

Short Selling Creates a New World of Volatility



By Bill Sammon

Last July, the Securities and Exchange Commission implemented an emergency rule to curb the abusive short selling in 19 of the largest publicly traded financial institutions. The names of those institutions include Bank of America, JPMorgan Chase, Citigroup, Merrill Lynch, Freddie Mac and Fannie Mae. The purpose was to restrict naked short selling to help restore investor confidence in the financial arena.

While the SEC's action helped alleviate some of the pressure on the largest financial institutions, many community bank stocks continue to experience heavy volatility. While the agency's rule does not directly affect commu-

nity banks, it underscores the role that short selling has played in the downdraft of financial stocks.

Short Selling 101

Short selling is the sale of a security made by an investor who does not own the security. The short seller expects a decline in the price of a security, which would allow the investor to then purchase the shares at a lower price in order to deliver the securities that were sold short earlier.

While this sounds fairly straightforward, the seller must take certain steps to execute a short sale successfully. For one, the seller must establish a margin account with a broker-dealer, which allows him or her to borrow the stock to be shorted. Settlement for a typical trade is three business days, which means that the seller must deliver the buyer shares during that time period. Since a short seller does not own the shares when they are sold, the seller must first find a broker willing to lend the shares to make delivery to the buyer.

Eventually, the seller needs to close the position. The seller accomplishes this by buying back the shares in the open market and then delivering those shares to the person or entity from which the seller borrowed the stock.

If the seller purchases the stock at a lower level than he sold it, he turns a profit. If not, the seller takes a loss.

Table 1 **Trading in Stocks Under the Up-Tick Rule**

XYZB	US \$	Market 18.75/19.10	2x2	Prev. 19.10	
Time	Size	Price	Bid	Ask	Tick
11:40:21	1000	19.10	19.05	19.10	↓
11:38:15	300	19.25	19.15	19.30	↑
11:34:58	600	19.20	19.20	19.25	↓
11:30:02	750	19.25	19.20	19.30	↓
11:27:07	100	19.45	19.35	19.45	↓
11:22:34	500	19.50	19.50	19.60	↓
11:20:18	1500	19.60	19.55	19.60	↑
11:10:22	200	19.55	19.50	19.65	↓
11:04:37	700	19.60	19.55	19.70	↓
11:01:30	300	19.65	19.55	19.70	↑
10:55:10	300	19.60	19.60	19.65	↓
10:49:58	900	19.75	19.70	19.90	↓
10:40:45	800	19.80	19.85	19.90	↓
10:35:23	100	19.85	19.75	19.95	↑
10:30:13	250	19.80	19.80	19.85	↓
10:22:36	1000	19.85	19.80	19.90	↓
10:18:45	800	19.90	19.90	20.00	↓

 Stock may be shorted due to an uptick

Source: Howe Barnes Hoefler & Arnett

Up-Tick Rule Change

The deterioration in the fundamental performance and credit quality of many large financial institutions has certainly been the biggest driver of poor stock performance. It is unfair to blame short selling for the current market cycle. Industry experts believe, however, that the change in the up-tick rule has led to increased volatility, causing stock prices to decrease more rapidly.

The up-tick rule was established in the late 1930s to prevent short sellers from driving a decreasing stock's price even lower. Per the rule, a seller was not allowed to short a stock

until a trade occurred at an uptick, or the stock traded at a price higher than the previous trade (see related graph).

The rule was eliminated on July 6, 2007. Therefore, sellers can short stock at any time, including while a stock is trading lower. This can help create tremendous downward momentum on a stock. The issue can be exaggerated when a stock is somewhat illiquid, as are most community banks.

The trading in Corus Bankshares of Chicago is a good case study examining the role that short selling can play in a stock's decline. Corus has \$9 billion in assets and has historically been

a large real estate lender. The profile of Corus' loan portfolio led many to speculate that stock would trade lower. Corus has 53.7 million shares outstanding. The current float—non-insider shares outstanding—is 27 million shares. Therefore, insiders hold approximately 50 percent of the company's shares.

Over the last year, the company's stock was down approximately 70 percent. The short position on Corus is 24,220,567 shares, which helps explain the decline its shares. Shorts represent almost the entire public float in the stock. This large of a short position would have been difficult to build.

What Can Banks Do?

Although it is important for publicly traded companies to know and understand the short position of their stock, it is difficult for banks to combat short sellers. The numbers are published publicly, but by the time they are available, the data is roughly two weeks old.

A short seller can borrow any public shares held in a margin account. A company could hypothetically ask its larger customers to hold their shares in cash accounts, but in most cases, the end result would not impact the share price. A buyback would lower the share count and cause fewer shares to be outstanding,

but a buyback should be used more as a capital management tool and not a way to thwart short selling.

In the end, the best way to discourage shorts is to show strong fundamentals. Short sellers have certainly focused on those companies that have shown rising credit problems. They have closely watched companies whose earnings have dropped. More recently, short sellers have focused on companies that have a large exposure to GSEs. Typically, investors will not bet against fundamentally solid companies. The silver lining, if it can be looked at that way, is when the market or the fundamentals of the companies

improve, many short sellers will feel compelled to cover. This could lead to rapid rises in stock prices.

Understanding why the volatility and trading volume of your community bank's stock has increased may make it easier to face a board of directors in light of falling stock prices. However, keeping your bank's fundamentals strong will encourage short sellers to look for other opportunities. ■

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