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# Short Selling: Fiduciary Prudence for the '90s

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by Jonathan A. Small*

The "prudent man rule" (the "Rule"), as articulated in one form or another by cases and statutes, provides the basic standard of care to be met by fiduciaries in making investment decisions. Although it was originally promulgated with respect to trustees of private trusts, some form of the Rule now governs the investment practices of fiduciaries of nonprofit institutions as well.

Much has been written in recent years criticizing the evolution of Rule.[1] The goal of this effort has been to restore the suppleness of the Rule as originally enunciated. The effort has met with considerable success in stripping away many of the per se applications of the Rule (e.g., the statutory lists of "Legal Investments"). But a trustee or director of a nonprofit organization who desires to take a modern and innovative approach to portfolio management, such as by making short sale investments, will find the case law to be at least somewhat

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1. See, e.g., Longstreth, Modern Investment Management and the Prudent Man Rule, 1986; Langbein and Posner, "Market Funds and Trust Investment Law," 1976 A.B.F. Res. J.1.

daunting, and perhaps very daunting, depending on which version of the Rule applies to his organization.

The purpose of this paper is to review the status of the Rule today, and then to focus on its application to a single investment strategy -- short selling. In terms of the lawyer-client relationship: what should a lawyer say to a fiduciary who asks whether it is permissible to engage in a short selling program (that is not part of a hedging strategy) as part of the overall management of an investment portfolio? This focus on a particular, inherently suspect investment strategy is intended to provide further support to the emerging "modern" view of prudence.

To respond to the fiduciary's question, it is necessary to put the Rule in its historical context by reviewing its origins, its unfortunate evolution and the status of the efforts to rehabilitate it so that it can provide meaningful guidance to current and future fiduciaries.

## I. The Historical Standard of the Prudent Investor.

Most of today's law on "prudence" derives ultimately from the articulation of the Rule in Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830). As spelled out by Justice Putnam, the Rule had a basic simplicity

that is particularly dazzling to students of the convoluted provisions of today's Internal Revenue Code. It did not have exceptions, or exceptions to its exceptions, or defined terms. It did not call upon "the Secretary" to issue regulations preventing abuses in its application. Its intent could be readily grasped by a lay reader proceeding at a normal reading speed:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested. 26 Mass. (9 Pick.) at 461.

Putting aside its gender bias, which is not the topic of this paper, the Rule was a splendid piece of verbal craftsmanship, providing a guide to conduct that fiduciaries could readily understand. As formulated, it lacked rigidity and tacitly embraced the idea that standards of prudence could evolve over time, as the thoughts of prudent men about investment decision-making evolved. Justice Putnam had before him a case dealing with a private trust, but his opinion did not explicitly distinguish between fiduciaries of charitable and non-charitable funds. The Rule was subsequently taken to apply to fiduciaries generally.

The Rule held on in Massachusetts, more or less in its original form, but most other states rejected its example during the subsequent decades, or paid it only lip service, attempting instead to give a more precise shape to the idea of prudence. In the endless quest for certainty, specificity and clarity, judges, legal scholars and legislatures sought to define prudent behavior in terms of identifying prudent investments.

What happened was a series of judicial decisions and legislative actions that purported to define prudence for eternity.[2] They encrusted the Rule with clarifying pronouncements, made in timeless terms without recognition of the crucial assumptions underlying them or of the fact that a changed economic environment could make these assumptions seem as foolish as they had, at first, seemed wise. The focus of these pronouncements was on preservation of capital and, secondarily, on a "reasonable" current return. In particular, persistent low inflation

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2. The most prominent of the court cases was probably King v. Talbot, 40 N.Y. 76 (1869), in which (long) common stock investments were essentially held to be imprudent per se. Most states eventually enacted legal lists of investments, primarily in fixed income securities. See G.G. Bogert & G.T. Bogert, Trusts and Trustees (2d ed. rev. 1980) § 613, at 55; Shattuck, "The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century," 12 Ohio St. L.J. 491, 499 (1951).

(even deflation) and unsophisticated notions of "principal" and "income" permitted the view that secure long-term bonds were perfectly adequate to preserve "principal" and provide a "reasonable" current "income."

In short, fiduciaries were told what to do -- not only in general terms reflecting the "preservation of capital" focus, but also, in some instances, with great particularity. The "legal lists" of investments enacted by state legislatures provided a trustee with the security of "prudence per se". An investment was prudent because it was "on the list". Fiduciaries could sleep well, secure in the knowledge that they were discharging their legal duties properly. As long as they did so, the economic consequences of their actions to the beneficiaries of the funds they administered were, as a practical matter, not their responsibility.

This evolution of the Rule made life easier for fiduciaries, but it also robbed the Rule of its flexibility, making it unable to respond to changes in thinking about portfolio management. As economic conditions and investment practices changed significantly in the second half of the twentieth century, the common law of fiduciary prudence changed little, leaving trustees little opportunity to make use of the new ideas. In time, prudent men

were inclined to act, "in the conduct of their own affairs," in a manner quite different from the manner in which the law suggested they might prudently conduct themselves. Anyone seeking to give legal advice today as to the prudence of a new investment strategy is struck by the chasm between the law on prudence, represented primarily by cases (mostly quite old cases), and the views of the investment community. Particularly striking is the extent to which top legal minds, such as Professor Scott in his treatise on trusts,[3] seem to have viewed then-current notions of prudence as immutable rules, rather than simply as the reflection of then-current economic conditions and investment practices.

## II. Accommodations in Prudence Law: Some Progress.

A. Improvements in State Trust Law and Legal Practice. A number of statutory and other advances have brought the law of fiduciary investing "into the twentieth century," but, at least in the case of state trust law,

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3. A.W. Scott and W.F. Fratcher, The Law of Trusts (4th ed. 1987) (hereinafter Scott on Trusts). While the fourth edition of Scott on Trusts retains the analysis of prudence set forth in earlier editions, recent supplements to the fourth edition do acknowledge in footnotes some of the contemporary scholarship that suggests different conclusions. See, e.g., Scott on Trusts (1990 Supplement) § 227.6.

have not brought it back to the original flexibility of Harvard College or up-to-date with modern investment theory.

First, state trust law has been modernized to the extent that legal lists have nearly universally given way to some more flexible standard.[4] This advance, however, has probably had less of an effect than one might expect. While the current prudence statutes specifically bless such once-banned gambles as common stocks, trustees and judges still must deal with conservative old cases when interpreting the more liberal statute. Courts are still inclined to consider the prudence of a given investment in isolation instead of examining whether it was prudently selected for its role in a portfolio. The easiest way for a trustee to argue that an investment was

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4. See, e.g., N.Y. EPTL § 11-2.2(a)(1), which restricts a trustee to "such securities as would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and preservation of their capital." Until 1972, language of this nature was part of the statute but was rendered largely superfluous by a legal list that directed trustees toward conservative investments in debt securities. The list was expanded and made more liberal through amendments beginning in 1950, but it was not fully supplanted by a pure prudent man rule until 1972. For discussion of the move from legal lists to a prudent man rule in other states, see Shattuck supra note 1, 499-504; Note, "Prudence in Trust Investment," 8 Michigan J.L. Ref. 491, 506-8 (1975).

prudent is to show that other trustees also thought it was prudent. Thus, despite the greater options that a straightforward prudent man statute should afford a trustee, the fact remains that a trustee generally is blameless for investing conservatively, while innovation may, in hindsight, be characterized as recklessness. The bias is toward buying what other trustees are known to be buying.[5]

As written, for example, the standard in the New York Estates, Powers and Trusts Law (see note 4) could (and should) be read as embracing the broad-gauge thinking inherent in the Rule as it was first articulated, before case law and statutes had established per se standards for judging prudence or the absence thereof. But the historic evolution of the Rule in cases and statutes leaves doubts as to the potential breadth of the New York formulation. Note the reference to "a reasonable income and preservation of their capital." May one read into the "preservation of capital" language the words "on an inflation-adjusted basis"? One would hope so, but case law offers

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5. As Longstreth points out, if a trustee must depend on such "seasoning" of new investment strategies before he can confidently try them, his performance will almost always be lower than what he could have achieved by using the new technique early, before other investors competed away the margins. See Longstreth, pp. 29, 98-100.

little help in this regard. Must the focus on "income" be investment by investment or in terms of the portfolio as a whole? Case law, unfortunately, tends to support an investment-by-investment approach.[6]

A second development has helped testators and trustees who are not inclined to accept the conservative bias of the law. Lawyers, trustees, and others have apparently made accommodations in drafting and practice. The dearth of recent cases on prudence suggests that a more modern view of prudence is being applied in practice. For example, most settlors are probably granting their trustees broader investment powers than the law might otherwise permit.[7] Such provisions, while narrowly construed, are routinely enforced.[8] In the charitable area,

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6. In re Bank of New York (Spitzer), 364 N.Y.S.2d 164 (1974), comes close to conceding that individual trust investments may be judged, at least in part, "by considerations of the performance of the fund as an entity." Id. at 168. But the court's remarks are ambiguous, and it seems clear that the court is not setting out purposely to overturn prior case law.

7. See Longstreth, supra note 1, at 17.

8. See, e.g., Jackson v. Conland, 420 A.2d 898, 900 (Conn. 1979); Perling v. Citizens and Southern Nat'l Bank, 300 S.E.2d 649 (Ga. 1983); Estate of McCredy, 470 A.2d 585 (Pa. Super. Ct. 1983); Estate of Niessen, 413 A.2d 1050 (Pa. 1980); Hoffman v. First Virginia Bank of Tidewater, 263 S.E.2d 402 (Va. 1980). See also N.Y. EPTL § 11-2.2(a)(1); 3 Scott on Trusts § 228.

moreover, it seems likely that state Attorneys General may be reluctant to challenge investment practices that, while nontraditional and perhaps occasionally unsuccessful, have become commonplace. The result is probably that many fiduciaries are applying modernized standards of prudence, despite inevitable concerns that the extant authorities are not supportive of their actions.

B. Statutory Advances Outside the Area of Private Trusts. Another force pushing for a modified law of prudence has occurred outside of state trust law. This has been the response to modern investment theory on the part of legal scholars, practicing lawyers, and bar organizations, and the statutes affecting investment management in other contexts that have resulted from or been influenced by their efforts. A concerted effort has been taking place in the legal community to bring the black letter law on prudence into the late twentieth century.[9] Bevis Longstreth's book, Modern Investment Management and the Prudent Man Rule, is a leading example of the work being done. Written with the assistance of economists from the Leonard N. Stern School of Business at New York

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9. See, e.g., Langbein and Posner, supra note 1; H. Bines, Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine, 76 Columbia L.R. 721 (1976).

University, and funded by five large foundations, as well as Columbia, Harvard, Princeton and Stanford Universities, it has the stated purpose of "offering a modern paradigm of prudence[, in which p]rudence is demonstrated by the process through which risk is managed rather than by the definition of specific risks that are imprudent."[10]

The view of prudence conveyed in this scholarship is one of great flexibility, with the key focus being on process. A fiduciary is given great latitude but he is burdened with responsibility for proceeding in a manner that will withstand close scrutiny of his decision-making process. No longer is any course of action "prudent per se." Investing over a long period in a portfolio of 30-year U.S. Government bonds for an institution that needs not only current income, but also protection of the long-term value of its assets against inflation, is no longer an obviously prudent move. In fact, it runs a high risk of being judged imprudent under the modern view of the Rule. In short, the modern commentators' version of the Rule makes the job of being a fiduciary much harder than it was in the past. It holds the fiduciary responsible for having a coherent, articulable view of his investment philosophy as applied to changing economic conditions. If

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10. Longstreth, _supra_ note 1, at 7.

a fiduciary has such a view and has carefully sought to implement it in structuring a portfolio, he is given wide latitude for unsuccessful results. But if he has simply "bought growth stocks" or "bonds" because he thought that that is what fiduciaries "do," the new version of the Rule would hold him accountable.[11]

In addition, or perhaps in response, to these scholarly efforts, there have emerged statutes and regulations, as well as legislative proposals, incorporating the "modern paradigm of prudence": from the National Conference of Commissioners on Uniform State Laws -- UMIFA; from Congress -- ERISA; from the Treasury Department -- the Internal Revenue Code § 4944 regulations; and from the American Law Institute -- the Restatement of the Law of Trusts (Prudent Investor Rule).

1. Uniform Management of Investment Funds Act (UMIFA). Two of the enacted statutory standards, those of UMIFA and ERISA, do not affect the state common law of trusts directly. But UMIFA, first promulgated in 1972 by the National Conference of Commissioners on Uniform State

11. Assuming that the modernized version of the Rule gains increasing acceptance, it will be interesting to study the extent to which that process is accompanied by an increased use of professional fiduciaries. The new freedom carries with it responsibilities that may prove too daunting for trusted advisors whose field of expertise is not managing investments.

Laws, shows how the influence of scholars, the bar, and quasi-legal organizations can be translated into statutes that make a difference. In the 1960s and before, fiduciaries of institutional funds were unsure whether their investment performance was subject to state trust law or state law governing corporate directors. In some cases the answer seemed to turn, rather arbitrarily, on whether the charitable institution was styled a "charitable trust" or a "charitable corporation." Two very influential authorities -- Judge Gerhard Gesell in the Sibley Hospital case[12] and William L. Cary and Craig B. Bright's study for the Ford Foundation, The Law and Lore of Endowment Funds (1969) -- came down on the side of standards governing corporate directors. But the issue has been in doubt in many states until their enactment of UMIFA, and may remain in doubt in the fifteen states that have not adopted UMIFA. UMIFA's prudence standard calls upon those fiduciaries subject to it to exercise "ordinary business care and prudence" in making investment decisions. This standard of care is applicable, in states that have enacted UMIFA, to investments made by fiduciaries of charitable "institutions," which means "incorporated or unincorpo-

12. Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C. 1974).

rated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes. . . ."[13] The investment must be made from such institution's "institutional fund," which means a fund "held by an institution for its exclusive use, benefit, or purposes, but does not include (i) a fund held for an institution by a trustee that is not an institution or (ii) a fund in which a beneficiary that is not an institution has an interest. . . ."[14] The official comment to these definitions offers "a bank or trust company" as examples of "a trustee that is not an institution."[15] Thus, while the distinction that UMIFA draws between trust funds and institutional funds may not be clear at the margins, UMIFA clearly does not apply to charitable lead trusts, charitable remainder trusts, and trusts that benefit institutions but are not administered by them.

The official comment to UMIFA states that "[the ordinary care and prudence] standard is generally comparable to that of a director of a private business cor-

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13. UMIFA, § 1(1), in 7A Uniform Laws Annotated, 712.

14. UMIFA, § 1(2).

15. Official Comment to Section 1 (Definitions), 7A Uniform Laws Annotated, 713.

poration rather than that of a private trustee. . . ."[16] In that context, it affords wide latitude in decision-making by offering the protection of the "business judgment rule." That rule, in essence, tells courts not to second-guess the business judgment of a corporate board, where that judgment has been made with reasonable care and in a good faith belief that it will further the best interests of the corporation.[17]

Applied in the context of managing fiduciary funds, the standard of "ordinary business care and prudence" should offer fiduciaries similar latitude in making investment decisions. To date, there appear to be no state court decisions applying UMIFA to investment activities that have not been traditional for fiduciaries. One hopes that means that UMIFA is working, as intended, to give fiduciaries broad discretion.

It may be, however, that UMIFA's "ordinary business care and prudence" standard will evolve along different lines than the one embodied in the business judgment rule. In the business context, the standard is intended to encourage entrepreneurial risk-taking. Direc-

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16. Official Comment to Section 6 (Standard of Conduct), 7A Uniform Laws Annotated, 721.

17. See, e.g., Henn and Alexander, Laws of Corporations (3d ed. 1983).

tors of business corporations are supposed to be dynamic, resourceful and innovative in managing a corporation's affairs. An investor holding a diversified portfolio will want the corporations in which he owns shares to take risks. If a shareholder believes a board is taking undue risks, he is free to sell his shares. But a beneficiary of fiduciary funds who believes that the fiduciary is taking undue risks usually has little recourse. Absent extreme circumstances, the beneficiary is unable to effect a change in fiduciaries. Accordingly, it is not clear that the "ordinary business care and prudence" standard of UMIFA will be found to offer the same latitude that it does in the context of directing regular business corporations. If it does not, the question is whether, and to what extent, authorities will arise that draw on the dated trust case law to circumscribe the discretion offered to fiduciaries under the plain language of the UMIFA text.

2. ERISA. The Employee Retirement Income and Security Act, enacted in 1974, requires fiduciaries of plans governed by it to invest "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA

§ 404(a)(1)(B). In particular, the fiduciary has the duty to diversify the plan's assets "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." § 404(a)(1)(C). Regulations add that the fiduciary must give "appropriate consideration" to relevant "facts and circumstances . . . including the role the investment or the investment course of action plays in . . . the plan's investment portfolio. . . . " ERISA Regs. § 2550.404a-1(b)(1). The regulations also require attention to "risk of loss and the opportunity for gain," diversification, and the liquidity and maturity schedule of investments as they relate to the cash flow and funding needs of the plan. Id., § 2550.404a-1(b)(2).

The legislative history of ERISA's prudent man standard contains little that aids in its construction. The conference committee explanation offers little more than what the statute and regulations say. In particular, though the conference report speaks of "trust principles" "codified" or "established" by the Act, it does not make clear the extent to which traditional trust law on fiduciary investing should be considered to be displaced by ERISA or, on the other hand, should be used to articulate and interpret it. The Labor Department, in the release

accompanying the adoption of the Section 404(a) regulations, was more helpful. While declining to endorse any particular economic theory of portfolio investment, the Labor Department stressed that no "investment or investment course of action" should be considered per se prudent or imprudent, and that "the prudence of an investment decision should not be judged without regard to the role" of the investment in the overall portfolio.[18]

In short, the ERISA rules are intended to contain a substantial amount of flexibility.[19] They also explicitly acknowledge that investments should be judged according to their role in an overall portfolio, particularly with an eye to diversification. Given the generality of the overall standard, however, and ERISA's requirement that all plan assets must "be held in trust" (§ 403(a)), it would be appropriate for Federal courts to bring principles from the common law of trusts to bear in articulating the ERISA standard, gradually establishing a "Federal common law" of prudence in pension investment. Thus, although the ERISA standard seems to be informed by

18. 44 Fed. Reg. 37,221, 37,222 (June 26, 1979).

19. ERISA does contain some prohibitions on certain kinds of transactions, called "Prohibited Transactions," but these are exclusively concerned with avoidance of self-dealing and breach of the duty of loyalty by the trustee and others.

contemporary thinking about investments, in a given case it will inherently be subject to being interpreted in the light of more old-fashioned state trust law principles. What kind of Federal common law ultimately develops will depend on the willingness of Federal judges to embrace the freedom that the ERISA prudence standard offers.

3. Section 4944. Section 4944 of the Internal Revenue Code overlaps to some degree with UMIFA and private trust law, as it applies to all "private foundations," as that term is defined in Section 509(a) of the Code. Section 4944 was enacted in 1969, and the relevant regulations under it were adopted in late 1972; they are roughly contemporaneous, in other words, with UMIFA and ERISA, and show the clearest signs of having been influenced by the legal scholarship of the time. Section 4944 imposes penalty taxes on private foundations and their "foundation managers" (directors or trustees, officers and others responsible for the prohibited act) for "invest[ing] any amount in such a manner as to jeopardize the carrying out of any of [the organizations's] exempt purposes." Section 4944(a). The guidance intended by this interdiction is not readily apparent from its words, but Treasury Regulation § 53.4944-1(a)(2) offers significant elaboration:

"(2) Jeopardizing investments. - (i) . . . [A]n investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts" and "calls," and "straddles," the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though as a result of such investment, the foundation subsequently realizes a loss. . . ." Treas. Regs. § 53.4944-1(a)(2) [underlining added].

This text represents a dramatic effort to modernize standards of prudence as they are to be applied under the Code to private foundations. Viewed in isolation, the Regulation seems to be a thoughtful statement of considerations fiduciaries should keep in mind -- nothing more. Viewed, however, in light of the constraints found by case law to have been imposed by the Rule, the Regulation offers a number of key liberalizations, as follows:

(a) the standard imposed is that of "ordinary business care and prudence," discussed above.

(b) the fiduciary's objective is to provide for the organization's "long- and short-term financial needs . . . to carry out its exempt purposes."

(c) the "return" on an investment is specifically recognized to include appreciation as well as income.

(d) "risk of rising and falling price levels" is to be taken into account -- a novel idea for generations of fiduciaries who viewed their job as consisting of buying bonds, collecting the interest and holding to maturity.

(e) "diversification within the investment portfolio" is to be taken into account in various ways -- as to type of "security" and "industry," as

to the "maturity of the company" and, in general, as to potential "risk and return."

(f) an investment is to be judged in the context of the organization's "portfolio as a whole."

(g) "[N]o category of investments" represents a per se violation of the statute -- though certain types of investments will be "closely scrutinized," including "selling short."

In other words, the Regulation goes a long way towards granting fiduciaries the freedom -- and giving them the responsibility -- inherent in the interpretations of the Rule espoused by academic commentators. It is interesting to note that the list of investments to be "closely scrutinized" seems somewhat quaint only 18 years after the Regulation was adopted, thereby offering an unintended rebuke to the concept of "legal lists" in changing economic environments.

By listing "selling short" as a "type or method of 'investment,'" the Regulation implicitly dismisses the view that selling short is simply gambling and therefore beyond the scope of permissible fiduciary activity. There have, however, been no cases elaborating on the standard of prudence set forth in the Regulation. Given the text of the rest of the Regulation, one would hope that the

required scrutiny would involve checking to determine that the fiduciary had, in fact, carefully considered the factors that are to be taken into account under the Regulation.

In any event, developments since the Regulation was drafted demonstrate the perils of creating a "special scrutiny" class of investments. For example, the purchase of a put on the S&P 500 when one's own portfolio generally reflects the S&P 500 is ordinarily a conservative move that effectively takes one out of the market, to the extent the put tends to offset the long holdings. By today's standards, such a purchase would not deserve "special scrutiny," but would be recognized as a technique for seeking to lower the transaction costs of getting out of the market during the life of the put. Accordingly, one would assume that the "special scrutiny" would be reserved for the situations in which hedging is not a principal aspect of the investment. Thus, in the case of a put, the "special scrutiny" standard would presumably apply in a situation in which a put was purchased on a security as a way of investing for depreciation in that security. Similarly, one would assume that, in the case of selling short, "special scrutiny" would be applied, in particular, to a short sale that was not part of a larger

hedged investment strategy, _i.e._, to a situation in which the anticipated performance of other securities was not a key focus of the decision-making process as to the security sold short.

One might also ask whether the "special scrutiny" standard might instead permit a judge to find in it a hidden version of a "jeopardizing per se" rule. In particular, as to puts and short selling, is it possible that the Regulation might be viewed as permitting a finding that only hedging transactions involving puts or short sales could survive "special scrutiny"? While judges have broad discretion, it seems that such a reading of the Regulation should be too much of a reach. To read the Regulation in this manner would directly contradict the text providing that "[n]o category of investments shall be treated as a per se violation." Moreover, as the Regulation is completely silent on hedging, it seems entirely inappropriate to read into it a conclusion that unhedged puts or short sales are impermissible per se.

Accordingly, it seems that the Section 4944 Regulation functions effectively to impose a modern, flexible standard of prudence. Under it, fiduciaries have great responsibility but they also have great freedom.

One final point to note regarding Section 4944 is that it imposes an excise tax on the "making" of a jeopardizing investment. It is clear under the Regulations that an investment is tested when made, and not by reference to later developments. Section 4944 is therefore not focused on the monitoring function imposed on fiduciaries by the Rule. By contrast, under the Rule as it has evolved in the trust context, and as embodied in UMIFA and ERISA, it is clear that a fiduciary is as responsible for imprudently holding an investment as he is for making it.

C. The New Restatement. The most recent manifestation of contemporary ideas about prudent investing is the Proposed Final Draft of the Restatement of the Law of Trusts (Prudent Investor Rule) (April 6, 1990). The Restatement is the least "official" of the legal developments canvassed in this section, in the sense that it is not a statute or regulation. But it is addressed to and will likely be influential in the state common law of trusts, which is the body of law that lags the furthest behind contemporary investment practice. The new Restatement is perhaps more likely to be cited in briefs and state court opinions than ERISA, UMIFA, or Section 4944, because it addresses itself to the particular concerns of

the state trust law of prudence, in which there is a dearth of contemporary case law. To the extent its views are incorporated into state law governing trusts, the Restatement would supply the prudence standard for trustees not subject to the standards imposed by UMIFA or ERISA.

The Restatement takes a position much like that of the Section 4944 regulations, the ERISA regulations and UMIFA (except that, unlike the Section 4944 regulations, it would subject no category of investment to "special scrutiny"). In particular, it would require that a trustee "manage the funds of the trust as a prudent investor would, in light of the purposes . . . and other circumstances of the trust." The standard is one of "reasonable care, skill and caution" and requires that investments be judged according to their role in an "overall investment strategy" for the "trust portfolio" as a whole.[20]

The drafters of this new version of the Rule note that it is "intended to reflect the lessons derived from modern experience and research, without either endorsing or excluding any particular theories of economics or investment. . . . [T]he objectives of the 'prudent

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20. Restatement (Third) of Trusts (Prudent Investor Rule), Proposed Final Draft, 7 (§ 227).

investor rule' of this Restatement Third range from that of liberating expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to the particular trust, to that of providing other trustees with reasonably clear guidance to safe harbors that are practical, adaptable, readily identifiable and expectedly rewarding."[21] If the Restatement Third is as influential as its predecessors, the drafters should see significant success in meeting these goals.

## III. Short Selling under Current and Evolving Ideas of Prudence.

A. What is Short Selling? Short selling ordinarily involves borrowing a security and selling it. The borrower obligates himself to return the security in the future, usually upon five days' notice from the lender. The proceeds from selling the borrowed security are ordinarily retained in an account, called the "short sale account," with the lending broker, acting for itself as owner of the loaned securities or as agent for another owner. The funds in the account are ordinarily invested in money market instruments and the income generated is either kept by the lender or shared by the borrower and

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21. Id., 3.

the lender pursuant to a negotiated split. The borrower also deposits cash in a "margin account" with the broker in an amount normally equal to 50% of the value of the borrowed securities. These funds are also invested in money market investments with the income therefrom being kept entirely by the borrower. The margin account is adjusted on an ongoing basis so that it, plus the short sale account, continue to equal 150% of the then value of the borrowed securities. If dividends or interest are paid on the borrowed securities, the borrower pays the amount of the dividends or interest to the lender; these payments are intended to put the lender in the position it would be in if it had not loaned the securities, but they do not technically constitute dividends or interest because neither the borrower nor the lender owns the securities in respect of which the payments are made.

The borrower's objective is to repurchase the securities at a price below the price he sold them for. He ordinarily pays for the securities out of the short sale and margin accounts and returns the securities to the lender. If the price of the securities has fallen (by more than his payments in respect of dividends and interest), he has a gain; if the price of the securities has risen, he has a loss, which would be reduced or negated by

his share of the income from the short sale account. (The income from the 50% margin account is, analytically, separate from the short sale transaction since the funds in that account are held by the fiduciary irrespective of any short sales.)

B. Risk, Return and Prudence. Short selling, unlike index arbitrage, has been around since there have been stock markets; it can hardly be said that fiduciary law needs to "catch up" to short selling in the sense of its being an investment innovation. But modern investment theory and practice see short selling differently from the way it was viewed even thirty years ago, and it is this new perspective that the common law of prudence has trailed.

It is worth considering the terminology that has surrounded a short sale transaction that is not part of a larger hedging strategy. Phrases such as "mere speculation" and "a naked bet" come readily to mind.[22] Such descriptions carry a moralistic air without attempting to

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22. One court called short sales, and all other "margin transactions," "rank gambles." Merrill Lynch, Pierce, Fenner & Smith v. Bocock, 247 F. Supp. 373 (S.D. Texas 1965).

articulate how short selling or other forms of "speculation" may differ from "investment."[23]

These characterizations of unhedged short selling do reflect, however, legitimate concerns about its riskiness. The most frequently cited concern about short sales is that there is "unlimited potential for loss." That is true. There is no limit to the price to which the security sold short might rise. If it is sold at $50 and rises to $200, the loss is $150 (plus the dividend or

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23. The basic intuition behind the idea that investment is good and speculation is bad is probably that investment contemplates the shared gains that come from the productive use of capital; speculation (like gambling) is apparently thought to contemplate short-term market moves, and, when applied to short sales, the term also contemplates a zero-sum game. A successful short seller is profiting from the misfortune caused by an investment gone sour, but provides little in return except liquidity and, perhaps, increased market "efficiency." But none of these concerns seems relevant to the question of whether the short-selling fiduciary has met his duty to his beneficiaries of investing prudently. Another way of expressing the same intuition is that the buyer of a traditional investment acquires an asset: an interest in a business, in the case of stock, or a contract for a series of payments, in the case of debt. The short seller, by contrast, seems to have acquired an indeterminate liability as well as a potential asset. Yet in today's world of index arbitrage and interest rate swaps, this analysis seems an old-fashioned description of assets, liabilities and "investment." The short-seller has acquired a complex bundle of rights and obligations, but the risks and opportunities involved in such a purchase are probably no less quantifiable than those in buying convertible debt.

interest equivalency payments and less the borrower's share of income from investing the $50 sale proceeds). On the other hand, if a security is bought "long" for $50, the maximum exposure is $50.

A second concern is rooted in historical economic trends and, perhaps, in a form of economic patriotism based on the fact that the stock market has tended to produce positive returns over time. (A commonly cited statistic is that the total annual return for common stocks, adjusted for inflation, averaged 6.9% per year from 1926 through 1976).[24] Since the market tends to rise, goes the argument, isn't it unwise to "bet against it" by selling short? A less analytical statement of this view is that it must be somehow un-American to try to make money from a decline in stock prices.

These two arguments against short selling -- unlimited risk of loss and bucking the trend of rising stock prices -- are the only arguments against short selling I have been able to identify. They are powerful arguments, but they are not conclusive. Responding to them serves to illustrate the evolving notions of prudence

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24. Ibbotson Associates, Stocks, Bonds, Bills, and Inflation: 1985 Yearbook (1985) at 90, 100.

expressed in the new Restatement, UMIFA, ERISA and Section 4944.

Under these evolving notions, it is hard to think of an investment technique that would be imprudent per se. Instead, every investment decision should be judged in the context of all the facts relevant to the management of the investment portfolio in question. Of course, short sales play in an unusual way into the "evaluate the investment in terms of its role in the portfolio as a whole" branch of the modern paradigm of prudence. If one buys a diversified group of junk bonds and low-priced stocks with 15% of one's portfolio, as a sort of "risk capital," balanced by other more secure and otherwise diversified investments, one can lose only the 15%. But sell one single share short, and the entire portfolio is at risk (i.e., liable to pay the debt), even if the risk is only theoretical.

Nonetheless, one would think that this risk can be estimated and weighed appropriately. A short sale of shares of AT&T presumably contains less in the way of "unlimited risk of loss" than does a sale of shares of a small genetic engineering company whose shares are traded in a thin market and sell for $2. Is the prospect that AT&T shares will double much greater than the prospect

that they will go to zero in a bankruptcy of AT&T? It is in asking and answering such questions and taking action accordingly (i.e., as a prudent investor so informed would do) that prudence lies.

Related questions that a prudent fiduciary would want to ask before making short sales of a company's shares would involve issues such as the quality of the company's management and products, the nature of its investor relations and financial reporting, the future of its industry, the extent of existing short interest in its shares, the liquidity of its shares, the relation between the price and perceived value of its shares, likely trends in the stock market as a whole and the transaction costs involved. Also relevant are the compensation arrangements with those effecting a short sale program: do they tend to promote excessive risk-taking?

Among other factors to be considered are: the relevant experience levels and performance records of those carrying out the program and the factors noted in the Regulations under Section 4944 that relate the short sales to the institution's investment portfolio as a whole and to its long-term and short-term financial needs. In particular, if an investment manager has produced a successful short selling performance record over a signifi-

cant period of time, that fact should be viewed as very important in evaluating the prudence of a fiduciary who has hired the manager to carry out a short sale program.

Moreover, a fiduciary must act prudently with respect to a short position _after_ he or she has decided to take the plunge. Thus the fiduciary must monitor the matters noted above as well as the short positions' proportion of the entire portfolio, the degree of diversification among the short positions, and the role of the short positions in the institution's cash flow needs and in the overall structure of its portfolio. If the market moves against one or more short positions, the fiduciary must judge whether to close out the positions and accept the loss or to wait, perhaps even selling more stock short, confident in the belief that the stock will decline. The fiduciary will generally want the investment professionals carrying out the program to maintain adequate records showing the rationale for making short sales or closing short positions. Most of these considerations are also present in the case of long investments, but the extra margin of risk involved in short selling requires increased thoroughness, diligence and vigilance on the part of the fiduciary.

If short sales are pursued in this way, there is reason for optimism that the short seller will have an edge over other (long) investors, because of the inefficiency of the short selling market. The research and analysis efforts are more likely to bear fruit because most other investors are seeking opportunities for appreciation, and so there may be less competition in investing for depreciation. This view is of course subject to attack on the ground that all long investors are seeking to avoid depreciation, and so are quick to sell a security, driving down its price, once they view it as lacking upside potential. Nonetheless, as an intuitive matter, it seems that a focus on spotting securities with a potential for appreciation may well make one less adept at spotting potential for depreciation than an investor whose focus is on spotting that potential.

Furthermore, the portfolio's other assets may well move favorably if short positions are moving unfavorably. Since "market risk" is a significant risk of investing, selling short, when long positions are held, involves some hedge against "market risk." (Selling Ford Motor Company common stock short while holding an equivalent position in the common stock of General Motors is clearly much more of a direct hedge than selling the Ford

stock short for a portfolio that holds no other investments in the automobile industry.) A related question is, what is the perceived risk level of the overall portfolio? Selling short a diversified, carefully researched group of securities in an amount representing 10% of the value of a portfolio consisting of 50% long-term U.S. Treasury Bonds and 50% securities comprising the S&P 500 is very different from selling short 10% of the value of a portfolio consisting entirely of a small number of venture capital investments.[25]

More generally, short selling simply broadens a fiduciary's options to seek higher returns. If research can uncover prospects that are as likely to go lower as other stocks are likely to go up, a fiduciary ought to have the opportunity to invest part of his portfolio in those prospects. He thus both increases and diversifies his investment arsenal.

In sum, a short selling program should not be viewed as inherently proper, or improper, behavior for a fiduciary. Instead, this investment method (investing for

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25. The short seller can take some comfort from the fact that "market risk" is generally perceived to represent a substantial portion of the risk inherent in owning a security. In other words, many short sales inherently represent, to a significant degree, a hedge against a decline in long positions held in the portfolio.

depreciation) should be evaluated, like any other investment method, by the manner in which it is investigated and implemented by the fiduciary (and those to whom the fiduciary has properly delegated responsibility). In terms of Longstreth's "modern paradigm of prudence," evaluating the fiduciary's prudence should consist of evaluating "the process through which risk is managed" in seeking to achieve the objectives of the short selling program.

C. <u>A Special Issue for Nonprofits: UBIT</u>. Most nonprofit organizations are subject to the provisions of the Internal Revenue Code imposing the "unrelated business income tax" ("UBIT"). Also, some states have statutes patterned on the UBIT provisions. A special factor to be considered by nonprofits in evaluating the prudence of short sales is the role of section 514 of the Code, which is the "debt-financed property" portion of the UBIT provisions (and any corresponding state law provision that may be applicable). Whether short sales give rise to taxable income for an otherwise tax-exempt organization is obviously an important factor to be considered by a fiduciary. The potential imposition of taxation should not, of itself, require the fiduciary to abandon such a pro-

gram. It is simply a factor to be taken into account in weighing the prudence of the program.[26]

A detailed discussion of Section 514 is beyond the scope of this paper but a brief look at its relationship to short selling is appropriate.

The UBIT provisions impose regular taxation (at corporate or trust rates, depending on the nature of the entity) on the "unrelated business taxable income" of an otherwise tax-exempt organization. "Unrelated business taxable income" is income arising from an "unrelated [to the organization's tax-exempt purpose] trade or business" that is "regularly carried on." Income from "debt-financed property" is deemed to have arisen from an "unrelated trade or business" that is "regularly carried on" and so the regular threshold questions as to UBIT do not apply (i.e., is there a "trade or business"? is it "unrelated"? is it "regularly carried on"?). The question, instead, is whether short selling gives rise to "debt-financed property." "Debt-financed property" is investment property with respect to which an "acquisition indebtedness" has been incurred. The sole question raised

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26. Fiduciaries of charitable lead trusts and particularly fiduciaries of charitable remainder trusts need to consider the special rules regarding the tax consequences to such trusts of deriving unrelated business income.

by short selling under UBIT appears to be whether it gives rise to an "acquisition indebtedness" and, if so, how is the resulting "unrelated business taxable income" to be computed.

My understanding is that the Internal Revenue Service is currently considering one or more ruling requests on this question. In 1988 it ruled favorably on the matter in a private letter ruling (PLR 8832052, May 18, 1988), finding that short selling involved "no net borrowing" and thus did not give rise to "acquisition indebtedness." That ruling did not contain detailed discussion of the conclusion. My understanding is that a ruling request now under consideration has been pending for over two years and so it appears that the issue is being closely scrutinized.

One important matter of statutory construction not discussed in the 1988 private letter ruling (which did not need to be discussed in view of that ruling's finding of "no net borrowing") is the question of whether short selling involves any "indebtedness" under Section 514 -- where what is borrowed is a security and not money. Significant authorities under other sections of the Code have concluded that, in the context of paying "interest," an "indebtedness" consists only of an obligation to pay

money. Deputy v. duPont, 308 U.S. 488 (1940); Autenreith v. Commissioner, 115 F.2d 856, 858 (3d Cir. 1940).

In view of the private letter ruling and the authorities defining indebtedness, there is a basis for optimism that the IRS will not consider the debt-financed property provisions to apply to short sales.

IV. Conclusion.

The modern view of prudence creates a lot of hard work for a fiduciary who desires to consider a short sale program. No longer may he simply conclude that such a program is unthinkable, and move on to other pursuits. If he does that hard work, and wishes to embark on a short sale program, he should be able to construct one that will meet the emerging version of the Rule as expressed in the new Restatement, UMIFA, ERISA and Section 4944.

A related point is that the emerging view of prudence tends to compel a fiduciary, or his agent, to undertake more work in managing a portfolio than was required in the past. Although no investment may be imprudent per se, neither is an investment likely to be prudent per se. Accordingly, a fiduciary is well advised to evaluate a wide range of investment options. While he is unlikely to be criticized for not undertaking a short

sale program, he may be at risk, under the emerging view of the Rule, if he fails to consider strategies, including short selling, that have historically been viewed as inappropriate for a fiduciary. New freedom appears to carry with it new responsibilities.