Short shrift

James Mackintosh

The gallows humour doing the rounds of hedge funds will not raise any sympathy among those blaming rich speculators for bringing down banks. Short selling, the most common form of hedging, is under attack from politicians, trade unionists, regulators, bank bosses and even archbishops, one of whom likened short sellers to "bank robbers".

Gordon Brown, British prime minister, told the annual conference of the ruling Labour party two weeks ago that his government moved to ban short selling of banks and insurers because "the interests of savers and homeowners and mortgage holders came before the interests of a few hedge funds".

Other political leaders ratcheted up the rhetoric. Silvio Berlusconi last week banned what he called "speculative attacks" on Italy's banks. Peer Steinbruck, German finance minister, went further, calling for a global ban on "purely speculative short selling".

Most of the developed world has moved in the past two weeks to impose temporary restrictions on shorting - or betting against - the shares of banks and insurers, with some extending the bans far wider. Perhaps the most serious assault on the public image of already reviled hedge fund managers came from the archbishops of Canterbury and York, the top Anglican clerics. Rowan Williams, archbishop of Canterbury and leader of the Church of England, even called on governments to "look to identify a few more targets" after the short sellers.

For now, though, it is short selling and the hedge funds that specialise in it that have become the villains of the financial collapse. They make an easy target, as profiting from someone else's misery is regarded by many as morally dubious - and also involves the easy-to-question practice of selling something one does not own (see box).

No surprise, then, that the US markets watchdog last week rejected hedge funds' pleas to scrap immediately its temporary ban on shorting financial companies. The ban now covers close to 1,000 stocks, about 15 per cent of those listed in the US. It includes manufacturers and information technology groups such as Ford and IBM as well as a swathe of healthcare companies, alongside the core banks and insurers.

For hedge fund managers, this represents a total failure to win the public debate. Indeed, there has barely been a public discussion; it has become received wisdom in the popular media that the failure of banks was the fault of short sellers, whom John Sentamu, archbishop of York, called "bank robbers and asset strippers".

"I think the hedge funds would have lost the debate anyway but given that no one turned up there was no chance," says one of the UK's largest hedge fund managers, who declined to be named. Dozens of other managers expressed similar sentiments: the press had already labelled hedge funds "spivs" and "speculators" and few wanted to go public to defend shorting when politicians and regulators were following in the media's wake.

Yet shorting is not a shady practice used only in dark corners of the City of London and Wall Street. It is core to the functioning of efficient financial markets. According to academics, it makes prices more accurate, while the investigations done by dedicated short-sellers such as Jim Chanos, head of Kynikos Capital, can help uncover frauds and badly run businesses.

Mr Chanos points out that analytical short sellers such as David Einhorn at Greenlight Capital, the US hedge fund, had been betting against banks for several years because they expected problems. "Are these the people you really want to be muzzling?" he asks. Hugh Hendry, co-founder of London hedge fund Eclectica, puts it more bluntly: "Short selling is the pursuit of truth."

Few go that far, but even some of the regulators have recognised the importance of shorting to efficient markets. London's Financial Services Authority, the first to introduce a temporary ban on shorting financial stocks last month, exempted short positions taken as a hedge against holdings of convertible bonds, which can convert into equity. It also allowed shorting by market makers - special traders who match buyers and sellers - and index arbitrageurs, who ensure index futures contracts trade in line with the underlying stocks.

In the US, the SEC said shorting "plays an important role in the market" by helping mitigate bubbles, adding liquidity and limiting market manipulation designed to boost stock prices, among other things. It said its rule would end three days after legislation for the $700bn bail-out was passed, which will be midnight Wednesday.

But the regulator was blasted by the industry for destroying the hedge funddominated convertibles market by refusing to exempt hedges against convertible bonds or convertible preferred stock. "The reason people like us are willing to lend money or invest money in these companies is because we can hedge the underlying risk of the company," fumed the head of one of the US's largest hedge funds. "The market is now completely shot as a way for companies to go out and raise capital."

Many of today's biggest hedge funds started out in convertible bond arbitrage, which appeals to the industry because its returns are normally independent of stock market performance. Last month it was the worst-hit hedge fund strategy, plunging 16.6 per cent, according to Chicago-based Hedge Fund Research's HFRX index, against a 6.9 per cent fall for the industry.
Whether or not to exempt certain types of short selling comes down to the concept of "good" versus "bad" shorting. Indeed, the Church of England makes this distinction itself in defending its use of currency hedging for its vast investment portfolio, a practice that could be described as shorting entire countries.

But the unintended consequences of banning shorting in financial stocks make clear that this distinction is hard to draw. Aside from convertibles, the biggest impact is on liquidity in the market - the ease with which shares can be bought and sold.

According to Credit Suisse, the cost of trading rose sharply in stocks that can no longer be shorted, as bid-offer spreads - the difference between buying and selling prices at any moment -widened "substantially". The reason was simple: volume plunged as hedge funds stopped taking long positions that they could not hedge with short positions in other stocks.

Analysts at Sandier O'Neill calculated that volumes of trades on US exchanges fell 41 per cent after the ban, with volumes in stocks that can no longer be shorted down 49.6 per cent, while for those that can still be shorted it was down 37.7 per cent. At the same time - as is normal when liquidity dries up - volatility increased sharply, making shares rise or fall faster.

"Many traders have simply stopped trading these names entirely, long or short," wrote Ana Avromovic, an algorithmic trading expert at Credit Suisse.

The problem here is that the computer-driven hedge funds that make up 30-40 per cent of trading on the world's major stock exchanges have cut back, as they cannot risk trading without short positions to protect them from overall market movements. The regulators appeared to believe that this was a price worth paying for bolstering financial share prices while the US's $700bn bail-out plan was put together.

Callum McCarthy, on his last day as chairman of the FSA just over two weeks ago, said that the UK watchdog had brought in the ban because it was concerned by "incoherence" in bank shares. He said "movements in equity prices can be translated into uncertainty in the minds of those who place deposits with those institutions with consequent financial stability issues", echoing worries that plunging shares can cause a run on a bank.

Last week the SEC raised the issue of rumour-mongering by short sellers, where a trader bets against a stock then spreads false rumours to push down the price. This is already illegal. "This

kind of manipulative activity is particularly problematic in the midst of a loss in market confidence," it said. "For example, in the context of a credit crisis where financial institutions face liquidity challenges but are otherwise solvent, a decrease in their share price induced by short selling may lead to further credit tightening for these entities, possibly resulting in loss of confidence in these institutions".

Bear Stearns, Lehman and Morgan Stanley all complained this year about false rumours and short sellers driving down their shares. Some hedge funds have echoed these concerns. Last year Philip Richards, co-founder of London's RAB Capital, blamed co-ordinated short selling for the collapse of confidence in Northern Rock.

Others say the ban was essential to calm the panic in markets after the collapse of Lehman Brothers, which threatened the survival of Morgan Stanley and Goldman Sachs. Several hedge funds and former regulators described the action as an attempt at a "circuit breaker" - although most went on to say it had not worked.

"Precluding short selling may be justifiable in extreme circumstances," says Harvey McGrath, former chairman of Man Group, the largest listed hedge fund, and soon to take over as chairman of Prudential, the British insurer.

Research on trading in banks such as HBOS in the UK and Morgan Stanley . in the US appears to show that levels of shorting were far lower before the ban than during the summer, and had barely risen. Hedge funds say the blame lies not with short selling but with selling by mutual funds, pension funds and other traditional investors. "There's a lot of long-only intelligent money that is looking at the fundamentals [of the banks] and saying this is not good," Mr McGrath says.

Hedge funds point to the rescues of Britain's Bradford & Bingley, Washington Mutual in the US, Belgo-Dutch bank Fortis and Franco-Belgian bank Dexia since the rules were introduced, saying they show the problem was not shorting but the inability of banks to finance themselves. (They also point out that China last month allowed shorting for the first time in an effort to avoid a repeat of last year's stock market bubble, since burst.)

The industry bolstered its lobbying power in January by recruiting Richard Baker, a Republican congressman, to head the Managed Funds Association, its US trade body. He expects hedge funds to press their case more strongly - not least, he says, because they believe the investment banks successfully shifted the blame for the crisis through their lobbying. "The political pressure came from the investment banking world," says Mr Baker. "Unfortunately it was the 50-60-70:1 leverage ratio which seemed much more determinative of their future than the actions of our members."

Mr Chanos is also hoping that the politicians will change target. "If you start seeing CEOs indicted and criminal investigations of accounting practices at big banks you may see a shift in the whole narrative of short sellers as villains," he says.

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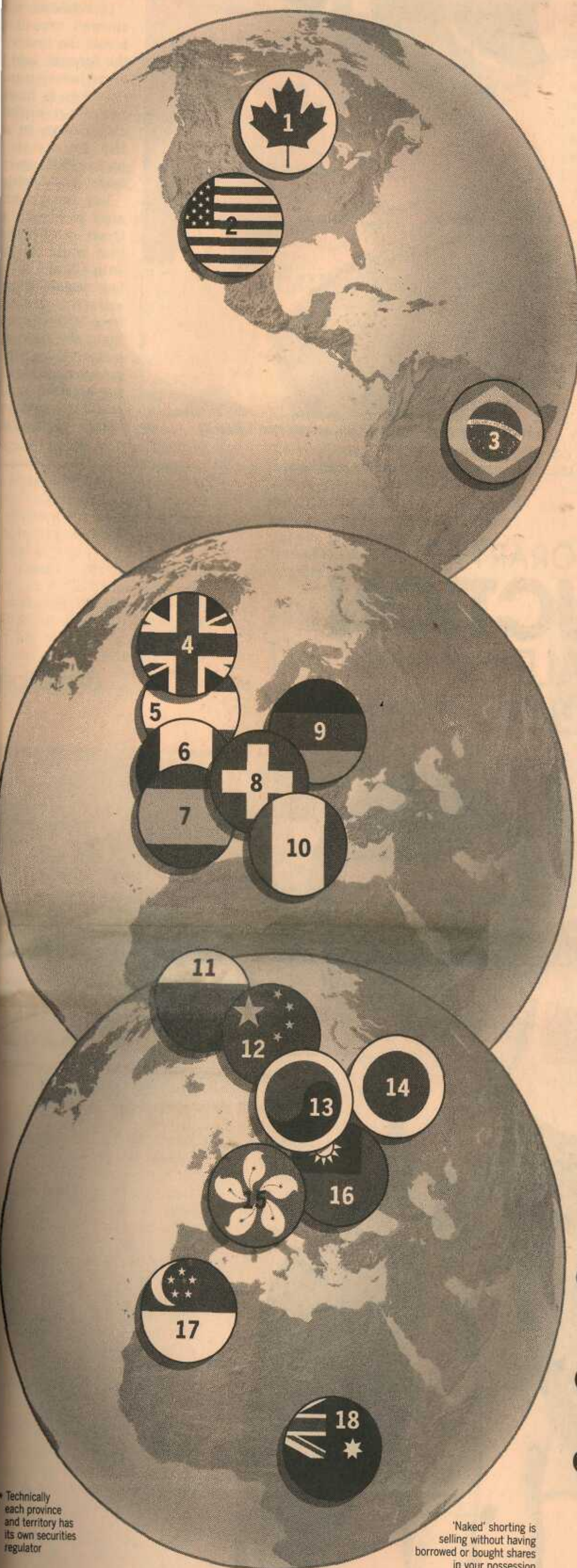

* Technically each province and territory has its own securities regulator

'Naked' shorting is selling without having borrowed or bought shares in your possession

Main markets regulator	What the regulator has done
1 Canada	
Ontario Securities Commission*	Banned short selling in 13 financial stocks until Oct 8
2 US	
Securities and Exchange Commission	Banned short selling on more than 900 US financial companies; ban due to end Oct 8
3 Brazil	
CVM	No change; short sellers have to post up to 200 per cent as collateral
4 UK	
Financial Services Authority	Banned short positions in 34 financial stocks until Jan 16, 2009. Increased disclosure requirements
5 Netherlands	
Authority For the Financial Markets	Banned 'naked' short selling in eight financial institutions until at least mid-December
6 France	
Autorité des Marchés Financiers	Short selling in banks and insurance stocks banned until Dec 19
7 Spain	
Comisión Nacional del Mercado de Valores	'Naked' short selling already banned; temporary measures call for disclosure of 20 financial stocks
8 Switzerland	
Federal Banking Commission	Naked short selling is not allowed. Warned it would act toughly on any infringements
9 Germany	
BaFin	Short selling of shares in 11 financial stocks banned till the end of the year
10 Italy	
Consob	Short selling of stocks banned from Oct 1
11 Russia	
Federal Service for Financial Markets	Ban on short selling renewed last week; set to run indefinitely
12 China	
Securities Regulatory Commission	Cabinet agreed on Sep 26 to allow short selling, overturning a previous ban
13 South Korea	
Financial Services Commission	Banned short selling of all local stocks on Sep 30 for an unspecified period
14 Japan	
Financial Services Agency	No change. Rules, in place since 2002, require investors to verify and mark whether the transactions fall into category of short selling
15 Hong Kong	
Securities and Futures Commission	'Naked' shorting already banned; enforcement of uptick rule – which only allows shorting of shares that have risen in value
16 Taiwan	
Financial Supervisory Commission	Complete ban on short selling until Oct 14
17 Singapore	
Financial Services Agency	Tightened rules to discourage 'naked' short selling and signalled penalties for failed trades. Held back from banning shorting
18 Australia	
Securities and Investments Commission	Short selling banned until at least Oct 23; exemption for arbitrage of dual-listed stocks

Fonte: Financial Times,London, October 6 2008, Primeiro Caderno, p. 10.