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ABSTRACT

We examine returns, order flow, and market conditions in the minutes before, during, and after NYSE and Nasdaq short sales. We find two distinct types of short sales: those that provide liquidity, and those that demand it. Liquidity-supplying shorts are strongly contrarian at intraday horizons. They trade when spreads are unusually wide, facing greater adverse selection. Liquidity-demanding shorts trade when spreads are narrow and tend to follow short-term price declines. These results support a competitive rational expectations model where both market-makers and informed traders short, indicating that these two shorting types are integral to both price discovery and liquidity provision.

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1. Introduction

Short sellers are at the center of an intense debate among regulators, politicians, the media, and academics. The key questions in this debate concern the role of short sellers in stock markets and elsewhere. In particular, do short sellers improve market efficiency? Do short sellers destabilize stock prices in any way? Do short sellers improve or worsen market quality?

On one side of the debate, industry observers, issuers, and some of the popular media argue that short sellers employ abusive trading strategies, damage investor confidence and market quality, and amplify price declines.¹ Company directors, shareholders, and the media have even gone so far as to blame short sellers for the sharp price declines or collapses of companies such as Bear Stearns,

¹ For examples, see “There’s a better way to prevent ‘bear raids’” by R. Posen and Y. Bar-Yam, *The Wall Street Journal*, November 18, 2008, “Anatomy of the Morgan Stanley panic” by S. Pulliam et al., *The Wall Street Journal*, November 24, 2008.

Halifax Bank of Scotland, Lehman Brothers, and Merrill Lynch.² Regulators have responded with several new rules to limit or discourage some short sales. For example, within one week of Lehman's collapse in September 2008, the US Securities and Exchange Commission (SEC) instituted a temporary emergency ban on short sales in all financial stocks, stating that “unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation.”³

On the other hand, most academic research argues that short sellers are relatively informed, improve market efficiency, and generally stabilize share prices by identifying and then leaning against overvalued stocks.⁴ Much of this academic literature analyzes the association between various measures of shorting activity and stock returns, typically at horizons of days, weeks, or months.

We contribute to this debate by taking a fine-toothed comb and analyzing the behavior of stock returns, order flow, and market conditions in the minutes before, during, and after short sales. We use trade-level information on all short sales executed on the NYSE and Nasdaq during the first eight months of 2008 for a sample of 350 stocks. Our analysis highlights the fact that there are two very distinct types of short sales: those that provide liquidity, and those that demand it. The heterogeneity we find suggests that researchers, regulators, and market participants should not view short sellers as monolithic.

The high level of granularity in our analysis is important for several reasons. First, it allows us to separate liquidity-demanding short sellers from liquidity-supplying short sellers. These two different types of short sales are likely to originate from different types of traders and therefore could have different effects on liquidity and price discovery. Liquidity-demanding short sales are likely to arise from informed traders, whereas liquidity-supplying short sales can arise when a market-maker with zero or negative inventory provides liquidity to an incoming buy order. Aggregating these two categories could mask important features of their contribution to liquidity. For example, if shorts contribute liquidity on average, but tend to take liquidity during times of market stress, it is not clear that they benefit markets. Our analysis allows us to examine this possibility and thereby provide a more complete characterization of the effects of short sellers.

Second, previous studies clearly document that shorts tend to be contrarian, but it is less clear *why* shorts are contrarian. Partitioning these two types of shorts can shed light on this question. In some sense, liquidity-supplying

short sellers are inherently contrarian, because they sell when there is buying pressure. However, if short sellers are able to detect and actively trade against mispricings, we should also see contrarian behavior by liquidity-demanding shorts.

Third, if short sellers are conducting ‘bear raids,’ they are likely to use aggressive liquidity-demanding short sales. By comparing price behavior around liquidity-demanding short sales vs. long sales, we provide evidence on whether the data contain patterns consistent with short seller bear raids. Again, disaggregating short sale types is important, as liquidity-supplying short sales could mask the patterns around liquidity-demanding short sales.

Finally, given that many short sellers employ high-frequency trading strategies, understanding the behavior of short sellers in today's markets, and how their trades impact the market, requires observations at intraday horizons.⁵

We find that seller-initiated short sales that demand liquidity are quite distinct from passive, liquidity-supplying, buyer-initiated shorting. Shorts that supply liquidity do so when spreads are unusually wide, which is when liquidity is most highly valued by market participants. These short sellers are also strongly contrarian, stepping in to initiate or increase a short position after fairly sharp share price rises over the past hour or so. In contrast, shorts that demand liquidity are not contrarian on average. Especially in smaller stocks, these aggressive short sellers tend to be momentum traders, as their shorting activity tends to follow a price decline over the previous 24 hours. In addition, we find that aggressive short sales have significantly bigger price impacts at short horizons. Our results are consistent with the predictions of a competitive rational expectations model in which both market-makers and informed traders use short sales. In addition, the finding that only liquidity-supplying shorts are contrarian on average is consistent with the hypothesis that the dynamics of liquidity provider inventories are responsible for a large part of the contrarian behavior of short sellers.

We find that at an intraday level, liquidity-supplying short sales are clearly a stabilizing force in stock markets. The evidence strongly indicates that they help to narrow spreads, limit price spikes, and provide liquidity at important times such as when it is scarce. These results provide an insight into why restrictions imposed on short selling harm market quality (Boehmer, Jones, and Zhang, 2013; Beber and Pagano, 2013). We also find that aggressive order flow from short sellers is not very different from aggressive order flow that originates from long sellers. Based on our close-in examination of the data, the evidence

² For example, Richard Fuld Jr., the former Chief Executive Officer (CEO) of Lehman Brothers, during hearings on the bankruptcy filing by Lehman Brothers and bailout of AIG alleged that a host of factors including naked short selling attacks followed by false rumors contributed to both the collapse of Bear Stearns and Lehman Brothers (<http://oversight.house.gov/documents/20081006125839.pdf>).

³ SEC press release 2008-211 (<http://www.sec.gov/news/press/2008/2008-211.htm>).

⁴ See, for example, Dechow, Hutton, Meulbroek, and Sloan (2001), Abreu and Brunnermeier (2002), Alexander and Peterson (2008), Boehmer, Jones, and Zhang (2008), Boehmer and Wu (2013), and Diether, Lee, and Werner (2009).

⁵ For example, Jones (2012) finds that ‘in-and-out shorting’ (short selling and covering the position before the end of the day as in the first scenario) represented about 5% of total daily volume (and a much bigger, but unknown, fraction of short selling activity) in the early 1930s. It is reasonable to expect this fraction to be higher in today's markets given the increases in automation, algorithmic trading, statistical arbitrage, and turnover. The argument that short sellers employ rapid trading strategies is also consistent with the finding of Diether, Lee, and Werner (2009) that short sales represent on average 23.9% of NYSE and 31.3% of Nasdaq volume.

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