INDUSTRY INSIGHT

Stock Loan and Shorting

BY FRANK E. TESTA, CMT, SENIOR VICE PRESIDENT, INVESTOR INTELLIGENCE

ARE ALL SHORT SELLERS EVIL?

While companies dedicate a significant number of resources and time to keeping abreast of their shareholders, when it comes to short sellers, unfortunately, information is extremely scarce. While this secretive group is hoping for the stock's decline to profit, not all short sellers are necessarily bearish. In the following two examples, neither seller has a negative opinion of the stock or company.

Market makers/specialists are encouraged to be the "seller of last resort" to maintain a "fair and orderly" market in the stock. Their presence increases the liquidity to enable an investor to acquire shares.

Merger arbitrageurs surface when a company makes an offer to acquire another company using their shares as currency. Typically, a merger arbitrageur will build a position in the target company, while simultaneously short shares of the acquirer with plans to cover the short upon consummation of the merger by converting the long position of the target company into the acquirer's stock to erase the short position. Moreover, the presence of the merger arbitrageurs provides confidence that the financial community believes the merger will be completed.

STOCK LOAN DEFINED

Before delving into short selling, one should be familiar with the process. Securities lending or stock lending refers to the lending of securities by one party to another. The terms of the loan will be governed by a "Securities Lending Agreement", which requires that the borrower provides the lender with collateral, in the form of cash, government securities, or a Letter of Credit of value equal to or greater than the loaned securities.

As payment for the loan, the parties negotiate a fee, quoted as an annualized percentage of the value of the loaned securities. If the agreed form of collateral is cash, then the fee may be quoted as a "rebate", meaning that the lender will earn all the interest, which accrues on the cash collateral, and will "rebate" an agreed rate of interest to the borrower.

In an example transaction, a large institutional money manager (typically index fund managers) with a position in a particular stock would allow those securities to be borrowed by a securities lender. The securities lender (investment bank) would then allow a short seller to borrow the stock and sell it. Once the shares are borrowed and sold, it generates cash from selling the stock. That cash would become collateral for the borrower. The cash value of the collateral would be market to market daily so that it exceeds the value of the loan by at least 2%. The institutional manager would have access to the cash for overnight investment and maintains a long position in the stock.

When security is loaned, the title of the security transfers to the borrower. This means that the borrower has the advantage of holding the security, as they become the full legal and beneficial owner of it. Specifically, the borrower will receive all coupon and/or dividend payments, and any other rights such as voting rights. In most cases, these dividends or coupons must be passed back to the lender in the form of what is referred to as a "manufactured dividend".

The principal reason for borrowing security is to make delivery of a short position. As you are obligated to deliver the security, you will have to borrow it. At the end of the agreement, you will have to return equivalent security to the lender.

While stock loan activity is often tied to short selling, there are other reasons to borrow shares. For instance, stocks can also be used as collateral to secure a cash loan, in a transaction known as stock lending. In this case, the owner of the stock places them in a secure account with a lender and receives a cash loan in return. The cash loan is subject to interest like a traditional loan and the stock is returned to the owner when the loan is repaid to the lender with interest. Depending on the stability of the stock put up as collateral, some lenders will offer up to 90% of the value of the stock as cash in the loan. This valuation is known as the loan-to-value ratio.

Another example pertains to dividend capture whereby an investor (often an offshore hedge fund) will borrow shares ahead of the ex-dividend date to be eligible to receive the cash payout and then will return them immediately after the ex-dividend date.

SHORT SELLING PROCESS

To sell a stock short, an investor needs to be in possession of the shares prior to the settlement date. To accomplish this requirement, the investor will typically borrow the shares from another party. However, the number of shares that are available to borrow and hence the cost to obtain such shares, can vary greater from one company to another.

The composition of the shareholder base, market capitalization, and liquidity of the stock are factors that impact the ease of borrowing and hence associated costs to ascertain the shares. As a rule of thumb, companies with many shares held by index institutions and ample liquidity will have a larger pool of shares available to borrow.

For example, three of the top four institutional investors in Tesla and Apple, Inc. are index firms that hold an aggregated 15% and 18% of the total shares outstanding, respectively. In addition, both stocks are extremely liquid, thus the cost to borrow shares is only 0.25% (As of 8/9/22), which represents the annualized rate that is paid by the borrower for the shares.

In comparison, the cost to borrow shares of thinly traded Century Casinos, which has only one index institution in its top five and has an average daily volume of a mere 82k shares, is 1.35%. As a result, assuming an investor has an equally bearish outlook on Tesla, Apple, and Century Casinos, the higher costs to borrow shares of Century to short would likely steer the investor toward shorting Tesla or Apple instead.

Once an investor has isolated security to short, entered into a lender's agreement to acquire the shares, which stipulates the agreed-upon interest rate, and deposited the collateral into the account, the investor enters an order to short XYZ Corporation. Within three business days of the executed order, the investor must then receive the borrowed shares to make delivery on the settlement date.