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SHORT SELLING MALIGNED: AN HISTORICAL PERSPECTIVE

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INTRODUCTION

The practice of short selling in the securities industry has a history rife with accusations of wrongdoing. Such charges originated from both the financial specialist and the relatively unschooled investor alleging that professional bear rings, price manipulators, and inside traders were abusively short selling. The high risk and speculative nature of the this transaction seems also to have augmented this negative view, especially among those with a more limited understanding of the securities industry. Predictably, these sentiments were most manifest during periods of economic upheaval.. During the Crash of 1929 the prevailing attitude berated short selling activities and blamed the crash upon those who found profitability in the mist of economic disaster.

This is not to be viewed, however, as a phenomenon of only historical merit. A similar story may be told for the 1980's, as is illustrated in the One Hundred First Congress and the subsequent legislative hearings brought about by Black Monday, 1987. Concerns about possible improprieties tied to short selling persist.

Objective analysis is critical to determine the real implications of short selling and to assess its position in the financial market. My intent is to provide an historical retrospective. Also of interest is observing the way in which people perceive the securities market. One view is that the exchange is like a casino and should largely be treated as such; that transactions are akin to 'gambling.' Alternatively, the market may be a very rational mechanism distributing wealth upon an even playing field; it may be interpreted as a systematic device. Whatever the case, short selling might best be examined during the periods under which it received the greatest criticism.

SHORT SELLING EXPLAINED

The profit motive of a short seller is substantially similar to that of someone in a long position; however, the sequence is done in reverse. The short seller borrows stock and sells it at the market. The investor speculates that there will be a decrease in the price after which time he will buy back shares to replace those which he did borrow. His profit would be the extent to which the price of the stock fell. Of course, the speculating investor faces a n unlimited risk in the transaction, for at least theoretically, the stock price has no upward boundary. Losses will be realized when the short seller is compelled to buy back the stock above his selling price.

The short seller, then, is always bearish on the market and will be most profitable when the financial market is performing poorly. His profit must necessarily come from the losses of others. Earlier this century this was looked upon as a particularly immoral method of making money. Add to that the perception which portrayed the short seller as one who initiated false rumors expressly to cause prices to fall, as in the case of bear rings, or simply one who took advantage of the ensuing decline in price, and it becomes clear to see how the short seller gained a nefarious reputation.

THE MARKET IN THE 1920'S

Before the United States entered W.W.I it was estimated that 2% of the population owned securities and by 1919 this figure had increased to 15%, due largely to the popular distribution of federal war bonds. Not surprisingly, the number of investment houses correspondingly increased, as membership of the Investment Bankers Association rose from 593 in 1918 to 1,902 in 1929 (Atkins, et al. p.47). Atkins describes the general market in the following way:

> Once advancing stock prices get well under way, they work to insidious ends. at the outset the careful and wise individual observes rising prices with a jaundiced eye, but by degrees his perspective becomes changed. Stocks which should not have risen have gone up; they are still going up, up. Everybody in the market seems to be making money. (They join) to swell the ever growing list of speculators.

This feeling of economic euphoria was, in part, artificial. This assertion is commonly buttressed by the belief that a speculative, irrational bubble formed in this period causing stock prices to surge and then subsequently crash. An irrational bubble is predicated on the notion that forces exogenous to the market give impetus to upward stock valuation. Stock prices

increased from the trading mania instead of from fundamental developments within the underlying companies. Management at several companies publicly stated that their stocks were overvalued, such as Canadian Marconi and Brooklyn Edison. In 1928, A.P., Giannini, head of BancItaly (now BancAmerica) warned the public that his bank's stock was overvalued, which then led to a sharp drop. (White, p.73)

Additional support may be seen in appendix 1: stock prices and dividend indices. From 1922 to 1928 dividends and the Dow Jones Index move in a substantially similar path, reflecting managers' beliefs that dividends should increase with fundamental stock appreciation (which primarily reflects growth in projected earnings). In the period between 1928 and the third quarter of 1929 there is a clear departure from this trend. One might initially ponder whether this deviation from the expected path was due to inflation stemming from an expanded money supply. However, the money stock in 1928, in billions, was 46.42 compared to 46.60 in 1929. The implicit price deflator, where 1929 is the base year, was 100.1 for 1928. (Friedman and Schwartz, p.123). Clearly, these statistics indicate inflation was not the responsible agent. Margin trading was likely instrumental in bidding up stock prices. At the peak of the bull market loans made to members of the NYSE financing security investment/speculation reached an unprecedented level of 9 billion. By the end of 1933 this amount had fallen to 593 million. (Clark, p.91) the margin to buy common stock in 1929 was most often in the range of 10% to 25%. There was no legislated margin requirement, however, until 1934. This flow of credit into the financial marked allowed investors to buy a great number of shares, through leverage, to fuel the rise in stock prices.

Information collected by Moody's Investors Service provides more helpful insights into stock prices in relation to earnings. For 50 representative industrial common stocks, Moody's found the following: 1) Stock prices rose from 6 billion in early 1926 to 21 billion at the peak of the bull market in 1929. 2) Earnings applicable to these shares were 169 million in 1926 and 327 million in the second quarter of 1929. Before 1926, earnings and stock appreciation increased by roughly the same percentages. In the period of 1926 to 1929, however, earnings increased only 93% while market prices increased 250%. (Clark, p.79) The market seemingly failed to evaluate these representative stocks at their real worth in relation to earnings.

Referring back to appendix 1, the departure of stock prices and dividend indices likely mirrors a change in managers' beliefs running counter to the market optimism; beliefs that the upward stock movements were temporary, or at least unfounded by their projected earnings estimates.

If we accept the explanation of an irrational bubble, it would be perfectly reasonable to assume that the increase in stock prices would be matched by a corresponding decline. When the market did collapse toward a more sustainable equilibrium (as the short sellers clearly believed that it would), the investors in long positions experienced great losses while those who were short made quick and substantial gains from the market inefficiency shown in the bubble. The practice of short selling, in this scenario, is completely defensible; it helped the market counter speculation and revalue stock prices to more accurately reflect value base on dividends and earnings. It was the short seller, however, and those associated with him, that had fallen into desrepute; all became known as "banksters," and were ultimately maligned as being the <u>cause</u> of the depression. Admittedly, part of their negative image is attributable to the general discontent with banks, financial markets, and the economy, but there were certainly complaints directed specifically at short selling. As inclined as we might be to label those who were suffering losses as malcontents searching for a scapegoat, the number of people holding these beliefs lend them enough credibility to warrant investigation. It is likely that the assertions had at least partial validity.

Early Arguments

William Perkins, in 1932 testimony before the Hartford, Connecticut Chamber of Commerce, said that short sellers have the "malevolent motive of taking advantage of distressed circumstances." This quotation implies that profits are immoral if they are made at the expense of someone else and was clearly an appeal to people's sensitivities concerning the recent crash.

It is difficult, however, to legislate morality and the fact that short sellers profit at the losses of others is not conceptually distinct from any of a multitude of other transactions operating on the principles of a zero sum game. Though possibly widely felt, this opinion had little compelling legislative force.

Of a more substantive nature, to the belief that short sellers were secretly tied to bear rings which propagated misinformation to depress prices, Perkins said that "temptation brings those vague foreboding and mysterious rumors which undermine our psychology and sap our initiative." If this statement's implication is taken as truth, which it probably should be, a legitimate concern is raised. Bear raiding and the circulation of false rumors on the NYSE has always been officially banned, yet not eliminated. Bear raiding refers to a powerful group of "bearish" investors who repeatedly sell the stocks of a targeted company, often amongst themselves, for the sole purpose of knocking down the price. When selling short, the raiders are able to manipulate the price, purchase it after it falls, and control, to some degree, their profits.

In the Congressional session of this same year there were bills proposed which would 1) Prohibit the short sales of stock [H.R. 4639 Seventy-second Congress], and 2) Prohibit communication of false information with respect to securities in certain cases [H.R. 4638]. When Adolph Sabath, an Illinois Representative, commented on the issue, he stated that "My aim is to eliminate what we term 'short selling' or 'bear raiding' which to my mind, is responsible for the conditions now existing" (U.S. House of Representatives-b, p. 7). Using bear raiding and short selling interchangeably clearly indicates his bias, but a bias held by a respectable segment of the populace.

Short Selling: Theory vs. Practice

When discussing short selling it is frequently important to make the distinction between legitimate and illegitimate practices. In testimony before Congress in 1932 a New York Lawyer named Harold Aron stated that there was a difference between "normal short selling" and "organized short selling" (bear raiding). His objection was not so much aimed at the theoretical aspects of shorting (i.e. whether or not it promotes market efficiency), but rather that there were abuses in shoring which magnify problems in the securities industry. Quoting a man who remained anonymous, he said that:

> During one bear market, when the writer was a member of the stock exchange a group of powerful floor traders went about the room day after day looking for stocks in which there was weak support. Whenever they found one they would promptly fill up the specialist's book and then trade furiously back and forth...and often succeeded in knocking $2 to $5 off the price...making a nice profit off their original sale of four or five thousand shares (U.S. House of Representatives-b, p.15).

This example provides a lucid demonstration of the bear raiding which was likely commonplace in this period before the securities acts. Another exchange member's statement, discussing trading in 1909 said "If he is a large operator, he will employ some carefully selected propagandist to circulate all sort of rumours, true and false" (U.S. House of Representatives-b, p.12). This condemning statement compels one to acknowledge the improprieties in short selling and makes the public's persecution of short selling more understandable, even if, at times, rather misdirected.

LEGISLATION IN THE 1930S

The decade immediately following the crash was the most prolific time of regulation that the securities industry has ever seen. Instead of the NYSE continuing to police itself, the field of investment was brought under comprehensive government control. Prior to the crash, stock swindlers and crooked promoters preyed on gullible investor, many of them inexperienced, who were pulled in by the bull market raging around them. Foreign government debt was frequently sold, often going into default after a revolution nullified the obligation, leaving investors with no recourse. With all of these investment hazards, the market was viewed by many as a loosely controlled game; a sort of gambling. After the regulation, it became a somewhat more orderly, controlled market. Perhaps the two best known pieces of legislation are the 1933 and 1934 Securities Acts.

The Securities Act of 1933 addresses primary issuances requiring disclosure and truthful

reporting, principally within the prospectus. The Securities Act of 1934 created the Securities and Exchange Commission, regulates trading practices, and permits the Federal Reserve Board to regulate margin requirements. This act also prohibits insiders from selling short company stock and requires them to submit information about any long trades. This arose out of public pressure advocating the elimination of short selling and insider profits. We see that the legislators compromised and were able to distinguish between the theory and the practice of shorting.

MARKET EFFICIENCY

There are several reasons to believe that short selling helps to promote an efficient market. An unexpected rise in the short interest in a stock sends signals to investors that bad news concerning that stock is pending. Even before that information is made public, then, the stock price tries to regain an equilibrium position.[1] The expected number of periods required for the absolute adjustment of price to bad and good news increases as the proportion of traders subject to restriction on short selling increases (Diamond and Verrecchia, p. 294). Impeding this flow of information is not only inefficient in itself, but can also contribute to an increase in the spread of the bid-ask quote of the risk neutral market maker.

The market maker observes all trades which take place and issues a quote reflecting the profit he hopes to gain from transactions with the uninformed investors and also the losses incurred from trades with the informed. Constraints which create a cost upon short selling have the tendency to drive out more uninformed shorters over the informed, since the informed are considerably more confident in their ability to make a profit and successfully encounter the risks involved. This change in the composition of the shorting pool forces the market maker to

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[1] At this point one might wonder why the price was adjusting **before** the information is made public, in the absence of insider trading. The Securities and Exchange Commission seeks to track down only those insiders who trade on undisclosed **material** information concerning their company. Thus, people within a company who believe that they have valuable information about their companies' prospects might well be justified in carrying out normal trading activities.

increase the spread or risk suffering greater losses. Overall, then, there is evidence to indicate that constraining short selling brings about undesirable results inhibiting market efficiency.

Current Short Selling

Robert Spira, Chairman of Berkeley Securities, gave critical testimony of the current practices of shorting, but acknowledged that "short selling is necessary for our markets to function. It serves well as a ballast for excesses, but should be done on a level playing field" (U.S. House of Representatives-a, p. 13). Despite all of the securities regulation since our earlier observations, bear raiding and other traditional problems with shorting appear to be persistent.

Shorting on the OTC

"I have observed many bear raids where a network of secret short sellers, working together, attacked the stock of emerging companies" (U.S. House of Representatives-a, p. 32). This is what Robert Flaherty, the editor of the OTC Review had to say in 1989 about the short selling on the over-the-counter market. The OTC traditionally trades the stocks of smaller companies which don't qualify to be listed on the exchanges. It is non-auction, negotiated trading where individual firms make a "market" in a particular stock. Since the great volumes on the exchanges now effectively insulate listed firms from being manipulated by bear raiders, the raiders have moved to different grounds, namely, the OTC.

The OTC is a less regulated market and restrictions such as the uptick rule do not apply. The uptick rule allows short selling on the exchanges only when a price is above the last downward tick. This helps prevent precipitous drops in a stock's price in the face of heavy selling. Since this regulation is absent from the OTC, little protection is afforded against bears smashing down prices. The consolidated tape reports trades on the NYSE, the regional exchanges such as the Philadelphia, Pacific, and Boston, as well as many third market firms. It tracks all price changes making uptick determinations instantaneous. Proponents arguing for an OTC uptick rule assert that this technology could easily be applied to the market makers in an

OTC security, which would then give the small companies the same protection granted to those firms on the exchange. This technology has not been implemented on the OTC perhaps for the important reason that many stocks are only lightly traded and it might not be cost effective to construct so vast a network connecting all broker-dealer firms making a market in any security.

The Network's Tools

Bear raiders, as told by Flaherty, have developed symbiotic relationships with both news publications and with the SEC. The raiding technique is simple and effective. A highly valued company is heavily researched by members of the network, using private detectives and other sources. The news uncovered is frequently forwarded to regulatory agencies such as the SEC, and offered, under conditions of anonymity, to news publications. All the while the network members are shorting furiously. Their shorting activity, allegedly much of it naked, serves to pummel the stock prices. When the story becomes public, the readers see no mention of shorting, hear the damaging news, and see the rapidly falling price. The public reaction adds to the price decline and the shorters buy up and reap considerable gains.

There are many cases which appear to lend credibility to these claims; one such case was that of Carrington Lab Stock. At various times in 1987, immediately <u>before</u> negative articles appeared in Barron's, the average daily trading figures were 200%, 375%, and 800%, respectively, above normal trading activity. American Solar, CopyTele, and Thousand Trails experienced similar jumps before heard-in-the-street articles appeared in the Wall Street Journal. The Feshbach brothers, 'professional shorters,' were short in all of these stocks (U.S. House of Representatives, p. 36). Emerging companies are the most frequent targets of these investigations and subsequent stories because of their vulnerability and inability to quickly enact damage control measures and provide a public relations defense (where it is assumed that long established companies would be more seasoned in these areas and less susceptible to attack).

In the above Carrington Pharmaceutical case, Tom Barton, a partner of the Feshbach brothers, once visited the SEC and charged Carrington with fraud in its quarterly and annual reports. Short sellers notified Dow Jones, Barron's, and the Wall Street Journal knowing that an investigation of their charges would result. The investigation revealed nothing, but the stock dropped to the benefit of the shorters who had been shorting in the meanwhile. Someone, believed to be a short seller, called the FDA alleging that Carrington did not have a pharmaceutical manufacturing license, which was found to be untrue. Tom Barton also called the fund manager of the trust department of Republic National Bank of Dallas which held over 50,000 shares of Carrington stock and indicated that Carrington was going bankrupt and its drugs were good only as plant food. Barton urged the fund manager to sell the shares held in the fund. This case is one of the most blatant examples of professional shorters actively, and illegally, seeking to manipulated the stock price of an emerging company.

Naked Shorting

Naked shorting amplifies the downward impact of shorting for it permits the trader to sell a limitless number of stocks. It is an abusive and illegal practice since the shorters have no possession, borrowed or otherwise, of the shorted shares. It is also sometimes referred to as 'creating shares,' for its impact is the same as if more shares were present. Somewhat paradoxically, individuals are barred from making this type of transaction but broker-dealer agencies have not been banned from doing so. This loophole allows professional shorters, such as the (in)famous Feshbach brothers, who own a broker-dealer firm to engage in this overshorting without penalty.

There seems to be a general disregard for brokers-dealers making naked shorts, as is reflected in Kurt Feshbach's comment that if investigating groups would talk to short sellers or to the broker's loan department that "they would find out that naked short selling is not a big deal" (U.S. House of Representatives, p. 63). Indeed, Barry Adler was quoted in the February 8, 1988 edition of Forbes magazine as saying:

> If the seller's broker doesn't deliver, don't insist unless the customer actually demands delivery of the physical certificates, which few people do...In all the years I've been short selling stock, I've only once been bought in, that is only once has somebody demanded delivery of the stock (U.S. House of Representatives, p. 63).

This naked shorting is another tool that the professional shorter may employ to gain leverage in depressing small firms stock prices.

The Playing Field

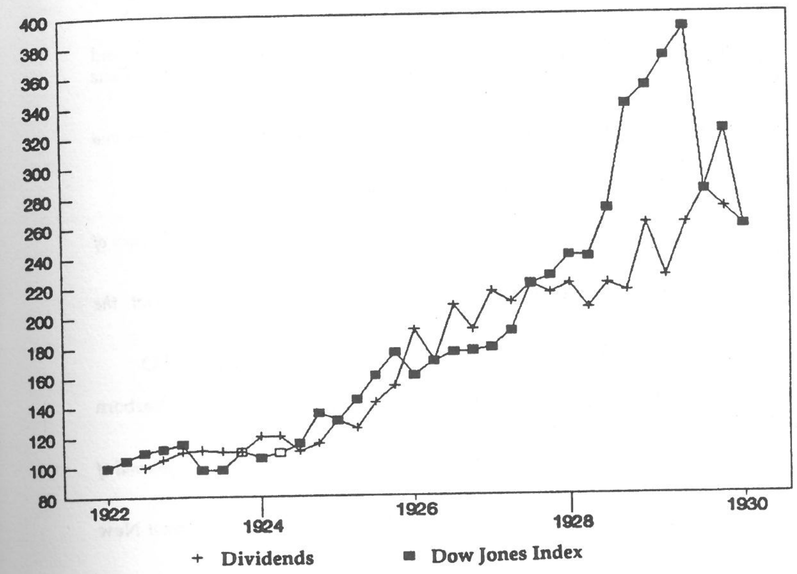
"None of the score or so full-time players...make a living shorting the Dow Jones," noted Robert Spira in a 1990 letter to the house Subcommittee. This indicates that even those professional shorters cannot consistently 'win' at the stock market by shorting those stocks they believe to be ready to fall. Quite to the contrary, it seems as though it is necessary to either have inside information, as in the case of networks employing private eyes, or be able to manipulate the price in some other way, as shown by the network's bear raids. All of these methods depend on an uneven playing field where the winners win because they have either manipulative power or information not available to the public. The general public, when shown the extensive regulations of the securities industry, is apt to perceive the market as being an orderly, "fair," and even playing field for transactions. To the extent that loopholes are available to the professional, the reality is that there is still a strong element of gambling when manipulation occurs. At its worst, this perhaps reaffirms the adage that on should not invest what one cannot afford to lose.

Conclusion

It seems apparent that the activities of professional shorters are illegal in some regards (the spreading of misinformation, etc.), or at best are somewhat immoral (plundering emerging companies). there are, however, legitimate arguments which can be made to show that even the professional shorters provide a public service. Consider a fraudulent company whose stock jumped from $5 to $15. The greater the upward pressure speculators exert on the price, the greater the eventual loss to the investors. Short sellers provide a restraining force and have an incentive to bring to light the information concerning the firm's fraud. If this occurs, the shorters have sped the flow of information to the public and saved them from greater losses resulting from the misguided speculation. The fact that this may be abused does not justify generally maligning short selling. Historically, people have often adopted alarmist views charging short selling with a number of evils. Some saw it as a morally reprehensible act; making money at the expense of others. Some believed that it caused the Great Crash of 1929, since the short sellers appeared to be the only ones to profit from this event. These views seemed widespread, perhaps due to the inexperienced and less informed composition of the investor pool, made up of those who were drawn in by the raging bull market. This is not to say shorters were above reproach. Bear rings and insider trading intimately linked to short selling were pervasive. Legislation in the 1930's addressing these problems as well as that of today attempt to prevent abuses while minimizing interference within the market. Though for a long time short selling was given short shrift for its shortcomings, provided that its abuse is minimized, it will continue to hold an important place in the securities industry and contribute to an efficient financial market.

APPENDIX 1

Stock Price and Dividend Indices



Source: White (1990) and Pierce (1986)

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SYMPOSIUM: EMIGRATION/IMMIGRATION

THE ECONOMIC IMPACT OF HONG KONG'S BRAIN DRAIN

BY MICAELA KELLEY

CUBAN IMMIGRANTS IN MIAMI

BY JILL CALAHAN