

## **Commentary: FSA Proposes More Sunlight on Short Sales**

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Early this month, the Financial Services Authority (FSA), more or less the SEC's counterpart in Britain, published Discussion Paper 09/1, entitled "Short Selling." A discussion paper is something like the concept releases published by the SEC. The FSA is basically trolling for comments on this issue.

The FSA's discussion paper should be of interest to US traders and investment managers because of the probability that some of the FSA's proposals will be adopted in the US. The FSA doesn't plan to implement its proposals unless they are also adopted in global markets, primarily meaning the US, and has prepared the paper for submission to the G-20, which will next meet in London in April. The US Treasury and the Fed are active participants at the G-20 Summit, while the SEC is a bystander.

DP 09/1 is based on the premise that short selling is generally a useful activity that enables the prices established by equity markets to reflect the negative opinions of short sellers. The resulting prices should be a better reflection of the value of a security, which is what markets are all about. However, the FSA also believes that short selling can be abused, particularly during periods of market stress. The theory is that short sellers can provoke panic in a skittish market, leading to the collapse of otherwise sound companies.

The FSA banned short selling in the stocks of a large number of financial institutions in September 2008, lifting it in January 2009. In contrast, the SEC banned short selling in similar stocks for a few weeks. The SEC has since acknowledged that the ban was imposed in response to political pressure and a mistake. Some markets have not yet recovered from the effects of this ban. The FSA acknowledges that there is no evidence that the downward pressure on the banned stocks resulted from short selling, but argues that the ban was justified because of the "risks" of abusive behavior and disorderly markets. Unapologetically, the FSA reserves the right to impose the ban in the future, without notice if necessary, to protect orderly markets.

The discussion paper also discussed prohibitions on naked short sales, which is the approach generally taken by the SEC. The FSA thinks the cost of this prohibition in lost market efficiency exceeds its benefits.

The FSA favors more disclosure. In their model, any short position greater than .5% of the outstanding stock should be disclosed to the public immediately on an individual basis. They reject the approach favored by the SEC, which is to require reports to the agency without making them available to the public. The real benefit of full disclosure, in their view, is that it signals the market that some market participants think a stock is over-valued. The FSA also believes that disclosure would prevent panic and disorderly markets because other market participants would be able to identify and evaluate the source of selling pressure. In addition, disclosure would deter short sellers from taking large positions because other market participants might use this knowledge against them.

Portfolio managers frequently argue that they expend valuable resources to identify unique market strategies for their benefit of their investors. Some have argued that these insights are valuable property protected by the US Constitution from a taking without just compensation. The FSA's position demonstrates contempt for this argument and a willingness to require investment firms to reveal their strategies, insofar as they involve short sales, to the investing public. Research, on this theory, is a public good.

I suspect that the FSA's position reflects the attitude of the G-20 members. It has become received doctrine that the cupidity and arrogance of the financial services industry is the root cause of the current economic downturn. Far from admiring their brilliance, policy makers increasingly view the "smartest guys in the room" as fools and charlatans. There is no policy justification for preserving the strategies of idiots. As unemployment continues to rise in the months ahead, it can be expected that the regulatory mood will darken.

At the risk of being reduced to a voice crying out in the wilderness, I believe the public eventually will see this condemnation as excessive and misplaced. A lot of smart people did what they were paid to do – make profits for their constituents – and did it very well. The difficulty is that their individual efforts – lawful, rational and even brilliant – collectively led to catastrophe. But, investment managers, and other industry participants, were not paid to consider the effects of their collective behavior on a wider public. Nor did they have the tools to accomplish such a task. That's what policy makers and regulators were paid to do, and they failed in this all-important mission.

In the interests of full disclosure, I continue to believe that the focus on short sales in the equity markets was a regulatory frolic and detour, inspired by political hysteria. With credit markets collapsing everywhere, there was no good reason to tamper with the equity markets, which were doing quite well without additional regulatory intervention. Some of the short sale rules adopted in this frenzy were appropriate, while others, such as the ban on short sales for stocks of financial institutions, were a colossal blunder. The equity markets have yet to recover.

It is a mistake to conclude that there is no merit in investment strategies when making policy decisions that will affect how the industry behaves going forward. The goal should be to regulate the third party effects of individually rational behavior.

This will require policy makers and regulators to look themselves in the mirror and ask where they got it wrong. Sadly, true introspection by regulators is as rare as humility among financial services industry executives.

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