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Short Sellers Do Work of Cops on Doughnut Break: Susan Antilla

Commentary by Susan Antilla

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Don’t worry. There are lots of people watching out to be sure the financial markets are running right. They just aren’t the regulators employed by the government.

If last fall’s 477-page “Investigation of Failure of the SEC” to nail Ponzimeister Bernie Madoff didn’t convince you that the securities cops have been on a long doughnut break, the more recent tome by the examiner in the Lehman Brothers bankruptcy proceedings should have put you over the edge. In that case, the blundering Securities and Exchange Commission was camped out in Lehman’s offices while the brokerage firm was listing toward oblivion. The document makes Bernie-gate look like petty shoplifting.

Yesterday, SEC Inspector General David Kotz gave further confirmation that investors are on their own. In a report detailing the handling of the agency’s kid-gloves investigation of the business-development company Allied Capital, one staffer told Kotz “it’s almost like they didn’t want to find something.”

But never fear. In the new Wild West of Wall Street, you just have to know where to look to uncover the players who have a role in exposing the bad guys and pushing for financial justice. With regulators taking a refreshing two-decade snooze, it’s now up to judges, plaintiffs’ attorneys, short sellers, bloggers and detectives to fill in for the somnolent stock cops.

Lehman Report

Take the Lehman report. At 2,200 pages, it is the definitive work on who-told-what-to-whom in the executive suites of the out-of-control brokerage firm. We learn, for example, that board members were fed pablum about the firm’s toxic subprime-loan holdings because Lehman’s president deemed them “not sophisticated” about such things.

By this point, it should come as no surprise that it takes a private lawyer (Anton Valukas) appointed by a judge in a non- SEC case (the Lehman bankruptcy) to produce an exhaustive investigation of the nauseating rule-breaking that went on at Lehman.

Regulators these days, in fact, have to be slapped around by courts that catch them siding with the bad guys. I’ll bet U.S. District Court Judge William H. Pauley III had one of those “did I read that right?” moments when he was reviewing a request by a group of 12 brokerage firms that wanted to scale back restrictions placed on them in the wake of the 2003 research analyst scandals. Not only were the firms asking to break down the firewalls that were put up to keep analysts from undue influence by investment bankers. They were making that request in cahoots with the SEC.

Watching Out

To do that would be “contrary to the public interest,” the judge said. At least the courts are watching out for investors.

U.S. District Judge Jed S. Rakoff is another jurist who has done his part to get the SEC to act like a regulator, rather than a Wall Street co-conspirator. In September, he told the SEC and Bank of America Corp. that their proposal to settle a case involving misleading statements made in connection with Bank of America’s acquisition of Merrill Lynch was an attempt to display a “facade of enforcement.”

Short sellers who place bets on stocks that they expect to fall are another important contributor to keeping markets honest, yet regulators and whiny corporate executives often think the wise way to deal with shorts is to investigate them -- not the public companies they target for incompetence or cheating.

Going Short

When hedge fund manager David Einhorn told an audience of investors in 2002 that he recommended shorting Allied, the SEC investigated him before they bothered to probe the company. The lukewarm probe the SEC wound up doing didn't even include a visit to Allied headquarters two blocks from the SEC. Ultimately, the SEC's documents on Allied were mysteriously deleted from the agency's computers, the new Kotz report says.

In a classic SEC farce, the agency has acknowledged the shorts' important role in balancing the boundless swamp of financial hype by slapping new curbs on them on Feb. 24.

No less an expert on white-collar crime than onetime jailbird Sam Antar, whose Web page says he masterminded "one of the largest securities frauds of its time" when he was chief financial officer of Crazy Eddie Inc. in the 1980s, says the way to counter market hype is to make it easier to research short- sale ideas and sue fraudsters. And trust me, Antar should know.

"There is nothing worse for a criminal to deal with than an adversary with a profit motive," he told me in a telephone interview.

Bloggers Too

Bloggers are doing their part to fill in where the regulators fail, too. Blogger Barry Ritholtz said on June 3, 2008, that it was time to sell Lehman Brothers at $30.61. Less than four months later, and after interminable carrying on by Lehman and others about short sellers telling unfair tales, the firm filed for bankruptcy.

Randy Shain, executive vice president at New York's First Advantage Investigative Services, says he has been getting business from types of customers he'd never signed up before. Small funds of funds and endowments that used to consider his services too expensive now find they can't afford to sit back and assume a regulator is watching out for them. Shain's competitors told me similar stories.

So it takes a village -- of private investigators, judges, short sellers, bloggers and court-ordered examiners -- to get any financial regulating done these days. Here's an idea for making things right for investors: How about shutting down the dysfunctional SEC and giving taxpayers a regulatory voucher in a new privatized world of financial policing? They can use the money to hire from the expanding list of private investigators before they pick a mutual fund, sign on with a hedge fund, or decide on the merits of their 401(k) plan. And there no longer would be any pretense that their tax dollars were paying for regulation that actually protected them.

(Susan Antilla is a Bloomberg News columnist. The opinions expressed are her own.)