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The Big (Tesla) Short

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Elon Musk has been in the news lately railing on the short sellers in his stock. Those diatribes have included criticisms of the SEC's handling of the same (which in this regard he sometimes refers to as the "Shortseller Enrichment Commission"). If we go a back a couple months, recall that Musk got himself in some trouble by tweeting some information regarding taking the company private. Recognize, Mr. Musk's short seller tirades are an extension of that go private mantra. To edify, Mr. Musk is not the first CEO to consider the notion of going private to "punish" and essentially never have to worry about short sellers. The notion is, by going private, short sellers would be forced to "close" and reconcile their outstanding short positions. Again, the threat of going private is just one potential remedy that several public CEO's have considered to compromise the impact of short sellers, so Elon's Musk's mention of the same is not particularly surprising or even rare.

Not surprisingly, Musk's assault on short sellers and the SEC's defense of them, has been met with dissent from some of Wall Street's finest. Warren Buffet weighed in recently saying *"We have no objection to anybody selling Berkshire short at all," he said. "The more shorts, the better, because they have to buy the stock later on."* Further he noted; *"There's nothing evil, per se, about — in my view — about selling things short," Buffett said. "Short sellers — the situations in which there have been huge short interests very often — very often have been later revealed to be frauds or semi-frauds," he added.*

Of course, these are two different angles that Mr. Buffett is expressing regarding short selling. The first, is that he simply sees short sellers in his own stock as stockpile of future buyers. But in the second case, he is suggesting short sellers sometimes in fact "very often", represent harbingers of fraud, revealing nefarious management schemes and exposing them through both narrative and price discovery. Incidentally, I think it is fair to say that the SEC has embraced such narrative as well. I have had discussions with executives who have told me that their complaints to the SEC regarding short sellers were met with responses regarding the value of such participants in promoting market and pricing "efficiencies" and keeping things like "irrational exuberance" in check. Moreover, the SEC's actions support that view, as they have suspended portions of existing short sale rules over various periods in the past. I think it is fair to say that in general, the SEC views short selling as more favorable than unfavorable. On the other hand, while the SEC likes to argue that short sellers are good for price discovery and fraud detection, they also suspended the short selling of banks stocks during the financial crises. Apparently efficient price discovery and fraud detection isn't always a good thing. To Elon Musk's credit, he is correct in arguing that there are clearly inconsistencies in the ways the regulators deal with short selling and it certainly appears to favor some over others, but then again, we learned all about that when we were introduced to "too big to fail", which in this case turned out to be "too big to short".

The above said, one of the problems with the short sale discussion is that in most cases, the portion of it that its detractors hate is not the same portion of it that its supporters like. That is, much of the criticism of "short selling" is actually levied at "naked short selling" and while they share some like elements, they are not the same thing.

In theory, I agree with Mr. Buffett and much of the short selling community that there is nothing fundamentally wrong with selling a stock short. Stocks rise and fall each day as investors make decisions about their ownership of individual companies and I have no qualms with the idea that some investors see some stocks as overvalued for any number of reasons. Moreover, I have no problem with them selling those shares short, (which is tantamount to selling them before you actually buy them), as long as they do so within the confines of the rules. The sticking point is in that "within the confines of the rules" part.

Short selling rules require that prior to selling a stock short, the seller must first "locate" and then borrow those shares from someone who actually owns the stock. That conduit of being able to "borrow" a stock (so it can be shorted) is made possible by hypothecation agreements that customers sign with brokerage firms when they open margin accounts. When a customer signs a hypothecation agreement with a brokerage firm, they essentially agree to pledge as collateral to the brokerage those shares purchased in the account (against funds they borrow on margin from the firm to purchase them in the first place). As such, that agreement allows the firm to in turn lend any shares the customer might hold in the margin account. Thus, if Customer A buys 100 shares of XYZ in their margin account, the brokerage firm can lend those shares to Customer B, so he/she can short XYZ. Again, because Customer A holds the shares in a margin account, those shares are basically collateral of/pledged to the brokerage firm, so in essence, the brokerage firm has the authority to loan them to whomever they wish. I would add, the firm charges the short seller a fee for those borrowed shares, which turns the whole process into a profit center for the brokerage firm. To reiterate, this entire process of locating, borrowing and shorting shares against other customers' long positions is predicated on those shares being held in a margin account, which by extension means if a stock is not marginable, it cannot be shorted. The locate and borrow mechanism also has some additional practicality in terms of the accounting and recognition of outstanding share counts.

The number of shares a public company has outstanding, is a matter of considerable scrutiny. Public companies have strict protocols and disclosures that are required in order for them to issue additional shares and increase those share counts. Moreover, the supply of those shares is important in determining the value of a company (the shares outstanding multiplied by the price of the stock), but also in turn to determining the value of the stock. As the laws of supply and demand dictate, the smaller the supply (number of shares outstanding) the higher the price. With that in mind, people short stocks because they think they are overvalued and ultimately their price will fall. As such, since increasing the supply of a stock would (again invoking the laws of supply and demand) theoretically push the stock price down, short sellers are not allowed to sell shares that don't exist (again increasing supply) but rather, are required to find existing shares to borrow. That mechanism ensures that the short sales do not lead to there being more shares in the public's hands than the company has actually issued.

So then, as determined above, shares that are not marginable generally cannot be shorted. However, *that rule* does not apply to "market makers" who trade stocks. Market makers are firms that trade stocks and in that capacity are charged with "keeping orderly markets". Market makers are allowed to carry short positions in the (non-marginable) stocks they trade, however, those short positions are to be rectified (covered) following settlement, which means that technically those short positions should only exist for a few days before they need to be covered. When they are not rectified after those specified number of days, they are termed a "fail to deliver". Firms with chronic fail to deliver issues are subject to regulatory fines. That oversight much like the locate and borrow requirements of marginable securities by customers, are meant to ensure that there are not more “shares” in the marketplace than the companies have actually issued. The vernacular for shares that are shorted but not borrowed, and/or by extension shorted but not ultimately delivered in required time frames are deemed “naked shorts” and they are illegal. It is important to recognize that those who extol the virtues of short selling are not generally including “naked” short selling in that same breath. Unfortunately, there is considerable evidence that the mechanisms put in place to ensure delivery of shorted shares by market makers predominantly, but also perhaps via the locate and borrow protocols described above are failing to essentially prohibit the creation of “phantom,” shares. Moreover, since that increased supply of unauthorized shares creates added supply, which in turns puts downward pressure on the stock, it follows to assume that designed naked shorting is essentially market manipulation. That is the basis of at least a portion of Elon Musk’s claims as well as those of Overstock.com founder and CEO Patrick Byrne, perhaps the market’s most outspoken critic of naked shorts and the inadequate oversight efforts and systems that allow them.

Just to provide a bit more color to the problem, at the heart of the naked short claims is the Depository Trust and Clearing Corporation (“DTCC”). DTCC is an industry organization that was formed by the large prime brokers (the large New York banks). Its function was/is to create a centralized clearing organization/system to replace the physical transfer of stock certificates from one owner to the next. Many believe, and I assume Mr. Musk is one, that DTCC is either incapable or unwilling to ensure the proper accounting of (among other things) the delivery and reconciliation of short positions on an ongoing basis. That is another way of saying that the organization charged with ensuring the clearing and balances of outstanding shares for virtually every U.S equity, as well as the transfer and ownership of those shares is compromised. Many believe that outside of occasional fines by industry regulators levied against some of the country’s largest brokers for failure to police naked shorts, the “system” which ends with DTCC is largely unaccountable when it comes to the negative impact of those naked shorts. I would surmise there have been hundreds of public companies that ultimately ended up with unreconciled and undelivered short positions that ultimately resulted in phantom share that substantially and illegally added to their effective outstanding share counts. In those cases, there is simply no possible way that the books of those companies could possibly balance at DTCC. No, possible way.

To date, DTCC has proven largely impervious to congressional inquiry and specific litigation seeking to peer inside of its black box. That is the reason why Patrick Byrne from Overstock.com is currently on a mission to develop a security clearing alternative around (decentralized) block chain technology that cannot be manipulated or otherwise left “unbalanced”. I submit, I am not a huge fan of all things Elon Musk, and frankly, he has given the street plenty of reasons why shorting his stock might make perfect sense. However, to summarily dismiss his concerns over short selling and the lack of regulatory oversight that is supposed to ensure the integrity of the process is misguided to say the least. He has a point, perhaps more than one, and I suspect there are many people in important places that would prefer that those points not be heard and would rather they be dismissed as the sour grapes rantings of a jaded snake oil salesman.