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Selling the Stock Market Short

Kevin Haeberle
William & Mary Law School, kshaeberle@wm.edu

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To some, the stock market is just a nationwide Las Vegas, albeit operated by an (arguably) more genteel cast of characters. To others, the market provides a core wealth-storage function for much more than even just the half or so of all Americans who own stock. To yet others, the market serves as the nerve center for our nation's economy, directing capital toward its best uses while improving the extent to which otherwise self-serving managers pursue the goals of shareholders and, in turn, society.

Recent events may suggest that this great market is, well, not so great at the two social functions that matter. To be sure, hedge funds are in the business of taking informed risk. But when their information leads to a negative view of a company, the costs of selling borrowed stock can limit their ability to sustain that risk. When the price of the stock goes in the opposite direction of their short bet (i.e., rises), short sellers have to increase the security they provide to stock lenders. That price can keep rising and rising, in contrast to the long-bet setting where the investor cannot lose more than the initial amount wagered. The end result is a bet that can be expensive to maintain. As the price of GameStop stock skyrocketed because of tremendous buying activity from a mob of retail-level traders last week, Wall Street do-gooders in the fight to keep prices aligned with fundamental values reached their limit. The price of GameStop's stock, we are told, is now untethered from the value of the future cash flows it is likely to produce for shareholders.

Given all this, it is fair to question the extent to which the stock market is performing its social functions. In particular, widespread overvaluation is a legitimate concern. But let's not sell the stock market short.

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The market's nerve-center function should be largely unaffected by this recent turbulence. The market serves this function by facilitating trading that impounds information into prices, thereby improving stock-price accuracy. But stock prices don't have to be accurate each minute, day, week, or even month for the market to do its job on this front. Instead, prices must merely reflect fundamental values when it matters, such as when firms are issuing yet more stock to the market. (The timing of core disclosure requirements imposed by the foundational federal securities laws reflects this understanding, imposing only periodic disclosure and disclosure triggered by certain firm events, rather than continuous sharing of all material information.)

Likewise, even if high stock prices relative to, e.g., book value, generally provide long-term blockholders and directors with a sign of quality management, those monitors of management at GameStop are unlikely to see the current share price as such a signal if they have reason to believe it is out of whack with reality.

Likewise, the market continues to provide its wealth-storage function. Even if GameStop stock figured into one's diversified index, on an expected basis, the chances of wealth-storing investors buying an index ETF that includes GameStop stock over the past week are the same as their chances of selling such an ETF. Of course, that's an "all-else-being-equal" statement. Yet we are told all else was far from equal. If GameStop stock is, in fact, unambiguously overvalued by the market because of a short squeeze, one would think that even investors following a passive approach would avail themselves of this opportunity to sell GameStop stock high. The result would be a wealth transfer from members of the mob to those who are investing in line with the advice of social science and the Securities and Exchange Commission (SEC).

Moreover, those passive, long-term investors don't need to borrow the stock in order to sell it. They already own it. So, they can't be short-squeezed. Given the scope of passive investment today, one would think this selling would impact price in important ways over the long run. Indeed, this selling already might be doing just that.

That leaves us with the third and final function of the market. To the extent gambling is driven by the utility gamblers receive from thrills and highs, it's been a good week.

To be sure, the law could take a paternalistic approach and take new steps to safeguard the gamblers' financial wealth. Calls from prominent politicians this past week to protect the mob's access to the market do the opposite for this group. More on target, regulators could shore up the market's ability to carry out its two meaningful social functions. If members of the mob made false or misleading statements in connection with securities transactions, the SEC and Department of Justice could bring, respectively, civil and criminal enforcement actions under Section 10(b) of the Securities Exchange Act.

Likewise, Section 9(a)'s prohibition on trading with the intent to move price to induce others to trade without an actual investment goal also can be deployed, even if proving one's mental state presents a considerable challenge. More generally, going forward, the SEC and the Financial Industry Regulatory Authority (Finra) could focus more on developing a market structure that ameliorates some of the asymmetric costs associated with impounding negative sentiment into prices, thereby reducing the chances of bubbles.

It is unlikely that GameStop-style mobs will stop this central institution from performing its core functions — even if the recent events give investors, market observers and regulators much to consider.

Kevin Haeberle is a professor of law at William & Mary Law School and a fellow with its Center for the Study of Law and Markets. He is the author of the recent paper, "Investor-Protection Advice for the New Administration."

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