EUROPEAN COMMISSION – PUBLIC CONSULTATION ON SHORT-SELLING

RESPONSE FROM JOHN CHAPMAN

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I welcome the opportunity to comment on possible approaches to the short-selling issue. But I find the approaches inadequate in several ways:-

- they do not recognise that substantial changes are needed in financial markets to prevent a recurrence of the general economic catastrophe many countries are facing because of the financial crisis;

- they reflect an inadequate discussion of the impact and effects of short-selling;

- they fail to consider that a ban on short selling would land a substantial blow on the hedge fund industry, whose activities are the single most pernicious development of the last 30 years;

- in particular, they do not take into account that the activities of the hedge fund industry, the main short-sellers, result in the "licensed robbery" of some £100 billion a year from traditional funds.

2 - The Commission's working document suggest three options. It is not easy to follow what increased transparency would achieve. Alerting all to the targeting of a company or country by short-sellers might well weaken confidence in the target and help the short sellers. Reducing the risks of uncovered short selling is virtuous, but perhaps a side issue. Allowing authorities of individual countries to restrict or ban short selling would be a step in the right direction. But restricting the exercise of such powers to "emergencies", and under the "co-ordination" of a quango, would be undesirable.

3 – Although the introduction of the Commission document does mention possible drawbacks of short selling, the general flavour of the proposals is "It flowers, so it must be preserved". But the rotten financial system, dominated by hedge funds and their short selling, that inept regulators and weak (or conspiring?) governments have allowed to develop over recent decades must be changed. The financial crisis, and the resulting general economic catastrophe now blighting at least a generation, should not happen again.

4 – Arguments for and against short selling have been made over the centuries, in particular between Wall Street practitioners and Washington regulators. It is therefore depressing that the FSA, a leading regulator (and thereby presumably a ready critic of short selling), recently took the view that "short selling is a legitimate investment technique in normal market conditions" (1). That a regulator can describe the borrowing of shares, or the buying of credit default swaps, to bet against a company or country as "investment" illustrates the decadence of today's financial culture.

5 – Debates about short selling typically focus on the claimed benefits of greater market efficiency and more liquidity versus claimed drawbacks of market abuses, disorderly markets, information asymmetries, etc. But little heed is taken of the possible effects on companies of both potential and actual short selling. The menace of short selling may well inhibit companies from desirable risk-taking, lest a setback makes them a target for short sellers. Also companies, and even countries, which experience a setback and are shorted have their chances of recovery reduced in the hostile environment created by the short sellers. Surely, in today's general economic catastrophe, creating an atmosphere of confidence for investment and growth is a much higher priority than preserving any "virtues" of short selling.

A ban on short selling

6 – The Commission should present an EU ban on short selling as a further option. Such a ban would restore long-only investment as the dominant feature of financial markets. The proper purpose of such markets should be to allow companies to obtain finance for their investment and growth, rather than for speculators to borrow shares or abuse credit default swaps to bet on the downfall of particular companies or governments As for efficiency, market analysts are capable of advising investors to buy or sell.

7 – A ban on short selling would give the general public comfort that some real retribution is being exacted from the financial community which has caused the general economic catastrophe. Curbs on banks and bonuses are unconvincing, as they may still allow speculators to indulge in questionable betting and make huge gains (at the expense of investors generally – see para 17 onwards). A ban on short selling would reduce the possibility of such gains.

Landing a blow on hedge funds

8 – Hedge funds are the most undesirable economic development of the last 30 years, and short selling is probably their principal weapon. Of course at first sight, "hedging" by combining going long with shorting another investment might seem fairly harmless. But it does involve the questionable betting against a company.

9 – A "gift" from President Reagan led to the take off of hedge funds. In 1982 Regulation D of the Securities Act 1933 provided that funds need not be regulated if they were for the use of millionaires, those with income of $200,000, and certain institutions. (In the UK access to hedge funds is limited to sophisticated investors). Freedom from regulation gave hedge funds multiple trading advantages over traditional funds, as I set out in an article for the FTfm section of the Financial Times of 5 December 2005, and again on 22 September 2009..

10 – Regulated retail and institutional fund managers have to provide prospectuses with disclosure of their investment strategies and holdings. They are open to all investors within their different ambits, and have to offer daily redemptions. They face high

administrative costs. They are restricted to particular assets, markets or strategies, and must diversify their risks.

11 – In contrast, unregulated fund managers are allowed to keep their strategies obscure, and even to focus on one entity. They can select their clients, and impose lock up periods with no client access to money. Hedge fund managers have unlimited use of derivatives (eg betting on share values years ahead), and can increase their bets through leverage (investing borrowed money). Hedge funds also have a significant advantage through their close relationships with prime brokers – divisions of Wall Street investment banks. Such prime brokers are the arms suppliers to the private financial army of hedge funds. They introduce clients, lend money for leveraging, arrange the borrowing of shares for shorting, and provide vital market information. Hedge funds can also use tax havens.

12 - But the greatest advantage of hedge funds may be their ability to short sell. In Robert Sloan's "Don't Blame the Shorts", there is a passage "Why did the NYSE fight so hard to make shorting the central element in the battle against regulation? Because it made them rich".

13 – It is unfair for hedge funds to have multiple trading advantages over other investors. The Alternative Investment Fund Managers Directive appears unlikely to affect the most significant trading advantages, like short selling. "Artificial" hedge funds under UCITS III are unlikely to affect the imbalance significantly. So the unfairness will remain, unless corrective action is taken – taxing hedge fund profits, or eliminating hedge funds, as I suggested to the House of Lords European Union Committee (Report on the Directive on Alternative Investment Fund Managers, February 2010).

14 – It might be argued that less rich people need the protection of regulation, whereas millionaires do not. But if selective regulation by wealth, income or expertise results in unfairness then it is highly questionable. There are no ready examples of other selective regulation. For example, millionaires are not allowed to be driven in super-charged limousines along public highways without any limits or any constraints on knocking other cars out of the way (see para 17 onwards).

15 – Hedge funds have several other negative features – their speculation dominating financial markets, their high rewards polluting the financial world generally, their attacks on governments (UK, SE Asia countries, Greece, etc), and their ever present role in crises, not only in LTCM but also in the 2007-2009 crisis – as brought out in the ECB June Financial Stability Review (sudden forced and voluntary sales by hedge funds of $2.1-4.3 trillion forcing prices down, and presumably leading to the freezing of markets)

16 – In a forthcoming issue of Public Policy Research (published by the think tank ippr), I have argued that such negative features, and short selling is the most negative, merit the phasing out of hedge funds. My recent analysis (below) highlights my arguments.

“Licensed robbery” of some $100 billion a year

17 – The trading advantages of hedge funds, of which short selling may be the most significant, lead to hedge funds out-performing traditional funds. After allowing for the economic growth of the market (the market beta), the battle for alpha, the gains from advantages, skills, etc, is a zero sum game. (Actual returns to the different funds also depend on their fees and charges). With a zero sum, the extra gains of the hedge fund industry must be matched by resulting losses of traditional funds.

18 - With a hedge fund industry of $1.7 trillion, and an annualized out-performance of 6%, the extra gains of the hedge fund industry are some $124 billion a year. This is matched by resulting losses of traditional funds of $124 billion a year. The actual gains/losses depend particularly on the scale of the out-performance, and the size of the hedge fund industry, but are likely to average at least $100 billion a year.

19 – Given that governments have willfully allowed hedge funds to have unfair trading advantages, the situation amounts to hedge funds being licensed to rob traditional funds of on average $100 billion or more each year.

20 – There has been little discussion of this licensed robbery, despite references like that of Richard Bookstaber in his “A Demon of our Own Design; Markets, Hedge funds and the Perils of Financial Innovation”, 2007:-

“There is a proliferation of hedge funds that continue to capture differentially higher returns. Over the past five years the assets under management by hedge funds have grown over sixfold from $300 billion to more than $2 trillion. And this does not include the quasi-hedge fund proprietary trading desks at firms like Goldman Sachs and Deutsche Bank. It’s a zero sum game, though, so if hedge funds are able to extract differentially higher returns, someone else is paying fir them. Maybe it’s you”.

21 – The analysis starts with hedge funds out-performing traditional funds, i.e. pension funds, insurance funds, mutual funds, etc_:-

- over the period 1991-99, the Hedge Fund MSCI universe annualized return was 20.4%, compared with the return from the Equities World Index of 13.6% (Adrian Blundell-Wignall, “An Overview of Hedge Funds and Structured Products”, OECD, 2007);
- over the period 1999-2009, hedge funds overall achieved an annualized return (net of fees) of some 8.5%; Table 1 shows Edhec returns from seven principal hedge strategies ranging from 6.5% to 11%; the Hennessee composite hedge fund index return was 8.6%;
- over the period 1999-2009, the annualized returns of the FTSE and S&P 500 were 3.5% and 0.9% respectively; those for UK fixed interest and US bonds were 4.2% and 5.4% respectively.

Table 1 - Performances of hedge strategies, equities and bonds

(hedge performances net of fees)	**1999-2009**	**Standard deviation**	**Correlation with FTSE**
	% pa	**%**	
Edhec Long/short Equity	8.0	13.7	0.89
Edhec Global Macro	8.3	5.7	0.74
Edhec Event Driven	9.5	12.2	0.86
Edhec Distressed Securities	11.0	13.9	0.79
Edhec Commodity TA Global	6.5	5.8	-0.71
Edhec Merger Arbitrage	7.7	6.9	0.59
Edhec Relative Value	8.1	9.4	0.74
Hennessee HF composite index	8.6	13.6	0.87
FTSE All Share Index (reinvested)	3.5	20.5	na
S&P 500 (reinvested)	0.9	21.2	0.86
Aon Consulting Fixed Interest Index	4.2	5.9	-0.57
Barclays Aggregate Bond Index	5.4	3.9	-0.62

Sources:EDHEC, Hennessee, Aon Consulting, Barclays.

22– Allowing for such factors as the charges on traditional funds, the greater relevance of US indices, and possible equity/gilt/other mixes of traditional funds, the net out-performance of hedge funds has been in the range of 5-7% pa.

23– For illustration, it is assumed that hedge funds have achieved an overall annualized net (after fees) return of 8.5%, and traditional funds a net (after charges) of 2.5% - figures broadly in line with Table 1. With a 2&20 hedge fund fee structure, an 8.5% net return is equivalent to a gross return of 11% for a 5 year investment. An initial fee of 2% is equivalent to an annualized charge of 0.4% over 5 years. Taking that charge of 11% leaves 10.6%, and a 20% share of that "profit" results in a fee of 2.1%, giving a net return of 8.5%.

24 – Charges on traditional funds may vary from say 0.1-0.3% pa for institutional funds to an effective 1.5% pa or more on mutual funds and unit-linked insurance and pension funds. A 1% average charge is assumed , bringing the gross annualized return on traditional funds up to 3.5%, from an assumed net return of 2.5%.

25 – At end 2009 hedge funds were estimated at $1.7 trillion (IFSL). It is assumed that traditional funds totaled some $65 trillion (some $20 trillion each from pension funds, insurance funds and mutual funds, with the rest from petro dollars and sovereign funds – (Aglietta and Rigot, "The regulation of hedge funds under the prism of the financial crisis – policy implications", 2009)

26 – It is generally accepted that the battle for alpha is a zero sum game. With a hedge fund industry of $1.7 trillion, the extra gains won by hedge funds are $1.7 trillion times

the difference between the hedge funds gross return of 11% and the notional "market beta return" of B%. i.e. 1.7 times (11-B).

27 – This extra gain must be matched by a resulting loss of traditional funds, amounting to $65 trillion times the difference between the market beta return of B% and the traditional funds gross return of 3.5%, i.e. 65 times (B-3.5).

28 – Solving the equation 1.7 times (11-B) = 65 times (B-3.5) gives B at 3.69%. The advantages, etc of hedge funds have enabled them to achieve a gross return of 11% instead of the notional market beta return of 3.69%. The extra gains won on average each year by hedge funds is $1.7 trillion times (11-3.69), or $124 billion. Conversely, the resulting loss of traditional funds is $65 trillion times (3.69-3.5), a matching $124 billion.

29 – 0f course, within the overall figures the performances of individual hedge funds and traditional funds will vary greatly. Hedge funds may take more risks, but their "hedging" results in lower average volatility than traditional funds, as shown by the standard deviations in Table 1. In addition, some traditional funds will be competing more directly with hedge funds, and will then be more affected by the out-performances of hedge funds.

30 – It is relevant to consider how the extra gains of hedge funs vary with the assumptions in the analysis, and this is shown in Table 2. The key factors are shown to be the scale of the out-performance and the size of the hedge fund industry.

Table 2 - Annualised transfers from traditional funds to hedge funds; changing assumptions

	HFs out-perf. (net) %	HFs net perf %	HF gross perf.(1) %	TFs net perf. %	TF gross perf. (2) %	HF size $ trillion	TF size $ trillion	Market beta-B %	Transfer TFs to HFs $ billion pa
1 Base case	6	8.5	11.0	2.5	3.5	1.7	65	3.69	124.3
2 Up out-perf	7	8.5	11.0	1.5	2.5	1.7	65	2.72	140.8
3 Less out-perf	5	8.5	11.0	3.5	4.5	1.7	65	4.67	107.6
4 More HFs	6	8.5	11.0	2.5	3.5	2.0	65	3.72	145.6
5 Less HFs	6	8.5	11.0	2.5	3.5	1.4	65	3.66	102.8
6 More TFs	6	8.5	11	2.5	3.5	1.7	70	3.68	124.5

Notes: (1) HF fees 2% & 20% of profits; (2) TF annualised charges 1%. 5 year investment,

7 HF fees 2&15	6	8.5	10.5	2.5	3.5	1.7	65	3.68	124.4
8 TF chge 0.7%	6	8.5	11.0	2.5	3.2	1.7	65	3.40	129.2

The battle for alpha is zero sum. The extra gain from the hedge fund out-performance equals the resulting loss of traditional funds. The HF gross performance less the basic market growth, beta - B, times the total of hedge funds equals the basic market growth, beta, less the TF gross performance, times the total TFs. In the base case, that is (11-B) times 1.7 = (B-3.5) times 65. B is then 3.69% The extra gain of hedge funds
is then (11-3.69) times 1.7, or $124 billion. The resulting loss of traditional funnds is (3.69-3.5) times 65, again $124 billion. The annualised out-performance of hedge funds then results in an annualised transfer from traditional funds to hedge funds of $124 billion.
As the above table shows, the main factors affecting the level of such transfers are the scale of the out-performance and the total size of hedge funds.

31 – Short selling is a principal weapon of hedge funds, if not the principal weapon. It is then a major factor in the "licensed robbery" of some $100 billion or more a year by hedge funds from traditional funds, i.e. pension funds, insurance funds and mutual funds. If short selling were banned, such licensed robbery would be substantially reduced.

32 – My conclusion is that the Commission should propose, and the EU adopt, a ban on short selling. Such a ban would:-

- help remove the dominance of markets by speculators, and make long only investment the principal feature of markets;
- give companies, and countries, the confidence that they can pursue their investment and growth programmes without hostile attacks by short sellers;
- land a blow on the undesirable hedge fund industry, with its several negative features;
- reduce the licensed robbery of at least $100 billion or more by hedge funds from traditional funds.

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