Short sellers not to blame for 2008 financial crisis, study finds

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Contrary to widespread media reports, the collapse of several financial firms during the 2008 economic crisis was not triggered by unsettled stock trades, according to new research from the University at Buffalo School of Management.

The study, forthcoming in the *Journal of Financial Economics*, analyzed the open interest of fails-to-deliver—stock trades in which shares are not delivered within the three-day trading cycle—in the days before and after the stock crashes of American Insurance Group, Bear Stearns, Lehman Brothers and Merrill Lynch.

The researchers, including co-author Veljko Fotak, PhD, assistant professor of finance and managerial economics in the UB School of Management, particularly focused on fails caused by naked short sales, deals initiated for securities the seller does not own and has not arranged to borrow. In each case, they found these trades were not responsible for falling stock prices.

"Short sellers have been accused of using fails-to-deliver as a way to cause sharp declines in stock prices and profit from the resulting collapse of several major financial institutions," Fotak says. "However, we found that on most days there weren't enough settlement fails to cause significant price changes. And when fails were unusually high, it was only after price declines generated by other negative economic news."

The study examined 1,492 New York Stock Exchange and 2,381 Nasdaq common-share trades from January 2005 to June 2008. The research showed that although regulators have been focusing on short sales, the impacts of short sales that fail to deliver and those that deliver on time are similar, and both largely beneficial for the market.

"Our results clearly show that restricting fails-to-deliver hurts the market," Fotak says. "These trades affect market liquidity and significantly reduce pricing errors, order imbalances and volatility over a single day."

Recent restrictions that mandate stock-borrowing arrangements before opening a deal essentially ban naked short sales and fails-to-deliver. Fotak says regulators should instead focus on eliminating the economic incentives for delivery failures by improving liquidity and transparency in the market.

Provided by University at Buffalo

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