Clothing shorts

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He who sells what isn’t his’n
Buys it back or goes to prison.
– 19th century Wall St. adage

He who sells what isn’t his’n
Finds the shares or goes to prison.
– Wall St. adage starting today
Overstock.com CEO Patrick Byrne is often in the news regarding his efforts to curtail injustice. These include his efforts to combat global poverty (through our Worldstock department and products), improve educational outcomes for the less fortunate (through his work with the late Milton Friedman and his support of Milton and Rose Friedman Foundation's school voucher initiative), battle the pernicious effect on America of Wall Street corruption in the form of naked short selling and collusion among hedge funds, prime brokers, and a few research analysts (as are detailed in lawsuits Overstock has filed against Gradient Analytics, Rocker Partners and Wall Street's major prime brokers), and expose corruption in business journalism via a handful of shill journalists who seek to hijack social media’s discourse regarding this scandal so that understanding does not form within the Blogosphere.

This page has been developed as a resource for those interested in poverty and social justice, educational reform, and corruption within Wall Street, financial journalism, and social media. We will add relevant media and articles from time to time. We welcome your comments or suggestions.

Naked Short Selling

Patrick Byrne is waging a fight with Wall Street over naked short selling. He believes that, through the practice of naked shorting, Wall Street is cheating Main Street America and destroying small companies for a profit. Byrne feels that the SEC is failing to protect retail investors and small companies because it has been captured by Wall Street, and that the New York financial press is similarly co-opted. Byrne believes that the SEC’s efforts to eliminate this abusive practice are falling short, not simply for Overstock (which has itself been on the Regulation SHO Threshold list for over two years), but in a way that creates the possibility of systemic risk for our financial world.
The undercurrent

- Latest initiatives all concern naked shorting (shorting without borrowing and delivering shares).

- But many complaining about naked shorting are actually opposed to all short sales.

- The SEC may not be opposed to all short sales but is indeed trying to throw sand in the gears of shorting more generally.

- This is not new. The tradition goes back centuries, especially when stock prices fall sharply.
Most US shorting restrictions date to the Great Depression...

- NYSE bans shorting for 2 days as England abandons gold standard
- SEC introduces uptick rule
- NYSE requires written authorization to lend a customer’s shares
- NYSE prohibits short sales on downticks
- Political pressure to rein in or ban shorting
- US Senate releases list of biggest short sellers
- Shorting gradually moves underground

Stock Price Level

1927 1928 1929 1930 1931 1932 1933 1934 1935 1936 1937 1939
What do economists say?

Theory: if shorting is costly and agents disagree, stocks can get overvalued.

Basic idea: when shorting is outlawed, only optimists hold stocks and determine stock prices.

Important papers:
- Diamond and Verrecchia (1987)
- E. Miller (1977)
- Harrison and Kreps (1978)
- Duffie, Garleanu, and Pedersen (2002)
Empirical evidence

Uniform results: with impediments to shorting, stocks can become overvalued:

- 1990’s tech spinoffs such as Palm/3-Com (Lamont and Thaler, 2003)
- Late 1990’s IPOs (Geczy, Musto, and Reed, 2002)
- Stocks without listed options (Danielsen and Sorescu, 2001)
- 1920’s US stocks that were expensive to borrow (Jones and Lamont, 2002)
- 1930’s changes in shorting rules (Jones, 2008)
Why might we want sand in the gears?

- Maybe this is one time when we need stocks to be overvalued (due to systemic risk).
- Maybe naked short sellers are largely manipulators, driving prices below fundamental value.
- Maybe “bear raids” are a real threat (particularly for financials) due to multiple equilibria (a Diamond-Dybvig bank run).
- Maybe the SEC needs to look like it’s doing something about the problem.
- Maybe behavioral finance is right, and a little marketing will change investors’ outlook.
- Or maybe not.
Why we have naked shorts

- Two main reasons
  - Short seller cannot find the shares to borrow
  - Short seller strategically fails to deliver shares
    - Can avoid negative rebate rates (out-of-pocket fees for borrowing shares) this way
    - Rebate rate savings can easily exceed the small amount of buy-in risk
- Reg SHO
  - requires a good-faith effort to locate shares for borrowing.
  - explicitly exempts options market-makers
  - has provisions for gradually eliminating failures-to-deliver if things get bad.
The mechanics of shorting

- Let’s see how a hedge fund might short 100,000 shares of IBM (with a share price of 120).

- To initiate the short, the Jones Fund would, say:
  - Confirm that IBM is easy to borrow
  - Short 100,000 IBM shares
  - Borrow the 100,000 shares from its prime broker or elsewhere and deliver these shares
  - Keep the $12 million in proceeds on deposit as collateral for the loan of stock

- Because the Jones Fund has cash on deposit, it receives interest at the rebate rate.
  - Most loans take place at the general collateral rate (typically near fed funds)
  - If there is heavy shorting demand, share borrowers may be willing to take a smaller return on their cash investment.
  - In this case, the stock may go on special. The rebate rate can go low or even negative.

- When the hedge fund wants to cover its short position, it:
  - Buys or otherwise acquires 100,000 shares of IBM
  - Returns the shares to the share lender
  - Gets back the $12 million in cash on deposit

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Periodic flows

- IBM Buyer
- Hedge Fund
- Share Lender

T+3

$12 million

100,000 shares of IBM

$12mm of cash (+ margin)

100,000 shares of IBM

Payment in lieu of dividend

Hedge Fund

Rebate Rate

Share Lender
Mar 2008: lots of fails in Bear Stearns

Fails in Bear Stearns (115mm shs outstanding)
Details on the July 15 emergency order

- Applied to 19 financial stocks
  - GS, MS, MER, LEH
  - BofA, Citi, JPM, BNP, Barclays, CS, Daiwa, DB, Allianz, RBS, HSBC, Mizuho, UBS
  - Fannie and Freddie
- Required actual pre-borrow rather than good-faith locate of shares.
  - Options market-makers exempted
- Dates
  - Announced July 15
  - Effective July 21
  - Expired August 12
Priors: would the ban do much?

- Reasonably large short interest in these stocks (3.91% of float)

- No fails data publicly available for July, but little evidence of large naked short positions
  - Nothing notable in the data through June
  - Only DB on the threshold list at time of announcement (to get on the list, fails must be at least 0.5% of shares outstanding for the last 5 consecutive days)

- Options market-makers exempted, so at worst all we’ve done is add a middleman as bears buy puts instead.
SEC emergency order timeline

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<th>Announced</th>
<th>Effective</th>
<th>Expiration</th>
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Graph showing financial data with dates: Jul07, Jul125, Aug14, Sep03.
Short interest fell as prices rose

Short Interest in Goldman Sachs (400mm shares outstanding)
Bris study (released Aug 12)

- Pre-July results:
  - G19 stocks sank more than control financial stocks in 2008 (43% vs. 35%)
  - Accounting performance of G19 and control stocks about equal
  - Shorting activity: non-financials < G19 < control stocks
  - G19 stocks are more likely (6 of 19) to have a convert outstanding, which leads to more shorting activity
  - Market quality of G19 stocks worse than for control stocks
  - Lower market quality is not associated with shorting activity

- Effect of the emergency order
  - Quoted spreads:
    - Widen most for G19 stocks (18% to 48%)
    - Control stocks widen less
    - Non-financial stocks show no change
  - No clear evidence on intraday volatility
New rules went into effect today

- Hard T+3 close-out requirement
  - Mandatory pre-borrow
  - Short sellers and their broker-dealers must deliver securities on the settlement date (T+3)
  - Broker-dealer violators prohibited from further short sales in the same security (for any customer) until failure cured.

- Press release says exception for options market-makers repealed
  - Options market makers will be treated the same as all others
  - Hard T+3 close-out and pre-borrow rules apply

- Rule 10b-21 short-selling anti-fraud rule
  - Short sellers who lie about their intention or ability to deliver securities in time for settlement are violating the law when they fail to deliver.