SEC Economist Leaving Amid Short-Sale Rules Conflict (Update2)

By Jesse Westbrook

March 9 (Bloomberg) -- The U.S. Securities and Exchange Commission's top economist is leaving the agency after Chairman Mary Schapiro merged his office with another and passed short- selling rules that hedge funds said ignored financial analysis.

James Overdahl, whose office reviews potential regulations to determine whether benefits outweigh costs, said in an e-mail today that he will step down March 31 to join NERA Economic Consulting. He joined the SEC in 2007 from the Commodity Futures Trading Commission, where he also served as the top economist.

Republican commissioners cited economic analysis last month as they protested the SEC's new restrictions on short-selling, saying the agency lacked data to show bearish stock bets contributed to the 2008 financial crisis. Kynikos Associates Ltd. President James Chanos, in a news release after the vote, said the SEC disregarded evidence that short-selling boosts liquidity and leads to more accurate stock valuations.

"Because there were fears that short-sellers were causing problems, the SEC responded," said Lawrence Harris, a former chief economist for the agency who's now a finance professor at the University of Southern California in Los Angeles. "We don't want to do things in the heat of the moment that we later regret. Analysis helps ensure that the government doesn't make capricious decisions."

Direct Reporting

Overdahl was named chief economist three years ago by Christopher Cox, Schapiro's Republican predecessor. He stopped reporting directly to Schapiro in September after she merged economic analysis with the office charged with spotting emerging risks to financial markets. Schapiro appointed University of Texas law professor Henry Hu to oversee the combined unit.
Overdahl said he will work in NERA's Washington office as a vice president in the securities and finance group. He declined to comment on whether the short-sale rules or the reorganization affected his decision, and said today in an interview that he began his job search before last month's vote.

"Given the importance of rigorous economic analysis to the commission, we truly appreciate Jim's dedication and his many contributions during a time of extraordinary challenges in our financial markets," Schapiro said in a statement today.

Short-sellers aim to make money by borrowing shares from brokers, selling the stock and then buying it back at a lower price. The traders then return the borrowed shares and pocket any profits.

Barney Frank

Lawmakers including House Financial Services Committee Chairman Barney Frank, a Massachusetts Democrat, urged the SEC to curtail short-selling after the Standard & Poor's 500 Index fell 38 percent in 2008. Morgan Stanley and Lehman Brothers Holdings Inc. executives blamed the bearish bets for driving down bank stocks.

SEC commissioners responded Feb. 24 by voting 3-to-2 to restrict short sales of a company's shares when the stock falls 10 percent from the previous day's close. Once the threshold is triggered, traders could only execute bearish bets at a price above the market's best bid.

Schapiro, a political independent who joined the SEC's two Democrats to pass the rule, said the agency took action because short-selling undermines investor confidence. The regulator struck the right balance by recognizing that shorting has "both a beneficial and a harmful impact on the market, depending on the circumstances," she said at a public meeting.

'Shifted Approach'

"The SEC shifted its rulemaking approach from relying on empirical evidence of what is in the best interest of individual investors to an emphasis on market psychology," Senator Mike Crapo, an Idaho Republican, wrote in a letter to Schapiro the day of the vote. "This change is a significant departure and raises many questions about how the SEC will proceed."

A December 2008 analysis by two SEC economists working under Overdahl found no evidence that "episodes of extreme negative returns are the result of short-selling activity." The economists, Daniel Aromi and Cecilia Caglio, said bearish bets actually make up a higher portion of trading volume when markets are rising than during periods of negative returns.

Republican SEC commissioners since President George W. Bush's administration have advocated that the agency conduct thorough examinations of how policies will affect markets, investors and companies before taking action.

The approach halted efforts to increase regulation of hedge funds and mutual funds six years ago, said Roel Campos, a former Democratic SEC commissioner who's now a Washington-based law partner at Cooley Godward Kronish LLP. It also slowed the agency in penalizing technology companies accused of manipulating employee stock-option grants in 2007, he said.

"It is very easy to measure costs and not so easy to measure benefits," Campos said today in an interview. "Too often economic studies are requested as a way of stalling and thereby killing initiatives."

To contact the reporter on this story: Jesse Westbrook in Washington at jwestbrook1@bloomberg.net.
Last Updated: March 9, 2010 17:29 EST