EVOLUTION OF THE WINDHANDEL: A CRITICAL ANALYSIS OF SHORT SELLING

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> And I want to call your attention to one other thing in connection with that: his argument that short selling is a benefit–that it is beneficial. Well, he reminds me of the story of the man who died and went up to the Pearly Gates and rapped. And St. Peter said, 'Who is that?' And he said,'A Wall Street broker.' 'What do you want here?' 'I want to come in.' 'What have you ever done that you should come in here?' 'Why,' he said,'one day on the Street I met a very destitute and feeble old lady, who had lost all her savings in one of the failed banks. She was absolutely without means, and I gave her a cent.'
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> St. Peter said to the recorder, 'Did he do that?' 'Yes; he said he did.' 'What else did you ever do?' The man said, 'I met a workingman who had had a home of his own and a family, and he had been trying to pay for that home, but the depression put him out of employment, and he could not meet his obligations, and he had come to the city to try to find work to get bread for his wife and children. He was accompanied by a farmer, one of the thousands and thousands who had lost their farms in the same way.'
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> 'Well, what did you do?' 'I gave him 2 cents.' 'Did you ever do anything else to benefit humanity?' 'Why, I placed a great many short sales on the market for various people.' 'Anything else?' 'I do not recall anything else.'
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> And St. Peter said to recorder,'What shall we do with this man?' And the recorder said,'Give him back his 3 cents and tell him to go to Hell.'[1]

This anecdote serves not only to amuse, but also to describe the almost mythological atmosphere that has surrounded the topic of short selling for the past five hundred years. The practice of short selling, in some form, has existed since the inception of the most primitive economies and has been executed in its current form since the early 1600s. No other financial instrument has attracted so much controversy, blame, and praise as short selling. Short selling has been hailed as a savior of free capital markets; it has been cursed as a demonic influence that has resulted in the downfall of nations. In general, short selling has been widely misunderstood as a result of the mythology that often precludes intelligent discussion about the subject. Furthermore, much bias has entered this forum due to the amount of money at stake; one's position on the

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[1] U.S. House of Representatives, 1932, p. 96.

subject can often be predetermined based on his occupation and financial status. Thus, an accurate study of the short-selling debate must be pursued with care and critical analysis; and it is my intention to proceed in this manner.

As convoluted as its definition has often become, a short sale is essentially a simple credit arrangement. A "short sale" is the sale of stock one does not own, combined with a credit arrangement that these "borrowed" shares will be replaced at a later date. Thus, the short seller is taking a position in the stock *opposite* to a regular, or long, purchase as he hopes that the stock price will fall, allowing him to replace the borrowed stock at a lower price. For example, an individual shorting 100 shares at $50 per share will immediately receive a check for $5,000, which in actuality is held by his broker until he replaces the borrowed shares. A month later, the short seller can repurchase 100 shares, which are now trading at $30 for only $3,000; thus, pocketing the sum of $2,000. This sum represents the decline in share price ($20) times the number of shares previously sold short (100).

At the elemental level, the term "short sale" can be applied to any transaction in which a commodity is sold today with the promise of future delivery. J. Edward Meeker illuminates this premise, as he states:

> The building contractor, as his very name indicates, is accustomed to contract to deliver in the future materials and labor which at the time of making the contract he does not possess. Automobiles are regularly sold to consumers before they are manufactured. The United States Treasury Department has often sold its interest-bearing notes in the anticipation of future revenue receipts from the Federal income tax.[2]

In essence, short-selling exists wherever an immediate, tangible exchange is absent, and a credit arrangement takes its place. While these analogies have been strenuously objected to, and I admit that these crude examples are not exactly the same as modern short sales, yet they do accurately depict the economic premise upon which the modern short sale is based.

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[2] Meeker, p. 19.

Technical Arrangements

After placing the order to short a stock, the broker must find a purchaser, who expects delivery of the purchased shares within a short period of time. However, the seller never possessed these shares to begin with, thus, the seller's broker must find a party willing to let him borrow shares. For most short-sale transactions, finding a lender is simple, especially given that the lender receives interest on these securities as in all other loan arrangements.

For widely-traded stocks, the above process flows smoothly; however, short selling in thinly-traded stocks can present two problems. First, the seller's broker may not be able to locate shares to borrow, and in this case the trade is immediately nullified. Secondly, the seller's broker may think he has found shares to borrow, but since delivery of the shares is not settled until five days after the initial agreement, these shares can sometimes disappear during this lag time should the lender decide to sell his shares in the interim. In this case, the trade will be listed as "fail-to-deliver" on the selling broker's books.[3]

Motivations of the Short Sale

The willingness to engage in this trade of each of the three parties involved is relatively straightforward. The purchaser of these shares is the "traditional" buyer in the market, buying at what he perceives as a low price with the intent on selling the securities for a higher price in the future. As described before, the lender receives a predetermined amount of interest for his loan, and feels that his proceeds from this interest will outpace the growth of the stock price in the same period.

The motivations of the short seller can take on a variety of forms, the most simple of which is that the short seller feels that, for whatever reason, the price of the stock will fall in the near future and he wants to receive today's price in exchange for promising to pay a future, hopefully lower, price. Irving Pollack states:

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[3] Committee on Government Operations, p. 3.

> Informational short sellers perceive the outlook for a company's stock as begin worse than the outlook perceived by investors in general, and they are thus willing to assume short positions over indefinite periods of time in the expectation that other investors will come around to their point of view and the stock's price will indeed decline.[4]

While this mentality may have been prevalent in the early days of short selling, it is rare now as today's institutional and large-block investors have more complicated rationales.

Market Liquidity

Traditional stock purchases require immediate capital, therein depleting institutional investors of capital. In contrast, short selling provides an infusion of funds into the marketmaker's balance sheets, in return for a liability-side entry of a certain number of shares. Thus, short selling serves to create a balance of supply and demand of stock that is necessary to the efficient function of capital markets. This importance of liquidity is evidenced by the fact that 80 to 85 percent of short sales are perpetrated by large-block dealers.[5]

HEDGING

Much of the emphasis of recent financial research has been on the area of risk reduction. A broker currently holding a portfolio of long-stocks is clearly at the mercy of the market forces, as his position can be destroyed by a rapid drop in share prices. Short selling provides a hedge against this possibility: by shorting a prescribed number of the same stock's shares, the individual can reduce his market exposure. While clearly his upside is limited by this action, his downside is also, thereby placing him within a statistically probable range of outcomes. It is important to note that virtually any security can shorted, thus, the scale of hedging extends far beyond basic stock insurance.

ARBITRAGE

[4] U.S. House of Representatives, 1989, pp. 281-2.
[5] ibid.

With the aid of computers, arbitrage has rapidly developed into a science, engaged in by mathematicians and computer scientists representing most of the United States' brokers. Simply stated, arbitrage is the practice of finding minute discrepancies in security prices and buying (or selling) in large quantities so as to profit from this spread. Arbitrage is not only of value to the aforementioned brokers, it also aids the market in general by returning prices to accurate levels. Short selling is widely used in arbitrage, and this mechanism is described by Pollack:

> When an arbitrager finds a security that is convertible into the issuer's common stock and the security is available for less than the current value of the shares into which it is convertible, he may sell these shares short and buy the convertible, subsequently turning those into common stocks to make delivery.[6]

TAX SHELTERS

Consistent with the American tax system, the current guidelines have provided a loophole that can be easily exploited through short selling. Known as "selling against the box", this method of short selling is done to avoid paying capital gains tax on the sale of stock. Rather than sell the shares outright in the market, an individual can short the same number of shares and cover them with his original shares, precluding the role of the lender. Since his original shares are collateral for the ones he has shorted, they cannot be taxed. The funds he has liquidated are held by his broker until the "borrowed" shares are repurchased; but the advantage is that he does have to pay tax on those shares currently; this burden is "rolled over" into the next fiscal year.

Legal Issues

There are two basic legal and regulatory conditions that are crucial to a full understanding of short selling. The first is the basic margin requirement, as set down by Federal Reserve Board Regulation T. This statute demands a deposit of 50% of the value of the shares shorted. Thus, an individual short-selling 100 shares at $50 each must have $2,500 on account with his broker to execute this deal. When combined with the $5,000 held by the broker until the contract is

[6] ibid.

fulfilled, the individual will have an account consisting of $7,500 in credits and a liability of 100 shares. The amount required as deposit may increase, depending on the broker's by-laws, should the price of the stock rise.

The second, and predominant, legal issue revolving around short selling is the "up-tick rule". This is delineated in section 240.10a-1 of the Code of Federal Regulations. Paraphrased, the regulation says that a short sale can only be executed after an "up-tick" of the stock. The result of this law is that a stock cannot be driven down continually by shorting a stock that is already depreciating. The up-tick rule is in place on the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), but is not currently instituted on the Over-The-Counter Market (OTC), a source of controversy that will be detailed later.

Classical Arguments for Short Selling

MARKET STABILITY

Proponents of short selling argue that the mechanics of short selling serve to offset fluctuations in stock prices, thereby acting as an invaluable cushion against price shocks. This argument holds that in times of rising stock prices, the short selling volume will increase as investors perceive the market as nearing its peak. This induced selling creates a temporary oversupply of stock, which serves to decrease stock prices. The contrary holds also, as low prices lead many short sellers to purchase their previously-borrowed stock at this time. These purchases drive up the demand for these stocks, whose prices soon follow. Supporters of the balance theory argue that short selling interacts with the fundamental laws of supply and demand to provide stability to the market.

Due to the aforementioned increases of short selling at the peaks and troughs of stock prices, it is fair to assert that short selling does, in these cases, produce greater volatility in individual stock prices. However, these frequent fluctuations tend to correct stock prices rapidly, and reduces the overall variance in a stock's price. Meeker elaborates this point:

> As far as price stability is concerned, it is much better to pay the price of more frequent fractional and temporary price oscillations back and forth, in order to avoid the extreme plunges in intermediate price fluctuations which the absence of a short interest intensifies...Speculation in exchange markets causes more temporary price fluctuations but confines them to fractional scope.[8]

HEDGING VALUE

Another popular argument made in favor of short selling is that hedging provides immense intrinsic value that allows many cautious investors, who otherwise could not bear market risks, to invest in stock.

The short seller is financially responsible for an *unlimited loss* in the event of a sharp rise in stock prices, which is a key difference between long and short sales. For example, a share valued at $10 can produce only a 100% loss if it is bought long, as the share price cannot fall below 0. However, a short sale of this same share of stock can result in an infinite loss. A price rise to $100, for instance, produces a loss of 1000%, and shocks of this nature are not rare when dealing with growth stocks (ie. Apple Computer, early 1980s).

While the preceding dangers to the individual investor are noteworthy, they are minimal when compared to the exposure risks taken by brokerage houses who amass large inventories of stock, such as odd-lot dealers. These houses serve a vital purpose in the financial markets, and cannot be expected to bear full market risk in the absence of short sales. States Martin Mayer, in his book Wall Street: Men and Money:

> Besides, the Stock Exchange could not operate without such tools as short selling. The short sale, for example, is essential to the operations of the specialist and the odd-lot dealer: both are charged with an obligation of selling to the public, and neither can be reasonably asked to hold an inventory large enough to meet all demands, if in his opinion the market is actually heading down.[9]

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[8] Meeker, p. 70.
[9] Mayer, p. 78.

In sum, hedging serves not only the obvious insurance value to individual investors, but allows large clearing houses to conduct business by safely balancing their portfolio risk. Without this virtue of short selling, the financial markets would be inaccessible to the majority of small investors.

PERFECT INFORMATION

Proponents of short selling also argue that short selling allows investors to express negative sentiment in the market, and that the absence of these judgements would intrude upon the principle of perfect information. States the Eleventh Report by the Committee on Government Operations:

> Negative evaluations of stocks then play a role, along with the positive evaluations of other investors who hold the same stock long in their portfolios, in determining the market price of this stock. This participation by short sellers thereby tends to enhance the efficiency of the market mechanism.[10]

The concept of perfect information was also alluded to by Kenneth Arrow. Arrow felt that the "state of the [economic] world" is a multi-dimensional vector consisting of "all initial holdings of goods, technological possibilities, and possible states."[11] He refers to these combinations as "contingent commodities", and feels that, unobstructed, these vectors combine to produce general equilibrium.[12] Arrow states that past and present markets have not been in general equilibrium, and also feels that *more* information in these vectors is required to produce a reality closer to this state. I infer from this that suppressing short sales would allow *less* information to be entered into this model; thus, this action would move the markets in the wrong direction–away from general equilibrium.

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[10] Committee on Government Operations, p. 12-13.
[11] Arrow, p. 221.
[12] ibid.

Classical Arguments Against Short Selling

EXPLOITATION OF SMALL INVESTORS

A common complaint made against short sellers is that they are a decidedly small group possessing information not available to the public, and that they use this knowledge to exploit the public. J. George Frederick refers to the landscape of short selling as "jungle economics", and continually opposes the:

> moral standard of *caveat emptor*, or everyman look out for himself, is fair enough *among equals* and among professionals, *but never among unequals and the public*. In any question in which the public is involved American business many decades ago learned that the fair, the wise thing is to make rules entirely from the point of view of public protection, and completely cast away the ancient *caveat emptor* business tradition.[13]

Frederick continues:

> It is easy to forget, but significant to remember, that short selling, when practiced by a limited group of technical and professionals on a par, in a market touching only a small group, is on a decidedly different basis, even morally, than when practiced in an exceedingly broad field where buyers or sellers are inexpert and are so numerous that they are virtually identical with the public at large.[14]

BEAR-RAIDING

The "bear-raid" attributes its name to those who perpetuate and, often originate, the conditions of a bear market. These offenses are criminal, and their existence has been long-debated. Their is convincing evidence that bear-raids have occurred, and will continue to take place. A secondary problem stated with bear-raids is that they not only jeopardize their primary target, but also create a domino effect among the target's competitors that threatens the entire industry. Support for this opinion is controversial, and will be examined in more detail later.

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[13] Frederick, pp. 19, 138.
[14] Frederick, pp. 24-25.

The anatomy of a bear raid is relatively simple, relying mostly on well-planted rumors which feed market hysteria. The plotter will first begin an acceleration of the stock price through large purchases himself and positive support for the company. Once the stock price nears its apparent peak, the bear-raider will both short sell vast, undisclosed sums of stock, as well as strengthening this downward impetus with condemnatory rumors about the company's earnings, future projects, or management. If the described ploy is targeting an under-capitalized, lesser-known company, this perceived vulnerability will cause many of its previous investors to cash in their stocks, and the stock price will plummet. Frederick describes the resultant stage as "liquidation", and states:

> Once such a supply is let loose *it has a cumulatively depressing effect upon the shares. Each point decline weakens so many accounts that forced liquidation is the result.*[15]

Once the bear-raider feels the stock price has bottomed out, he will now purchase stock to fill his short-sale orders, profiting handsomely in the process.

MORALITY

Opponents of short selling have a plethora of moral arguments, three of which I will discuss here. The first contention is that short selling constitutes gambling, and that since other forms of gambling are illegal, short selling should be declared illegal as well. This argument usually makes a distinction between "speculation" and "gambling", claiming short selling represents the latter. This argument is not taken seriously today as gambling is commonplace, but in previous times, the definition of the word "gambling" was argued as vehemently as any other topic of the time.

The second major moral argument impugning short selling was that "it is illegitimate to sell what one doesn't own."[16] Advocates of this point saw short selling as nothing short of theft, and, needless to say, the argument surrounding the short-selling debate has progressed since this

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[15] Frederick, p. 64.
[16] Meeker, p. 45.

time. This argument is currently thought of as a naive understanding of credit markets, and has been abandoned.

The final moral argument against short selling is that the practice dampens economic enthusiasm and can stagnate the nation's economy. Short selling is viewed as an additional and unwarranted opportunity to sell stock, when such a mechanism, in the form of long-stock sales, already exists. Short sellers are often viewed as "unpatriotic", or "doomsday prognosticators", and are often blamed for market failures. Given that during these failures a political or economic scapegoat is often sought, the relative merit of this line of reasoning is questionable.

Thesis Statement

The semantics and the classical arguments of short selling have been presented, thus, the reader has been afforded the proper background in which to interpret the remainder of this paper. I will proceed to trace the evolution of short selling through three historical periods, focusing continually on the economic background, controversy over short sales, and regulatory actions of financial bodies. The three eras to be examined each represent critical times in the history of short selling; the first being 1600 Holland, the second 1932 United States, and finally, 1987 United States.

Some of the minor contentions of short selling opponents will be supported, and suggestions made so as to alleviate these problems. In particular, "bear raids" are detrimental to society in unquantifiable terms, as many growing companies are unethically ravaged before their products ever reach the marketplace.

However, it is my feeling that the most central theme of short selling adversaries, that short selling is detrimental to the health of markets in general, is entirely *false*. Short selling cannot be attributed to causing any major financial collapse since short selling is such a minute portion of exchange trades. I feel that short selling is strictly a scapegoat in these situation, and that a wealth of factors more central to any economy's status are the primary factors in times of great financial hardship. In short, during these devastating periods the markets are guided by

market hysteria and other intangible factors, and to pinpoint short selling, or any other single factor, as the sole cause of these distresses in shortsighted.

In fact, short selling serves several worthwhile and irreplaceable purposes that account for more efficient markets and move these markets closer to general equilibrium. Short selling should be preserved in its current form, and a historical examination of financial markets will reinforce this view.

1600 Amsterdam--The Birth of the Windhandel

The first major epoch in the history of short selling began in Holland in the early 1600s. Short selling was known in Holland as "windhandel" or "wind trade", in reference to the trading of something as invisible or intangible as wind. The early Dutch exchange was called the "Amsterdam Bourse"[17] and it consisted of two major trading companies, the Vereenigde Oost-Indische Compagnie (Dutch East India Company, or VOC) and the West India Company (WIC).[18]

In his book Every Man His Own Broker, Thomas Mortimer describes the early Dutch experience, and complains of the damaging efforts of "stock jobbers" who manipulated the market in three ways:

•Foreign trading of Dutch securities

•Trading with extraordinary knowledge; or inside trading

•Inverse trading on credit; or short selling[19]

Mortimer continues him attack on these brokers, by adding:

> In short, the jobbing brokers are the only persons, who have been known to raise fortunes by jobbing, all the losing accounts being for their employers, and all the winning for themselves.[20]

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[17] Meeker, p. 205.
[18] Bianchi and de Marchi, p. 7.
[19] Mortimer, p. 51.
[20] Mortimer, p. 89.

In this statement, Mortimer captures some of the earliest disapproval of short sellers, and begins the historical examination of bear raiding.

This condemnation of bear raiding continued, and the practice of short selling was cited as the cause for most stock declines. Both the VOC and WIC corporations shared this condemnatory view, and one spokesman for the VOC is recorded as stating:

> Bear attacks, which generally assume the form of short selling, have caused and continue to cause immeasurable damage to innocent stockholders, among whom one will find many widows and orphans. If persisted in, such attacks are bound to impair seriously the country's business interests.[21]

The principle objection to this mentality is that it assumes that the stock market is only healthy if it is rising, and that there is no need for market corrections. Meeker states:

> Operators for the rise are *personae gratae* with legislators. They are regarded as patriots, while speculators for the decline are branded as traitors and enemies of the people.[22]

Clearly, this viewpoint is ignorant, as no market can sustain unlimited upward growth. Neither is such growth desirable, as it would only lead to mass inflation. In fact, the presence of short selling often corrects the inefficiencies in companies, and many stocks actually trade higher when this type of speculation is allowed.

However, the Dutch legislature did not realize the importance of two-sided movements of stock prices and enacted a partial ban on short selling on February 27, 1610. This ban disallowed the borrowing of stock to cover a short position, thus, short selling remained legal only when personal shares were used as cover. States Joseph de la Vega: "The sale of shares of the company by bona fide owners for future delivery was allowed."[23]

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[21] Meeker, p. 205.
[22] ibid.
[23] U.S. House of Representatives, 1989, p. 10.

Brokers soon found methods to evade the 1610 legislation, the primary of which was using a series of owner-transfer papers used to misrepresent the true owner. Following a large 1621 bear raid against the WIC, legislators passed a second law against short selling.[24]

Despite these two regulations, short selling persisted throughout out the 17th century by employing various schemes. Finally, in 1687, a Dutch jurist, Muys van Holys, proposed a tax on the proceeds from short sales. This proposal was met with mixed reaction, but was passed by the Amsterdam city council on January 31, 1689. It has been noted that van Holys intentions were not dissimilar from the bear raiders', as Meeker proclaims:

> If Nicolas Muys van Holys knew as much about commerce...as he does about *corpus juris*, he would not have proposed a new tax in addition to the many which are already interfering with the country's trade and industry...It is reliably reported that Muys van Holys had confided to a well-known broker on the Floor that he had published his plan concerning the levying of a tax on short sales primarily for the purpose of depressing prices and reaping profits by the recession.[25]

In sum, the Dutch attitude toward windhandel was generally antagonistic, and greatly restricted the short selling activities in the 17th century. However, this opposition of short selling resulted from mainly personal and political agendas, rather than economic fact, and detracted from the efficiency of the 17th century Dutch markets.

1929--The Great Depression

PRELUDE TO THE CRASH

In order to fairly assess the effects of short selling during the Great Depression, the background of the 1920s economy must first be understood. The 1920s was a decade of classic post-war growth, as American industry revitalized itself following a financially draining World War I. Many of the businesses that would be pivotal in later years grew out of these fledgling beginnings, and the successes of this growth pervaded the entire American population.

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[24] Bianchi and de Marchi, p. 12.
[25] Meeker, p. 207.

By the eve of the late 1920s, activity in the stock market by small investors had reached frenzied levels, with an average volume of 4.5 million shares traded per day in the first half of 1929.[26] Previously unimaginable lines of credit were extended, and most Americans felt invincible to the substantial financial risk they had subjected themselves to. States Joseph Lawrence during the 1932 Congressional Hearings on short sales:

> Many citizens infected in better years by the psychology of extravagance are now smitten by its fallacy. Incomes were spent before they were received and increases anticipated which failed to materialize.[27]

The first three weeks of October 1929 were highly erratic, with the Dow Jones Industrial Average (DJIA) moving from 344 to 325 to 352 to 320; margin calls were also prevalent during this period. On October 23rd, stock prices fell 15 points to 305, yet many investors were buying heavily in the market. Finally, "Black Thursday" hit, and by mid-day stock prices were down 15-20%. Barrie Wigmore describes the sentiment of Black Thursday as follows: "There was a tidal wave of panic, not a gradual loss of confidence."[28] Yet, J.P. Morgan & Co. formed a "Banker's Pool" that began a successful attempt to bid up stock prices. By the closing bell, the DJIA had fallen only 6 points, despite the volatility of the day. Friday and Saturday maintained even prices, although trading was again conducted in record volumes.[29]

On Monday morning, all semblance of control was relinquished as the bottom of the market fell out. The Dow fell 14 percent to 260, and margin calls were expedited. Tuesday saw stocks fall another 60 points, and the *New York Times* described the event as the "most demoralizing conditions of trading in the history of the Stock Exchange."[30]

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[26] Wigmore, p. 5.
[27] U.S. House of Representatives, 1932, p. 168.
[28] Wigmore, p. 6.
[29] Wigmore, pp. 10-15.
[30] Wigmore, p. 15.

These highly volatile cycles of large declines followed by Morgan-induced minimal gains finally ended on Thursday, November 14, 1929, exactly three weeks after Black Thursday. By the end of the Crash many companies had declared bankruptcy, and a massive, disastrous run on the banks had occurred.

THE WITCH HUNT

By early 1932 the economy had begun to stabilize itself, and Congress felt it appropriate at this time to examine the relative merits of short selling. Representative Adolph J. Sabath of Illinois proposed bills H.R. 4638 and 4639 to Congress. H.R. 4638 was defined as "A bill to prohibit communication of false information with respect to securities in certain cases", and H.R. 4639 was defined simply as "A bill to prohibit short sales of stock."[31] Although neither of these bills was enacted, the hearings on the bills, especially H.R. 4639, provide a good insight into the debate surrounding short selling following the stock market crash. I will analyze the major assertions of short-selling opponents, then counter these arguments.

Henry Aron accurately describes the purpose of the Congressional hearings:

> The importance of your inquiry from a public standpoint is not into the theoretical economics of short selling; it is into the actual practice of short selling as it is conducted day by day on the stock exchanges of this country.[32]

Aron is an opponent of short selling, but this neutral statement cites the goal of the hearing well. The economics of short selling are presumed sound in a perfect state of the world, but Aron and his counterparts fear that short selling in practice poses a viable threat to fair and efficient market functions, and was largely responsible for the stock market crash.

BEAR-RAIDING AS THE PRINCIPAL INSTIGATOR OF THE CRASH

The core argument against short selling in 1932 contended that a relatively small group of investors took unfair advantage of the crash by shorting stock when the market was already in hysteria. Supporters of this view feel that the market was healthy until the level of short interest

[31] U.S. House of Representatives, 1932, p. 5.
[32] U.S. House of Representatives, 1932, p. 10.

reached record levels, and that short selling provided neither stability nor compassion in the weeks following the crash. Thus, short selling is blamed for both causing the crash and exaggerating its effects once it began.

In evaluating the effects of short selling, it must first be noted that the total number of shares held short in the last days of the crash represented roughly 3/1000 of the total exchange volume.[33] Thus, opponents of short selling imply that a large multiplier effect must be in place to account for the precipitous drop in the stock market. While I find the previous statistical evidence to be a strong defense of short sales, Jackson Martindell stated:

> The published short account figures covering the entire stock list are meaningless. They give no indication of the tremendous influence that in and out day trading by short on the floor of the stock exchange have had on stock prices. The stock market during times of financial stress may be compared to a snowball rolling down hill. Every little push that a short trader gives this snowball is far more important than any mere statistical tabulation can possibly indicate.[34]

However, Martindell does not defend this position with any statistics, and does not address the two major faults with the bear-raiding logic.

The first shortcoming of this theory is elaborated by Sanford J. Grossman, in his book The Informational Role of Prices. Grossman describes a model in which informed and uninformed investors interact. The informed parties have greater insight into the markets (acquired through data simulation, computer models, contact exploration, etc.), but have paid a fixed cost for that good. On the contrary, uninformed speculators have little advanced knowledge, but they also have lower costs. This theory must also be prefaced with the fact that it applies only to high volume (NYSE & AMEX) stocks where such information is fully obtainable and void of duplicity. Grossman states:

[33] Meeker, p. 252
[34] U.S. House of Representatives, 1932, p. 32.

> We can calculate the expected utility of the informed and the expected utility of the uninformed. If the former is greater than the latter (taking into account the cost of information), some individuals switch from being uninformed to being informed (and conversely). An overall equilibrium requires the two to have the same expected utility.[35]

Applying Grossman's theory to the previous debate, it is clear that the "bear raiders" possess no comparative advantage over the "uninformed public", since all relevant information is relayed via the market into an individual stock's price.

The second, and more direct, problem with the bear raiding critique is that every time a share is sold short, someone is *buying* this share. The short seller is not flooding the market with some manufactured share; an informed buyer is betting against the short seller that the price of the stock will rise. This argument comes into problem with individual, thinly-traded stocks, but in the case of the large, industrial stocks that define the DJIA, the arguments of Aron and his ilk regarding bear raiding can be discarded.

The second major attack on short selling during the 1932 hearings called into question the supposed stabilizing mechanism of short selling. The assumption made by Aron is that once the crash had begun, the short-selling cushion failed to intervene. He muses: "Where was the restraint in 1929; where was the cushion in 1930; where was the stability in 1931?"[36]

The ridiculous assumption made by Aron is that short selling, representing less than 1% of shares trades, can serve as an insurer for a market that has engaged in ever-optimistic buying for several years. Richard Whitney, President of the NYSE, stated:

> A man should not put the blame for his lack of business judgement upon the market..the stock market reflects business conditions. It is not their cause. It is wrong to say that a ban on short selling would have halted our business depression.[37]

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[35] Grossman, p. 92.
[36] U.S. House of Representatives, 1932, p. 34.
[37] U.S. House of Representatives, 1932, pp. 64-65.

Whitney goes on to cite a list of individual stocks with high short interest whose prices fell within a prescribed range during the period Aron refers to.

In addition, it appears Aron did not closely investigate the data of this era, but rather focused entirely upon the crash itself. Further examination of stock prices from 1929 to 1932 by Wharton Professor S.S. Huebner revealed that:

> With the exception of the first decline [the crash] all of the succeeding six downward movements were fairly orderly and free from demoralization despite the blackness of the news. Each successive decline was halted, in large part by the buying of short sellers who had sold previously and who were desirous of taking profits following the decline.[38]

The suppositions of short selling opponents, as stated during the Congressional Hearings of 1932, are two-fold. Both do not withstand scrutiny. Bear raiding did not cause the stock market crash of 1929, and the cushioning effect was not absent, but rather served a valuable role in the recovery of the market. The remainder of the 1932 testimony details the virtues of short selling in opposition to a ban, but these arguments have been stated previously.

It should be noted that although neither H.R. 4638 nor H.R. 4639 was passed, the attention these hearings drew to the stock markets resulted in the 1934 formation of the Securities and Exchange Commission. The purpose of this act was not to hinder short sellers, but to regulate the entire capital market in an effort to preclude another Black Thursday. The SEC, acting on substantiated complaints of bear raids of thinly-traded stocks, enacted the up-tick rule in 1934. The tone and purpose is best described by Wigmore, who states:

> Some short sales were made by brokers to hedge their trading inventories or put and call operations, but all short sales were publicly condemned because they appeared to capitalize on the nation's problems. The attention to short sales in the press and other commentary verged on sensationalism or a search for a scapegoat.[39]

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[38] U.S. House of Representatives, 1932, p. 75.
[39] Wigmore, p. 31.

October 1987--The Second Great Crash

> Although the basic practice of short selling is not new, it has taken on a new significance just recently. Modern innovations in the clearing and settlement of securities transactions and the wide-spread adoption of book entry recordkeeping systems have dramatically reduced the costs and increased the market opportunities for short-selling transactions. A new evaluation of how short selling fits into modern securities markets and whether the complaints being heard are valid is therefore needed.[40]

The decade preceding the 1987 crash paralleled the Roaring Twenties in spirit, as the pro-business policies of the Reagan Administration led to massive expansion of industry following the oil-shock doldrums of the late 1970s. This rapid expansion outgrew the market's capacity to support higher stock prices, and the stock market again crashed in October 1987. Just as had happened fifty-eight years previously, the public demanded a scapegoat and short-selling hearings were convened.

During the 1989 hearings, the fundamentals of short selling were not questioned and short selling was never targeted as the instigator of the 1987 crash. Rather, the incidences of bear raiding and other practices on the OTC exchange were investigated, with many sound suggestions coming out of these hearings. Surprisingly, as of yet none of these ideas has been implemented by the SEC.

MOTIVATIONS AND METHODS OF MODERN BEARS

The short selling practices of the 1980s have produced a new breed of (in)famous characters, including "The Mortician", Rusty Rose III, and "The Stockbusters", the Feshbach brothers.[41] These men have developed a method of short selling predicated on the insufficiencies of regulation on the OTC exchange, and have used modern communicational technology and new trading methods to inflict harm that was not possible in the 1930s. These methods are described here by Robert J. Flaherty, who states:

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[40] Committee on Government Operations, p. 1.
[41] U.S. House of Representatives, 1989, p. 32.

> They have developed symbiotic relationships with regulatory agencies, such as the SEC, so they can provide information which can trigger investigations. Sometimes shorts spread rumors of future investigations which never occur but frighten outsiders and hurt shares. They speed dissemination of bad news to the press and also often to the target company's current and prospective customers, suppliers, financial backers, and friendly market makers and institutional shareholders. They do heavy prepublication trading even up to hours before the appearance of the first negative article which follows their story line and usually was initiated anonymously by one of the short selling network.[42]

When the above tactics are employed on most third-exchange stocks the new, and often illegal, supply created by short selling constitutes a proportion capable of permanently endangering a stock, as has too often been the case recently. Illegal shares have been manufactured by the process of "naked shorting", wherein a short sale is executed but not covered by existing stock. This process results in extra shares being traded in the market that do not exist on the companies books, and it is estimated that in some instances, the ratio of naked shares to issued shares has reached 5 to 1.[43]

Thus, the mechanics of the bear raid have not fundamentally changed over time, but two key differences are present today. First is the aforementioned "naked short", which creates an imbalance in supply and demand. When perpetrated at the peak of a stock's price. naked shorting can ruin a small company. Secondly, press releases, investigations, and other forms of false information are usually used in concert with naked shorting. The combination of these two factors, when combined with orchestrated buying and selling, is a problem in today's markets that imposes both tangible (fiscal) and intangible costs on society.

The aforementioned intangible costs have been the foremost concern of legislators. While the financial resources of OTC companies are relatively small, the value of their ideas and new products are never known, since shorts often drive these companies out of business while their operations are still in the planning stages. Granted, the short must repurchase some stock in order to replace his borrowed shares, but this usually happens when the stock price is precipitously low

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[42] U.S. House of Representatives, 1989, p. 33.
[43] U.S. House of Representatives, 1989, p. 153.

and incapable of future resuscitation. Not only do shorts destroy existing corporations, but they also dissuade many inventors and scientists from pursuing ventures, as often these people feel these efforts will ultimately be in vain as a result of bear raiding. States the former Chairman of the now-defunct Carrington Laboratories, Thomas J. Marquez:

> The greatest damage in our case may not be to shareholders, but to those people who are dying of AIDS and cancer in this country at the rate of more than one a minute who could be receiving effective treatment.[44]

STATISTICAL EVIDENCE

A 1989 survey by the National Association of OTC Companies lends some statistical support as to prevalence and extent of bear raiding of third-exchange businesses. The survey was conducted among 183 random companies with a median market capitalization of $60 million. 22% percent of these companies "responded affirmatively when asked if they believed that their company's stock had been the subject of short selling by professional short sellers." 50% reported that the duration of the attack extended over a period of 15 weeks. 58% replied that their stockholders had been negatively affected, and 28% indicated that the company had been affected.[45]

POLICY SUGGESTIONS

A variety of suggestions for the alleviation of these problems were expressed in the 1989 hearings. The most implementable and important policy changes include:

> • OTC adoption the "up-tick rule", which would limit the extent of downward movement among targeted stocks.
>
> • The outlaw of "naked short selling", combined with active enforcement of this rule by the SEC.
>
> • The implementation of a law that would require short sellers to file with the SEC upon shorting 5% of a company's stock. Note that this regulation is currently in place for long stock purchases.

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[44] U.S. House of Representatives, 1989, p. 111.
[45] U.S. House of Representatives, 1989, pp. 184-185.

> • The regulation of press releases; and the adoption of severe penalties for both the shorters and publications responsible for false accusations.[46]

In closing, the 1989 Congressional hearings were much more accurate in their assessment of the problems of short selling than those held in 1932, and called for action in a commonly exploited area of the financial markets.

Conclusion

In theory, short selling represents a fundamental credit arrangement that has existed since the earliest beginnings of commerce. In practice, short selling is a financial tool used to express information in financial markets that contributes to the general equilibrium of these markets.

However, due to the perceived "backwardness" of short sales and the impression that short selling relishes the downfall of stock prices, the practice has come under scrutiny in times of financial distress. The same basic arguments as to the merits of short selling have encompassed this debate since 17th century Holland, and have perpetuated themselves to 20th century America.

In this paper, I have attempted to conduct an objective study of the short selling debate, weighing the arguments on both sides equally, When these assertions are taken in context with the political and economic situations surrounding short selling, it is my feeling that, with the exception of modern manipulations on the OTC exchange, short selling serves a valuable role in our financial markets and has been criticized for primarily political reasons. Short selling transmits much-needed information into our capital markets, and serves a prominent role in contributing to the efficiency and general equilibrium of our economy.

In conclusion, my sentiments are accurately portrayed by Huebner, who stated during the 1932 hearing:

> Short selling is an outstanding practice on all organized markets-both security and commodity-and its origin as an institution coincides substantially with the very beginning of such markets. When business conditions are normal or prosperous,

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[46] U.S. House of Representatives, 1989, pp. 96, 186.

and the price of everything is reasonably high as a consequence, no complaints are heard. But every time that business of all kinds is in the depths of a business convulsion (which seems to have occurred about every 8 to 10 years during the past 200 years) and prices of all things-including not only stocks and bonds but also real estate, mineral products, and wholesale and retail prices of the multitudinous number of nonexchange commodities-are generally depressed, the reading public is supplied with barrage after barrage against short selling. Comparatively little thought, however, is given to the fact that nonexchange quotations show on the average during each of these business convulsions a price decline fully as great as those established upon our speculative exchanges.

It is only natural to search for an explanation of our constantly recurring business convulsions, and in this connection if short selling is wrong or evil it ought to be prohibited. But if necessary and useful in the maintenance of a free and two-sided market, although never perfect in the sense that none of our good economic institutions are perfect, it should not be prohibited or unnecessarily stifled in its economic functioning. Reasonableness requires that we affix the blame for our recurring business convulsions upon the excessively speculative nature of man.[47]

[47] U.S. House of Representatives, 1932, p. 67.

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