

# Shorting Ban Could Stall Hedge Fund Activity

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While the U.S. government's ban on short-selling financial stocks has helped boost markets, this temporary plan will put hedge funds in a tough spot, at least until the restriction is lifted on October 2.

"Shorting is very much in essence what hedge funds do," says Pierre Saint-Laurent, president of Toronto-based Asset Council Inc. "It will be very hard on the management of the funds. If you remove the components [that make hedge funds work] you're taking some legs off of the stool."

The new restriction prevents short-selling for 799 financial stocks, including Morgan Stanley, Citigroup and Wachovia. It also bans the practice of "naked" shorting, which is shorting without actually borrowing the stock first. This trading method is already illegal, though authorities rarely crack down on this activity.

Saint-Laurent says the U.S. federal government implemented this ban because shorting exacerbates market volatility. "We don't need extra volatility at this point," he says. "What this does though is, in effect, create a cease-trade situation for hedge funds."

Wilfred Hahn, chief investment officer at HAHN Investment Stewards & Company, says the move to ban short-selling is "ridiculous." He says the ban effectively means that excessive buying of over-leveraged and over-valued stock is fine, but "should anyone have an opinion of a stock that's over-valued then that's criminal. It's Orwellian because I can only think positive things about everything."

He adds that the markets are binary — there's a buyer and a seller — and each side should have the freedom to express opinions of what things are worth. "Longer-term and to the integrity of capital markets, this is pathetic that we have to get to situations like this," he argues.

There are a number of different types of hedge funds, but Hahn says the ones that will be affected the most are the 130-30 types. He explains that funds are going to have to buy back some of the securities they shorted so they won't be in a short position. The market is already seeing that happen as financials are pushing the overall market numbers up.

It's hard to say if hedge funds will be affected long term by this ban, and it's not clear whether the Securities and Exchange Commission will extend the deadline, which they can do by 30 days. However, Saint-Laurent explains that we could see a significant deterioration of hedge fund performance, with a number of funds not being able to execute their strategies.

"They're basically preventing them from doing what they do best," he says. "Does this mean financial markets are put at risk? I don't think so, but from the point of view of investors and hedge funds, among which are very large pension funds, they're managing money for future retirees and that's put at risk."

Although this ban is American — the U.K. enacted a similar measure this week as well — Canadian-based hedge funds could be affected, as many of them don't trade exclusively in this country. "Canadian hedge funds do not limit themselves to the Canadian market to any significant extent," explains Saint-Laurent. "In as much as any market

participant in those markets which are affected by demand concern, Canadian hedge fund managers would be impacted the same way. No more or less."

What hasn't been affected so far, however, is Canadian ETFs that participate in short-selling, such as the double short ETF from Horizon's BetaPro.

Howard Atkinson, president of BetaPro Management, says his funds that sell short do have some exposure to U.S. financials, but that exposure is through the futures markets, which the ban does not cover.

The funds also have exposure to Canadian financials, but so far shorting is still allowed here.

Atkinson is watching the markets closely, though, and he's in communication with his portfolio manager in the U.S., whose company, ProShares ETFs, has been affected by the ban. His lawyers have also been in talks with Canadian regulators to see if a shorting stoppage will come, though he hasn't heard anything indicating it will.

While many in the industry feel the short-selling ban is a positive temporary measure to help the markets — despite that, hedge funds are feeling the pinch — others wish the Feds would do away with these funds altogether. Don Macfarlane, a Toronto-based advisor, says shorting by hedge funds has had a negative influence on market volatility.

"I don't think one day the markets can go 300 points up and then down by the same amount. That's unheard of," he says. "I'm sure a lot of this is being driven by hedge funds. It's the old fear and greed, but hedge funds are fear and greed on steroids."

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