrow shares before selling them, and results in a failure-to-deliver after three days if the seller does not deliver the shares within that time frame. The Emergency Order discourages broker-dealers from allowing their customers to engage in naked short sales by imposing severe penalties on the broker-dealer when a customer fails to deliver a particular security within three days of the sale.<sup>7</sup> Thus the Emergency

<sup>4</sup> In these scenarios the short seller could claim that the offered shares were not used to cover the short. Nevertheless, in economic terms, these strategies mimic the ones that Rule 105 was originally designed to prevent.

<sup>5</sup> The bona fide purchase exemption stemmed from comments by individuals that opposed the amendment to Rule 105 due to unintended effects for offers with little or no advanced notice. The SEC acknowledged that this exemption does little to alleviate this concern in the case of overnight offers.

<sup>6</sup> We thank Vijay Singal for suggesting this test.

<sup>7</sup> In particular, if a short seller fails to deliver a particular security within three days of the sale, the broker-dealer of that short seller is not allowed to facilitate short sales in that particular security for any of its clients unless it first borrows the shares. See Securities and Exchange Commission, Release No. 34-58572/September 17, 2008. This rule was made permanent in July 2009; see SEC Release No. 34-60388.

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