The life of a short-seller is a hard one—especially when markets turn sour and people look for someone to blame

IT IS difficult being a short-seller. Most shareholders and managers agree that you are an important part of an efficient stockmarket—until you dump shares in their company. Then things can turn nasty. "We appreciate that, asshole," barked Enron's chief executive, on a public conference call, to a suspected short-seller who had complained about the lack of a published balance sheet. Sometimes bears need even thicker skins. In 1995 Malaysia's finance ministry reportedly proposed caning as a punishment for abusive shorting.

Since markets turned sour last year, plenty of financial firms, from Bear Stearns and Lehman Brothers in America, to Babcock & Brown and Macquarie Group in Australia, have seen increased shorting. A few have grumbled about unfair speculation. In February MBIA, an embattled bond insurer, complained to a congressional committee that "self-interested parties have gone to substantial effort to undermine the market confidence that is critical to MBIA's business". Yet the regulatory response was muted until Britain's Financial Services Authority (FSA), a City watchdog, abruptly announced new disclosure rules for anyone short-selling the stock of companies in the delicate process of issuing shares to raise capital. If market abuse does not stop with this new regime, due to come into force from June 20th, the FSA will take further steps. Since it intervened, British banks raising emergency capital have seen their shares rise.

A reaction against short-selling often follows big stockmarket declines. Congress held hearings in the United States after the crashes of 1929 and 1987, some Asian governments imposed restrictions after the regional crisis in the late 1990s, and America's Securities and Exchange Commission (SEC), the FSA and other national regulators investigated allegations of abuse after September 11th, 2001.

However, since the 1970s the best-known official studies in the West have shown that short-selling is broadly a force for good, aiding price discovery and preventing shares from becoming overvalued. That conclusion is supported by academic research. After examining the run-up to the crash of 1929, Owen Lamont of Yale University and DKR Fusion, a hedge fund, found that the more investors wished to short-sell a stock, the more overvalued it proved to be. In another study of American firms since the late 1970s, Mr Owen found that companies that attack short-sellers, with belligerent statements or harsher tactics, are likely to go on to underperform the wider market.

In reality, short-selling is far from being financial black magic. It is a difficult strategy to pull off, because in the long run stockmarkets tend to rise. It is also a minority activity: only 4.3% of shares on the New York Stock Exchange had been sold short at the end of May (see chart). Data for London are less transparent, but the best proxy is the level of shares being lent (to bet on a share price falling, short-sellers often borrow stock and then sell it). According to Data Explorers, a research firm, only 4.5% of the FTSE 100 index's value is out on loan. Many short sales are innocuous attempts to hedge other positions. Unlike going long, actively betting against a share
price involves red tape and runs the risk of unlimited losses (since a share price can, in theory, rise for ever, whereas it cannot fall below zero). The best bears, says Jim Chanos, of Kynikos Associates, the world's biggest short fund, are not bullies but "financial detectives", scrutinising companies. The short-seller that infuriated MBIA's management, William Ackman of Pershing Square Capital Management, was certainly vocal, but nobody doubted that he had done his homework.

If short-selling is generally beneficial, does it face hurdles? America introduced the "uptick rule" in 1938, aiming to act as a "circuit-breaker" by forcing short-sellers to execute above the price level of the last reported market trade. It has recently scrapped this rule, which short-sellers argue was largely symbolic, and it remains in place at only a few of the world's big stock exchanges. Both the SEC and Australian regulators are examining "naked short" positions, in which a fund sells shares it has not yet got in its hands, gambling that it can borrow some before the trade is settled. Still, regulators' concerns about naked shorting mainly reflect the risk to settlement, rather than to the integrity of large companies' share prices. Finally, almost all countries (although not Britain) require aggregate short positions in individual stocks to be disclosed.

None of these restrictions impose a really onerous burden on short-sellers. Compared with them, the FSA's intervention is heavy handed. Forcing funds to disclose short positions if they exceed 0.25% of the capital of a company in a rights issue is far more stringent than the obligations long positions face—and probably bureaucratic too. But it is the FSA's threat to "take further measures" if need be, say, limiting stock lending during rights issues, that has really spooked short-sellers.

The regulator says that "market abuse" may have driven the share prices of banks near or below the offer price for new shares, putting pressure on the underwriters of the rights issues to buy the new stock. Yet market abuse, which the FSA has defined as including insider trading, spreading false information, or deliberately distorting share prices, is usually pursued by prosecuting offenders, not restricting types of activity. And although short-selling was certainly taking place in London, the FSA has yet to show that the level of activity was great enough to dominate trading and thus distort the banks' share prices. Data Explorers estimates that the stock on loan for HBOS, a big British bank, has been fairly constant at about 7% of its market value since it announced its rights issue.

All of which suggests that the FSA wanted to ensure banks can successfully raise capital. That is a worthy objective—assuming those banks are solvent—but it may have been better done by other means. The banks could have issued new shares at a bigger discount without, at least in theory, damaging their shareholders. And the underwriters could have stepped up to the plate. The FSA says its measures are temporary, and promises to conduct a review with the Treasury. But the episode has a familiar ring. Once again short-sellers have found that their business is permitted and even lauded by regulators—until prices fall and the blame game begins.