Shorting America

By Walter Cruttenden

It is widely agreed that excessive short sale activity can cause sudden price declines, which can undermine investor confidence, depress the market value of a company's shares and make it more difficult for that company to raise capital, expand and create jobs. This is particularly aggravating for entrepreneurial companies; the engines of new job creation. In the crash of 2008 short sale activity reached record levels and exacerbated the market turmoil, leading to one of the most severe economic declines in modern history.

Job formation is highest among pioneering companies, such as those in the computer, biotech and emerging growth industries. Studies show that approximately 80% of all new jobs come from small businesses or new companies in their fast growth phase; those that grow the fastest hire the most. However, because research, development and new product innovation are risky and often require multiple rounds of equity financing, short sellers often target these companies, to the detriment of America.

Short sellers are essentially traders that are hoping a company will experience problems (such as product delays or the inability to raise financing) so they may profit from the setbacks. These traders or trading machines make the most if a company struggles and goes out of business, and some short sellers actively work to make that happen. Aggressive shorters, and short selling pools, will sometimes hire stock "bashers", people paid to post negative articles on blogs and message boards. Their goal is to put out negative news on a company or its products in an effort to cause the company problems and insure the stock declines so their negative bets pay off. Others will put up "flash orders" advertising to sell a large number of shares in an effort to drive down the price. Thus entrepreneurial companies not only need to fight the battles of developing new products and markets, they have to stave off the short sellers in the meantime. This growing culture of betting against a company for the sake of short-term trading profits (regardless of economic consequences) has negative economic repercussions. This trend has been fostered by:

- Technology that allows trader anonymity without consequence. Short sellers, like private hedge funds do not have to disclose their negative bets, whereas mutual funds and most institutions are required to publicly report their holdings.
- Brokerage firm procedures that make it easy for short sellers to borrow stock without informing the shareowner of the transaction or potential consequences.
- Internet forums and message boards that allow traders to quickly publish negative comments about a company, thus forcing down prices.

- The repeal of the uptick rule, which had required traders to only short when it wouldn't hurt a company's stock price, and now allows shorting regardless of the company's current stock price direction, enabling "piling on" trading.

As asset prices decline people feel less wealthy and spend less, which in turn causes real economic contraction. Economists recognize that investor confidence determines economic activity and Fed Chairman Bernanke recently commented that the economy could avoid a "double dip recession" as long as markets stayed healthy. Governments around the world are now struggling with how to stop the proliferation of short sellers that bet against the economic well being of their nation. This past summer Germany banned short sales outright in an attempt to quiet its markets during a run on the Euro.

How did things get this way?

Short Sale History

Originally there was no short selling. People that owned shares of a business rarely traded those shares and would never loan their shares out to a third party to bet against them. Short selling began as a way to accommodate buyers and sellers. Market makers (such as the brokers that originally met under the buttonwood tree which became the NYSE) knew people that wanted to sell their shares if the price reached a certain level. If a buyer showed up and wanted to purchase a security when that seller was physically unavailable, the market maker would stand in for the seller and "short" the shares. The outstanding short rarely lasted more than a few days. Thus there were no actual short sale investors, just brokers that were temporarily shorting a stock to accommodate a real seller. And these short sales generally took place when there was demand, meaning at favorable prices, or at an "uptick" (increase to the prior sale price) and were triggered by the fact the stock traded up to a certain level. It was a win-win transaction for all parties. In these early days, traders did not bet against companies, and there was no ability to artificially drive down the price of a stock.

Share ownership was originally represented by a physical certificate in the shareholders name kept by the owner in a safe deposit box, or sometimes under the mattress. With the prosperity of the post World War I economic boom, more people became invested in the markets, and as trading frequency increased, investors began to leave their shares with a brokerage firm for convenience purposes.

At first the certificates were kept in the name of the individual shareholder but as trading volume increased the brokerage firm simply kept the shares in "street name", meaning the name of one of the brokerage firms on the street, with an accounting entry to trace the ownership. This made it easy for the brokerage firms to get into the business of making "margin" loans against the securities. The securities (collateral for the margin loan) were already in the brokers name and possession so they did not have to worry about having to foreclose on the collateral if that became necessary. As margin loans became common trading volume further increased.

Short selling first came into vogue with the crash of 1929 when certain investment pools realized it was easy to bet against a company, especially with so many margin loans outstanding. The market was declining rapidly and shares could be borrowed from brokerage firms, and the brokerage would get paid for lending those shares.

This historic first wave of large scale short selling probably exacerbated the market decline, and in some cases, may have gone hand in hand with stock manipulation. Short sellers realized that if they could force down the price of a stock they could force a margin call. This effectively forced a sale of the shares allowing the unscrupulous trader to make money on their short. The severe decline of so many companies in 1929 through the early 1930's forced the regulators to study the matter. Finally in 1938 the "uptick" rule was adopted. This required any investor that wanted to short a stock to sell only on an uptick (thus returning to the original de facto practice), and greatly reduced the amount of short selling activity. Prosperity soon returned to America.

By allowing short sales only on price strength, the rule mitigated the "piling-on effect" and the self-fulfilling prophesy that short selling can bring about when left unrestricted (short selling causes price declines which in turn shake the confidence of long term holders who then sell and prolong the downward price trend regardless of underlying fundamentals, eliminating the company's ability to raise new capital, causing a vicious cycle). Thanks in large part to the "uptick rule", short selling was held to a minimum. Consequently, short sale activity and market volatility remained relatively quiet during the 69 years the rule was in effect until its repeal in 2007. To the student of history it is no coincidence that the repeal of the uptick rule was followed by one of the worst market declines in recent memory.

Since 2007 there has been a marked increase in short sale activity. Aggressive short selling not only hurt small companies, it aggravated the 2008 run on Lehman Brothers, Bear Stearns, Merrill Lynch, WaMu and other long standing financial institutions, that depended on stable equity values while they worked out their financial problems. Short selling effectively reduced the duration of the workout window and the result was a domino effect of economic decline. While the big names captured the headlines many emerging growth companies suffered similar attacks on their stock and were forced to downsize or otherwise curtail job creation efforts. As the securities of the unstable companies, large and small, became worth less many companies found it suddenly impossible to exchange equity for debt, raise new financing or otherwise restructure in a normal manner. Rampant short selling causes adverse economic consequences on a scale that quickly gets out of hand yet its full ramifications are still not widely recognized.

Aggressive short selling was a major contributor to the recent economic troubles as evidenced by the fact that more large companies have gone into bankruptcy or closed their doors in the three years since the repeal of the uptick rule, than at any other time since before the uptick rule. During this period short selling activity became almost a mainstream activity as new short selling funds proliferated. Many of these so called "Bear Funds" now leverage their investments whereby ever dollar put up results in two or three dollars of shorted stock. Jim Cramer and other market pundits have called for a ban on such funds.

This economically contracting behavior has been accompanied by an increase in market volatility, evidenced by the rise in the "VIX" (the CBOE volatility index), which has reached historical levels over the last three years. Needless to say, these larger than normal market swings spook long-term investors, and drive people out of the equity markets. This not only shakes investor confidence, but it is bad for the capital formation process as it restricts financing for innovation and exacerbates economic difficulties.

Fed Chairman Ben Bernanke, Morgan Stanley CEO John Mack, Congressman Gary Ackerman, Former SEC Commissioner Chris Cox and others have called for a review of the decision to lift the uptick rule. However, there are now many traders that have an interest in large short selling funds and as of this date there has been no agreement to bring back the uptick rule. The SEC did recently adopt Rule 201, which bans short selling if a stock has fallen more than 10% in a single day. But the fact is if a stock does decline 10% in a single day it has already spooked investors in that company. While it is a laudable effort it does nothing to address the underlying operational issues that enable large scale short selling. The easiest and most natural way to rein in aggressive short sellers is a return to a permission-based system that involves the investors who shares are being borrowed. In other words, require the approval of the person whose shares are being loaned to the shorts before short sales can be implemented.

The Genesis of the Problem

Anyone that would like to short a stock must first arrange to borrow those shares, because stock clearing rules require delivery of the shares to be made within three business days. If stock certificates were still held by individuals, and these individuals therefore had to approve the loan of their certificates to would be short sellers, there would likely be very little shorting activity. After all, what long-term investor would actually loan his or her shares to someone that wants to bet against his or her economic interests?

Since the 1960's, technology, record keeping and trading activity have advanced to the point where not only do most investors find it more convenient to keep their securities with their broker, but many opt for full featured accounts that give the account holder the right to borrow against the market value of the account, use a credit card against the account, or enjoy other borrowing privileges. This means the investor has signed a margin and hypothecation agreement with a brokerage firm and therefore that brokerage firm can now freely lend those shares in the account to prospective short sellers without the investor-owner's knowledge or permission.

The original purpose of the hypothecation agreement was to give the brokerage firm access to the client's securities simply so they could put these securities up as collateral at a bank to borrow the funds they were loaning to the client. But eventually the brokerage industry realized the broadly written hypothecation agreement would also allow them to lend the securities to prospective short sellers, and generate additional income for the firm.

Most shareowners are completely unaware they have given up such extensive rights under these margin or “hypothecation”agreements. As they are now written, even if an investor has a minimal loan balance outstanding, the brokerage firm can lend out shares in that investors account. This practice has evolved so that most brokerage firms now maintain “Stock Loan Departments” and they get paid well for loaning those certificates out to short sellers, yet rarely do these proceeds make it to the individual investor. Many investors have no idea they are effectively aiding the short sellers that are betting against them. The ease of borrowing such shares nowadays, without an investor’s specific knowledge, is a major factor in the increase in short sale activity.

Investor Rights Violated

If shareholders knew that their shares were being loaned to prospective short sellers, whose purpose is to effectively bet against the owner of the securities, few of the stock loans to short sellers would be made. There is currently no required disclosure to the rightful owner that provides the owner with right to say yes or no. This lack of transparency is the root of the issue.

While it is justifiable that a brokerage firm should have the right to borrow against the shares of anyone they make a margin loan to, they should not be able to loan these shares to a third party that has an economic interest opposite the shareowner s without specific approval of that shareholder. But current margin agreements, written by the brokerage firms to include blanket hypothecation language, do not differentiate between legitimate borrowing to accommodate a margin loan, and the loaning of shares to short sellers. Thus current procedures effectively allow the borrowing of shares from one party to be loaned to another party that bets against the economic interests of the first party, without specific disclosure.

Unauthorized Share Issuance

Another related problem, that occurs with significant short selling, is the lack of disclosure that the float is effectively being increased without conveying that information to the public. The creation of phantom shares, by loans of existing shares to short sellers, boosts the float (number of freely traded outstanding shares) by artificial means even though no such increase in shares was ever authorized by the company or the SEC. For example, one company we have studied has 40 million shares outstanding and a 6 million short position. Thus investors think they own 46 million shares, even though neither management nor the SEC ever authorized the extra 6 million shares. In truth there are only 40 million shares outstanding and the extra shares have been created out of thin air by the shorts. Far from the original purpose of the practice these shorted shares often stay outstanding in virtual perpetuity.

But worse than the issuance of phantom shares is the fact this is happening on a large scale with many investors being taken advantage of without their knowledge. Again, this is because most investors are effectively loaning their shares to short sellers without realizing they are helping these short sellers to degrade the value of their securities. The ability to borrow shares to short, which has become relatively easy, works to the detriment of long-term investors and the capital formation process.

Solution

The present system lacks transparency. Investors should never be put in a position where their investments are used to bet against them without their specific knowledge. Fortunately, it is an easy fix:

Brokerage firms should be required to modify their hypothecation clause in new account and margin agreements to specifically inform investors that their shares may be loaned to short sellers that are betting against them, and only allow this practice with an investor's knowledge and express permission. This would only require a few sentences to be changed and should include a check box where an investor is required to give permission. This would not preclude the brokerage firm from legitimate borrowing against these shares, it would only preclude the loaning of such shares to short sellers without an investors knowledge.

The effect of this action would be that if a brokerage firm wants to loan out the shares on its books (for short sale purposes) it could only do so if the investor has given permission, whether or not those shares are held in street name or margined or otherwise obfuscated by commingled ownership. Some brokerage firms would argue that if they have made margin loans against those securities they should have the right to loan those shares to other investors. But this is not a valid argument, as loaning shares to a bank for borrowing purposes has no negative economic consequence to the owner of the shares, whereas loaning shares to a short seller has direct negative consequences to the owner of said shares. The two situations should therefore be bifurcated: investors should have the right to approve any loans of their shares to short sellers, and brokerage firms should retain their rights to the collateral for legitimate borrowing and collection purposes.

As long as investors are responsible for paying interest and paying back the margin loans they should have the right to determine what is done with the underlying shares. They should not forfeit this right under any circumstances. Giving investors this basic right in no way diminishes the brokerage firm's ability to liquidate such shares if for any reason the investor is unable to pay his margin balance. In fact, it could be argued that the collateral value of the underlying shares will hold "more" value if they are NOT being loaned out to short sellers.

The result of such a rule (which could be adopted by the SEC or passed as a law by Congress) would be to once again return short selling to its original purpose. This would naturally limit the number of people that could bet against investors' interests, as very few investors would allow such activity if they were aware that it might directly impact the value of their securities held. Indirectly it would also reduce the number of "flash orders" and "machine trades", which are both highly dependent on the easy borrowing of shares to short. Furthermore, it would help out entrepreneurial companies, by returning confidence to the long-term investor, the backbone of America's job creating capital markets system.

Summary

In summary, investor rights were slowly usurped by the advance of technology that did away with the investors name on specific certificates of ownership. This obfuscated the rights of the certificate holder and led to an increase in the transfer of those securities for short sale purposes, against the investor's best interest. The potential damage of increased short sales was held at bay by the uptick rule that effectively limited the amount of shares that could be shorted but this rule was repealed. By returning to a permission based system, whereby the holder of the securities regains the full right to determine the fate of those securities, a natural balance will be returned to the short sale market (whether or not the uptick rule is reinstituted). The rightful owner of the securities will once again be in a position to determine if he or she wants to loan their securities to a third party.

The result of full disclosure and the return of this basic investor right will be reduced market volatility, an economic system that does not penalize innovation, and a level playing field for all investors.

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