Short Selling Boosts Stock Prices – October 3, 2008
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I thought that headline would peak your interests. Short selling boosts stock prices? Wouldn't it be the other way around? Wouldn't selling first buying back later reduce the value of the equity being sold?

If you believe the financial opinions being drafted by near all off of the financial media outlets, the rally cry for the elimination of the short sale ban has been – short selling would have held our markets together. But with the ban on short sales in place, the financial markets and Wall Street in general have fallen under a lack of buy-side interests.

After all, every short seller has to be a buyer at some stage of the investment and when we have a lack of buyers out there, and a ban on short sales, the buy side interest has all but dried up.

Now call me naïve but does that argument even come close to passing the smell test?

Let's hear from some of the geniuses that put up copy for our nations finest.

"Even though the temporary ban against short-selling financial stocks has failed to stop the sector's slide…That last comment is worth thinking about when you consider the mechanics of short selling. If someone shorts a stock, they do have to buy it back someday." These are the absurd logic by Paul R. La Monica, CNNMoney.com editor at large in an article posted October 2, 2008 headlined; 'The SEC's crusade against shorts is a joke'.

"If not for these short-sellers, potential buyers would not be able to consummate their purchases in the market as easily, since there would be no potential sellers…Two immediate consequences of the short-selling ban, aimed at halting the decline in the prices of financial stocks, may have already contributed to a further decline in prices." These are the comments as stated in a Forbes.com Op-Ed piece titled 'End The Ban On Short-Selling' by Menachem Brenner and Marti G. Subrahmanyam are, respectively, professor of finance and Charles E. Merrill professor of finance, economics and international business at the Stern School of Business, New York University.

“FEDERAL regulators have banned short sales of more than 800 stocks, mostly of financial companies, in an effort to stabilize prices in a shaky market. But the move may have an unintended consequence: reducing the stock market’s efficiency and prolonging the current crisis.” These are the claims of Mark Hulbert of Marketwatch.com in his article titled ‘Maybe Short-Selling Isn’t So Bad, After All’

“Short sellers, as compared to long sellers, are buyers of the stock, since the seller's profit is derived from a subsequent purchase. The activities of short sellers therefore enable markets to adjust smoothly to these expectations, rather than experience free falls, the result when many investors decide at the same time to sell long.” This as spoken by Stephen J Nelson; The Nelson Law Firm, LLC in his piece dubbed ‘Short Sale Regulatory Panic’.

I could go on, and I could list quotes from those who draft fiction from the NY Times and WSJ but in all honesty, you people need to be able to keep your dinners intact.

The concern I have with each who has written such fiction is that they are absolutely devoid of logic and common sense. How would the short selling have protected the collapse of the financial markets? Better still, what defines the true value of these markets at a time when value is based on an ability to raise credit and when credit, on a day to day basis, is free falling.

Had we honored the requirements of these writers our markets would be lower by another 2000 points and the banking sector in far worse trouble than it is already in. The $700 Billion bailout would have reached well over a one trillion as the self-fulfilling prophecy of short sale activities would have created chaos at a pace far faster than our distinguished members of Congress, focused more on re-election than economic health, could agree to disagree on.

So you have to wonder where these ideas come from.

Ironically, each of these articles detail to some extent the exact views and opinions of a single voice we hear at near the same frequency as the writers themselves; the views of one James Chanos. That is $7 Billion hedge fund manager James Chanos of short based Kynikos Associates.

Chanos has met with the SEC Commission staff and has plead his case both personally and through the high priced lobbying of former Congressman turned lackey Richard Baker. And when the lobbying failed to drive change his way, Chanos went to his friends at the WSJ who offered him endless space in their Op-Ed section to dispel his self-serving opinions to the public. Chanos did the same at the NY Times, Financial Times, and any other news rag he could muster support from.

Chanos position “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 spreads, improving the speed of price adjustments based on new information, and pumping liquidity into the market.” As he stated in his WSJ Op-Ed ‘Short Sellers Keep the Market Honest’.

Since all want to follow the cue card of poor misunderstood James Chanos let me just wrinkle the story just a tad.

The SEC’s action to eliminate all short sales in near 1000 markets was not a favorable one to Jim or me. I think the SEC had better alternatives but most likely their actions were in response to something they saw that they have not yet made public. That being said, what of the argument that the SEC’s actions failed to stop the slide in our financial markets?

Well first of all, the SEC never came out and stated that their intent was to boost the economy by restricting short sales. It does not take a rocket scientist to figure out that a country in recession is going to continue to fall until Congress steps in and addresses the underlying issue. As confidence in our economy waivers, we expect stocks to slide but a safety valve is to insure that the slide down is a slower one that will allow for change to come before death arrives.

Second of all, market value is not something that fluctuates to great extent intra day and yet much of the concern by Chanos is his inability to rapid trade a market and be out of it that same day. In fact in the Chanos Op-Ed he claims “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.”

I ask, without a fundamental view of the company how does the short seller “help to bring share prices to levels supported by the fundamentals” as Jim also pointed out in that same Op-Ed? Certainly you can’t be both market neutral with no fundamental view of a market and likewise bring efficient market pricing based on fundamental views.

The intelligence pool of the financial press also seemed to ignore the evidence we have seen regarding excessive short selling during a declining market. Certainly, if a short seller is going to bring market efficiency in pricing, the least that short seller can do is use sales that are represented by available shares to sell. Certainly selling what does not exist can’t be efficient can it?

According to the Regulation SHO threshold list that is exactly what is taking place as more than $10 Billion worth of shares were sitting on the books of our market members each and every day in the month of June as unsettled trades. As for these unsettled trades again Mr. Chanos opined during his complaint about the mandatory pre-borrow that “before undertaking a short selling strategy, a market participant must consider in advance the costs and risks of ensuring with 100 percent certainty that enough shares will be available to cover the maximum number of shares that may be sold short throughout the duration of the strategy.”

I’m sorry but for a guy who continues to claim he does not naked short and any naked shorting is at the responsibility of the broker-dealer, it certainly reads to me that Jim Chanos would prefer to be allowed to sell short without the expectation of meeting settlement on 100% of his trade.

Gee, now if every short seller felt and acted that way, and they did so in concerted efforts, wouldn’t that create undue pressure on a market already in distress?

But don’t worry about using logic when weeding through fact or fiction regarding this issue. The Wall Street beat writers will continue to take their cues from those they rely so heavily on for future stories and will thus deny the public a more balanced view of this issue. Right now the pitch card they have been given is, short sellers raise market prices because they have to buy back their short position – sometime.

For the short sale apologists like CNN’s Paul Lamonica who believes that yes abusers do exist Paul believes argues "This may be true [short sale abuse]. But shouldn't the SEC more aggressively go after the short sellers that are actually committing fraud instead of banning the entire practice?"

I wonder if Paul were a fire fighter rushing to a fire in a local movie theater, would he cease to take care of the fire and the victims first and instead start right out and focusing on who the arsonist may be? That certainly seems to be the logic in his commentary above as any third grader understands that regulatory enforcement lags the act of fraud by years.

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