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Short Sellers Keep the Market Honest

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By James S. Chanos

We are currently witnessing one of the periodic financial convulsions that inevitably follow eras of easy credit and lax regulation. As someone once said: "Politicians and people who lose money always need someone to blame." So who is to blame now? According to the guardians of our economy, it's the short sellers, those investors who believe certain stocks are overvalued for fundamental reasons.

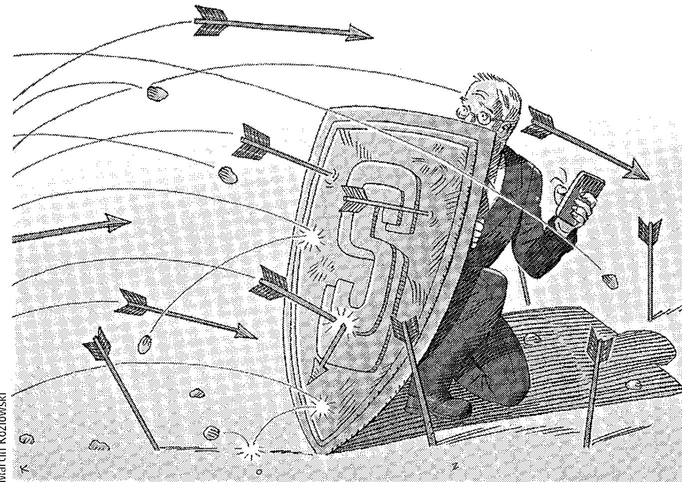
In the latest of a series of constantly changing rules announced overnight without public comment or participation, the Securities and Exchange Commission has imposed a ban on short selling 799 financial companies through Oct. 2. But the regulator has yet to put forward any supporting data, or a clear justification, for this and prior emergency actions against short selling this summer.

> The government should not try to put a floor under stocks.

Meanwhile, the causes of the collapse in the financial sector go ignored. Never mind that months ago short sellers were warning about the problems we now see undermining American capitalism. In the spring of 2007, I joined another fund manager in outlining to finance ministers and central bankers (at a G-7 finance ministers meeting) the looming crisis in credit structures and overleveraged banks and brokerage firms. Our audience listened politely, but, as events now show, failed to take any meaningful action.

These are extraordinary times, and, as participants in the capital markets, we need to support the commission's efforts to ensure that fraud and manipulation have no place in this market. But the haste, confusion and scapegoating that has ensued may well do more harm than good. Unfortunately, the recent spate of hurried actions may worsen the quality of our capital markets at a time when we need to attract investors—both pessimists and optimists—by promoting deep liquidity, vigorous price discovery and open competition. These are the key factors in determining the value of securities.

This tale is not a new one. Short selling has been misunderstood and maligned throughout history. In the 1630s, England banned short selling after tulipmania collapsed in the Netherlands to prevent a similar fallout in England. More recently in Malaysia and Pakistan, short sellers have been faulted for stock-market busts. In the U.S., we've seen how corporate executives have tried to place the blame for their failures on short sellers instead of on themselves. In the end, short sellers—not management—defended honesty in the pricing of shares by demanding accountability. Short sellers openly warned about the problems at Enron, Tyco, Fannie Mae and Freddie Mac before their meltdowns. And when it comes to investigating corporate fraud, it's the short sellers who are the detectives, while all too often our regulators practice archaeology. Indeed, my firm was among the first to raise red flags about Enron's finances.



Martin Kozlowski

The vast majority of equity short sales are market neutral; the short seller has no fundamental view of a company's outlook but is taking a short position to hedge risks. A short seller may want to lock in a spread, hedge a convertible bond by shorting the same company's equity, or add liquidity in mergers by buying the target company and shorting the survivor.

As Warren Buffett has acknowledged, though, "it's a tough way to make a living," because over time stock markets rise more than they fall, the transaction costs are high, and the risks great.

Regardless of the reasons why an institution may take a short position, there is an important fact to keep in mind: Compared to the total volume of securities transactions, short selling comprises roughly 4% of total shares outstanding on the New York Stock Exchange. Short-biased funds make up a small fraction of the $2 trillion managed by private investment companies.

Still, when times get tough, the accusations fly, even though most research suggests investors and financial markets benefit from short selling. Specifically, short sellers act as "safety valves." Their transactions help to bring share prices to levels supported by the fundamentals, decreasing the likelihood of price bubbles. Short selling also improves market quality and efficiency by narrowing the bid-ask spread, a drawback noted by policy makers rushed to stop the bleeding. In the unfolding drama, short sellers were an easy target and quickly cast as the Darth Vaders of Wall Street.

I believe the SEC was tough but balanced with the three initiatives announced last Wednesday. Broker-dealers who lie about their ability to deliver borrowed securities should face the consequences under anti-fraud rules. And, broker-dealers should deliver stocks sold in a short sale within three days of a trade.

But apparently this was not enough. After last Wednesday's announcement, pressure mounted for the SEC to do even more as its counterpart in London ratcheted up its regulatory responses. By evening on "Black Wednesday," the SEC had decided to require investment managers to publicly report their short positions weekly.

I believe the SEC has every right to obtain and review information about short positions for market surveillance purposes, but forcing public disclosure will have serious consequences for the market. Companies may retaliate against short sellers. Fund managers will lose their ability to manage assets without revealing their strategy. Other traders will "pile on," and may trigger panicky selling if an investor sees that noted short sellers have shorted the stock.

On Friday, the SEC went even further with its short-selling ban, following a similar move by the Financial Services Authority in the United Kingdom. Halting trading activity will only worsen market conditions and exacerbate volatility, hindering the ability of markets to do what they do best. Economists have long believed that market prices are best set by a variety of viewpoints, including by those with no previous ownership interest. In the financial markets, that latter group is the short-sellers. As a former SEC chief economist aptly observed, "To ban short selling is to in effect say that the gov-

ing spreads, improving the speed of price adjustments based on new information, and pumping liquidity into the market.

In the past, SEC Chairman Christopher Cox and Federal Reserve Chairman Ben Bernanke have both expressed their views that short selling is valuable. They make the point that overinflated securities prices waste valuable capital and harm investors, as occurred in the dot-com bust in 2001. "We need the shorts in the market for balance so we don't have bubbles," said Mr. Cox.

But in a week when the markets froze, assets became untradeable, and investor trust plummeted, policy

selling is to in effect say that the government is going to try to determine what stock prices should be."

For our investors and our country to emerge with strength from these extraordinarily difficult times, it is imperative that our regulatory bodies respond in a way that appropriately balances vigilant protection of investors with open, vigorous competition. Closing down short sellers will not work to help the U.S. maintain the freest, strongest and most liquid capital markets in the world.

Mr. Chanos is founder and president of Kynikos Associates, LP and chairman of the Coalition of Private Investment Companies.