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COMMENTARY

The impact of short selling on insider trading

By Qian Wenlan

HISTORY is replete with examples of insider trading, globally and in Singapore.

The Monetary Authority of Singapore (MAS) took action against former banker Vincent Rajiv Louis last October for contravening the Securities and Futures Act after he admitted to insider trading.

Insiders capitalise on profit opportunities because they have private information – details that can be obtained only because they are close to the source of information. Hence, insiders are said to be "informed".

However, we often think that such informed people are only those in, or associated with, a particular firm.

There is one group whom few consider as informed: short sellers.

Short sellers are investors who sell shares that they do not currently own in the belief that prices will decline. This means they can buy back the shares at a lower price and earn a profit. That they are able to analyse and identify overvalued or "suspicious" stocks that will soon experience a price decline or regulatory intervention make these short sellers informed investors, although not from privileged information typically associated with insiders.

Beyond being informed, short sellers execute a considerable amount of trades, making them a critical part of the stock trading system.

Daily shorting is prevalent in many stock exchanges. It has been reported that short selling accounts for 24 per cent of the New York Stock Exchange's (NYSE) share trading volume and 31 per cent of NASDAQ's.

The question is: can informed short sellers affect insiders who do not short sell?

According to my study at the National University of Singapore Business School with fellow researchers Massimo Massa, Xu Weibo and Zhang Hong, the answer is "yes".

We examined publicly listed companies on the NYSE, NASDAQ and AMEX stock markets, using information from various sources such as Thomson Reuters, and found that the behaviour of insiders – directors and officers of listed companies – changes with the presence of short sellers in the market.

Short sellers are potential competition in the trading of private information.

Take, for instance, a firm that is planning to invest in projects with negative net present values. Its insiders (such as its management and directors) would have privileged information, and could decide to profit from trades before the market is aware of the plan.

CATALYST FOR INSIDERS

While short sellers are generally slower than insiders when it comes to obtaining such information, we found that the mere presence of short sellers in the market serves as a catalyst for insiders to trade sooner, and faster.

Insiders are incentivised to sell their shares before the short sellers attack the firm, because competition from short sellers reduces the profitability of insider trading as time goes by.

This results in insiders bringing forward their trades before any short selling occurs – which in turn reduces the average time span of insider sales.

Interestingly, we found that the more shares short sellers have, the more shares insiders want to sell before a short seller attack.

Particularly when short sellers have more shares to sell, insider trading is more likely to occur among more informed insiders such as directors than less informed insiders – suggesting that the more informed insiders are, the more they will exploit their informational advantage to pre-empt short sellers.

This also means that directors and such senior management are most affected by short sellers.

The effects of short selling on insider trades are also amplified when short sellers continue to pay attention to the firm.

We found that companies with more negative news in the subsequent month – hence drawing the attention of short sellers – have more and faster insider selling.

LESSER OF TWO EVILS?

All in, short selling introduces competition that accelerates the rate at which private information is revealed to the market via insider trading.

While there has been talk about limiting short selling, what our research shows is that such a move may have the inadvertent consequence of not exposing insider trading earlier and, hence, decelerating the rate at which private information is revealed to the market.

Regulators will have to think about which is the lesser of the two evils — short selling or insider trading – because, as it turns out, short selling has its benefits, after all.

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