Why short selling is good for the capital markets

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Short selling often gets a bad rap because it is a type of trade that bets against the success of a firm. In essence, short selling allows investors to borrow stock from a broker to sell into the market with the hope of

buying the stock back at a cheaper price, thus, profiting on the difference between the sell and buy prices. Because of this practice, short selling is sometimes seen as a controversial tactic.

Furthermore, speculative short selling attacks are concerning as they can put downward pressure on the entire stock market. It is for this reason that governments and regulators have stepped in to curtail or ban short selling during times of market stress such as the Global Financial Crisis or more recently, at the onset of the COVID-19 pandemic.

Contrary to the negativity surrounding short selling, SMU Associate Professor Rencheng Wang told the Office of Research and Tech Transfer, "Quite honestly, there are many benefits of short selling. Short selling can drive market liquidity, price stocks more efficiently, mitigate market bubbles, as well as provide a check on upward market manipulations."

"Because of monetary gains, short sellers are motivated to detect and expose negative news such as poor firm performance that investors have yet to be informed, or unethical and opportunistic behaviors taken by managers at the cost of investors. In other words, short sellers are like detectives of the capital markets," Professor Wang adds.

Given that there are still so many unanswered questions about the positive benefits of short selling, Professor Wang and his collaborators decided to probe deeper into the issue. Specifically, Professor Wang wanted to understand how short selling affects the behaviors of the firm's managers and large shareholders.

Short sale regulation

The regulation on short selling had remained relatively intact since its introduction over 60 years ago. It was believed that the short sale rule

had become increasingly susceptible to abuse and was inconsistent with market developments, which led the SEC (U.S. Securities and Exchange Commission) to adopt a modified version of the proposed Rule 202T in 2005.

As part of the review of the short sale rule, the SEC introduced a pilot program for a select group of securities, of which represented a third of the securities listed on the Russell 3000 index. Rule 202T referred to a temporary exemption from Rule 202 of Regulation SHO (short selling regulation) that suspended any short sale price test for the select group of securities.

The purpose of this pilot program was to enable the SEC to study the effects of unrestricted short selling on, among other things, market volatility, price efficiency, and market liquidity.

The research

Given this scenario, Professor Wang was able to take advantage of this temporary rule exemption by designing a quasi-experiment to compare the performance and behaviors of the designated group of securities (pilot firms) with the rest of the securities (control firms) on the Russell 3000 index.

Professor Wang elaborated, "Our intent of conducting this research was not merely to observe the impact of Rule 202T on short selling. Rather, we expect the firm's managers, whom we call insiders, to adjust their behaviors to reflect the increased threat of short selling."

The sample included 974 pilot firms and 1,935 control firms listed on the Russell 300 index. The research included a total of 55,002 firm quarters in the pre-period of Rule 202T (January 2002—April 2005) to post-period of Rule 202T (May 2005—July 2007).

In conveying the research findings, Professor Wang was pleased to inform the Office of Research and Tech Transfer, "We saw a reduction of 11 percent in opportunistic insider sales in the pilot firms, which means that short selling has a disciplinary effect on the behaviors of the insiders. And the threat of short selling was more pronounced in deterring insiders whose firms have higher litigation risks, greater reputation concerns and have more insiders with large stock-related holdings."

He added, "When we extended our research to the securities listed on the Chinese (Shanghai and Shenzhen) and Hong Kong Stock Exchanges, we also saw a similar pattern—short sellers can deter unethical insiders from engaging in high volume opportunistic sell offs in stock exchanges that differ in culture, market development, and legal environments—from the New York Stock Exchange to other exchanges in Asia. Thus, we provide new evidence to highlight the importance of short sellers in capital market development and governance reforms across different institutional environments."

More information: Kemin Wang et al, Insider Sales under the Threat of Short Sellers: New Hypothesis and New Tests, *The Accounting Review* (2021). DOI: 10.2308/TAR-2018-0196

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