Short Selling

• An analysis, with particular reference to the local market.

By JAMES M. ROBB

There are few subjects connected with the business of buying and selling securities more controversial than short selling. For many years bitter and acrimonious debate has raged on the New York Stock Exchange between brokers and traders favoring unrestricted short selling, and those who damn "shorts" as destroyers of the market and a menace to the nation. This is the natural result of the fact that a short is, inevitably, a pessimist. He believes, as a result of study of the market and of business and political conditions, that stocks are overpriced and are certain to decline. He backs up this opinion by contracting to sell stock at the market, expecting to "cover" at lower prices later. The difference between what he contracted to sell the stock for, and what he buys it for is his profit.

This is short selling reduced to its simplest terms. The practise, logical and innocent-appearing though it may be, has been known to result in speculators jumping off into space from upper floors of New York skyscrapers. Normally calm and dignified gentlemen, after a "bear raid", become metamorphosed into incoherent, apoleptic wrecks. For a "bear", when he first forms his opinion as to the future course of the market, runs counter to the opinion of everybody else. We are all optimists at heart, and 99 per cent of us speculate on the *upside*. Excluding those who buy stock strictly for investment, most people buy hoping to sell at higher prices. When enough people feel that way, a bull market results. When that market recedes for any reason, a lot of people lose money. And they don't like to see "shorts" cleaning up at their expense.

One of the biggest bears who ever operated, James R. Keene, once had to hire bodyguards to protect him from bodily harm after he cleaned up millions selling short during a particularly disastrous market collapse. Of course, Keene himself was in large part responsible for the bitter feeling people had toward him at that time—he took fiendish delight in striding out on the stock exchange floor shouting "sell 'em, sell 'em, they're not worth anything! Sell everything! Anything you get is a gift!"

That is the fundamental reason for the widespread opposition to short selling: shorts make money while everybody else loses. Of course, this is not the reason that is put forward most often in arguments for the abolition of short selling. Shorts are accused, sometimes justly, of raiding a sound market, forcing it downward by offering large blocks of stock for sale which the market cannot absorb; of spreading false rumors about a stock issue, etc. Brokers have been known to use clients' pledged securities (which they have power to use for their own account) to short a market, thus knifing their own clients, since those same clients have obviously margined their holdings in anticipation of a rise.

Defenders of short selling point out that it acts as a check on a runaway bull market—now recognized as an evil since it leads to collapse of inflated values with possible disorganization of the economic machinery of the country. Further, since shorts must cover some time, short selling also is a check on a violent downswing. Another argument in favor of short selling which is probably not so valid as these two, is that speculators enter the stock market with their eyes open. They hope to make big profits—to get something for nothing—and have no kick coming if they lose their shirts. The writer personally inclines toward this view, although recognizing that the twenty percent or so who buy stocks strictly for investment must be protected.

Regulation of short selling: There was very little regulation of the practise of selling short on the New York Stock Exchange until 1934. What limitations there were before that time were checks upon unethical practises described in the last paragraph, and were not regulatory of legitimate short selling as such. In that year the reform movement known as the New Deal got around to reforming the stock market, and the newly-created Securities and Exchange Commission, with the somewhat unwilling cooperation of the Board of Governors of the Exchange, imposed a set of regulations designed to protect legitimate market investors to a certain extent from the risk of violent market downswings which could be said to be engineered or at least helped along by bear operators. Within these limits, the practise was allowed to continue, the Commission realizing, apparently, that legitimate short selling does indeed perform a useful function by checking runaway boom markets, and braking runaway bear markets when shorts buy stocks to cover their selling commitments. In point of fact, short selling has, in the long history of the Exchange, been outlawed only at very rare intervals, during periods of great emergency, and then only for very short periods. The last time was for a few days when England went off the gold standard.

Both local Exchanges barred short selling last year, under pressure, it is said, from members who were heavily loaded with margined securities (which they, in turn, had pledged to the banks) at the time of the market collapse which set in about the time of the famous Quezon-Sayre statement. It was not until the First of this month that short selling was again permitted (on the Manila Exchange, with the International following suit), under regulations patterned after those now in effect in New York. Trading in futures—stocks for future delivery—was also installed, although likewise under strict limits.

Short sellers are very vulnerable to regulation: The paramount weakness of a bear's position is the fact that in order to sell short at all, he must commit himself to sell stock *which he does not own.* This fact makes him highly vulnerable to regulation by any agency with authority. If he actually owned the stock which he contracts to sell, he very probably could not be regulated at all, or at least not to the extent to which his activities are regulated at present. Any man has a perfect right to sell stock (or anything else) which he owns, at any price at which he chooses to sell it. (As a matter of fact, many capable lawyers have always doubted the validity of the pegged prices imposed by both Exchanges last year.)

The regulations adopted here have obviously seized upon this outstanding weakness in a short seller's position. Limitation of shorts' activities is accomplished primarily by making it hard to acquire the use of stock sufficient to cover selling commitments. This becomes apparent upon examination of the "Rules Governing 'Short Sales', 'Loaning of Securities' and 'Futures' " issued recently by the Board of Governors of the Manila Stock Exchange.

Definition of a "Short Sale": Paragraph 1 of the Rules defines a short sale as follows: "A 'Short Sale' means any sale of a security listed in the Exchange which the seller does not own or is consummated by the delivery of a security borrowed by, or for the account of, the seller." The last clause in this definition is the more important one, since (see Paragraph 2, *infra*) all short sales must be consummated (by delivery of certificates to the buyer) in the same manner as any other sale and this is accomplished through the seller's broker, who must go out and borrow certificates for his client, unless he happens to have them on hand himself. (*infra*)

Short Sales Distinguished from Futures: Paragraph 2 of the Rules ordains that "Short sales shall be consummated in the same manner as regular sales". This, naturally refers one to the general rules governing trading on the Exchange, and the whole machinery whereby ownership of stock is accomplished quickly and easily between brokers on the floor is applicable to short sales. "Shall be consummated" means, simply, that certificates must be delivered to the buyer at the close of trading on the date that brokers for the buyer and seller note a sale on their little memo pads, and deliver a copy of the memo for recording on the ticker and on the big board.

Since a short seller hasn't got the certificates, and yet is under obligation to deliver them before the close of trading, he has to obtain them somewhere. He does this through his broker, who, (Par. 8, Sec. a, *infra*) must have made previous definite arrangements for obtaining the certificates before making the sale. Unless his broker has certificates on hand which he either owns or has authority to lend under the usual margin agreement, he must go out and borrow them from another broker. The business of loaning securities between brokers is covered in several paragraphs of the Rules:

Paragraph 3, for example, provides that "Members shall segregate securities on which they are lending money (i. e. margined stock) from securities on which they have no lien, the latter being known as 'custody securities' (for example, securities purchased for a client on a regular buying order, held for the client's account and subject to his call), and every broker handling short sales must first set up his books and arrange his certificates showing a clear division between margined and 'custody' securities." Paragraph 1 of the Rules governing Loaning of Securities is practically a reproduction of this paragraph.

Paragraph 2 of the Rules governing loans provides that, "Members may lend securities to each other with the borrowing member putting up 125% margin in cash or securities at current market value." The paragraph contains provisions for adjustments in the event that a borrowing member puts up securities instead of cash, and the securities advance or decline in price.

The short seller, as provided by paragraph 5, may deal on margin, and is required to put up 50% (of the market price of the stock sold) with a minimum of 25% in cash, "the balance in securities at market value of double the difference between the cash deposit and 50%."

These provisions create two distinct relationships: those between the seller's broker, and the broker from whom he borrows certificates (putting up 125% margin), and those between the seller and his broker. Under paragraph 6, the seller is credited on his broker's books with the proceeds of the sale, without interest. His broker has recourse against him for eventual delivery of the certificates, and the client is likewise liable for all dividends, rights, etc., which may accrue on the stock before the sale is covered.

Finally, Paragraph 8 (b) provides that "No short sale may be effected—at a price below the last regular transaction recorded on the board of the Exchange." This provision is designed to prevent a repetition of the 1936 panic which was touched off by a broker going up on the Board as a seller of San Mauricio several points below the market price. Bears may now *anticipate* a decline; they cannot *create* one, at least not by this means.

Other provisions are designed to eliminate sharp practise by brokers. Paragraph 9 prohibits brokers from effecting short sales *while acting as brokers*, with their own stock except when, 1. "He or his firm is willing to sell at a point below that mentioned in his client's order, or, 2. except when by reason of his failure to execute an order, he or his firm is compelled to supply, through his error account, securities named in the order".

These provisions simply provide that a broker, after accepting a short sale order from a client, cannot fill the order with securities of his own or owned by his firm unless he or his firm 1. agrees with the client that the market will go down, and is willing to take a chance by selling to the client at a point below the market price, or 2. the broker or the firm makes a mistake; fails to execute a short sale order after accepting it, and is compelled to make the mistake good.

Paragraph 9 (b) prohibits the practise, said to have been indulged in by some brokers in the past, of dealing on the short side in securities pledged to them by clients on margin agreements.

Paragraph 9 (c) is designed to prevent "dumping" of large blocks of stock in order to effect a rescession in the market.

Other miscellaneous provisions are of slight importance. Paragraph 10 deals with off-sets and intra-office sales by odd-lot dealers. Since an odd-lot broker accepts buying and selling orders in quantities below the units of trading, and, consequently, does not use the machinery of the Exchange until his accumulated orders equal units of trading, special provisions must be written for him. A few brokers have odd-lot desks. Paragraph 11—entirely superfluous—states that the Board of Governors, in their discretion, may suspend short selling. Certain other provisions require brokers to segregate margined stock on which they have authority to lend, from "custody" shares; to denominate each order when received as a short or long sale, etc.

The Rules are obviously a compromise between those favoring unrestricted short selling, and those who would abolish the practise altogether. You can still sell short, but your broker must deliver certificates to the buyer before the close of trading on the date that the sale is made. You can sell on margin, but you must put up at least 25% in cash, and 50% in securities at the market value—or a total of 75% margin, unless you can put up 50% in cash. Your broker has to put up 125% in securities with the broker from whom he borrows the stock for your account. Your broker must at all times so keep his books that the Board of Governors of the Stock Exchange can determine at a glance what his clients' positions are at any one time. The Board can suspend short selling at any time.

Those speculators who have made money on the short side feel that the Rules are too stringent. Their dissatisfaction is understandable: after all, stocks go down three times as fast as they go up, and anyone can make money (and lose it) just as easily on the short side as on the long, and three times as fast. These people are forced to trade in stocks for future delivery—"Futures"—if they want to avoid the limitations of the Rules on Short Selling. And since this market is a market of headlines, where anything can happen from day to day and usually does, trading in futures is not likely to attain very large proportions.

As we went to press, short selling was negligible. As one broker put it, "what would you short?" With Averages fluctuating within a ten-point range, on small volume, short selling is not only dangerous but unprofitable from the point of view of the risks involved. It will probably not be until the public reenters the market, and some kind of volume develops on rising prices, that short selling will appear to any extent. And then we will see how the new Rules work.