Short Selling and Market Efficiency

A few interesting findings about short selling:

1. There is evidence in short selling activity consistent with information leakage and front-running. (Do Short Sellers Front-Run Insider Sales? Khan and Lu, June 2008.)

2. Short selling restrictions tend to be effective against negative skewness at market level but not at individual stock levels. (Efficiency and the Bear: Short Sales anad Markets around the World, September 2004, Bris, Goetzmann and Zhu.)

3. Where short sales are possible, aggregate stock returns are less volatile and there is greater liquidity. When countries start to permit short-selling, aggregate stock price increases, implying a cost of capital. There is no evidence that short-sale restrictions affect either the level of skewness of returns or the probability of a market crash. (A Study of Market-Wide Short-Selling Restrictions Jan 2005, Caroenrook and Daouk.)

4. While short-sellers take larger positions in stocks with recent price declines than in stocks with recent price increases, when the analysis is conditional on accounting-based measures of fundamental value, the positions of short-sellers in stocks with price declines are concentrated in stocks that are overvalued relative to fundamentals. (Does short-selling amplify price declines or align stocks with their fundamental values? May 2008, Curtis and Fargher.)

5. Stocks with limited lending supply and high borrowing fees respond more slowly to market shocks. Second, short-sale constraints have a small impact on the distribution of weekly stock returns. Limited lending supply is associated with higher skewness, but not with fewer extreme negative returns.

Third, stocks with limited lending supply and higher borrowing fees are associated with lower R2s on average. (Price Efficiency and Short Selling, January 2008. Saffi and Sigurdsson.)

Point 1 above is interesting. It implies that someone somewhere has asymmetric (superior) information and at least some of these are short sellers.
Points 3, 4, 5 all point to greater market efficiency where short selling is permitted.
Point 2 implies that short selling has some negative impact on market returns but not on efficient pricing at the stock level. Measures that slow the momentum of short selling may correct some of the negative skewness without taking away too much from the market efficiency. An uptick rule would likely widen bid offer spreads as well as encourage smaller but more frequent trades.