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Information advantage, short sales, and stock returns: Evidence from short selling reform in China☆

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ABSTRACT

We study short selling around earnings announcements and examine the potential sources of their information. Using unique daily aggregate short selling transactions in China, we find that short sellers significantly increase (decrease) their short positions before negative (positive) earnings surprise. In addition, abnormal high short selling is significantly associated with negative post-earnings announcement stock returns. The findings suggest that short sellers, on average, are informed and sophisticated traders and they can exploit profitable opportunities contained in earnings announcements. Finally, we find that stocks with poor governance or more insiders have higher (lower) abnormal short selling in negative (positive) earnings surprise, indicating private information leakage from firms with weak governance; which is consistent with the tipping argument. Our findings have important policy implications for capital market regulation in China.

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1. Introduction

The pros and cons of short selling are always hotly debated (Fox et al., 2010). Some regulators and corporate executives view short sales contributing to negative stock returns and excessive volatility. For instance, the "bear raids" of early 1930s usually push the targeted stock's price down and make windfall profits through concerted short selling and spreading adverse rumors. Most financial economists, however, argue that short sales can enhance the price efficiency (Diamond and Verrecchia, 1987; Boehmer et al., 2008; Diether et al., 2009; and Engelberg et al., 2012). For example, Bris et al. (2007) and Saffi and Sigurdsson (2011) document that short sales incorporate negative information into the stock price and hence reduce stock overvaluation; that is, short selling pushes share prices around their fundamental values. Short sales research primarily focuses on developed markets, however. A small number of studies on emerging markets, such as those of Chang et al. (2007, 2014), emphasize the impact of a reduction of short sale constraints on pricing efficiency. Thus, little is known about the short sellers' information advantage in emerging markets, especially the potential channel that short sellers build their advantage.

The objective of this paper is to examine whether short sellers possess an information advantage during earnings announcement periods after the 2010 short sales deregulation in China. With the exception of Chang et al. (2014); Zhang et al. (2016), and Zhao et al. (2014), few papers study short selling in China. Given Chang et al. (2007) show that short selling has an important effect on asset prices in China, it is informative to control for this relationship generally. International investors who are interested in the Chinese stock markets can learn from our findings.

While our study is related to that of Chang et al. (2014), it has two major differences. First, Chang et al. examine pricing efficiency and volatility in the Chinese stock market, while we study the information advantage of short sellers after the short sales deregulation. Second, Chang et al. consider the addition of a new firm to the list of shortable stocks as an event to study pricing efficiency and volatility changes. Instead, we use the earnings announcement of a firm after short selling deregulation as the event. Hence, our study focuses on the impact of short sellers *after* a firm has already been added to the list of shortable stocks rather than the *initial* impact on the stock price after the immediate lifting of the short sales constraint on the stock; that is, our study examines short selling for a stock whose pricing efficiency has already improved. Finally, we also complement Chang et al. (2014) because they find the potential good effect of short selling in China—improve information efficiency, while we discuss its bad effect—profits from

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material, non-public information leakage. Our study is also related to discussion on short sale transactions preceding bad news. While Christophe et al. (2004) document that abnormal short selling significantly increases prior to negative earnings announcements in U.S., Daske et al. (2005) and Blau and Pinegar (2013) both do not find this phenomenon in their respective sample.[1] In addition, Blau et al. (2011) and Henry and Koski (2010) do not find abnormal short selling around dividend announcements and seasoned equity offerings. Thus, the results from U.S. are inconclusive. Different from these studies on US market that has already had a long history of short selling and strict regulation on informed trading, we focus on the impact of short selling deregulation in an emerging market characterized with weak corporate governance and bad law enforcement (Fan and Wong, 2002; Allen et al., 2005; Fan et al., 2011; and Xu, 2011).

Finally, different from Christophe et al. (2004) and Daske et al. (2005), we also shed some lights on the source of short sellers' information advantage. Specifically, we consider the impact of corporate governance and insider variables on our base findings of short sellers' ability to increase (decrease) their short positions before negative (positive) earnings surprise. Our exploratory attempt not only strengthen our understanding on the source of information advantage for short sellers, but also highlight the potentially serious information leakage issue in an emerging market. By focusing on the short selling before earnings announcement, we are able to examine the impact of a firm's corporate governance on potential short selling activities.

Our results suggest that short sellers in China have an information advantage and are able to build short positions before a negative earnings surprise. Short sellers are also able to reduce (increase) short selling positions before a positive (negative) earnings surprise. Extreme short selling in China can predict future holding period returns (HPRs) in a three-day window after the earnings announcement. Our results are robust to different specifications of abnormal short selling and subsamples without confounding news events. In addition, we find that stocks with poor governance or more insiders have higher (lower) levels of abnormal short selling in the case of a negative (positive) earnings surprise, indicating that tipping is an important source for short sellers' information advantage in China. Our Chinese findings are different from those of Engelberg et al. (2012) and Curtis and Fargher (2014), who find the information advantage of short sellers is due to their ability to process public information, suggesting that the sources of short sellers' information advantage may not be the same in different markets. It is natural because many short sellers in U.S. are hedge funds and professionals using advanced technology and superior information processing skills, while short sellers in China are not sophisticatedly equipped.

Our study makes two contributions to the literature. First, we show that short sellers in China leverage their private information before an earnings announcement to their benefit. The information advantage of short sellers adds to the policy debate of short sales deregulations in emerging markets. While Chang et al. (2014) suggest that lifting the ban on short sales improves pricing efficiency, our study suggests that short sales allow some investors (short sellers) to take advantage of important corporate announcements. The information advantage of short sellers before earnings announcements together with their ability to engage in short sales to produce good returns is a legitimate concern to regulators. Second, our study adds to the literature of short sales by incorporating the impact of governance and insider variables on short selling positions before earnings announcements, a new perspective not discussed in existing literature. Overall, our study is consistent with the literature that short sellers are sophisticated and informed investors (Asquith et al., 2005; Boehmer et al., 2008; Boehmer and Wu, 2013; Christophe et al., 2004, 2010; Desai et al., 2006; Diamond and Verrecchia, 1987; Diether et al., 2009; Drake et al., 2011; Henry and Koski, 2010; Khan and Lu, 2013; and Senchack and Starks, 1993). In this regards, emerging markets are similar to mature markets.

2. Background

To promote economic growth, China introduced stock markets in the early 1990s to facilitate capital formation. Over the last 20 years, the Chinese stock markets have experienced tremendous growth.[2] With stock market development and progress in securities laws, Chinese regulators began to ease restrictions on short sales. In October 2005, the Securities Law of the People's Republic of China was revised to allow short sales in stock trading. Then, in April 2008, the Chinese government passed the Regulations on the Administration Supervision of Securities Company and Regulations on the Risk Management of Securities Firms to allow securities firms to include short sales as part of their normal securities business. Nonetheless, short sales were not executed until March 31, 2010, when the China Securities Regulatory Commission (CSRC) officially allowed 90 stocks to be shortable. These initial 90 stocks are the constituent stocks of the Shanghai Stock Exchange 50 index and the Shenzhen Stock Exchange 40 index. To execute short selling, the uptick rule applies. Naked short selling (short selling without borrowed stocks) is prohibited. On December 5, 2011, the number of shortable stocks was increased to 278 and was later increased to 700 stocks on September 16, 2013.

The CSRC only allows qualified investors to participate in short selling. Short sellers need to have a brokerage account in an eligible brokerage firm for at least 18 months with no less than 500,000 RMB before they can set up a short selling account. In addition, brokerage firms are required to assess the investors' trading experience, risk tolerance, and financial assets before allowing clients to conduct short selling (KPMG, 2011). Therefore, short sellers in China are equipped with more money and are possibly more sophisticated than common investors. Different from the U.S. where most short sellers are hedge funds equipped with advanced technologies, hedge funds in China are under-developed. Thus, it is an interesting question whether short sellers in China can predict forthcoming earning surprise in an environment without hedge fund operations.

3. Data and method

3.1. Data source and sample

We investigate short selling around annual earnings announcements during the three-year period from 2010 through 2012. The data for this study come from multiple sources. The earnings announcement dates, stock returns, and accounting data were extracted from the China Security Market and Accounting Research database. We cross-checked the earnings announcement dates with Gildata.[3] We found discrepancies for three firms and thus checked the original announcement dates from the website of the Shanghai or Shenzhen Stock Exchange. Analyst earnings forecasts are from Gildata.

Most of the U.S. literature uses monthly short interest, which is the quantity of shares that investors have sold short but not covered in a point for the past month. China's unique environment allows us to use daily aggregate short sale transactions from the WIND database, which reports short selling in China for each day. The higher frequency of

[1] Different findings may due to different research sample. For example, Daske et al. (2005) use data from the New York Stock Exchange (NYSE) for the period April 1, 2004, through March 31, 2005; Blau and Pinegar (2013) use NYSE and Nasdaq sample from January 2005 to December 2006; and Christophe et al. (2004) focus on firms in the Nasdaq National Market System for a much shorter period of September 13, 2000 to December 12, 2000.

[2] According to the World Bank (http://data.worldbank.org/indicator/CM.MKT.LCAP.CD, last accessed on July 25, 2014), the stock market capitalization for China was US$2.03 billion in 1991 and increased to US$3.70 trillion in 2012.

[3] Gildata is a database affiliated with Hundsun Technologies Inc., a publicly traded firm in China.

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