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The ethical sentiment in securities trading- Case study in short selling

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Abstract
Corporate governance and finance are dynamic academic fields that offer myriad opportunities for business ethics analysis. Within the corporate governance triad in recent years, shareholders have increased their power over boards of directors and executives through both regulation and movements to change corporate by-laws. The impact of board characteristics on firm performance has proven elusive, leading to questions concerning board processes and individual director beliefs and behaviours. At the same time, CEOs have lost considerable power, leaving many struggling to regain their control and maintain their compensation levels, while others adopt a stewardship approach to their posts. In the field of finance, the recent financial debacle has led to a re-examination of financial regulation and of the fundamental nature and purpose of the industry. All of these issues provide business ethicists fodder for investigation and analysis.
In this article, we shall examine the oscillating sentiments of the trader vs Investor vs. the Financial Market, with a view to dissect the overriding views from rash reasoning.
In Particular, we shall touch upon 'Short Selling' and understand its criticisms and I conclude with my conciliatory opinion.
This article is very subjective, open to arguments and based on historical facts and current practices that are tenable to public scrutiny.

Keywords: Short selling, black Wednesday, finance ethics

1. Introduction
1.1 Finance Ethics
Finance is the science of money and the love of money is the root of all evil. It's therefore imperative to guard the gateway to the bank of human emotions like greed, avarice and laziness, with a stricture of norms globally accepted. Some of the below reasons can be attributed to Financial scams of the past.

- Barriers of information, Bargaining Power & Resources create unethical advantages
- Negative impact affects the majority while the minority benefit because of unethical practices
- Incorrect reporting or cross exchanging reports leads to legal implications
- Scams are born due to neglecting the importance of Finance ethics

1.2 A cursory view of major types of financial fraud
- Insider Trading
- Stakeholder Interest vs. Stockholder interest
- Investment Management
- Fraudulent Financial Dealings
- Cheating Customers of profits
- Unauthorised accounting Transaction
- Frauds and Manipulations
- Unequal Bargaining power
- Unethical takeover and mergers

2. Introduction to Trading Securities.
2. 1 Types of Trading Securities
- Shares
- Bonds
- Currencies
- Mutual Funds
- Derivative instruments- Futures, Forwards, Swaps, Options etc

2.2 The stages of a trade
1. Order initiation and delivery. (Front office function)
2. Risk management and order routing. (middle office function)
3. Order matching and conversion into trade. (front office function)
4. Affirmation and confirmation. (back office function)
5. Clearing and Settlement. (back office function)

The main objective of every trade is to get executed at the best price and settled at the least risk and less cost.

2.3 Trade life cycle is divided into 2 parts
- Pre-trade activities consists of all those steps that take place before the order gets executed,
- Post trade activities are all those steps that involve order matching, order conversion to trade and entire clearing and settlement activity.

3. Types of trading orders in a terminal
- Order can be a Limit order (where you specify the buy/sell price),
- Market order (where you buy/sell at market price), SL/SL-M (stop loss/stop loss market).

The difference between SL and SL-M is that when the trigger price is hit, the stop loss order is sent as a limit order with a limit price mentioned by you in the SL order, whereas in SL-M, the order is sent to the exchange as a Market order.

4. Key Corporate Events and its impact on Markets
4.1 Monetary Policy
The monetary policy is a tool with which the Reserve Bank of India (RBI) controls the money supply by controlling the interest rates. They do this by tweaking the interest rates. RBI is India's central bank. World over every country's central bank is responsible for setting the interest rates.
The key RBI rates are Repo Rate; Reverse repo rate; Cash reserve ratio;

4.2 Inflation
Inflation is a sustained increase in the general prices of goods and services. Increasing inflation erodes the purchasing power of money. All things being equal, if the cost of 1 KG of onion has increased from Rs.15 to Rs.20 then this price increase is attributed to inflation. Inflation is inevitable, but a high inflation rate is not desirable as it could lead to economic uneasiness. A high level of inflation tends to send a bad signal to markets. Governments work towards cutting down the inflation to a manageable level. Inflation is generally measured using an index. If the index goes up by certain percentage points, then it indicates rising inflation, likewise index falling indicates inflation cooling off.
There are two types of inflation indices – Wholesale Price Index (WPI) and Consumer Price Index (CPI).

4.3 Index of Industrial Production (IIP)
The Index of Industrial Production (IIP) is a short term indicator of how the industrial sector in the country is progressing. The data is released every month (along with inflation data) by the Ministry of Statistics and Programme implementation (MOSPI). As the name suggests, the IIP measures the production in the Indian industrial sectors keeping a fixed reference point. As of today, India uses the reference point of 2004-05. The reference point is also called the base year.

4.4 Purchasing Managers Index (PMI)
The Purchasing managers index (PMI) is an economic indicator which tries to capture the business activity across the manufacturing and service sectors in the country. This is a survey based indicator where the respondents – usually the purchasing managers indicate their change in business perception with respect to the previous month. A separate survey is conducted for the service and the manufacturing sectors. The data from the survey is consolidated on to a single index. Typical areas covered in the survey include factors such as new orders, output, business expectations and employment amongst others.

4.5 Budget
The Budget is an event during which the Ministry of Finance discusses the country's finance in detail. The Finance Minister on behalf of the ministry makes a budget presentation to the entire country. During the budget, major policy announcements and economic reforms are announced which has an impact on various industries across the markets. Therefore the budget plays a very important role in the economy

4.6 Corporate Earnings Announcement
This is perhaps one of the important events to which the stocks react. The listed companies (trading on stock exchange) are required to declare their earnings numbers once in every quarter, also called the quarterly earnings numbers. During an earnings announcement the corporate gives out details on various operational activities including.

5. Scandals and the Market sentiment
5.1 Barings Bank Collapse
The players: Nick Leeson. The story: In 1995, Leeson, the head derivatives trader for Barings' Singapore operation, began to conceal his losing trades in a secret account. He was able to do this because he was also in charge of auditing and reporting all trading activity. As his losses piled up, Leeson took on riskier trades, unknown to his superiors in London, in an attempt to make back the money. But things went from bad to worse as he ultimately lost more than $1.3 billion, twice the Barings' total available capital, causing the bank to collapse and sending Leeson to jail.

5.2 ImClone Systems Insider Trading
The players: Martha Stewart. The story: On Dec. 28, 2001, ImClone Systems stock dropped dramatically after the U.S. Food and Drug Administration announced that its drug Erbitux didn't receive regulatory approval. Numerous ImClone executives, including the founder, were eventually

found guilty of insider trading, selling their shares before the announcement was public. But then it was revealed that Martha Stewart had sold her shares one day before the announcement after receiving a "tip" from her broker. Stewart tried to conceal that fact from investigators which eventually led to her conviction on conspiracy, obstruction and making false statements to federal investigators.

5.3 Lehman Brothers Collapse
The players: Dick Fuld, Timothy Geithner, Hank Paulson. The story: Lehman Brothers was a major buyer of sub-prime loans – aka toxic debt -- during the housing boom of the mid-2000s. Using an accounting trick, it "sold" much of this debt to Cayman Island entities -- agreeing to buy it back at a later date – in order to make its balance sheet look stronger than it was. When housing values began to drop in 2007, Lehman was forced to disclose its losses, which rendered the company fiscally unsound. Treasury Secretary Hank Paulson and New York Federal Reserve President Tim Geithner arraigned a meeting with Lehman' Chairman Dick Fuld and the CEOs of other major banks in order to find a buyer for the company. When none could be found, the 158-year old company filed for bankruptcy.

6. What is Short Selling
Short selling is the sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit. Short selling may be prompted by speculation, or by the desire to hedge the downside risk of a long position in the same security or a related one. Since the risk of loss on a short sale is theoretically infinite, short selling should only be used by experienced traders who are familiar with its risks.
Every short sale can involve up to four different parties -- beyond that of clearing organizations, such as depositories and banks, which may also have a role in the transaction. (See figure 1)
Here are the functions that each player has in the process:

6.1 The Short Sale
The transaction (known as a "short sale") is initiated by an individual or an organization (known as a "short seller"), who desires to " short " a stock. Once the stock is sold short, the short seller must deliver the stock to the buyer. The buyer cannot differentiate whether the seller is a short seller or a long seller of stock -- nor do they care. The buyer is only interested in receiving the stock they have paid for. The short seller has a problem though. He or she does not own the stock sold to the buyer. Hence, the short seller must borrow the stock to be able to deliver it to the buyer. How? The short seller will utilize a selling broker to arrange to borrow the stock from a stock lender to be used to satisfy the short seller's sale of stock to the buyer.
This transaction takes place in a margin account and might have other economic consequences, which I will discuss later on. Please note that in some instances, the selling broker may in fact be the stock lender while in other circumstances, the selling broker must borrow stock from a third party securities lender.
When the buyer receives the stock and pays for it, he or she is satisfied and no longer has any involvement in the transaction. The other three parties (the short seller, selling broker and stock lender) are still linked together with the stock loan.

6.2 Short Position
Since the stock lender has lent out securities, it will require that the borrower (the short seller) post collateral to secure the loan. This collateral is derived from the short sale proceeds, which the short seller receives from the buyer. However, the selling broker will actually receive the cash from the buyer and will not disburse it to the seller. Instead, the selling broker will withhold those short sale proceeds, make a "memo entry" in the short seller's account and then use the short sale proceeds to post as collateral against the stock that was borrowed from the stock lender.

6.3 Short Covering
At a later date, the short seller will "cover" the short position. When the short seller does this, he or she will buy the same stock in the open market and the entire process that I've described so far will unwind.
The short seller buys stock from another seller. The short seller's broker will then pay for the stock out of its client account, by using the stock to then return the stock loan to the stock lender, freeing up the cash collateral and margin requirement in the process.

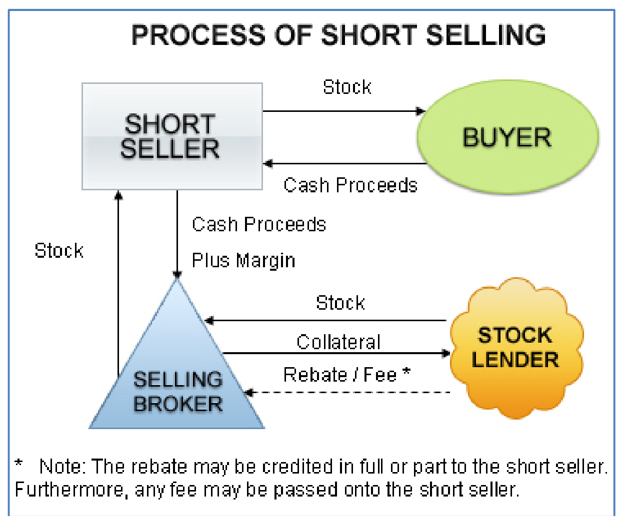

Fig 1: Process of short selling

7. Black Wednesday
A system called European Exchange Rate Mechanism (ERM) was introduced by the European Community in March 1979. The goal of ERM was to reduce exchange rate variability and achieve monetary stability in Europe and ultimately moving to Economic and Monetary Union with a single currency which eventually took place on 1 January 1999. United Kingdom however declined to join the ERM in 1979.
Impressed by the inflationary record of West Germany, the UK Treasury followed a semi-official policy of 'shadowing' the Deutsche Mark in the late 80s, though the UK had not joined the ERM. The UK finally decided to enter ERM in 1990, effectively guaranteeing that the British Government would follow an economic and monetary policy that would prevent the exchange rate between the pound and other member currencies from fluctuating by more than 6%. The pound entered the mechanism at DM 2.95 to the pound.

Hence, if the exchange rate ever neared the bottom of its permitted range, DM 2.778, the government would be obliged to intervene. With the UK inflation at three times the rate of Germany's the ERM were not favourable at that time. In the early 90s, factors such as internal economic condition in the UK, German economic policies and USD depreciation, put a lot of strain on GBP.
Many traders, including notably George Soros recognized that due to increasing downward pressure on GBP, the UK may not be able hold on to ERM policy for very long. So these traders started to short sell GBP in very large quantities. This further added to the downward pressure on GBP. Finally, on 16 September 1992 the British government was forced to withdraw the pound sterling from the ERM after they were unable to keep it above its agreed lower limit. On 16 September 1992 the British Conservative government was forced to withdraw the pound sterling from the European Exchange Rate Mechanism (ERM) after they were unable to keep it above its agreed lower limit.
The traders who had made short selling bets on GBP, profited in huge amounts, including George Soros who made over 1 billion GBP profit.

8. Views on Short Selling from an ethical standpoint

If George Soros broke the Bank of England and ruffled the Stirling, did he commit a crime? Are we seeing bans on short sales? Why and why not? Ethicists are divided on this topic
But despite its critics, it's tough to deny that short selling makes an important contribution to the market by:

- Adding liquidity to share transactions.
  The additional buying and selling reduces the difference between the price at which shares can be bought and sold.
- Driving down overpriced securities by lowering the cost to execute a trade
- Increasing the overall efficiency of the markets by quickening price adjustments
- Acting as the first line of defence against financial fraud.

For instance, in 2001, famed short seller James Chanos identified fraudulent accounting practices that occurred with the Enron Corporation, an energy-trading and Utilities Company. The company's activity became known as the Enron scandal when the company was found to have inflated its revenues. It filed Chapter 11 bankruptcy at the end of 2001.

9. The author’s opinion

While the conflicts of interest from investment banking keep some analysts from giving completely unbiased research, work from short sellers is often regarded as being some of the most detailed and highest quality research in the market. It's been said that short sellers actually prevent crashes because they provide a voice of reason during raging bull markets.
However, market regulators should build consensus to devise a mechanism to detect ‘Short and Distort’ trading patterns that are not in line with healthy financial analytics.
I firmly believe that each bank should discern and report suspicious activities to the ombudsman, irrespective of whether the act had any potential or intent.

10. Conclusion

Short selling need not be a crime, but its impact is one of great devastation. Hence, it’s important to clarify and streamline ‘short selling’ laws across countries.

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