The Oil Drum
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

No Naked Short Selling => No Short Selling at All => No Future Energy?

Posted by Nate Hagens on September 19, 2008 - 10:05am
Topic: Miscellaneous
Tags: christopher cox, original, sec, short-selling [list all tags]

In an amazing (and as yet unconfirmed) development tonight, the SEC has announced a temporary ban on ALL short selling. In the 100 or so posts on theoildrum in the past 3 years, I usually save my opinions for the conclusion. Tonights news has me a bit outraged, so forgive me if I 'temporarily' diverge from that pattern. If ALL short selling is truly banned, whether it be for a week, a month or a year, the capital markets as we know them will cease to function, which among other things, will cause subtle but serious danger to the future production of energy. (UPDATED at end of post 9/19 06:30 CDT)

Backdrop:
In 1938, the SEC instituted the uptick rule, where stocks could only be sold 'short', on up or neutral 'ticks' in the stocks movement. In July of 2007, for reasons I never understood, the SEC eliminated the 'uptick' rule, allowing stocks to be sold short at anytime.

Earlier this summer, as the financial crisis began to unfold, the SEC announced a list of 19 financial stocks that would no longer be allowed to be sold short 'naked'. Naked short selling differs from normal short selling in that no stock needs to be borrowed and no margin needed until settlement date - normal short selling requires immediate margin funds AND the ability to borrow shares. OK. Fair enough - one SHOULD have margin/funds available and be able to borrow a stock to short it.

Earlier today, the FSA (Britains version of SEC), announced that short selling of financial stocks would be temporarily halted. British financial shares, after being down sharply, rallied dramatically. At the same time this was announced, US financial shares also staged a sharp turnaround - heavily shorted shares like Wachovia Bank rallied 60% - most financial companies rallied over 10%. Rumors in US markets that such a 'short-selling ban' would be more broadly instituted in our markets caused massive short covering in heavily shorted stocks. (For example, the stocks in 2 leading mattress manufacturers - Sealy and Temperpedic - had very different afternoon responses to the British announcement (and subsequent rumors). Sealy, which has very little short interest, rallied 4%. Temperpedic, which has a very similar product to Sealy, but has 61% of its float as short interest, rallied 50% from it's lows on triple normal volume. This was not random. The shorts were covering where they had to.

Tonight we hear that we are taking it one step further than Britain and announcing a temporary ban on ALL short selling (as opposed to naked short selling and as opposed to just financial stocks). The Wall Street Journal reports that the details have not been officially ironed out:

> SEC Chairman Christopher Cox briefed Congress late Thursday of the agency's intention to take the extraordinary step of interfering with the market's regular functioning. Short-selling is a trading strategy of selling borrowed stock in hopes it falls and can be repurchased at a lower price.
>
> It's unclear if the SEC's intention has been approved by the commissioners, which is required, and whether which stocks are covered or for how long it will be in effect. Earlier this summer, the SEC moved to restrict certain short-selling practices for 29 days, covering 19 financial stocks.

I spend much of my free time trying to kickstart a national energy discussion and suss out ways of taking at least baby steps away from our global conspicuous consumption carrot, but I still maintain close friendships with some former wall street colleagues. After seeing this news, I have talked to a gaggle of wall streeters and the mood is somewhere between bewilderment and bitterness. Here is an aggregate of opinions and reactions. The predictions are my own.

First of all, we simply CANNOT halt all short selling. The public (Hillary Clinton and Chuck Schumer) position is that short selling was the root cause for the demise of Bear Stearns and Lehman Brothers and why Morgan Stanley and Goldman are currently on the ropes. The truth is that SOME short sellers have recently used unscrupulous methods to make short selling stocks (or more correctly, Credit Default Swaps), a self-fulfilling prophecy, and thereby profit. The vast majority of short sellers however act as cleaner-fish, policing the stock market for crooked management, unethical practices and bad business models. I have been told that what is underway is a large scale witch hunt that in the next few weeks will show the public some 'very well known' names ending up in jail. But just as pursuing ethanol to wean us off of oil, and pursuing oil speculators to blame oil price rises on, eliminating ALL short sellers in order to punish a few bad eggs will have wide boundary unintended consequences. Instead of the normal knee-jerk scapegoat lynching, perhaps this time our leaders will look deeper for the real 'witch' responsible for the recent explosion in systemic risks and financial upheaval - whoever approved and subsequently encouraged the use of enormous leverage in the financial markets via scaling of investment banks assets and liabilities. Oh wait - that would be the same people looking for the witches..

What will happen if the SEC continues down this path of banning short sellers:

a) an enormous short covering rally. If there were no grandfather clause (meaning existing shorts would have to cover), we could see all time highs in stock market within weeks. I expect if this rule goes into effect there will be some clause preventing this and that only financial stocks will be censored- but who knows?

b)once all the shorts have covered, the long-only hedge fund managers would say 'thank you very much' and sell their (now vastly overvalued) holdings in Corus Bankshares (81% of float short), Downey Financial (69% of float short), etc. at valuations far higher than the underlying businesses deserve.

c)once the up/down purification was complete, we would have far fewer market participants, much less liquidity, lower stock prices, and much less trust in our markets, without having any impact at all on the fundamentals of the companies involved. Quelle surprise.

d)changing rules overnight like this is beyond a Monty Hall campaign. It is the beginning of the nationalization of industry, which started with the Bear Stearns bailout and has continued with various market interventions. Until now I thought financial markets would be the last thing to go - not the first - if this rule goes through I am not so sure.

e)People are not allowed to short in their IRAs. So Wall street created synthetic securities that you can 'buy' (go long), but the return you receive is the inverse of the underlying index (or in many cases, double the inverse such as the SKF in finance). Think of all the tens of thousands of people that own some SKF (or any related ETF) in their IRAs and will wake up to double digit losses tomorrow, only owning the stock with the purpose of lowering the risk of their retirement 'long only' account.

f) **in a world where renewable energy infrastructure needs urgent and massive scaling, and access to high quality fossil reserves is getting more expensive by the year, functioning capital markets will be vital to this transition.**

g) **in a world needing financial capital for energy, we will also need the ability to vote against smart, optimistic, confident entrepreneurs that promise new energy futures based on prototypes. The aggregate hedge fund/short seller will suss out the true value of these new energy technologies, and buy them if for real, and sell them short if they are like most new 'green' energy companies - good on an empty planet, but lacking scalability, and profitability using wide boundary criteria - we desperately need to avoid the Tragedy of the Energy Investing Commons in a declining EROI environment.** .

h) options trading would either totally cease, or the bid-ask spreads would be so wide as to make it ineffective as a hedging vehicle. Options market makers need the ability to short sell to hedge exposure when big options trades come in. How will retail investors (or any investors) hedge their exposure on stocks they own if they can't buy puts?

i)the lone silver lining I see here is that Congress and the rest of American polity may undergo a giant wake up call on how lack of understanding, oversight, and foresight have allowed us to reach this financial morass. If they recognize the misdirection of our financial policies perhaps they will have the courage to learn and change our energy straits at an accelerated pace.

Christopher Cox has no idea what he is doing if he allows this to proceed - why not just reinstate the short on 'uptick' rule that was reversed earlier this year? Hank Paulson (in my opinion) knows exactly what is going on. When he suggested today a resurrection of the RTC (Resolution Trust

Corp) that was used after the US Savings and Loan debacle in the 1990s, longs cheered and shorts scrambled to cover related financial names. But Paulson (so far) has been craftier than that. The terms the Treasury extended to AIG were onerous, not a freebie, and intended as a message that the moral hazard has been approached if not breached. By re-opening the RTC (they are apparently waiting for a President), they would put firms in receivership to monitor and oversee the liquidation of assets and liabilities - this would NOT be a bailout for these companies - the shareholders might be left with nothing, and the bondholders left with some value.

This short selling rule is over the top. I see no way that it will actually be instituted the way that CNBC announced it tonight. Someone will have to overturn or modify it before the open tomorrow - already SP500 futures are up 100 points from early afternoon trading.

In sum, I will close this rant from a mild mannered guy with this thought. We have entered new territory (obviously). Scary territory for many who have become accustomed to a certain way of life, and have not yet thought through the possible paths we might collectively go down in the coming years. Ultimately this is a story about energy - lower energy surplus all around makes people more likely to swing for the fences. While swinging for the fences inevitably some are going to strike out. The umpires at the game should have the wisdom and guts to call those players 'out' while letting the other athletes continue playing the game. In a perfect world, some of the best athletes, who have been pursuing inclusive fitness defined in our era by pecuniary terms, will migrate towards an area that urgently needs creativity, passion, tenacity and follow-through - the local and global scaling of renewable energy infrastructure that we will need as fossil fuels decline in coming decades. Without functioning financial systems, and the trust of large capital players, the energy future we are attempting to change, cannot even get started...

In the end, I think the SEC wants to halt shorting of CDS and other derivatives, but is sending a signal via stocks. However if this rule holds, I predict a positive feedback unraveling (in a negative way) as shorts cover, then EVERYONE sells and we are in worse situation than we started, and playing short stacked to boot. I fully expect, (and hope) that when I wake up tomorrow, this rule will have been voted down, or at least watered down...But the way things are going, perhaps I will wake up to a news flash - that the Fed and SEC are working towards a new mandate that will guarantee stock returns at or above their historical average of 10% forever (but a ban on buying if we ever exceed +15% intrayear).

(Disclosure: In my own portfolio, I am short some stocks (though none mentioned here), as hedges against my longs, to reduce the volatility of my overall portfolio.) I have also put my fathers IRA into some SKF - he will not be pleased).

P.S. Note to Hillary Clinton, Chuck Shumer and Christopher Cox - let's remember to not disallow ALL short selling, because short selling of oil futures gives American's lower gas prices!!!! (sarcasm, for those who weren't sure)

(***UPDATE 6:40 am Well, , they did it, though as expected a watered down version limited* ***on the surface*** *to only 799 financial stocks. Other wrinkles will require short sellers to publicly disclose their positions and easing restrictions on securities issuers repurchasing their securities. But the damage is done I am afraid. Who is going to want to short stocks now, even non-financial ones, at risk of future rule changes at any point? Expect coming lawsuits from state class-action from retirees invested in SKF as a hedge - expect strong language as analysts on CNBC and other network that understand the implications of this move fight back. This will cause the SEC to further backpedal on this rule, perhaps publicly stressing that current shorts don't need to cover, etc..*

What the SEC fails to realize is that there will be a mini-exodus from the business in the next 2 weeks before quarter end and maybe a mass exodus from the business by year end due to lack of confidence, which up til now Paulson and crew continued to convey to the larger players. The short selling ban may actually hurt the very firms it was purposed to defend. The end result now will be far worse than some of our banks going under (which will happen anyways due to deteriorating company fundamentals) -it will continue the demise of confidence in the financial system, and may well lead to a Constitutional crisis. Furthermore, the volatility it will engender might stave off bank runs, but almost certainly will incite 'runs on hedge funds', as people under lock-up will want to exit funds at the earliest opportunity - in addition to the many funds that will just shut their doors due to changing rules intra-game. Thus, the intent to delever, if done too rapidly, will beget even larger volatility.

I expect just like with any freebie, there should now be a long line of 'related' companies raising their hands and asking to be added to the list of 799. Financial companies like Capital One and GE (GE Capital is large % of their business) may have valid cases - but then autos, airlines, health care.....dare I say energy companies? will also line up for protection - where will the line be drawn?- Who will be the first brave Paul Revere company to say - "please remove me from the no-short selling list as it endangers our financial system"? This is truly a 'finger-in-the-dike' scenario - plug one hole and then some other angle not thought about Thursday night surfaces. If I wasn't living it I would think this is all being made up. We need to stop being reactive and start being proactive, which will only happen if we have a new political party or new way of measuring success other than wealth transfer, (or both).

While I have been in the near term peaking camp due to accelerating costs of the marginal barrel (lower net energy), due to this debacle, I believe both nominal and net Peak Oil are now things of the past. There will never be a year where we produce more crude oil than in 2008, (and if things fall fast, then 2008 still may not catch 2005). Energy and finance are critically linked. The deepening banking crisis now combined with apathy and reduced confidence in our financial system will evaporate any chance we had of offsetting oil depletion with new production and new technology. You can bank on it.