ARE SHORT SELLERS STAKEHOLDERS?

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ABSTRACT

This paper analyses the role of short sellers in the context of stakeholder theory and poses the question: should short sellers be considered as stakeholders? The paper examines the conditions under which short sellers operate and how short selling can be a profitable activity. Next the paper considers the view of short sellers from the perspective of the finance literature and this perspective is contrasted with concerns which are frequently expressed in the news media about the activities of short sellers. The constraints on short selling are discussed, together with the phenomenon of optimism in analysts' forecasts which is believed to support 'high' share prices. The usefulness of the preceding analysis is then discussed in the context of stakeholder theory and the paper discusses some potential policy implications in terms of corporate governance and financial reporting.

The paper concludes that short sellers can legitimately be regarded as stakeholders and, indeed, encouraging short sellers to operate more effectively in the market as well as providing fuller disclosure of their activities could provide a useful anti-dote to some of the excessive and unjustified share price rise which have been seen in recent years in failing companies.

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1. Introduction

The purpose of this paper is to examine the role of a particular interest group, short sellers, in relation to stakeholder theory. In section 2 the paper sets out the conditions under which short selling can be a profitable activity. Section 3 shows how short sellers are viewed from the perspective of the finance literature and the paper then continues, in section 4, to contrast this perspective with disquiet in the media about the activities of short sellers. Section 5 reviews the related phenomenon of optimism in analysts' forecasts and section 6 discusses the insights into stakeholder theory which can be usefully gained from this analysis. Section 7 provides some conclusions and implications for policy making.

The strength of agency theory lies in its focus on two main parties in the operations of a firm: namely principals (shareholders) and agents (managers). In contrast, a main contribution of stakeholder theory is that it attempts to move away from what is considered to be a too narrow focus on just two parties in the firm and seeks instead to examine the relationships between a wider group, extended to include parties such as employees, customers, suppliers and government.

It might be argued that a weakness of stakeholder theory is an underlying assumption that all parties have the efficient functioning of the firm as a main interest, even though conflicts may exist between the different parties. This paper describes one group which is relevant to the firm (at least in terms of a need of access to financial information) but which at the same time would benefit the most if the firm were to be made bankrupt, that is cease to exist. In the case of a single firm, and in this extreme scenario, short sellers would maximise the return on their 'investment' if the shares of the firm fell to a zero value. This paper therefore poses the simple question – are short sellers stakeholders? In seeking to answer this question it is hoped that some light can be shed on the nature and usefulness of stakeholder theory in relation to corporate governance.

2. Taking a short position

At this point it is useful to say elaborate on short sellers and short selling. For instance, what do we mean by 'short selling'?

The basic principles of short selling are (in theory at least) relatively straightforward[1] and they can usefully be thought of as the opposite of taking a 'long' position. A long position is the traditional view of an investor who purchases, say, shares for cash, and at a later date, once the shares have risen in price, can realise a profit by selling them in the market. If one believes, ex-ante, that share prices are likely to fall in the future, an individual can always sell shares which are already owned and thereby minimise losses caused by a subsequent fall in the share price. But can individuals actually profit from a falling share price? They are able to do this if they adopt a short position. Thus an investor can request a broker to short N number of shares in company C. The broker carries out the instruction by borrowing N number of shares from another client and then selling them in the market. The short position can be maintained as long as the broker has access to shares which can be borrowed. Eventually the investor will close the position by purchasing an equivalent N number of shares in the market, so that the purchase and sale of shares is exactly matched. The motivation for such a transaction is the investor's belief that the share price of company C will be lower at the time of purchase than it was at the time of sale, thus generating a profit. Note that in the case of a short sale, the 'sale' effectively precedes the 'purchase'.

Short selling has been recognised for hundreds of years. Staley (1997) points out that at the beginning of the seventeenth century, directors of the Dutch East India Company blamed short sellers for sharp declines in the price of the company's shares on the Amsterdam Exchange. The companys' directors complained that 'bear attacks, which generally assume the form of short selling, have caused and continue to cause immeasurable damage to innocent stockholders, among whom one will find many widows and orphans' (quoted in Staley, 1997, pp. 235-236). Short sellers were thus a convenient excuse for the company's problems. On the other hand the officials of the Amsterdam Exchange believed that the declining share price was due to unsatisfactory business conditions. This negative attitude to short sellers has persisted through the centuries and Shiller (2005, p. 182) refers to the fact that short sellers were widely blamed for the US Stock Market crash of 1929.

But in practice, such transactions can present complications. If at any time the broker is unable to borrow sufficient shares, then the investor will be short-squeezed and will be forced to close the position. Any dividend income received by the investor between sale and purchase is paid to the broker who passes it back to the original owner of the shares. The investor is also required to open a margin account with the broker into which are placed cash or marketable securities. In the event that the share price of company C increases after the sale, then the assets in the margin account will need to be increased. Bailey (2005, p. 14) points out that some regulators allow shares to be sold short only when there has been a recent increase in the market price (the 'uptick rule'). The existence of such restrictions on short sales is said to be justified on the grounds that it helps to prevent excessive falls in prices.

But instead of borrowing shares to sell short, it is possible for an investor to benefit from future declines in a company share price by using futures or options.[2]

Futures contracts

A futures contract involves two parties who agree to buy and sell an asset at a future date. Note that the transaction price (the futures price) is agreed at the date the futures contract is initially agreed. In the case of company shares, the seller of the futures contract agrees to deliver shares (the 'underlying') to the buyer of the futures contract at the settlement date (delivery date) and at the futures price. The seller of the futures contract will make a profit if the share price at the settlement date is lower than the futures price. The reason is that, at the settlement date, the seller of the futures contract can buy an equivalent number of shares (at the lower price) to deliver to the buyer of the futures contract. On the other hand, the seller of the futures contract will make a loss if the share price at the settlement date is higher than the futures price. The seller of the futures contract will be forced to buy an equivalent number of shares (at the higher price) to deliver to the buyer of the futures contract.

Options

As an alternative to short selling or agreeing a futures contract, an individual can take advantage of a fall in future equity prices by buying a put option or selling a call option. The options can be European options or American options. A European option can be exercised only on the date on which the contract expires. On the other hand, an American option can be exercised at any time up to the date on which the contract expires. The distinction between European and American options is not particularly material for this discussion, and for ease of exposition, the following illustrations are based on European options.

Buying a put option

A put option gives the holder the right (but does not impose an obligation) to sell shares (the underlying) at a specified price (the strike price or exercise price) in the future. Assume that an individual buys a put option for a single company share where the option price is $2 and the strike price is $20. Immediately on buying the option the buyer pays to the seller the option price of $2. Suppose that the market price then falls to $1 at the expiration date. It will be to the advantage of the holder of the option to exercise the option and realise a profit of $17 calculated as $20 - $2 - $1. The maximum profit the holder of the option can make is the strike price minus the option price, minus the cost of purchasing a share at the prevailing market price (at the expiration date). The maximum loss the holder of the option can incur is the option price ($2).

Selling a call option

Alternatively, an individual can take advantage of a future fall in share prices by selling a call option. Selling a call option means that the buyer of the option has the right (but not the obligation) to purchase the company share in the future. Therefore, the seller (writer) of the call option may be called on to sell the share in the future if the buyer (holder) of the option decides to exercise the option. Assume that an individual sells a call option for a single company share with a strike price of $20 and an option price of $2. Immediately on writing the option, the seller receives $2. Suppose that the market price then falls to $1 at the expiration date. It will not be to the advantage of the holder of the option to exercise the option since this would imply buying a share at $20 when it could be bought in the market for $1. Thus the option will not be exercised and the seller will keep the option price of $2. Thus the maximum profit the seller can make is the option price ($2). On the other hand, the maximum loss is (in theory) unlimited since it will be calculated as the share market price at the expiration date minus the strike price minus the option price. Assume that at the expiration date the market price of the share has increased to $200. It will be to the advantage of the holder to exercise the option and make a profit of $178 calculated as $200 - $20 - $2. The seller of the call option will make a loss of $178, also calculated as $200 - $20 - $2.

Contrasting futures and options

A main difference between futures contracts and options is that in the case of futures contracts, both buyers and sellers are fully committed to fulfilling their part of the bargain. In the case of options, however, the buyer of the option must pay the option price to the seller of the option, but the buyer is under no obligation to exercise the option unless it is to their advantage. But if the buyer of the option chooses to exercise, then the seller must fulfil their part of the bargain.

3. How are short sellers viewed in the finance literature?

Miller (2004) shows that shares can potentially be overpriced because of the regulatory restrictions on short selling. This is because prices are likely to be set by optimistic investors (taking a long position) rather than by less optimistic investors (taking a short position). In terms of efficient markets, unfavourable opinions are therefore prevented from being fully reflected in share prices. Miller argues that mainstream finance theory assumes that investors can take short positions as easily as they can take long positions. But in practice, in a world of informed and uninformed investors, the informed investors will not hold sufficient quantities of overpriced shares such that their trading would eliminate overpricing. So, although underpricing is not possible, overpricing will exist. Because of the obstacles to short selling, the implication is that 'there will be some overvalued stocks that can be identified with publicly available information' (Miller, 2004, p. 82). Restrictions on short selling imply that many overvalued stocks will be excluded from the portfolios of informed investors. Prices of these stocks will be set by the most optimistic investors, not by the typical investor (Miller, 2004, p. 114).

Lamont (2004) also refers to the obstacles faced by investors who wish to sell short:

> US equity markets are not set up to make shorting easy. Regulations and procedures administered by the SEC, the Federal Reserve, the various stock exchanges, underwriters and individual brokerage firms can mechanically impede short selling. Legal and institutional constraints inhibit or prevent investors from selling short (most mutual funds are long only). We have many institutions set up to encourage individuals to buy stocks, but few institutions set up to encourage them to short. The growth of hedge funds is a welcome correction to this imbalance'. (Lamont, 2004, p. 182).

Lamont refers to attempts from Napoleon onwards to prevent or restrict the activities of short sellers, and the harassment faced by short sellers, usually in times of crisis or following major price declines.

> The events following September 11, 2001 are consistent with this pattern. Following a major terrorist attack on the United States, the SEC and various other regulatory bodies investigated the claim that terrorists had shorted stocks or had bought puts, armed with foreknowledge of the attacks. This investigation turned up no evidence of terrorist shorting. As far as [Lamont knows], there is no evidence that Osama bin Laden, the Kaiser, Stalin, or any other major villain ever shorted stock'. (Lamont, 2004, p. 183).

Jones and Larsen (2004, p. 206) point out that short selling of stocks which are thought to be overpriced has the potential to improve mean portfolio returns. In addition, the opportunity to short sell can effectively double the number of assets, which gives the potential to reduce portfolio variance.

Angel et al (2003) refer to the view of many practitioners who believe that short selling occurs infrequently in the NASDAQ or any US market. The reason is that 'such a risky, costly strategy attracts mainly the well-informed and aggressive, who short stock only when they expect large returns' (Angel et al, 2003, p. 67). Based on NASDAQ data in 2000, Angel et al find that short sales occur on average in approximately 1 in every 42 trades and involve 1 in every 35 shares traded. They also find that short selling occurs more often on actively traded shares. It is worth noting that the most actively traded shares are likely to be those of the largest and most well known companies. In addition, the finding that only a very small proportion of share trades involve short sales, means that short sales as a proportion of total issued share capital is probably extremely small. Hence it would seem that short sellers are likely to have very little downward influence on share prices for the market as a whole.

Dechow et al (2001, p. 78) find a strong relation between the trading strategies of short sellers and ratios of fundamentals to market prices. They also find that short sellers target securities with low fundamental-to-price ratios and then unwind their positions as these ratios revert to normal levels. The evidence from Angel et al (2003) and Dechow (2001) is consistent with short sellers being informed investors who are able to pursue successful investment strategies.

Can the profits made by short sellers be justified? Choie and Hwang (1994) argue that short sellers have a rightful claim to profit since they deserve a reward for enhancing the efficiency of the stock market (Choie and Hwang, 1994, p. 33). 'Without short sellers, the market could become structurally biased against the ability to distinguish weeds from grass because many institutional investors are prohibited, legally or otherwise, from shorting stocks even if they know a firm is engaging in accounting gimmickry or fraud'. Also 'short sellers, as a group, consistently make a substantial profit, and a majority of their positions yield a profit' (1994, p. 33).

Christophe et al (2004) report evidence that in the majority of cases they investigated, post-announcement stock return was negative following unusually high short selling. They recommend that investors should be more fully informed of unusual short selling activity in order to facilitate more orderly price movements and more efficient incorporation of private information into stock prices. They therefore conclude that financial market rulemakers might consider requiring more extensive and timely public disclosures of short selling (2004, p. 1874). However, an alternative (and perhaps more contentious) interpretation of their results would be that market regulators should in fact ease some of the obstructions to short selling, thereby helping to facilitate the activities of short sellers.

Aitken et al (1998) report evidence based on short sales on the Australian stock exchange and conclude that 'in a market environment in which short sales are fully transparent moments after execution, they are almost instantaneously bad news' (1998, p. 2206). Aitken et al argue that an absence of transparent short sales may potentially inhibit the market's ability to impound relevant information (1998, p. 2222).

In summary, the view from the finance literature seems to be that short sellers do tend to be successful, there is little reason for regulators to restrict their activities and in fact there are grounds for believing that releasing increased information to the markets about their activities is likely to improve market efficiency.

4. Disquiet in the media about the activities of short sellers

The news media, on the other hand, do not always take such a charitable view of the activities of short sellers. Following the terrorist attacks of 11 September 2001, there was a marked increase in the number of stories in the media about the activities of short sellers and their consequences for stock markets. Table 1 compares the number of stories in the UK and US news media for periods before and after 11 September 2001. These data are taken from the LexisNexis Executive database. The search term used was 'short seller' and the UK news media represents a wide range of media, mainly newspapers, such as the *Financial Times*, *The Times*, *The Independent*, *The Daily Telegraph*, *The Daily Mail*, *Sunday Express* etc. US news media again represents mainly newspapers such as *The New York Times*, *The New York Post*, *The Washington Post*, *The San Francisco Chronicle*, *The Seattle Times*, *The Boston Globe* etc.

Table 1

Number of news stories in UK and US news media before and after 11 September 2001

Days Before	UK News	US News	Days After	UK News	US News
7	5	7	7	9	19
14	9	12	14	32	35
21	14	20	21	40	44
28	18	27	28	59	57
60	30	51	60	72	83
90	48	72	90	85	117

Source: UK and US news media stories based on Lexis-Nexis Executive database.

For UK news media, stories about short sellers were averaging about 5 per week in the days leading up to 11 September 2001, while stories in the US media were averaging about 7 per week.

After 11 September 2001 the picture changed substantially. In the UK, in the first few days after the attacks, the number of stories began to increase and by weeks two, three and four after 11 September 2001 the weekly average of stories was running at about three times higher than before 11 September 2001. By the second and third months after 11 September 2001, the number of stories had more or less returned to the 'before' levels.

In the US, the news media were somewhat quicker to jump on the short seller bandwagon and in the first week after 11 September the number of news stories nearly tripled, compared with the 'before' levels. The first 28 days after 11 September 2001 saw over twice as many stories compared to 'before'. In months two and three after 11 September 2001, the experience was similar to that of the UK and the number of news stories began to return to the 'before' levels.

In the UK news media, 18 stories appeared in the 28 days before 11 September which contained the term 'short seller'. Many of the articles were relatively objective about the activities of short sellers. A few were more critical, such as the report[3] in the *Sunday Business* which referred to 'the "cyber smear", usually practised by "short" sellers – investors who sell borrowed securities in the expectation that prices will fall – to drive down a stock price on the basis of false information'. But in none of the 18 articles was the word 'terrorist' or 'terrorism' mentioned.

In the first few days following 11 September 2001, some stories did mention the terms 'terrorist' or 'terrorism' together with the term 'short seller' but these stories were often based on views that it might be unpatriotic to sell short in the (then) unusual circumstances. Also stories took a view that destabilisation of financial markets could be an objective of terrorists. Moreover there were stories to the effect that some leading investment banks, under pressure from regulators, had placed a ban on short selling in order to try to stabilise the markets and prevent a massive sell off of shares. Stories also discussed the possibility of economic recession and the *Sunday Times* in a report[4] on 16 September 2001 referred to recent profit warnings from Ford and General Electric blaming the terrorist attacks. But it might be asked whether these profit warnings used the terrorist attacks as a convenient excuse in order to distract attention from more fundamental and long term commercial problems.

But it was not until 18 September 2001 that an article in *The Guardian* made the connection that terrorists might actually have benefited from short sales of shares, especially in companies in the airline or insurance industry.[5] From then on the story was taken up in other newspapers. For example, on 23 September 2001, in a *Sunday Times* article[6] headlined 'Terror insiders may have made millions from stocks' it was suggested that unusually high levels of short selling took place before 11 September 2001 in companies such as American Airlines and insurance companies such as AXA and Swiss Re. The article also suggested (quoting 'German authorities') that the terrorist organisers could have made big profits by trading in oil and gold (commodities which would have been expected to increase in price following 11 September 2001). This raised the possibility that the terrorist organisers were not only buying long (oil and gold) but also selling short (airline and insurance stocks). If true, this would have represented a fairly sophisticated finance operation. However, the *Sunday Times* article of 23 September 2001 acknowledged that the US airline industry was already experiencing financial problems before 11 September 2001 and a *Financial Times* report[7] of 22 September 2001 stated that many hedge funds were already betting on a fall in equity markets even before 11 September 2001. So there may have been a perfectly innocent explanation for the apparently high levels of speculative activity before 11 September 2001.

Despite reports that a number of regulatory authorities in different parts of the world began investigating irregular investment activities which occurred around 11 September 2001, it appears (consistent with the view of Lamont, 2004, cited above) that no concrete evidence has been produced to date of short sales of stock by terrorists.

5. Optimism in analysts' forecasts

As mentioned above, there seems to be sound evidence that short sellers are able to operate successfully. One explanation for this fact might be found in a view of markets which argues that, although markets may be efficient in the long run, they are not necessarily efficient in the short run. One area of research in the finance literature has focused on the activities of analysts who forecast company earnings and there is a substantial body of empirical research relating to the area of optimism in analysts' forecasts.

Kothari (2001, p. 153) in his review of capital markets research in accounting refers to the problems of apparent optimism in analysts' forecasts. Research by Lim (2001, p. 383) suggests that analysts following poorly performing companies refrain from fully revising their estimates downwards and this can lead to greater positive bias. In addition, Lim finds that analysts working with smaller brokerage firms produce more optimistic forecasts.

Although the literature appears to have reached a consensus on the evidence for optimism in analysts' forecasts, what is more debatable is the motivation for such optimism. There are at least two plausible explanations for the optimism. Firstly, one possible explanation is that analysts could have an incentive to issue optimistic forecasts in return for services provided by the corporate finance section of an investment banking firm. Another possible explanation is that analysts might issue optimistic forecasts in order to gain increased access to information from management.

McNichols and O'Brien (1997) find evidence consistent with the hypothesis that analysts report selectively when they have relatively favourable information. Thus analysts will tend to drop coverage of firms for which they have pessimistic expectations. On the other hand they will initiate coverage for firms about which they have optimistic expectations. McNichols and O'Brien argue that their evidence 'is at least a partial explanation for the commonly observed phenomenon that analysts' forecasts of earnings are generally and persistently overoptimistic' (1997, p. 197).

Dugar and Nathan (1995, pp. 132-133) find evidence that 'analysts who issue research reports on companies that are also investment banking clients of their brokerage firm (investment banker analysts) tend to be more optimistic in their earnings forecasts relative to other analysts (noninvestment banker analysts)'. Moreover, Dugar and Nathan find that investment banker analysts are more optimistic in their investment recommendations, relative to noninvestment banker analysts.

Finally, the threat of legal action by a company may make analysts cautious about issuing a pessimistic forecast or recommendation. In the case of the collapse of Robert Maxwell's business empire in 1991 (see Wearing, 2005, p. 34), it later transpired that some analysts who had tried to warn of Maxwell's business activities had been subjected to threats of legal action. An analyst, who worked for Phillips and Drew, wrote a sell notice on MCC shares in 1989 and as a result Maxwell withdrew £80 million of the MCC pension fund from Phillips and Drew Fund Management, making a point of saying that it was due to the analyst's criticisms. In 1997 WorldCom gave Salomon Smith Barney the exclusive right to administer the WorldCom stock option plan. Jack Grubman, an analyst with Salomon Smith Barney was an enthusiastic supporter of WorldCom and continued to rate WorldCom's stock as a buy even when the share price was falling after 1999. In May 2004 Citigroup (which controlled Salomon Smith Barney) announced that it would pay $2.65 billion to settle an investor lawsuit which had alleged that Jack Grubman 'had deliberately painted too positive a picture of WorldCom's prospects before an accounting misstatement drove it into bankruptcy'.[8]

In 2002 LVMH sued Morgan Stanley on grounds of bias and defamation in a French court. In 2006 the French court of appeal overturned a lower court finding of bias but upheld the defamation finding on the grounds that Morgan Stanley did not properly disclose its corporate relationships. As argued in a *Financial Times* editorial ' … it is absurd to allow a company to sue a critical analyst for defamation … analysts need no encouragement to puff up shares, since nobody is likely to contest a glowing report'.[9]

6. The relevance of short sellers to stakeholder theory

Stakeholder theory stresses the importance of all parties who are affected either directly or indirectly by a firm's operations. The term 'stakeholder' is normally seen as referring to any party who has a 'stake' in the company, and while this can obviously include the shareholders and directors (principal and agent in agency theory) it can also include parties such as employees, government, customers, suppliers, bankers etc. Indeed the list can be extended to include the general public if it is accepted that a firm can affect the public through its actions on the environment. But note that Sternberg (1997) has criticised stakeholder theory as being incompatible with corporate governance and argues that the number of groups identified as stakeholders has increased dramatically to the point where the term is no longer meaningful for analysis. 'Stakeholder theory provides no effective standard against which corporate agents can be judged. Balancing stakeholder interests is an ill-defined notion, which cannot serve as an objective performance measure; managers responsible for interpreting as well as implementing it are effectively left free to pursue their own arbitrary ends' (1997: 5).

On the other hand supporters of stakeholder theory such as Blair (1995) argue that 'Boards must understand that they are the representatives of all the important stakeholders in the firm – all those whose investments in physical or human capital are at risk. Thus, individuals who explicitly represent critical stakeholders should be put on boards, to give those stakeholders some assurance that their interests will be taken into account' (Blair, 1995: 326). Although Blair acknowledges that conflicts of interest could result, these conflicts could be reduced by ensuring that all stakeholders received an equity stake proportional to their firm-specific investments. The conventional wisdom is that shareholders receive dividends and capital gains as a reward for risking their investment in a company (although modern finance theory shows that firm specific risk can be reduced through portfolio diversification). But stakeholder theory makes the important point that employees also risk their capital, that is human capital, when they work for a firm. Under stakeholder theory this is just as important an investment as financial capital and one could argue that employees are not in a position to reduce their risk through diversification.

In order to make a compelling case for short sellers to be considered as stakeholders, the traditional view of stakeholder theory (as advanced by Blair) would need to be modified. Nevertheless, a case can be argued on the grounds that the activities of short sellers can be seen as beneficial to a company in the long run and their actions could, conceivably help to prevent corporate collapse. Indeed, it could be argued that fewer constraints on short sellers in cases such as Enron and WorldCom in the US and possibly Maxwell and other cases in the UK might have prevented unreasonably inflated share prices and could have limited the losses of some shareholders, especially those who were encouraged to buy at the peak.

It cannot be denied that if short sellers are to operate effectively then they need access to financial information of equivalent quality to that demanded by traditional shareholders, institutional investors and banks etc. This would seem to indicate that short sellers have rights to information commensurate with other, recognised stakeholders.

Gamble and Kelly (2001) argue in favour of corporate pluralism and a more formal recognition in company governance of the investment and risks incurred by stakeholders (not just shareholders). ‘The corporate pluralism position on the company in the stakeholding debate proposes to acknowledge the pluralistic structure of the modern company by changing the legal framework to accommodate it. The strength of this perspective is that it offers a way to make the company both more efficient and more legitimate’ (Gamble and Kelly, 2001: 115). Such a view would seem to apply equally well in the case of short sellers, since it acknowledges a changing financial environment in which short sellers would be recognised as performing a positive role in the market.

This view is also consistent with Jensen (2001) who argues for a modified approach to agency theory and comes down in favour of enlightened value maximisation and enlightened stakeholder theory. In the long run, for a firm to be successful, ‘managers must pay attention to all constituencies that can affect the firm’ (Jensen, 2001: 304). In other words, for a firm to be successful and survive it needs to address the needs of all its stakeholders.

In a stakeholder framework, the problem is somewhat more complex because of the added dimension of conflicts between the various stakeholders. Hill and Jones acknowledge that, although the different groups may have competing claims (for example increased wages would be incompatible with increased dividends, other things being equal), nevertheless, ‘on a more general level, each group can be seen as having a stake in the continued existence of the firm (Hill and Jones, 1992: 145). And this is perhaps the important point, the long term survival of the firm and therefore the long term survival of all the stakeholders. Although this might seem to be an anomaly in the case of short sellers, in fact, short sellers are only a symptom of the problem;

the real cause of company failure (the point at which short sellers maximise their return) is far more likely to lie with ineffective or even corrupt management.

Donaldson and Preston (1995) point to the growing debate over the role of stakeholders in the academic and professional management literature and argue that the critical underpinning for stakeholder theory is its normative base. In other words, stakeholder theory is a theory about *what should be*, and not necessarily *what is*. This is an interesting point, since it seems plausible to argue that shareholder theory has evolved out of financial economics, using conventional 'positive' analysis, whereas stakeholder theory is more strongly embedded in a tradition of moral and philosophical rights of stakeholders. The efficiency argument is perhaps easier to make for shareholder theory than it is for stakeholder theory, but we should not forget that both shareholder theory and stakeholder theory have normative elements. Donaldson and Preston (1995: 87) conclude with their belief that 'the ultimate justification for the stakeholder theory is to be found in its normative base. The plain truth is that the most prominent alternative to the stakeholder theory (i.e. the "management serving the shareowners" theory) is morally untenable'.

7. Conclusions

Would a reduction in the constraints on short sellers lead to a disastrous fall in share prices? On the contrary; where share prices are unreasonably higher than economic fundamentals would dictate, the activities of short sellers would increase up to the point where share prices are forced into line with economic fundamentals. At this point, investors taking a 'long' position would find their activities more profitable and the activities of short sellers would become less profitable or loss making.

In this paper, the fact that a case can be made for short sellers to be considered as a legitimate stakeholder group actually serves to strengthen the claims of stakeholder theory as a valid and inclusive model for corporate governance. Short sellers would seem to have legitimate information needs and require information of a similar quality to traditional shareholders, institutional investors and banks.

The positive view of short sellers and their activities which is put forward here envisages a scenario where short sellers effectively act as a safety valve for companies in distress. Instead of curbing their activities (which only exacerbates the problem) short sellers should be encouraged, in order to bring share prices back to realistic levels. Short sellers effectively act as an antidote to 'irrational exuberance'[10] in the economy.

One of the problems with the current situation is that there are arguably too many vested interests in favour of relentlessly increasing share prices. These vested interests include government (who often see buoyant share markets as an indicator of economic success), life assurance companies and pension funds (who need to satisfy the claims of their clients) and companies themselves who need a buoyant share price in order to attract additional funding and reduce their costs of finance.

In the case of WorldCom it was reported that even short-sellers, who had been profiting in the market from WorldCom's falling share price were surprised at the scale of the accounting disclosures. *The New York Times* quotes one short-seller as saying that investors cheered WorldCom's acquisition binge when its stock was rising and paid little attention to how the company generated its profits. That attitude encouraged the company to stretch accounting rules and take ever-bigger risks in an effort to keep its stock rising, and 'the executives, the money managers, the auditors, the CFOs, the CEOs, the ones that got ahead were the most reckless, the least ethical'.[11]

Chief executives can be quick to criticise short sellers for bringing about the collapse of their companies, but less ready to acknowledge that short sellers can only make abnormal profits when company shares are unreasonably overpriced. Kenneth Lay who created Enron was convicted in May 2006 on charges of fraud and conspiracy in connection with the Enron bankruptcy in 2001. But in his defence Lay chose to portray Enron as a successful company which failed as a result of sceptical news reports and aggressive short selling by hedge funds which led to a collapse in investor confidence.[12] Such a defence may be consistent with media hype, but less in line with research conducted in the finance literature.

So should short sellers be encouraged or discouraged? The conclusion from this paper is that encouraging short sellers to operate is likely to enhance corporate governance and improve the efficient operation of markets. This in turn leads to the conclusion that regulators might usefully consider how restrictions on short selling can reasonably be relaxed, and what further information might be provided to the markets, via the financial statements, which would indicate the level of activity of short sellers in the market. Financial reporting could usefully include data on the level of activity by short sellers in a company's shares. This would provide relevant information to stakeholders such as traditional 'long' investors, debt providers, employees and regulators to help form a judgement about whether a particular company's shares are unreasonably overpriced in relation to other comparable firms in the market.

Encouraging short sellers to operate more effectively in the market as well as providing fuller disclosure of their activities could provide a useful anti-dote to some of the excessive and unjustified share price rise which have been seen in recent years in failing companies.

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Notes

[1] See, for example, J.C. Hull (2006), pp. 99-101.
[2] See Fabozzi,, F.J. (2004) 'Shorting Using Futures and Options' in F.J. Fabozzi (ed) (2004).
[3] *Sunday Business*, 19 August 2001: 26.
[4] Sunday Times, 16 September 2001: Business Section.
[5] The Guardian, 18 September 2001: 23.
[6] *Sunday Times*, 23 September 2001: Overseas News.
[7] Financial Times, 22 September 2001: 15.
[8] *Financial Times*, 11 May 2004: 21.
[9] *Financial Times*, 1 July 2006: 14.
[10] A phrase attributed to Alan Greenspan, former chairman of the US Federal Reserve (see R. Shiller (2005)).
[11] *New York Times*, 26 June 2002: 1.
[12] *Financial Times*, 6 July 2006: 27.