

# THE MORALITY OF SHORT SELLING

**Randy Benjenk**

## **Abstract**

The controversial investment scheme of short selling has come under fire as a scapegoat for the economic crisis of 2008 despite evidence that it is an economically valuable practice. This paper seeks to explain the moral suspicions of shorting by examining a short seller's emotions. A short seller hopes for negative events to occur that will drive down the price of stock, and feels satisfaction if and when such events occur. These emotions, which I call shorthope and shortsatisfaction, are problematic for two reasons. First, they conflict with a justified norm of proper competition that allows investors to be respected and self-respecting. Second, they can conflict with an investor's own moral attitudes, creating undesirable moral binds. Because of countervailing considerations, these conclusions do not necessarily justify a ban on shorting. They do, however, warrant further philosophical debate about the practice as well as moral reflection by its participants.

## **Introduction**

On September 19, 2008, the United States Securities and Exchange Commission issued an emergency ban on the short sale of nearly one thousand financial stocks for a nineteen-day period. Citing "market manipulation" and a loss of investor confidence, SEC Chairman Christopher Cox stated that "temporarily banning short selling of financial stocks will restore equilibrium to markets."

On the afternoon of the ban, David Gaffen of the *Wall Street Journal* articulated an economic defense of short selling in an article entitled "Five Reasons: Why the Short Selling Ban Stinks." Gaffen was hardly alone in his frustration, as the financial press railed on the SEC for its decision to ban a practice that the editorial pages claimed was innocuous (Kudlow 2008; Brenner and Subrahmanyam 2008). Yet, in a survey of newspapers and journals, one would be hard-pressed to find

arguments against short selling. But anti–short selling sentiments do exist, even if they are not articulated fully as arguments. Many believe that “[s]hort selling is un-American. It is done by rogues, thieves, and especially pessimists who are, of course, the worst of the lot” (Fabozzi 2004, ix). Some have “labeled short sellers as hyenas, jackals, vermin and vultures” (Foroohar 2008). With defensiveness on one side and name calling on the other, a question emerges: Is there something morally wrong with short selling? Why or why not?

This thesis was born on the intuition that the emotions involved in short selling, not the action itself, cause the defensiveness of the financial press. By examining the emotions associated with shorting, we will see that an argument emerges that short sellers are sometimes undesirable in a market—not because of their economic effects, but because of their moral attitudes and the moral attitudes of interested parties. Two strong conclusions may naturally follow from these considerations: that short selling should be outlawed, and/or that short selling is morally wrong. This paper, however, will refrain from such sweeping conclusions, largely because of three countervailing considerations: the economic benefits to shorting stock, the possibility of an emotionless investor, and respect for the self-determination of the marketplace.

What this paper intends to do is show that short selling occasionally violates existing moral norms. These moral norms need not be universal, nor must short selling violate them in every instance. Yet, because of these violations, people’s moral suspicions of short selling can be rational and justified. The second section of the paper intends to show that short selling can sometimes violate the investor’s own moral attitudes, creating an undesirable moral bind. What follows from these conclusions is unclear; they intend to explain existing suspicions as well as encourage people to think about their moral attitudes toward the emotions involved in financial investments. This paper intends to begin a philosophical debate about short selling.

### **What Is Short Selling?**

Short selling is in some ways the opposite of “investing long,” which is when an investor purchases a security when he believes it is underpriced or will increase in value and sells it when it becomes overpriced or increases in value. In contrast, a trader engages in a short

sale when he believes a stock is overpriced or anticipates an event that will drive down its value. As an example, the Slate Rock and Gravel Company (SRGC) trades at five dollars per share and a trader believes the shares are overvalued. The trader decides to short sell ten shares. He first borrows ten shares of SRGC from a financial institution such as a bank. Then he sells those ten shares at the price of five dollars each to a buyer in the marketplace, giving him a net gain of fifty dollars in his account. He still owes the bank ten shares of SRGC. Next, he waits for the share price to fall. If and when it does, he buys ten shares at this lower price (we will assume in this example that SRGC falls to four dollars per share) and returns the shares to the bank. He thus makes a profit of ten dollars, minus any interest paid to the bank. The lower the share price falls, the greater the investor's profit. If, contrary to the short seller's expectations, SRGC increases in value after he sells ten shares, he must cover his borrowed shares at a higher price. In that scenario, a short seller loses money as the value of SRGC increases.

There are also illegal methods of shorting a stock, including "naked" short selling and the spreading of false rumors. However, this paper only considers legally permissible short selling in its most basic form as outlined above.

### **The Emotions of Short Selling**

A short seller, during the course of his transactions, inevitably hopes for a negative event to occur; stocks fall in value when markets experience a downturn, something bad happens to the company or its sector, or negative publicity is released regarding the company. We shall call this peculiar emotion *shorthope*. This feeling is accompanied by a positive emotion if the negative event occurs, and a negative emotion if the negative event does not occur. When a short seller hears news that will negatively affect the share price of the stock he shorted, he experiences an emotion that we will call *shortsatisfaction*.

But why should we care about emotions? One may object that emotions are meaningless in the market as they are passively experienced and irrational, and thus irrelevant. This view, however, is simplistic and to some extent outdated. The first point suggests that emotions are involuntary and thus cannot be subject to moral constraint. But we do have control of our emotions in the sense that we

can choose to put ourselves in situations that cause certain emotions. When assessing culpability for our emotions, “it is sometimes enough that we are responsible for being the kind of person who no longer has a choice in this situation” (de Sousa 1987, 278).

As for the second part of the objection, emotions, while not always rational, matter because they “sensitize us to what is significant in and for our lives.” Our emotions “allow us to make discriminations, to formulate desires and goals and, crucially, to evaluate contrastively between them” (McNamee 2003, 4–5). Other people’s emotions allow us to sense their desires and goals and means of achieving those goals. The intersection between our moral standards and other people’s emotions is a place where we can question and judge their desires and goals. We want to know how we will be treated and how we are viewed by others. Emotions are a window into those problems. If a person feels an evil emotion in a certain situation, we object because we suspect it denotes true evil in that person.<sup>1</sup> Perhaps the evil emotion even indicates moral attitudes that will result in the person committing harms in the future. Emotions, therefore, are crucial signals in philosophy and morality. They are evidence of people’s underlying attitudes that play a large role in our moral lives.

But how does this relate to the market? One may believe that the market is an emotion-free zone, a place where only actions matter. There are two problems with this objection. First, it is not entirely clear where the market ends and what fills the void in its absence. The attention paid to corporate social responsibility in the last decade has shown that companies are not insulated from the public’s moral judgments and the public is not insulated from the effects of companies’ moral judgments. Since we care about emotions because they reveal moral judgments, and markets are not insulated from the public, we should care about emotions in the market for the same reasons we care about emotions in nonmarket interactions.

The second problem with the objection is that actions alone are not the only things that matter in the market. Marketplace norms regulate intentions as well. If a CEO were to attempt to murder a competitor but fail in his efforts, he would be criticized widely and justly. The CEO would have violated not only a law, but a competitive norm—though what, exactly that norm is may be difficult for his critics to spell out.

Similarly, negative attitudes toward short selling, even if not fully explained, are evidence of one or more moral norms that short

sellers violate. It is the purpose of the following sections to explain what these moral norms may look like and where they come from.

### Competition Thesis

The first thesis of this paper is that *shorthope* and *shortsatisfaction* violate a justified moral norm reflecting a conception of what it means to be a proper market competitor. Competitors in the market have desires to obtain a certain result for themselves and will innovate, cut costs, or lower prices to attain that result. There are norms that govern these desires. Such norms stipulate and evaluate *what* results the agent desires, *how* he desires the results to occur, and *why* his desires are so. The reasons behind the desires are their most important feature because they justify the norm. The competition thesis will make the case for a specific norm of competition, then argue that the emotions involved in short selling violate this norm.

There are at least two norms of competition that one could likely find in the attitudes of market agents, and each has its own answer for the *what*, *how*, and *why*. The first norm, held by many advocates of the free market, is the desire to “win.” Winning is achieved when a market agent prevails over the field and his results are the best in the market. The ultimate win is to do so well as to drive the opposition out of business. In service-based industries, winning is accomplished by achieving the largest market share. For investment advisors and fund managers, including short sellers, winning is accomplished by posting the highest returns relative to the market opposition, as well as acquiring the most customers or investors. The desire to win is necessarily a comparative norm because the end cannot be achieved without reference to others’ results. *How* should winning be attained? For most of the proponents of the norm,<sup>2</sup> by any legal means necessary. As long as the competitor does not break the law, he is free to pursue the win.

This second conception of competition is the force of market pressure to maximally improve one’s products or services. People who hold the second norm of competition want to improve their efforts and fulfill their own potential. This is a noncomparative norm because success and failure are judged without reference to other people’s outcomes. Still, opponents are a motivating force. A competitor is informed and guided by the successes and failures

of his opponents. He sees what succeeds in the market and what needs improvement. He examines the actions and nonactions of the opposition to find market gaps in pricing, service, or product innovation and tries to fill that niche. Ultimately, however, he judges his results on his own abilities and accomplishments. These results can be attained in a way that does not contradict his moral attitudes.

### **The Case against the First Norm of Competition**

Now that the two norms of competition have been distinguished with respect to *what* and *how*, we can distinguish them with respect to *why* their results are desired. What justifies these norms? Two arguments can be made in support of the desire to win. First, winning is a valuable signal of fitness to other people and a source of pride and satisfaction for oneself. Second, the motivation to win drives wealth creation in the market.

The first justification falls short. Winning, by itself, can be an empty accomplishment. Good athletes, for example, do not want to compete against bad or poorly performing opponents. A win (in markets as in sports) against the best competition is perceived by outsiders as more legitimate and makes the winner feel the best about himself. Competitors cannot feel profound pride in a win unless it is earned over a worthy opponent to whom they are capable of losing.

But do athletes really hope to face the strongest opponent? Mike McNamee sees “the delight on the face of a contestant whose competitor falls at the last hurdle, fails her final jump, or injures himself in the warm-up” (2). Perhaps the descriptive claim that good athletes want their opponents to do well is too strong. Instead, we shall make the normative claim that athletes should seek to beat the best opponents rather than the worst. This can be justified from either the perspective of the impartial observer or the perspective of the athlete. The impartial observer should hope that both sides play well for the sake of advancement of good sport. Well-performing athletes usually play a more exciting game when they face equally matched opponents, and the impartial fan is rewarded no matter the outcome. This is true of the market as well. When there are several strong companies competing at a high level, stakeholders in that sector tend to be rewarded. It is less clear why an athlete should hope his opponent does well. When an athlete is directly pitted against another,

his outcome is inversely proportional to the quality of his opponent's play. At first thought, we may sympathize with a person who hopes for his opponent to stumble; his self-esteem inversely depends on the self-esteem of the competitor. Due to self-esteem's importance, we may conclude that feelings of *Schadenfreude* (pleasure in another's suffering) in competition are ethically excusable. However, this reasoning conflates self-esteem and self-respect; the possession of the latter by one competitor "does not entail its exclusion in another" (McNamee 2003, 9). Self-esteem is merely a favorable opinion of oneself, whereas self-respect is proper regard for one's dignity. Self-respect is the healthier of the two concepts (Langer 1999; Sachs 1981, 348). Consequently, self-esteem issues cannot excuse feelings of *Schadenfreude*. Winning against poor opponents may boost self-esteem, but it does not improve self-respect.

The second justification of the first norm of punishment holds that the desire to win is instrumentally valuable in motivating market agents, and this ultimately generates economic growth. Joseph Schumpeter's "creative destruction" model of capitalism describes economic growth as a process of destroying weak and stagnant market agents. Proponents of this view believe that ruthless desires to win and destroy one's competitors help fuel the economy.

It is unclear whether the desire to win is a stronger motivator than the desire to improve and maximize one's productivity, but intuitively, it seems that the second norm should be as effective as the first. It is also evident that the desire to win, by itself, does not always create wealth. A competitor's desire to win could be satisfied by the rest of the agents in the market making errors or bad products. For a fund manager, the desire could be satisfied by a market crash that spares a few select securities. Winning in the first sense of competition is consistent with situations where aggregate wealth is not generated. The wealth gains from the wins may be fully offset by the loss of wealth by the losing competitors. This is especially true in the case of a short seller.

While previous arguments used an analogy between sports and markets, competition in sports is distinct from competition in the market in two crucial respects. First, investors can profit without their opponents sustaining capital losses. The well-being of one competitor does not directly depend on the failure of another. Consider a simplistic case in which an investor trades with his own money; he could be satisfied simply by turning a profit greater than the return from

a risk-free security. He does not need to defeat other investors; for all he cares, some could make double his profits. Now consider the more advanced case of a fund manager who creates a portfolio with other people's money. His success is tied both to his fund's rate of return and its return relative to the competition. He does not only want to turn a profit; he wants to beat the industry average return to help him secure future investors. In this situation, there are winners and losers. Those who underperform relative to the industry average may lose business to the competition. Still, the fund manager can win without the losers sustaining capital losses. Conversely, he can turn a profit, lose the competition, and care little about the loss. This is a crucial distinction between investors and athletes. The investor's fortunes do not fully depend on his relationship to the competition. The investor does not need to hope for his competition to stumble in order to profit and he will not dwell on a loss if he lands a profit. Winning is secondary to profit; a rational investor would prefer to lose and have a capital gain than to win and have a capital loss. Thus, the investor need not win at all moral costs. The prospect of a win is merely added incentive for an investor to perform to his full capabilities.

A second distinction is that, while a central purpose of athletic competition is crowning a winner, market competition ideally never crowns a winner. This may seem counterintuitive at first because many market competitors want to drive their opponents out of business and be the last man standing. But that is an undesirable goal from the perspective of an outsider to the competition. Noncompetitive stakeholders want to avoid an end state in which one company, having defeated the competition, has a monopoly in its industry because higher prices and poorer products and services will follow. Thus, a number of laws and institutions exist to induce competition and prevent monopolistic practices. That is not to say that the market should prop up weak competitors at the expense of strong competitors; this would be inefficient, and the weak do not deserve this support. Rather, consumers prefer that a win not be the ultimate result of competition, even if it is motivation for competitors.

The preceding arguments have intended to prove a normative claim: the first norm of competition is not justified and people should expect more out of competitors than merely winning. It is also descriptively true that many people do expect more from market agents than the desire to win. Corporate scandals such as the demise of the accounting firm Arthur Anderson elicited disgust

from the American public. We can assume the public would object to accountants from Arthur Anderson intending to break the law, even if they did not ultimately do so. There are stringent moral demands inherent in certain professions, and a comparative norm of success may lead to an intentional or emotional violation of those demands in pursuit of a win.

### **The Case for the Second Norm of Competition**

Why is the second norm of competition justified instead? First, it can accommodate stringent moral and professional standards. Since it is a noncomparative norm and people set their own standards for success, people are under less pressure to compromise their values in pursuit of profit. Second, it is a psychologically healthier norm. Fulfillment comes from one's own work, and not from others' failures. A competitor can "lose," comparatively, and still profit and be proud of his accomplishments. Third, the second norm of competition allows competitors to be self-respecting.

One way to frame this third justification is through Michael Walzer's conception of recognition. Walzer believes that "we honor people in accordance with their victories because the qualities needed to win the general competition are roughly the same as the qualities we are likely to admire in any case" (256). Furthermore, we tend to see ourselves in the same way that others see us. Our self-respect depends on the recognition that others give us, and that recognition depends critically on the commonalities between "winning" qualities and "admirable" qualities. There are moral norms that govern this link; self-respect requires "some substantial connection...to the movement that champions the idea of professional honor" (278). To be a self-respecting competitor as an athlete, winning is not enough; one must follow the rules and perhaps act over and above the rules. The evidence for the norms governing sports comes from people's attitudes toward what constitutes a respectable competitor. We celebrate sportsmanship, teamwork, hard work, and adherence to the rules and we denounce showmanship, selfishness, laziness, and cheating. A game won without respect for the rules, one's competitors, sportsmanship, teamwork, and hard work is an accomplishment that does not correspond to any potential accomplishments outside of athletics. Perhaps people's opinions on the

precise qualities to be valued differ, but sports fans channel their internal appraisals of an athlete's character into recognition. Since athletes' self-respect depends on the recognition fans give them, those norms tend to govern the athletes' feelings of self-respect.

Similarly, we can discuss an investor as a self-respecting competitor. Investors who make a large profit are deserving of recognition and respect insofar as their ability to make sound investments corresponds to other qualities we admire. What are the qualities of a good investor? He must be an analytical thinker, a careful researcher, and a principled decision maker. These are admirable qualities. But a profitable investor can also be ruthless and opportunistic; he may break or circumvent the rules. Sometimes he experiences emotions that contradict his or other people's moral attitudes. These qualities are not always admirable in private life. We can only respect an investor if he follows some moral standards, including fair play. Moral standards allow an investor to be respected and self-respecting.

As Walzer's self-respect does for other moral standards, it justifies the second norm of competition because the norm corresponds to admirable qualities outside of market activity. For investors to be respected and self-respecting: (1) they should hope for their own successes, not for the failures of others, and (2) they should draw satisfaction from their own efforts, not from the failures of others. These standards are valuable because they correspond to admirable qualities in everyday life. Take love, for instance. I might desire to be loved by a woman because I deserve it based on a true connection with her. Or, I might desire that a prior partner break her heart so that she falls in love with me in her insecurity. Hoping for deserved love is more admirable than hoping for a love based on another's misfortune. The emotions of hoping for and drawing satisfaction from one's own success (rather than others' failure) allow an investor to be self-respecting because they conform to valid standards outside of the market.

### **Short Selling and the Second Norm of Competition**

The final step in the competition thesis is to apply short selling to the second norm of competition. If short sellers want to make a profit, they necessarily experience *shorthope* in desiring that the stock they short decline in value, and *shortsatisfaction* after it does fall in value.

A stock that declines in value is a failure of the company's managers and investors. When the short seller experiences *shorthope*, two desires are conflated: his desire to succeed and the accompanying, necessary desire that others should fail. When he experiences *shortsatisfaction*, two sources of satisfaction are conflated: his satisfaction in earning a profit, and the accompanying, necessary satisfaction in the fact that others have failed. Short sellers thus violate the aforementioned standards—valid because they allow investors to be self-respecting—derived from the second norm of competition.

To make this point clearer, consider the case of a fund manager who short sells stocks of nonfinancial companies that are unrelated to his employer and not otherwise competing with him. Yet, when the short sale is initiated, the investor becomes an opponent of the company. While the two parties are not competitors in the sense that they can cause each other to fail, this resembles the first, less desirable sense of competition because one party's outcome depends inversely on the other's outcome. Either the stock loses value and the investor gains, or the stock increases in value and the investor loses money.<sup>3</sup> There must be a winner and there must be a loser, and this fact perpetuates the first norm of competition.

If a short seller wanted to justify *shorthope* and *shortsatisfaction*, he might tell us that in all market competition one hopes for others to fail so one can win. But the competition thesis attempted to show that there is a norm of competition, allowing investors to be respected and self-respecting, that operates differently. The emotions of short selling violate this norm. And not only should we feel suspicious of short selling because it is anticompetitive, short sellers should feel moral qualms as well.

### Moral Bind Thesis

The second thesis of this paper holds that *shorthope* and *shortsatisfaction* can conflict with an investor's other emotions in a problematic way, putting him at risk for undesirable moral binds caused by emotional confusion. This is best illustrated by two hypothetical situations.

Imagine an investor who sells SRGC short on September 10, 2001. He hopes that SRGC will fall in value and net him a profit. What the short seller does not know is that the company is sound

financially; the market in fact values the company correctly. The next day, terrorist attacks in New York kill several thousand people. American stock exchanges close for a few days to prevent a crash, but when they reopen, they suffer the largest one-week point drop in history because of a loss of investor confidence. SRGC is not spared from this collapse and the short seller profits. What emotions is he supposed to feel? Pride in a successful bet, even though the short sale was poorly researched and his profit was lucky? Sadness at the horrifying cause of his windfall? Happiness because of the money in his bank account? The inner turmoil he feels is caused by the same moral intuitions that cause people to be suspicious toward short selling; namely, reprehension toward the set of feelings he experiences during the course of his short sale.

*Shorthope* and *shortsatisfaction* are morally dubious emotions in this case because they express attitudes that contradict the short seller's compassion. There are two possibilities as to the result of this conflict. The first possibility is that his *shortsatisfaction* limits the amount of compassion he would otherwise feel. Compassion is an awareness of another's suffering marked by a harmony of feeling between both parties. He cannot experience a harmony of feeling with the victims' families because he has gained and they have lost. Alternatively, the investor feels full *shortsatisfaction* and full compassion, a conflict of interest of the heart. Competing emotions can make it difficult for a person to act in accordance with either one of them. This is clear in the next example of a moral bind.

Suppose an investor discovers that vegetables from a region of South America have been found to contain a strain of harmful bacteria. He researches the retail food companies that have purchased vegetables from the region and quickly initiates a short sale of these companies before the news becomes public. What is wrongful about his action? It is unreasonable to expect him to help alleviate the situation; he is an investor, not an FDA official, and presumably the parties that can stop an outbreak are being notified around the time he starts the short sale. So we probably cannot object to his action on the grounds that he should have tried to prevent an outbreak. Yet the short seller is in a moral bind, because of the nature of his *shorthope*. What does the investor hope for in this situation? He wants news of a potential outbreak to be released because this will cause the stock price to decrease. But how bad should the news be? The stock price of the retail food companies will not decrease much if an outbreak

is quickly prevented and no one becomes sick. It will decrease substantially if customers get sick. It will free fall if they die. So what does the short seller want to happen? There is a conflict between what he wants as an investor and what he wants as a moral agent.

These examples emphatically seek to demonstrate that short selling can put investors' emotions in conflict with their moral attitudes. Though emotions are passively experienced, they arise in predictable patterns. Accordingly, we have an obligation to avoid situations where our emotions cause moral problems. Though the average short seller may not experience moral binds regularly, their mere possibility casts a cautionary cloud over any instance of short selling.

An objection may be formulated against these claims. It may be that moral binds are simply the costs of short selling, and if people are willing to risk incurring them, they should have the freedom to do so. The market often places agents in moral binds when they do not short sell. Loyalties to employers sometimes conflict with loyalties to one's conscience, but we usually accept such conflicts as a necessary evil to achieving other important ends. Perhaps investors' consent to short selling's moral hazards is enough to alleviate our concerns. If investors say, "You worry about your problems and we'll worry about ours," we can rest easily.

The response to this objection becomes clearer in an analogy to gambling. If we were to object to gambling because of the risk involved, a gambler may similarly argue that he alone accepts the risk, and since he can only harm himself, his risk should not interfere with our moral attitudes. Still, we object to a society that allows people to incur dangerous risks and become gamblers. The moral bind thesis is not an argument against individual short sellers; it is, instead, an argument against society allowing short selling. It is problematic when the market allows people to be in a position where they have the lucrative opportunity to take moral risks.

James H. Michelman sees the problem of moral binds in terms of a conflict of desired moral character and desired business character:

What are the attitudes and actions that we would like to think are part of our own moral makeup and that we would wish others to exhibit in their relationships with us? A non-exhaustive list surely includes courage and intelligence, kindness, compassion... . Call this set of characteristics our *desired moral character* or the

*human virtues.* What characteristics would we look for in the managers of a company in which we held an important stake? Whatever this catalog turns out to be, call it the *desired business character.* (82)

A number of ugly consequences follow from the conflict between our loyalties to the desired business character and our aspiration to attain the desired moral character. Chief among them is that in order to act with desired business character, a market agent may often have to override his disposition to act in accordance with the human virtues. If he does this often enough, he would “develop habitual attitudes of rationality expressed by hardness, shrewdness, and single-mindedness. These attitudes, or some of them, might begin to determine his actions under private circumstances” (84). Applied to short selling, this argument evokes some dangerous outcomes. If people take moral risks in the marketplace, they may take such risks in their private lives. Perhaps the greatest danger inherent in short selling is that these investors will start to sell other people short, so to speak. They have been conditioned to view objects of judgment skeptically, always seeking to find and exploit flaws. If investors accept the moral hazards of short selling, they do not only accept that their emotions will conflict with their moral attitudes, but also the possibility that their emotions will override and shape their moral attitudes for the worse.

It must be noted that long investors can face moral binds as well.<sup>4</sup> Short sellers risk moral binds because of the nature of the investment procedure. The moral binds that long investors risk facing can occur for two reasons: the nature of the stock or the nature of the investment procedure. It would be problematic for the moral bind thesis if the latter usually caused moral binds for long investors, for this would undermine the claim that short selling is more problematic than long investing in virtue of its structure.

A possible case of a long investor’s moral bind is an investment in a company, such as a pharmaceutical or defense corporation, that offers remedies to people’s suffering or conflicts. The investor in these securities hopes for the value of the stock to increase. It follows that he is susceptible to moral binds in situations where suffering arises and the company’s stock increases in value as it offers the remedy. Imagine, for instance, a flu epidemic that causes a pharmaceutical company’s stock to appreciate as it provides the

cure. This situation would likely cause a conflict of desired business character (as the investor experiences *shortsatisfaction*) and desired moral character (as he would otherwise hope that the epidemic did not occur).

Is the conflict in this case a result of the investment structure or the nature of the stock? One strategy here is to postulate that the nature of the company (providing a cure) actually relieves the tension between desired business character and desired moral character. Because the pharmaceutical company provides a positive service that alleviates suffering, investing in it long, thereby hoping for its success and providing it capital, is an action that is consistent with desired moral character—which, if possessed, would lead a person to hope for this very outcome.<sup>5</sup> Thus, the nature of the company's mission shields the investor from the negative effects of *shorthope* and *shortsatisfaction*. If he believes that the essential purpose of the company is morally good, his desire to profit through investing in its securities does not place his emotions in conflict with his moral attitudes. There is no moral bind.

With the stocks of some companies, such as cigarette manufacturers, we cannot deny the moral binds caused by the investment structure. The investor in Big Tobacco experiences emotions similar to *shorthope* because he must hope for a negative event—a net growth in cigarette addicts, usually among impressionable youths—to occur to increase the value of his investment. The moral bind associated with the *shorthope* cannot be shielded by the mission of the company; the mission is not morally good. But while investment in a cigarette company can cause moral binds due to the investment structure, it also causes moral binds because of the nature of the company, and this reason seems to be the more significant cause of any misgivings.

There are, however, other financial instruments that do cause moral binds only because of their structure. One is a “death bond,” a life insurance policy that is sold by a cash-strapped policyholder to an investor who pays the premiums and collects on the policy when the original policyholder dies (Goldstein 2007). The investor hopes for the policyholder to die as soon as possible in order to make a profit on the investment. A less dramatic but similarly problematic security is a credit default swap, which is a contract sold to bondholders as insurance against a credit event. Like a death bond, it can be sold to an investor who does not own the underlying bond that it insures. That investor, in turn, wants the bond issuer to default. But that will

result in a loss of money for the bondholder and, eventually, the bond issuer. Death bonds and credit default swaps have similar structures: they are both insurance contracts that cause moral binds only when they are not held by the party that actually needs insurance. Like short sellers, investors in these securities profit from negative and sometimes tragic events. Such events put investors' emotions in conflict with their moral attitudes.

### **In Defense of Short Selling**

As stated earlier, this paper does not hold that the philosophical arguments against short selling justify a ban on the practice. There are three reasons that banning short selling would be imprudent: the economic value of shorts, a counterexample of an emotionless investor, and respect for the self-determination of the market.

A commonly held but fallacious belief is that short selling permanently drives down the price of stock. Short sellers do cause a temporary depression in the price of a stock when they sell borrowed shares, but the price returns to its original level when they cover their positions by buying back the same number of shares. If the demand for the stock decreases between the moment they sell and the moment they cover, the price will decrease from its original position. However, that fall in price is due to the decrease in demand, not short sellers' actions (Culp 2008, 47–48). Short sellers do not cause a permanent decrease in price; they merely profit from it.

There are two real economic effects of short selling. First, short selling increases price volatility of the stock being shorted. Short sellers, when they sell and cover, cause prices to fluctuate back and forth. Constant price fluctuation is a somewhat dangerous economic force, especially in an unstable economy where investor confidence depends on price stability. On the other hand, the second economic effect of short selling is the prevention of overoptimistic valuation of securities. Recessions are often caused by the bursting of undesirable stock market bubbles, which are periods when the prices of stocks are consistently higher than their true value. Since short sellers can temporarily decrease the prices of securities, they can force prices today to reflect the change in demand that will probably happen in the future. This helps prevent bubbles.

From an economic perspective, it is unclear whether the benefits of preventing overvaluation outweigh the costs of volatility. Still, these effects give us reasons to believe—though not conclusively—that banning short selling altogether may be to the detriment of an efficient market.

The second reason that a short selling ban may be unwarranted comes from a hypothetical case of an emotionless short seller. Imagine a computer that has been programmed to spot overvalued securities and sell them short. Now assume that no person has any sort of stake in the outcome of the computer's investments. The computer does not make money for anyone, its profits are sent to an account that cannot be accessed by anyone, and its inventor is dead so he cannot take pride in its success. The computer makes money because it is programmed to do so and there is no other reason for it to be operating. No one involved with the computer's investments feels *shorthope* or *shortsatisfaction*. Therefore, the computer is not susceptible to the competition thesis or the moral bind thesis because these theses point to the conflicts between an investor's emotions and his or other people's moral attitudes. In this example, there is little wrong with the short selling, which is a series of transactions without connected emotions. Generalizing from this case, there can be other cases where shorting is not morally problematic. The one requirement for a possible counterexample to the competition thesis and moral bind thesis is that there be no emotions involved that are proportionally connected to the outcome of the short sale. The possibility of an investor emotionally disconnecting himself completely from the outcomes of his investments exists, but it also seems immensely unlikely. Nevertheless, the mere possibility of an emotionless investor—who must also have no bosses, coworkers, or dependants hoping for his success—implies that it is difficult to condemn short selling universally.<sup>6</sup>

The third countervailing consideration is the self-determination of the marketplace. This paper holds that existing suspicion of short selling is rational and valid, and follows from reasonable beliefs about competition in the market. However, if lawmakers, regulators, and the public are not troubled by shorting after carefully considering the moral issues involved, then a ban would be unjustified. But we should only accept that conclusion if people do engage in the debate about the emotions of short selling.

## Conclusion

A moral discussion of short selling is a microcosm of a broader philosophical inquiry into the role of markets in society. This inquiry seeks to develop a vision of a morally ideal market. One feature of the ideal market is that it facilitates the right emotions that make for a better society. Identifying the market institutions that cause emotions detrimental to society is one step in transforming the existing market into the ideal. The claim that short selling can violate moral norms and moral attitudes does not suggest that short sellers are essentially evil people. Rather, it suggests that short selling as an institutional mechanism demands emotions that contradict worthwhile moral norms.

Other commonplace market institutions sometimes generate emotions that derive from the first sense of competition and contradict moral norms. People in business often hope for their competitors to stumble and fall. Yet this paper does not condemn the institutions that give rise to these emotions. The difference between commonplace market institutions and short selling—both of which can give rise to equally unhealthy emotions—is that most market institutions do not demand these emotions; they merely allow them. Short selling, on the other hand, requires them of all participants who are emotionally attached to their success at work.

Why, then, do the competition thesis and moral bind thesis not justify a legal ban on short selling? The philosophical vision of an ideal market is not a legal vision but a moral vision. It requires a highly compelling moral vision to influence the law. Such a vision may be compelling in virtue of its widespread acceptance or in virtue of the validity of its justification. This paper does not claim to possess either mandate. Instead, it presents short selling as a wrinkle of imperfection in the market while advising individuals to base their investment practices on the way they want to live their lives independently of the market. If fund managers do not wish ill will upon the people who work for, invest in, or depend upon the companies they sell short, they should consider refraining from the practice. Short sellers, as agents within an imperfect system, are not necessarily “rogues” or “thieves” or even “jackals.” They are people who may have neglected to think about the consequences of their emotions and moral attitudes. If and when they do so, the vision of an ideal market will be one step closer to fruition.

## NOTES

1. In a chapter entitled “When is it Wrong to Laugh” in his book *The Rationality of Emotion*, Ronald de Sousa demonstrates that there are situations where it is morally wrong to have certain emotions. Implicit in his writing is the pertinent notion that we cannot separate emotions from their causes; emotions can only be immoral in virtue of their causes.
2. I infer that followers of Milton Friedman, holding that the social responsibility of a business is to maximize its profits under the law, are proponents of the first norm of competition.
3. Or, the stock’s value does not immediately change and the investor does not make or lose money. In this scenario the investor, if he believes his research is correct, is likely to wait until there is price movement to cover his borrowed shares.
4. Long investors are not usually susceptible to the problems raised by the competition thesis. An exception is when a long investor hopes for the failure of the competitors of the companies in which he invests.
5. Some have seen pharmaceutical companies’ actions, such as their pricing practices, as immoral or greedy. Such controversies should not harm the conclusion of this hypothetical investment scenario because from the investor’s perspective, hoping for the success of a crooked pharmaceutical company would cause a moral bind in virtue of the nature of the company, not the investment structure.
6. It is not necessary for an activity to be morally problematic in every instance in order to justify a ban on it. However, because our moral objections here deal with emotions and not harmful actions, it is best to be conservative in our conclusions.

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