# Investment Value Digest Blog

Review of investments, Wall Street, and noteworthy publications, by Andy Szabo of Greenwich Financial Management. From a standpoint of fundamental value. Inviting your response.

## Friday, July 18, 2008

### SEC Slams Sinister Short-Sellers

Christopher Cox, the Chairman of the Securities and Exchange Commission (SEC), announced on July 15th restrictions on short-selling of certain financial stocks (including Fannie Mae and Freddie Mac) by nineteen major broker-dealers. List of dealers barred and stocks affected (Reuters). The SEC stated: "Today's commission action aims to stop unlawful manipulation through naked short selling that threatens the stability of financial institutions." The temporary rule sets an unwise precedent.

Here's some background. Short-selling is a technique for profiting from the expected decline in the price of a stock. The person using this technique, the "short-seller," must find a willing lender of the security (a process handled by a special back office department of broker-dealers).

The ability to take a negative bet on stocks through short-selling is part of the process that leads to rationality in markets. If we can only push stocks up, there could be an irrational over-valuation of certain securities that would be difficult to set right. Moreover, the ability to borrow a stock and short it helps other derivative instruments work properly. Thus, if you pay a premium to purchase a put option on a stock from a trader over the counter, giving you the right (but not the duty) to sell a security at a certain price for a certain time (or interval) , the trader who writes that put might possibly short some stock to hedge the risk. Something similar happens in the case of exchange traded options.

Sometimes the management of a company whose stock is declining may deride short-sellers for their evil ways. This is what Enron management said before their financial house collapsed. It was hogwash.

There are certain firms that specialize in taking negative bets on stocks. That's a damn hard job, as the very long-term trend of stocks is up. A famous short-seller, and a very smart one, is James Chanos of Kynikos Associates. Another notable short-seller who does his homework is Manuel Asensio. Asensio publicizes some of his research as an aspect of his business model; while such release seeks to advance the Asensio firm's private interest, the research also serves a public interest, throwing light on various unsavory stock promotions and bogus or exaggerated management claims. See Asensio.com Website.

The temporary SEC rule prohibits traders at the named broker-dealers from shorting stocks before first arranging to borrow the shares. Traders might otherwise make a "naked" short and arrange later (in the day) to borrow the shares; if they can't borrow eventually, a so-called "fail" develops, which can be costly. As robber-baron Daniel Drew wittily warned, "He who sells what isn't his'n, Must buy it back or go to prison." Citation (TIME Magazine). These days, the market cost is negotiated in the form of the "rebate." Rebate Defined (Investopedia) The new SEC rule requires delivery of shares on settlement date, so a fail might be interpreted per se as a violation, which would be problematic. The rule was implemented for one week, from July 21st to July 29th, but it can be extended to last for thirty days.

Rumors can be a problem. Recently, on July 10th, a false rumor circulated that Lehman Brothers would sell itself to Barclay's for only $15 per share. A short-seller could have initiated this rumor, although I've seen no proof of that. It could have been some Bozo.

From an economic point of view, the government could have a justifiable reason to seek out and punish people who intentionally spread false information. Indeed, the SEC states that its goal is the "prevention of the intentional spread of false information intended to manipulate securities prices." SEC, others, to probe short seller manipulation (MarketWatch). The market eventually ferrets out much false information, but this can take time, and markets may be distorted. The Securities Exchange Act (1934) gives the SEC the power to punish such activities, as effectuated under Regulation 10(b)(5). The rule punishes any act or omission [including verbal acts] with the intention of committing fraud in the purchase or sale of any security. Under this rule, it is an offense: "To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." See SEC Rule 10b-5 (Wikipedia). However, the short-seller of a stock may be spreading *true information* or *no information*. The SEC thus confuses a neutral trading technique—short selling—with a punishable offense.

For the SEC to get so intimately involved in the mechanics of trading is most unwise. First, although nominally aimed at fighting perceived market excesses, the SEC action helps to fix in the public mind the false idea that the problems at banks are caused by the devilry of short-sellers. Second, the rule responds to a problem that is already well-handled by market forces. Third, the rule fails to address the true problem, which relates to the spreading of intentionally false information.

The Federal government has an interest in the stability of financial institutions. This includes quasi-government agencies, like Fannie Mae and Freddie Mac, where investors rely on the government's implicit guarantee, as well as commercial banks, where FDIC explicitly guarantees deposits of up to $100,000 per depositor. It includes an interest in investment banks, even, like Bear Stearns or Lehman Brothers, where the government may feel a strong national interest to prevent financial chaos. However, the government also has a competing interest in the operation of free markets and the free exchange of information. In weighing these different interests, the SEC Chairman has blundered.

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