



1967

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## Recommended Citation

William J. Rankin, Short-Sales of Securities, 16 Clev.-Marshall L. Rev. 351 (1967)

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## Short-Sales of Securities

William J. Rankin\*

THE FIELD OF SHORT SELLING is bathed in confusion, complexity, and contradiction. An attempt will be made in this article to arrive at order and understanding in this complex area. Before analyzing short selling in detail, it will be helpful to establish a proper background by considering a purchase of stock outright, a purchase on margin, and hedge transactions applicable to the commodity market.

No attempt can be made to cover the entire securities market. For comprehensive coverage of the securities market, the reader is referred to other publications.<sup>1</sup> Extended coverage of custom, usages, and rules applicable to the securities market is also beyond the scope of this article.<sup>2</sup> Notwithstanding, it should be emphasized that legal aspects of dealings with brokers include the laws of contract<sup>3</sup> and agency.<sup>4</sup> Regarding the property aspect of a stock certificate, it has been said that shares of stock are mere evidence of interest in a corporation<sup>5</sup> and thus fungible.<sup>6</sup> But this view may have been altered by the Uniform Commercial Code, Article 8, which specifically refers to securities as property.<sup>7</sup>

### Cash Purchases of Stock

In *Lamprecht v. State of Ohio*,<sup>8</sup> it was stated that a broker purchasing stock for a customer acts in a threefold relation—agent, creditor, and pledgee.<sup>9</sup> First, consideration will be given to cash purchases of

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<sup>1</sup> See 2 Oleck, *Modern Corporation Law*, chap. 35, *Securities Markets*, 293-357 (1959); Schabacker, *Stock Market Theory and Practice* 167-275 (1930); Twentieth Century Fund, Inc., *The Security Markets* (1935); *Securities Act of 1933*, § 2(1) as amended (1964); *Ohio Securities Act*, Ohio Rev. Code § 1707.01 et seq. (1964).

<sup>2</sup> For extensive coverage in these areas, see Jackson, *Stock Broker's Liability Under Customs, Usages, and Rules*, 12 *Clev.-Mar. L. Rev.* 111 (1963); Knowlton v. Fitch, 52 N. Y. 288 (1873); Bibb v. Allen, 149 U. S. 481 (1893); Morris v. Jamieson, 205 Ill. 87, 68 N. E. 742 (1903), affirming, 99 Ill. App. 32 (1901).

<sup>3</sup> Campbell v. Wright, 118 N. Y. 594, 23 N. E. 914 (1890); Morris v. Jamieson, *supra* n. 2; 12 C. J. S., *Brokers* § 31 (1938), 48 Ohio Jur. 2d (Part 2), *Secured Transactions* § 30 (1966).

<sup>4</sup> Brown v. Carpenter, 182 App. Div. 650, 168 N. Y. S. 921 (1918); Burke v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 363 S. W. 2d 392 (Tex. Civ. App. 1962); Jackson, *op. cit. supra* n. 2.

<sup>5</sup> Atkins v. Gamble, 42 Cal. 86 (1871); Richardson v. Shaw, 209 U. S. 365 (1908); Sargent v. Whitfield & Co., 226 Ky. 754, 11 S. W. 2d 926 (1928).

<sup>6</sup> Uniform Commercial Code § 1-201(17), § 8-107 comment 1, § 8-313(2) (1962).

<sup>7</sup> Uniform Commercial Code § 8-304(1)(b), § 8-313(2), § 8-317(2) (1962). Also see, *Ohio Securities Act*, Ohio Rev. Code § 1707.01(L) (1964).

<sup>8</sup> 84 Ohio St. 32, 95 N. E. 656 (1911).

<sup>9</sup> *Id.* at 41, citing Jones on Pledges (2d ed.), Sec. 496; also 8 Ohio Jur. 2d, *Brokers* § 32 (1954).

stock by the broker, as agent (fiduciary), for the customer.<sup>10</sup> If the stock certificate is registered in the customer's name, delivered to the customer, and the customer keeps the certificate in his safety deposit box, no problem arises. However, if the purchased stock certificate is left with the broker, it presents the problem of whether the title to the certificate is in the customer's name or in the broker's name.<sup>11</sup> Naturally, if the certificate is registered in the customer's name, the title would be in the customer. If the stock certificate purchased by a cash customer is registered in the broker's name, i.e., street name, apparently a trust relationship arises<sup>12</sup>—the legal title is in the broker and equitable interest in the customer. A simple analysis can be made to determine if the stock certificates are registered in street name or in the customer's name. If the dividends, reports, and proxies are received directly from the company of the respective stock held, that is a good indication that the stock certificate is registered in the customer's name. However, if the dividends, reports, and proxies are forwarded to the customer by the broker, the certificates are registered in the broker's name.

If a broker fails to deliver securities upon request, the broker is subject to the charge of conversion.<sup>13</sup> In the event of the broker's death<sup>14</sup> or bankruptcy,<sup>15</sup> additional problems occur. If the broker goes bankrupt, the cash customer has preferred status and is entitled to immediate possession of his securities. However, before a cash customer can reclaim his property, he must identify his stock.<sup>16</sup> If the stock certificate is registered in street name, even though at least one court has said that the customer owns the stock,<sup>17</sup> tracing the subject matter may be difficult and thus the cash customer may find himself coming in with the rest of the general creditors of the bankrupt broker.<sup>18</sup>

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<sup>10</sup> See, generally, Protection of the Accounts of Stockbrokerage Customers, 77 Harv. L. Rev. 1290 (1964); 8 Ohio Jur. 2d, Brokers § 26, § 31 (1954).

<sup>11</sup> McNeil v. The Tenth National Bank of the City of New York, 46 N. Y. 325 (1871); 8 Am. Jur., Brokers § 110 (1937); 12 Am. Jur. 2d, Brokers § 131 (1964); 12 C. J. S., Brokers § 29 (1938); Uniform Commercial Code § 8-107 Comment 1 (1962).

<sup>12</sup> Bogert, Law of Trusts, 49-86 (4th ed. 1963); 8 Ohio Jur. 2d, Brokers § 32, § 42 (1954).

<sup>13</sup> Markham v. Jaudon, 41 N. Y. 235 (1869); Richardson v. Shaw, *supra* n. 5; State v. Channer, 115 Ohio St. 350, 154 N. E. 728 (1926). See generally 12 C. J. S., Brokers § 31 (1938); Ohio Rev. Code § 2907.34 (1964). 48 Ohio Jur. 29, Secured Transactions § 92, § 100 (1966); Uniform Commercial Code § 8-107 Comment 1 (1962).

<sup>14</sup> Citizens Bank Adm'r v. Andrews, 24 Ohio N. P. (n.s.) 361 (Hamilton County C. P. 1923); also 8 Ohio Jur. 2d, Brokers § 35 (1954).

<sup>15</sup> Sargent v. Whitfield & Co., *supra* n. 5; Jackson, *op. cit. supra* n. 2.

<sup>16</sup> Bankruptcy, 11 U. S. C. A. § 96 e(1)-(2) (1943); see also Protection of the Accounts of Stockbrokerage Customers, *op. cit. supra* n. 10.

<sup>17</sup> Lamprecht v. State of Ohio, *supra* n. 8; 8 Ohio Jur. 2d § 32 (1954).

<sup>18</sup> Uniform Commercial Code § 8-313 (2) (1962); 8 Ohio Jur. 2d, Brokers § 38 (1954).

### Margin Purchases of Stock

Buying a stock on margin likewise can present problems.<sup>19</sup> As a condition precedent to buying stock on margin, usually the broker requires that the customer sign a margin agreement.<sup>20</sup> The signing of the margin agreement can have many pitfalls such as conveying authority to the broker to register the stock certificates in street name, giving authority to the broker to repledge or hypothecate stocks in excess of the debt, and giving the broker a waiver of notice to sell the customer's stock. Fortunately for the customer, the courts have held that the signed paper, resembling a contract, lacks consideration because, for the parting of one's rights, no correlative advantages are obtained. Although the Securities and Exchange Commission recognizes the above paper as a contract it holds that repledging or hypothecation in excess of the debt will not be enforced.<sup>21</sup>

In buying stock on margin, the customer pays part of the money (or deposits securities) and the broker advances the remainder—resulting in a debtor-creditor relationship.<sup>22</sup> Authorities seem to reason that because the broker advances part of the funds required to purchase the stock, the broker has a lien<sup>23</sup> for the amount owed and the stock is pledged<sup>24</sup> as secured interest for the debt. In *Provost v. U. S.*,<sup>25</sup> it was stated that in order to establish a pledge at common law, there must be a transfer of possession, the legal title must remain in the pledgor (customer), and the pledgee (broker) must have a lien on the property.<sup>26</sup> Some authorities have said that a pledge is an agency coupled with an interest.<sup>27</sup> It has also been stated that a pledge is a bailment arrangement.<sup>28</sup> Regarding possession of pledged stock, it has been said that in perfecting the pledge of stock, the stock broker receives possession of the stock. However, according to the Uniform Commercial Code, the debtor could be in possession of the security by agreement.<sup>29</sup>

<sup>19</sup> See Jackson, *op. cit. supra*, n. 2; Knowlton v. Fitch, *supra* n. 2; Richardson v. Shaw, *supra* n. 5; Sargent v. Whitfield & Co., *supra* n. 5.

<sup>20</sup> 12 C. J. S., Brokers § 29 (1938); 8 Ohio Jur. 2d, Brokers § 34 (1954); 48 Ohio Jur. 2d, Secured Transactions § 90 (1966).

<sup>21</sup> Jackson, *op. cit. supra* n. 2.

<sup>22</sup> 12 Am. Jur. 2d, Brokers § 115 (1964); State v. Channer, *supra* n. 13.

<sup>23</sup> McNeil v. The Tenth National Bank, *supra* n. 11; Smith v. Craig, 151 App. Div. 648, 136 N. Y. S. 423 (1912); Sargent v. Whitfield & Co., *supra* n. 5; 12 Am. Jur. 2d, Brokers § 131, § 241 (1964).

<sup>24</sup> Markham v. Jaudon, *supra* n. 13; Richardson v. Shaw, *supra* n. 5; Lamprecht v. State of Ohio, *supra* n. 8; 12 C. J. S., Brokers § 31 (1938); Uniform Commercial Code § 9-102 (2) (1962); 48 Ohio Jur. 2d, Secured Transactions § 84 (1966).

<sup>25</sup> *Provost v. United States*, 269 U. S. 443, 46 S. Ct. 152, 70 L. Ed. 352 (1926).

<sup>26</sup> State v. Channer, *supra* n. 13; Lamprecht v. State of Ohio, *supra*, n. 8; Sargent v. Whitfield & Co., *supra* n. 5; 12 Am. Jur. 2d, Brokers § 115 (1964).

<sup>27</sup> Hess v. Rau, 95 N. Y. 359 (1884); 13 Ohio Jur. 2d, Corporations § 767 (1955); 48 Ohio Jur. 2d, Secured Transactions § 84 (1966).

<sup>28</sup> 48 Ohio Jur. 2d, Secured Transactions § 26 (1966).

<sup>29</sup> 13 Ohio Jur. 2d, Corporations § 765 (1955); 48 Ohio Jur. 2d, Secured Transactions § 26, § 78 (1966); Uniform Commercial Code § 9-202, § 9-205 (1962).

Many sources stress the fact that title<sup>30</sup> to pledged securities vests immediately in the customer (pledgor) as owner even though the security is purchased in street name.<sup>31</sup> There is authority for the proposition that legal title<sup>32</sup> is in the broker when securities are purchased for the customer on margin.<sup>33</sup> To the student of corporation law, it is known that title to a stock certificate is transferred to a new owner by registration on the corporate book and issuance of a new certificate.<sup>34</sup> Thus it is apparent that, if the certificates are registered in the broker's name, the broker has legal title and the customer will have an equitable interest.<sup>35</sup> As previously indicated, according to the Uniform Commercial Code, a pledge security interest is perfected whether the title is in the debtor or creditor.<sup>36</sup> However, the Code does not champion either the title theory or the lien theory but maintains that possessory interest as required by common law must be enforced to perfect the pledge.<sup>37</sup>

Under the theory that a stock certificate is mere evidence of property and fungible, it has been held that it is not necessary to replace the identical share repledged but only to return a similar security when the debt is paid.<sup>38</sup>

There are two methods by which securities belonging to a customer are held by the broker—the method of individual identification and bulk segregation. In the individual identification method, the securities are individually tagged or placed in customer's envelope. In bulk segregation (this is the method used by the large brokerage concerns), the particular corporate stock is merely carried in street name. Obviously, if stock of cash customers and margin customers is registered in street name, there is a commingling of stock.<sup>39</sup> Therefore, if street stock is being used for loan purposes on pledged stock, there can be no segregation of identifiable stock.<sup>40</sup> The Securities Exchange Act of 1934 theoretically prohibits any hypothecation without consent but the Securities

<sup>30</sup> 12 C. J. S., Brokers § 29 (1938); Sargent v. Whitfield & Co., *supra* n. 5.

<sup>31</sup> 8 Ohio Jur. 2d, Brokers § 32 (1954); State v. Channer, *supra* n. 13; Putnam v. Ford, 155 Va. 625, 155 S. E. 823 (1930).

<sup>32</sup> Richardson v. Shaw, *supra* n. 5; Tree Farmers Inc. v. Goeckner, 86 Idaho 290, 385 P. 2d 649 (1963); 8 Am. Jur., Brokers § 110 (1937).

<sup>33</sup> Hall v. Paine, 224 Mass. 62, 112 N. E. 153 (1916).

<sup>34</sup> 13 Ohio Jur. 2d, Corporations § 765 (1955).

<sup>35</sup> 12 C. J. S., Brokers § 29 (1938).

<sup>36</sup> Uniform Commercial Code § 9-102 (2), § 9-202 (1962).

<sup>37</sup> Uniform Commercial Code § 9-202 Comment, § 9-205 Comment 6, § 9-507 Comment 1 (1962).

<sup>38</sup> Knowlton v. Fitch, *supra* n. 2; Richardson v. Shaw, *supra* n. 5; Lamprecht v. State of Ohio, *supra* n. 8; Provost v. United States, *supra* n. 25; 12 C. J. S. Brokers § 31; 8 Ohio Jur. 2d, Brokers § 32 (1954); Uniform Commercial Code § 8-107 Comment 1 (1962).

<sup>39</sup> Protection of the Accounts of Stockbrokerage Customers, *op. cit. supra* n. 10; 12 C. J. S., Brokers § 29 (1938); 48 Ohio Jur. 2d, Secured Transactions § 90 (1966); Uniform Commercial Code § 8-313 (1), § 8-320 (1962).

<sup>40</sup> 8 Ohio Jur. 2d, Brokers § 35 (1954); Citizens Bank Admr. v. Andrews, *supra* n. 14.

and Exchange Commission holds that usages permitting the broker to mingle the customer's securities in the broker's general loan will not be enforced.<sup>41</sup> In this connection, it should be mentioned that stock brokers trade extensively for their own accounts even to the extent of using cash funds of their customers.<sup>42</sup> Returning to the street name stock, it is further apparent that in the event of the bankruptcy of the broker, the customer owning the stock being unable to identify his particular shares would have to come in with the general creditors. Even without the possibility of bankruptcy losses, for those states adopting the Uniform Commercial Code, the law is that when the collateral is in the secured party's possession, the risk of accidental loss or damage is on the debtor (customer) to the extent of any deficiency in effective insurance coverage.<sup>43</sup>

### Hedge Transactions

To understand a hedge transaction<sup>44</sup> applicable to the commodities market, it will be helpful to give several examples. A hedge can be made on purchases of various commodities such as corn, cotton, etc. For instance (example 1) in the terminal market<sup>45</sup>—as a grain elevator buying corn from farmers—the grain elevator can hedge against a future fall on the terminal market by selling a future contract on the commodity market, i.e., stock exchange.<sup>46</sup> The transaction is closed by selling the grain on the terminal market and buying the future contract on the commodity market. In order for the hedge to insure protection, the two markets must move together. It appears that the selling and buying of corn contracts in the commodity market are merely gambling contracts and illegal.<sup>47</sup> However, for gambling to occur, there must be a mutual intent to gamble.<sup>48</sup> It should be noted that the grain elevator operator actually purchased the corn; i.e., there was actual delivery of goods, and he intended to hedge rather than to gamble. Although deliveries of commodities on the contract sold on the commodity market are not usually made (i.e., two separate markets), deliveries on the contract

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<sup>41</sup> Protection of the Accounts of Stockbrokerage Customers, *op. cit. supra* n. 10; Jackson, *op. cit. supra* n. 2.

<sup>42</sup> Protection of the Accounts of Stockbrokerage Customers, *op. cit. supra* n. 2; Uniform Commercial Code § 8-107 Comment 1 (1962).

<sup>43</sup> Uniform Commercial Code § 9-207 (b) (2); see also § 8-320 (5) (1962).

<sup>44</sup> Converse, *The Elements of Marketing*, 290-301 (5th ed. 1954); Phillips, *Marketing*, 460-468 (3rd ed. 1956).

<sup>45</sup> Converse, *op. cit. supra* n. 44, at 292; Phillips, *op. cit. supra* n. 44, at 460.

<sup>46</sup> Converse, *op. cit. supra* n. 44, at 291; Campbell v. Wright, *supra* n. 3.

<sup>47</sup> Irwin v. Williar, 110 U. S. 499 (1884); Embrey v. Jemison, 131 U. S. 336, 9 S. Ct. 776, 33 L. ed. 172 (1889); Lester v. Buel, 49 Ohio St. 240, 30 N. E. 821 (1892); John Miller Co. v. Klovstad, 14 N. D. 435, 105 N. W. 164 (1905); Lamson Bros. & Co. v. Turner, 277 F. 680 (8th Cir., 1921).

<sup>48</sup> Bigelow v. Benedict, 70 N. Y. 202, 26 Am. Rep. 573 (1877); Bibb v. Allen, *supra* n. 2; Lamson Bros. & Co. v. Turner, *supra* n. 47; 25 Ohio Jur. 2d, Gambling § 2 (1957).

have been made in a few instances.<sup>49</sup> For clarification purposes, it should be noted that in reality the terminal market is where an exchange of goods actually takes place. However, in the commodity market, usually only contracts are traded.

It will be easier to understand short selling of stock certificates if terms such as sale short and short against the box are fitted to the above example. In the above corn illustration, it was noted that the operator of the grain elevator actually purchased the corn and has it in his own storage. It is further noted that an executory (or option) future contract was sold.<sup>50</sup> By selling the contract, a sale short (hereinafter also designated as a sale short contract) was accomplished. Furthermore, since the grain elevator operator has the corn in his own possession and a sale short was made, a short against the box<sup>51</sup> was accomplished; i.e., the corn being in the operator's storage box or container.

Another example (example 2) of hedging is accomplished by a manufacturer operating a cotton mill. Suppose the terminal market price and the commodity market price for cotton are both \$.20. The manufacturer purchases a future contract for \$.20. Since the manufacturer wants to select his own grade of cotton and assuming that the cotton has risen in price to \$.22, the manufacturer purchases the grade of cotton he wants on the terminal market and sells his future contract on the commodity market. Thus the hedge has been carried out—theoretically insuring the manufacturer the cost of cotton at \$.20.<sup>52</sup>

Since speculators<sup>53</sup> are involved in the commodities market and the stock market, in order to understand the role of the speculator in short selling in the stock market, it will be helpful to associate the speculator in example 1 with the speculator in example 2. In example 1, the grain elevator operator had the corn in his box and sold a short contract. The sale short contract was purchased by a speculator. Emphasis is being made that corn was actually purchased and the grain elevator operator in business performing a service. By selling a short contract to a speculator, a hedge was perfected which served a useful purpose in theoretically insuring the cost of corn at a certain value.

In example 2, the manufacturer purchased a cotton future contract. Since in every purchase there is a sale, in this particular purchase of a cotton future contract, there was a corresponding sale of a contract by a speculator. The speculator, by selling a future contract,

<sup>49</sup> Lamson Bros. & Co. v. Turner, *supra* n. 47; Converse, *op. cit. supra* n. 44, at 286.

<sup>50</sup> Lester v. Buel, *supra* n. 47; Smith v. Craig, *supra* n. 23.

<sup>51</sup> DuPont v. Commissioner of Internal Revenue, 98 F. 2d 459 (3rd Cir., 1938); DuPont v. Commissioner of Internal Revenue, 110 F. 2d 641 (3rd Cir., 1940).

<sup>52</sup> Converse, *op. cit. supra* n. 44, at 291.

<sup>53</sup> Phillips, *op. cit. supra* n. 44, at 466-467; Converse, *op. cit. supra* n. 44, at 284-286, 298-301.

made a sale short (short sale).<sup>54</sup> In example 1, to start the hedge, corn was actually purchased and held by the grain elevator operator. In example 2, there was no actual purchase or sale of cotton and, furthermore, the speculator did not own the cotton that he sold short. However, in example 2, a reputable manufacturer intends to hedge cotton and a useful purpose is accomplished, and the courts have held that the transaction is legal.

### Short Selling

From the foregoing background, the mechanics of a short sale of stock certificates should be readily understood.<sup>55</sup> There are two ways to execute a short sale; one involves *borrowing* stock and the other involves a *sale short* as previously described in the two hedge transactions.

Since there is no upper value limit to a short sale, a margin account must be opened as previously discussed under stock purchases.<sup>56</sup> Furthermore, the broker; i.e., customer man, agent, or employee acting for the broker, will request that the familiar margin agreement be signed. It should be noted that if the customer fails to provide additional funds when demanded by a margin call (i.e., request for additional funds), the short sale can be covered (stock bought) without notice by the broker.<sup>57</sup> In covering the short sale, the broker in effect closes out the transaction, without notifying the customer, since the customer failed to comply with the margin call.<sup>58</sup> It should also be noted that a short sale of a stock is not permitted except on a rising price; i.e., "up tick."<sup>59</sup> Although thorough analysis of various transactions involving short sales would be interesting, it is beyond the scope of this paper.<sup>60</sup> However, a put, classified as a short sale for tax purposes will be briefly defined.<sup>61</sup>

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<sup>54</sup> Phillips, *op. cit. supra* n. 44, at 466; Converse, *op. cit. supra* n. 44, at 284.

<sup>55</sup> Provost v. United States, *supra* n. 25; Commissioner of Internal Revenue v. Levis' Estate, 127 F. 2d 796 (2d Cir., 1942); Commissioner of Internal Revenue v. Wilson, 163 F. 2d 680 (9th Cir., 1947); Schabacker, *op. cit. supra* n. 1, at 167; Cormier, Wall Street's Shady Side, 75 (1962); General Rules and Regulations Under the Securities Exchange Act of 1934, Rule 3b-3 (1965).

<sup>56</sup> Twentieth Century Fund, Inc., *op. cit. supra* n. 1, at 358; Barber v. Ellingwood, 144 App. Div. 512, 129 N. Y. S. 414 (1911); White v. Smith, 54 N. Y. 522 (1874); Guy v. Schneider, Bernet & Hickman, Inc., 341 S. W. 2d 461 (Tex. Civ. App., 1960).

<sup>57</sup> Knowlton v. Fitch, *supra* n. 2; Boyle v. Henning, 121 F. 376 (W. D. Ky. 1902); Barber v. Ellingwood, *supra* n. 56; Smith v. Craig, *supra* n. 50; 12 C. J. S., Brokers § 34 (1938).

<sup>58</sup> Burke v. Merrill Lynch, Pierce, Fenner & Smith, *supra* n. 4; Prentice Hall, Federal Tax Handbook, 330 (1965); Ehrenkranz, The Application of the Short Sale Rules to Security Investors, 43 Taxes 85 (1965).

<sup>59</sup> 2 Oleck, *op. cit. supra* n. 1, at 309.

<sup>60</sup> DuPont v. Commissioner of Internal Revenue, *supra* n. 51 (both cases).

<sup>61</sup> Ehrenkranz, *op. cit. supra* n. 58.

A put<sup>62</sup> is a unilateral option contract,<sup>63</sup> furnished by the seller (maker) for a fee, giving the purchaser (holder) the privilege of *delivering* a stipulated amount of stock to the seller at an agreed upon price on or before a specified time. Conversely, a call<sup>64</sup> is an option contract giving the holder the privilege of *receiving* the stock at an agreed price.

### Short Selling Borrowed Stock

The short sale involving borrowed stock was used extensively during the stock market crash of 1929. As the stock prices went down, people became panicky and sold their stock, causing the prices to drop still further. Some manipulators, individually or as part of stock market "pools," sold the market short, thus hastening the market's crash.<sup>65</sup>

A short sale is a sale of securities that the seller does not own.<sup>66</sup> The securities for delivery to the purchaser are borrowed from or by the customer's broker.<sup>67</sup> The short sale transaction is consummated by actual purchase and return of similar stock to the customer's broker or lender.<sup>68</sup> The stock delivered to the purchaser is borrowed from various sources such as margin-account customers, customer's broker, and other brokers.<sup>69</sup> In the short sale being discussed, an actual sale of stock is made to the purchaser. It is apparent that the actual sale would involve a transfer of the shares on the corporate books and thus a transfer of legal title to the purchaser. However, it is conceivable that—even though the shares of stock are sold to another broker, endorsed in blank, and with power of attorney to transfer the shares on the corporate books, and the short sale is open for a short period of time—the identical shares of stock could be returned to the customer's broker.<sup>70</sup>

In *Provost*<sup>71</sup> it was stated that the reason a lender loans his shares of stock is because he receives in money the full market value of his shares which is more than he would ordinarily receive by pledging them.

<sup>62</sup> Schabacker, *op. cit. supra* n. 1, at 505; Twentieth Century Fund, Inc., *op. cit. supra* n. 1, at 251; *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S. D. N. Y. 1955), *modified* 232 F. 2d 299 (1956).

<sup>63</sup> *Bigelow v. Benedict*, *supra* n. 48; *Lester v. Buel*, *supra* n. 47.

<sup>64</sup> Schabacker, *op. cit. supra* n. 1, at 506; Twentieth Century Fund, Inc., *op. cit. supra* n. 1, at 251.

<sup>65</sup> Whalen, *The Founding Father*, 110, 133 (1966); Cormier, *op. cit. supra* n. 55, at 3.

<sup>66</sup> 2 Oleck, *op. cit. supra* n. 1, at 243, 309; Schabacker, *op. cit. supra* n. 1, at 167.

<sup>67</sup> *Smith v. Bouvier*, 70 Pa. 325 (1870); *Hess v. Rau*, *supra* n. 27.

<sup>68</sup> *Brown v. Carpenter*, *supra* n. 4; *Provost v. United States*, *supra* n. 25; *United States v. Uhlmann Grain Co.*, 84 F. 2d 901 (7th Cir., 1936); *Ehrenkranz*, *op. cit. supra* n. 60.

<sup>69</sup> *Knowlton v. Fitch*, *supra* n. 2; *White v. Smith*, *supra* n. 56; *Hess v. Rau*, *supra* n. 27; *Provost v. United States*, *supra* n. 25; *Guy v. Schneider, Bernet & Hickman, Inc.*, *supra* n. 56.

<sup>70</sup> *McNeil v. The Tenth National Bank*, *supra* n. 11; *Provost v. United States*, *supra* n. 25; Schabacker, *op. cit. supra* n. 1, at 173; 13 Ohio Jur., *Corporations* § 768 (1955). *Uniform Commercial Code* § 8-107 (1) (1962).

<sup>71</sup> *Supra* n. 25.

It is of value to analyze the interest matter from the point of view of borrowing the stock from the broker and from the margin-account customer. As the customer borrows stock from the lending broker through his broker, the customer deposits either money or stock as collateral. The customer's broker advances the funds according to the margin agreement. The full market value of the stock is deposited with the lending broker (customer's broker or other broker).<sup>72</sup> The customer pays interest on the funds advanced by his broker. In *Provost*<sup>73</sup> it was also stated that the lender usually pays interest on the deposit. The interest may be reimbursed to good customers.<sup>74</sup> According to the general borrowing theory of short sale, the stock is actually sold.<sup>75</sup> Thus the customer's broker receives the funds on the stock sold and interest on the funds used. The effect is that the customer's broker receives interest from the short sale customer, interest from the lending broker, and interest on the funds from the borrowed stock sold. With regard to the stock borrowed from the margin-account customer and actually sold, the broker will receive interest from the short sale customer, interest on the funds received from the borrowed stock sold and interest from the margin-account customer<sup>76</sup> from whom the stock was borrowed and whose stock was actually sold.

### Short Selling Involving a Sale Short

Since a sale short of stock is part of the subject matter of short sale, and the sale short has been explained in detail during the discussion of hedging, it will only be necessary to cover the highlights of sale short.<sup>77</sup> For a sale of stock against the box, as in example 1, the customer owns the stock and sells a short contract (executory contract) purchased by a speculator.<sup>78</sup> To close the short against the box, the stock held by the customer in his safety deposit box is delivered on the contract.<sup>79</sup> Actually, by shorting against the box, a liquidation of a long position is

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<sup>72</sup> *White v. Smith*, *supra* n. 56; *Commissioner of Internal Revenue v. Wilson*, *supra* n. 55.

<sup>73</sup> *Supra* n. 25.

<sup>74</sup> *Schabacker*, *op. cit. supra* n. 1, at 275; *Commissioner of Internal Revenue v. Wilson*, *supra* n. 55; 48 Ohio Jur. 2d, Secured Transactions § 82 (1966).

<sup>75</sup> *Hurd v. Taylor*, 181 N. Y. 231, 73 N. E. 977 (1905); *Chandler v. Prince*, 221 Mass. 495, 109 N. E. 374 (1915); 12 C. J. S., Brokers § 34 (1938).

<sup>76</sup> 13 Ohio Jur. 2d, Corporations § 765 (1955).

<sup>77</sup> 12 C. J. S., Brokers § 34 (1938); 12 Am. Jur. 2d, Brokers § 116 (1964); *Leffler*, *The Stock Market* 221 (3rd ed. 1963).

<sup>78</sup> *Supra* n. 51 (both cases). Selling stock against the box by option contract can also involve the sale of borrowed stock. *Twentieth Century Fund, Inc.*, *op. cit. supra* n. 1, at 362; *Ehrenkranz*, *op. cit. supra*, n. 58.

<sup>79</sup> *Provost v. United States*, *supra* n. 25; *Huntington Nat. Bank v. Commissioner of Internal Revenue*, 90 F. 2d 876 (6th Cir., 1937).

accomplished.<sup>80</sup> However, since tax laws are unique, the customer is able to defer income gains or losses to following years.<sup>81</sup>

The transaction has been defined as a situation where the seller may own the stock but prefers to sell it short.<sup>82</sup> Other authorities say that a sale short means a sale of that which the seller does not at the time possess.<sup>83</sup> It was seen in example 1 that a sale short involved actual possession of corn. Furthermore, it was also seen that a sale against the box, involving actual possession of stock, was accomplished by a sale short contract. Thus it is apparent that authorities stressing that a sale short can only be accomplished by a sale of that which the seller does not at the time possess are in error.

There is case law that states that a sale short means a sale of that which the seller does not at the time possess.<sup>84</sup> In *Knowlton v. Fitch*,<sup>85</sup> plaintiff Knowlton (customer #3) ordered Fitch (broker) to make a short sale. Brownell (customer #2) had previously made a short sale by borrowing stock from the broker belonging to one of the broker's customers (customer #1). By the short sale of Knowlton there appears to be an alchemical delivery of shares to purchaser Brownell which was set off against the shares Brownell had borrowed. The court made the following comments:

The effect of this transaction (i.e. short sale of plaintiff) was precisely the same as if Brownell had returned the borrowed shares, and they had been immediately redelivered to him in performance of the contract of sale made for the account of the plaintiff.

... The result of the transaction was to leave the defendants liable to their customer (customer #1), as before, to deliver to him an equal number of shares when demanded; the plaintiff being substituted in place of Brownell as the borrower of the shares, and the defendants standing responsible to their customer for the plaintiff instead of for Brownell.<sup>86</sup>

In looking at the case from the standpoint of the broker and customer #1 (customer whose stock was borrowed), it is presumably admitted that the broker made a sale short, or sale short contract, by selling customer #1's stock. When the broker sold customer #1's stock, all that customer #1 had to show for his stock was a purchase contract. Accordingly, it is conceivable that a new customer could sell a stock short

<sup>80</sup> Twentieth Century Fund, Inc., *op. cit. supra* n. 1, at 362; Commissioner of Internal Revenue v. Ferree, 84 F. 2d 124 (3rd Cir., 1936).

<sup>81</sup> Huntington Nat. Bank v. Commissioner of Internal Revenue, *supra* n. 79; Ehrenkranz, *op. cit. supra* n. 58.

<sup>82</sup> Leffler, *op. cit. supra* n. 77, at 221.

<sup>83</sup> 12 C. J. S., Brokers § 34 (1938); 12 Am. Jur. 2d, Brokers § 116 (1964).

<sup>84</sup> Boyle v. Henning, *supra* n. 57; Lamprecht v. State of Ohio, *supra* n. 8.

<sup>85</sup> *Supra* n. 2.

<sup>86</sup> *Id.* at 294.

merely by contract<sup>87</sup> and the broker (or customer) could purchase the contract (as in example 2). This Broker-Customer transaction, apparently, would be illegal since no stock was borrowed and no actual sale or purchase of stock was made nor contemplated.<sup>88</sup>

### Conclusion

As seen from the above case analysis and discussion, it is apparent that there are abuses involving customers' security transactions, and a need for law and order.<sup>89</sup> However, neither the SEC nor NASD has attempted to regulate the handling of customers' securities in the possession of the brokers.<sup>90</sup> Consequently, there is a need for the SEC and NASD to regulate the handling of customers' securities in possession of the broker, and movement in this direction should be encouraged. Not only is there a need for SEC and NASD regulation of customers' securities in the hands of brokers, but there also is a need for attorneys to handle investment customers' lawsuits. Thus, not only are the SEC and NASD encouraged to enter the area of regulation of customers' securities in the hands of brokers, but attorneys are also needed and are encouraged to enter the field of customers' securities protection.

<sup>87</sup> *Boyle v. Henning*, *supra* n. 57; *Commissioner of Internal Revenue v. Ferree*, *supra* n. 80; *Huntington Nat. Bank v. Commissioner of Internal Revenue*, *supra* n. 79.

<sup>88</sup> *Lester v. Buel*, *supra* n. 47; *Boyle v. Henning*, *supra* n. 57; *Hurd v. Taylor*, *supra* n. 75; 12 C. J. S., *Brokers* § 34 (1938); 12 Am. Jur. 2d, *Brokers* § 116 (1964); *Loss*, *Securities Regulations* 26 (1951).

<sup>89</sup> *Burke v. Merrill Lynch, Pierce, Fenner & Smith*, *supra* n. 4; *Chandler v. Prince*, *supra* n. 75; *Insuranshares Corp. of Delaware v. Northern Fiscal Corp., Ltd.*, 35 F. Supp. 22 (E. D. Pa. 1940); *Jackson*, *op. cit. supra* n. 2.

<sup>90</sup> *Protection of the Accounts of Stockbrokerage Customers*, *op. cit. supra* n. 10.