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Don't Sell Hedge Funds Short

They were the first to signal troubles at Tyco, Enron and now Fannie Mae, Freddie Mac and banks.

By L. GORDON CROVITZ

After a dinner in April with Treasury Secretary Henry Paulson, Lehman Brothers CEO Richard Fuld emailed the good news of what he learned to his general counsel. Mr. Fuld reported that Mr. Paulson wanted to "kill the bad" hedge funds and "heavily regulate the rest."

Mr. Fuld was delighted to hear that Treasury sided with Lehman against hedge funds that were short selling its shares, along with those of several other investment banks. Instead of blaming hedge funds for their prediction that the Lehman share price would fall, Mr. Fuld should have acted on the short sellers' clear warning, months ago, that he was atop a powder keg of mortgage-related securities that would soon explode. Instead, Lehman is bankrupt and Mr. Fuld is a former CEO.

For their part, regulators spooked markets by trying to make short sellers the scapegoats for problems they didn't cause. The biggest impact of the temporary ban on short selling, which expired earlier this month, was its role in undermining the trust on which markets rely. Why would regulators ban short selling in nearly 1,000 companies, effectively banning accurate information from the markets?

By targeting short sellers as a way to prop up share prices, regulators clearly panicked. This in turn panicked financial professionals and individual investors who saw regulators losing faith in the system they oversee. A UBS research note spoke for the widespread disbelief that modern regulators could ban short selling, even temporarily, even as a form of circuit breaker. "This can be characterized as a populist reaction of no positive value," the report said. "Anyone who seriously thinks that the cause of this crisis arises from the actions of evil and manipulative speculators lacks the insight and knowledge to be allowed anywhere near the regulation of financial markets."

Academic studies found that the three-week ban on short selling did not stop banking shares from continuing their fall. But the ban had several unintended consequences. It undermined risk-lowering hedging strategies. It raised the costs of trading by widening the bid-ask spread, added to volatility, and made prices less accurate. In the meantime, we haven't heard much about the Securities and Exchange Commission investigation launched in the summer into whether any

short sellers violated the law by spreading false rumors about financial firms. The truth, it seems, was bearish enough.

Admittedly, short sellers are not especially sympathetic characters. After all, they benefit from the decline in value of other people's investments. But in complex markets, short sellers are akin to investigative journalists, looking for the scoop of finding an overvalued company or industry. Also like journalists, short sellers aren't always popular with corporate management or regulators. Forensic accounting experts at hedge funds have performed the hat trick of being the first to signal, through short selling, troubles at Tyco, Enron and now Fannie Mae, Freddie Mac and banks.

Adding ironic insult to hedge-fund injury, several funds are in danger of being driven out of business as collateral damage from the Lehman bankruptcy. Lehman acted as a prime brokerage to some 3,500 clients, including many hedge funds, which used Lehman for stock and derivatives transactions. Lehman's London affiliate has some $65 billion in client assets, with $45 billion in long positions and $20 billion in short positions. The company's administrators in bankruptcy say they may demand margin calls on shares that were sold short.

These accounts have been frozen at Lehman for weeks. The hedge funds find that they might have been turned into unsecured creditors, with their assets wiped out. One Hong Kong hedge-fund manager complained, "We're looking at many hedge funds that will have to shut down, but they can't even shut down because they don't know what they have left." Many hedge funds are suing Lehman for their assets -- including allegations of fraudulent conveyance for transferring funds to the London affiliate -- and meanwhile billions of investment dollars are out of the system when they're needed most.

Hedge funds would be forgiven for asking, "Where's our government bailout?" There are estimates that half of the 8,000 hedge funds in the U.S., with a total of $400 billion in investments, could go out of business as their returns falter. This is bad news for their investors, which beside wealthy individuals include public-sector, union and company pension funds as well as university endowments and charitable foundations.

Hedge funds managed to operate profitably outside the morass of mortgage-based securities. They are lightly regulated, in contrast with traditional investment and retail banks. This means that the least regulated financial institutions were the ones that identified problems in the most regulated parts of the industry. Hedge funds and their short sellers deserve thanks for delivering information to markets. But alas, it's human nature instead to blame the messengers of bad news, especially when the news turns out to be true.

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