



Full length article

Analysis of market quality before and during short-selling bans



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ABSTRACT

We measure the impact of the August 2011 bans on covered short-selling adopted by several European countries. Our results provide evidence that the impact on prices was short-lived: the positive price impact disappears after ten days. The short-selling restrictions did not contribute to reduce the volatility of the financial stocks subjected to the bans; on the contrary, our findings indicate that volatility actually increased by a greater extent for these stocks than for other financial stocks with similar characteristics. The bans also had a negative impact on liquidity. Moreover, stocks subjected to the bans exhibit a longer delay in the assimilation of negative market news during the banning span.

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1. Introduction

The years 2010 and 2011 were characterized by a high degree of uncertainty in the stock and bond markets. The stock market volatility hiked, but that increase was more prominent among financial issuers. The European sovereign debt crisis started in Greece, Ireland and Portugal, but soon began to threaten Italy and Spain, contributing to this increase in volatility. During the second quarter of 2011, political measures were deployed to mitigate the possible implications of debt restructuring in Greece. This period was also rife with countless rumours related to the resolution of the European sovereign debt crisis and the disclosure of the results of stress tests in several European banks.

Within this context, some European regulators temporarily banned the short-selling of financial stocks on August 11, 2011. This step aimed to reduce volatility and to stop (or, at least, mitigate) financial panic and downward spiral in prices. Evidence of rumours with the purpose of market manipulation served to justify the bans, which were implemented in France, Italy, Belgium and Spain (hereinafter, FIBS). Although these measures were expected to be in place for 15 days only (with the exception of Belgium, which announced that the ban would remain in effect indefinitely), they remained active until

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¹ The views stated herein are those of the authors and not necessarily those of the CMVM.

February 2012². This paper addresses the impact of these bans on the covered short-selling activity on financial stocks in FIBS. We first investigate the bans' effects on market quality, i.e. liquidity, volatility and price discovery mechanisms. Then, we evaluate the impact of the bans on the price dynamics of securities covered by the bans. This assessment is important in order to appraise whether the bans were effective in reducing the risks of negative price spirals.

Most neoclassical models in finance assume that some market players (arbitrageurs) have the ability to 'enforce' the law of one price. Aligning market prices with theoretical prices may sometimes entail the implementation of short-selling strategies. Short-selling may also be important for investors not holding the stocks that want to trade on their negative beliefs. In fact, in the presence of short-selling restrictions, prices will only reflect the negative beliefs of stockholders, and will not reflect the negative beliefs of investors who do not hold the stocks. This signifies that banning short-selling may have implications on market efficiency, and for that reason it is a topic of obvious interest for academics, policy makers and practitioners.

There is a large bulk of literature investigating the effects of short-selling restrictions on liquidity, volatility, price discovery and overpricing³. For example, [Boehmer et al. \(2008, 2013\)](#), [Fotak et al. \(2009\)](#), [Gagnon and Witmer \(2010\)](#), [Kolasinski et al. \(2013\)](#), [Battalio and Schultz \(2011\)](#), [Marsh and Payne \(2012\)](#) and [Beber and Pagano \(2013\)](#) find that short-selling restrictions have an adverse effect on liquidity. However, [Jones and Lamont \(2002\)](#) present conflicting evidence. In terms of price discovery, [Diamond and Verrecchia's \(1987\)](#) theoretical model predicts that the existence of trade restrictions hinders price discovery asymmetrically, with less retardation in upward than in downward movements. [Miller \(1977\)](#), [Harrison and Kreps \(1978\)](#), [Biais et al. \(1999\)](#), [Bris et al. \(2007\)](#), [Chang \(2010\)](#), [Saffi and Sigurdsson \(2011\)](#), [Boehmer and Wu \(2013\)](#) and [Beber and Pagano \(2013\)](#) provide similar empirical and theoretical findings.

In contrast to [Diether et al. \(2009\)](#), [Boehmer et al. \(2010\)](#) and [Beber and Pagano \(2013\)](#), several authors, including [Jones and Lamont \(2002\)](#), [Chang et al. \(2007\)](#), [Lobanova et al. \(2010\)](#) and [Autore et al. \(2011\)](#), provide evidence consistent with the overpricing hypothesis (i.e. short-selling restrictions lead to price inflation). [Boehmer et al. \(2010\)](#) find that stocks with relatively high short open interest subsequently experience negative abnormal returns, but the effect can be transient and of debatable economic significance. Finally, [Abreu and Brunnermeier \(2002, 2003\)](#), [Scheinkman and Xiong \(2003\)](#), [Hong and Stein \(2003\)](#), [Charoenruek and Daouk \(2005\)](#), [Bris et al. \(2007\)](#), [Lioui \(2009\)](#) and [Boehmer et al. \(2013\)](#) indicate that short-selling restrictions are associated with higher volatility.

Although most studies support the hypothesis that short-selling constraints contribute to decrease market efficiency, this conclusion is not shared by all researchers. This paper adds to the literature by investigating the effects of the 2011 short-selling bans in FIBS markets. The analysis of these specific episodes is important for several reasons, but perhaps the most important is that, following these bans, the harmonization of the EU's Regulation on Short-selling ("REGULATION (EU) No 236/2012 on short-selling and certain aspects of credit default swaps")⁴ was conducted by policy makers as a response to uncoordinated actions from the competent authorities of member states. Currently, policy makers are still discussing this issue under the new Markets in Financial Instruments Directive (MiFID). The analysis of the 2011 episodes merits a special attention because it focuses only on European Union (EU) markets, where there is still scarce evidence on the effects of short-selling bans and where this issue is under intense debate.

Up to now, studies have mainly focused on the U.S. stock market, although a few reports ([Beber and Pagano, 2013](#), as well as [Bris et al., 2007](#), among others) discuss the impacts of short-selling on a multi-country setting. Despite the recent global trend of harmonization, U.S. markets have long had different rules and a unique market architecture, characterized by a market-driven order book and by the importance of market-makers and specialists in providing liquidity and immediacy. As an example of this idiosyncrasy, the 'up-tick rule' was adopted following the Great Depression to restrict short-selling activity in a declining market, in order to avoid an out-of-control negative spiral. After prevailing for 70 years, it was only eliminated by the U.S. Securities and Exchange Commission (SEC) in 2007. Because market architecture and rules are important and influence the behaviour of market players, it is important to evaluate the effects of short-selling restrictions in jurisdictions and markets other than the U.S. Additionally, studies that cover several countries usually concentrate their efforts in analysing specific periods (as [Beber and Pagano, 2013](#), with the 2007–2009 financial crisis). As these are not natural experiments, the specific environment that surrounds those bans could influence their subsequent effects. In that sense, analysing events that happened in other periods is worthwhile, since they may reinforce, or not, the conclusions of other studies and provide new insights on how the environment at the time of the bans affects its impact.

This paper addresses two different research questions. In the first one, we investigate the impact of the bans on market efficiency, namely on liquidity, volatility and price discovery. We find that the bid–ask spread (and the Amihud liquidity indicator) increases significantly during the ban period for financial stocks domiciled in Western Europe. However, that increment is more severe among those stocks affected by the restrictions. Thus, we conclude that the short-selling bans had a negative impact on market liquidity, consistent with the findings of [Boehmer et al. \(2013\)](#), [Battalio and Schultz \(2011\)](#) and [Beber and Pagano \(2013\)](#), among others, for similar episodes. In parallel, our findings also point towards an increase of volatility of Western Europe financial stocks during the ban period. Strikingly, the volatility up-trend of the stocks affected

² On February 13, 2012 FSMA (Belgium) and AMF (France) announced the suppression of the ban. This measure was also announced on February 15, 2012 by the CNMV (Spain). Finally, on February 24, 2012 the CONSOB (Italy) ban also expired.

³ See [Beber and Pagano \(2013\)](#) for a recent literature review.

⁴ See <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF>

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