# Financial Warfare: “Sheared by the Shorts”. How Short Sellers Fleece Investors

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> “Unrestrained financial exploitations have been one of the great causes of our present tragic condition.” — President Franklin D. Roosevelt, 1933

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Why did gold and silver stocks just get hammered, at a time when commodities are considered a safe haven against widespread global uncertainty? The answer, according to Bill Murphy’s newsletter LeMetropoleCafe.com, is that the sector has been the target of massive short selling. For some popular precious metal stocks, close to half the trades have been “phantom” sales by short sellers who did not actually own the stock.

A *bear raid* is the practice of targeting a stock or other asset for take-down, either for quick profits or for corporate takeover. Today the target is commodities, but tomorrow it could be something else. When Lehman Brothers went bankrupt in September 2008, some analysts thought the investment firm’s condition was no worse than its competitors’. What brought it down was not undercapitalization but a massive bear raid on 9-11 of that year, when its stock price dropped by 41% in a single day.

The stock market has been plagued by these speculative attacks ever since the four-year industry-wide bear raid called the Great Depression, when the Dow Jones Industrial Average was reduced to 10 percent of its former value. Whenever the market decline slowed, speculators would step in to sell millions of dollars worth of stock they did not own but had ostensibly borrowed just for purposes of sale, using the device known as the short sale. When done on a large enough scale, short selling can force prices down, allowing assets to be picked up very cheaply.

Another Great Depression is the short seller’s dream, as a trader recently admitted on a BBC interview. His candor was unusual, but his attitude is characteristic of a business that is all about making money, regardless of the damage done to real companies contributing real goods and services to the economy.

**How the Game Is Played**

Here is how the short selling scheme works: stock prices are set by traders called "market markers," whose job is to match buyers with sellers. Short sellers willing to sell at the market price are matched with the highest buy orders first, but if sales volume is large, they wind up matched with the bargain-basement bidders, bringing the overall price down. Price is set by supply and demand, and when the supply of stocks available for sale is artificially high, the price drops. When the bear raiders are successful, they are able to buy back the stock to cover their short sales at a price that is artificially low.

Today they only have to trigger the "stop loss" orders of investors to initiate a cascade of selling. Many investors protect themselves from sudden drops in price by placing a standing "stop loss" order, which is activated if the market price falls below a certain price. These orders act like a pre-programmed panic button, which can trigger further selling and more downward pressure on the stock price.

Another destabilizing factor is "margin selling": many speculative investors borrow against their holdings to leverage their investment, and when the value of their holdings goes down, the brokerage may force them to come up with additional cash on short notice or else sell into the bear market. Again the result is something that looks like a panic, causing the stock price to overreact and drop precipitously.

Where do the short sellers get the shares to sell into the market? As Jim Puplava explained on FinancialSense.com on September 24, 2011, they "borrow" shares from the unwitting true shareholders. When a brokerage firm opens an account for a new customer, it is usually a "margin" account—one that allows the investor to buy stock on margin, or by borrowing against the investor's stock. This is done although most investors never use the margin feature and are unaware that they have that sort of account. The brokers do it because they can "rent" the stock in a margin account for a substantial fee—sometimes as much as 30% interest for a stock in short supply. Needless to say, the real shareholders get none of this tidy profit. Worse, they can be seriously harmed by the practice. They bought the stock because they believed in the company and wanted to see its business thrive, not dive. Their shares are being used to bet against their own interests.

There is another problem with short selling: *the short seller is allowed to vote the shares at shareholder meetings*. To avoid having to reveal what is going on, stock brokers send proxies to the "real" owners as well; but that means there are duplicate proxies floating around. Brokers know that many shareholders won't go to the trouble of voting their shares; and when too many proxies do come in for a particular vote, the totals are just reduced proportionately to "fit." But that means the real votes of real stock owners may be thrown out. Hedge funds may engage in short selling *just* to vote on particular issues in which they are interested, such as hostile corporate takeovers. Since many shareholders don't send in their proxies, interested short sellers can swing the vote in a direction that hurts the interests of those with a real stake in the corporation.

**Lax Regulation**

Some of the damage caused by short selling was blunted by the Securities Act of 1933, which imposed an "uptick" rule and forbade "naked" short selling. But both of these regulations have been circumvented today.

The uptick rule required a stock's price to be higher than its previous sale price before a

short sale could be made, preventing a cascade of short sales when stocks were going down. But in July 2007, the uptick rule was repealed.

The regulation against "naked" short selling forbids selling stocks short without either owning *or* borrowing them. But an exception turned the rule into a sham, when a July 2005 SEC ruling allowed the practice by "market makers," those brokers agreeing to stand ready to buy and sell a particular stock on a continuous basis at a publicly quoted price. The catch is that *market makers are the brokers who actually do most of the buying and selling of stock today*. Ninety-five percent of short sales are done by broker-dealers and market makers. Market making is one of those lucrative pursuits of the giant Wall Street banks that now hold a major portion of the country's total banking assets.

One of the more egregious examples of naked short selling was relayed in a story run on FinancialWire in 2005. A man named Robert Simpson purchased all of the outstanding stock of a small company called Global Links Corporation, totaling a little over one million shares. He put all of this stock in his sock drawer, then watched as *60 million* of the company's shares traded hands over the next two days. *Every outstanding share changed hands nearly 60 times in those two days, although they were safely tucked away in his sock drawer*. The incident substantiated allegations that a staggering number of "phantom" shares are being traded around by brokers in naked short sales. Short sellers are expected to cover by buying back the stock and returning it to the pool, but Simpson's 60 million shares were obviously never bought back to cover the phantom sales, since they were never on the market in the first place. Other cases are less easy to track, but the same thing is believed to be going on throughout the market.

**Why Is It Allowed?**

The role of market makers is supposedly to provide liquidity in the markets, match buyers with sellers, and ensure that there will always be someone to supply stock to buyers or to take stock off sellers' hands. The exception allowing them to engage in naked short selling is justified as being necessary to allow buyers and sellers to execute their orders without having to wait for real counterparties to show up. But if you want potatoes or shoes and your local store runs out, you have to wait for delivery. Why is stock investment different?

It has been argued that a highly liquid stock market is essential to ensure corporate funding and growth. That might be a good argument if the money actually went to the company, but *that is not where it goes*. The issuing company gets the money *only* when the stock is sold at an initial public offering (IPO). The stock exchange is a *secondary market* – investors buying from other stockholders, hoping they can sell the stock for more than they paid for it. In short, it is gambling. Corporations have an easier time raising money through new IPOs if the buyers know they can turn around and sell their stock quickly; but in today's computerized global markets, real buyers should show up quickly enough without letting brokers sell stock they don't actually have to sell.

Short selling is sometimes justified as being necessary to keep a brake on the "irrational exuberance" that might otherwise drive popular stocks into dangerous "bubbles." But if that were a necessary feature of functioning markets, short selling would also be rampant in the markets for cars, television sets and computers, which it obviously isn't. The reason it isn't is that these goods can't be "hypothecated" or duplicated on a computer screen the way stock shares can. Short selling is made possible because the brokers are not dealing with physical things but are simply moving numbers around on a computer monitor.

Any alleged advantages to a company or asset class from the liquidity afforded by short selling are offset by the serious harm this sleight of hand can do to companies or assets targeted for take-down in bear raids. With the power to engage in naked short sales, market makers have the market wired for demolition at their whim.

**The Need for Collective Action**

What can be done to halt this very destructive practice? Ideally, federal regulators would step in with some rules; but as Jim Puplava observes, the regulators seem to be in the pockets of the brokers and are inclined to look the other way. Lawsuits can have an effect, but they take money and time.

In the meantime, Puplava advises investors to call their brokers and ask if their accounts are margin accounts. If so, get the accounts changed, with confirmation in writing. Like the "Move Your Money" campaign for disciplining the Wall Street giants, this maneuver could be a non-violent form of collective action with significant effects if enough investors joined in. We need some grassroots action to rein in our runaway financial system and the government it controls, and this could be a good place to start.

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