This blame game is short on logic

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After acquiring General Re in 1998, Warren Buffett, the veteran investor, learnt the hard way that "derivatives are like hell, easy to enter but almost impossible to exit".

Four years later, Mr Buffett, chairman of Berkshire Hathaway, argued that highly complex financial instruments and derivatives were time bombs and that these "financial weapons of mass destruction" might harm the economic system. His caution was prescient – like that of many others who have identified company frauds or diagnosed previous credit cycles gone wild. Yet most of these gloomy messengers have been ignored. Since Mr Buffett's warning, financial markets have imploded and policymakers have failed to address the abuses that created the crisis, from the excess leverage of banks to ratings agency failures.

Instead, public policy has become focused on a blame game aimed at restricting the short-selling of securities – especially of a financial kind. In July, Christopher Cox, chairman of the US Securities and Exchange Commission, announced a plan to curb improper (naked) short-selling. In doing so he has (de facto) attempted to limit the activity of short-sellers. Mr Cox seems to be implicitly blaming the shorts for the unprecedented fall of bank, government-sponsored agency and brokerage stocks over the past year – even though short-sellers were the very group that warned of the dangerous credit cycle and its consequences.

Short-selling runs deep in financial history. Perhaps the first case dates to 1609 when the Dutch trader, Isaac Le Maire, targeted the shares of the shipping company, Vereenigde Oostindische Compagnie (the Dutch East India Company). VOC was the first multinational corporation in history and had broad powers. Nonetheless, Le Maire, concerned about threats of attack by English ships, sold VOC's shares short. After learning about Le Maire's tactics, the stock exchange governing VOC's trading banned short-selling (although the ban was later revoked).

In the early 1630s, the Dutch economy fell into a depression following a speculative peak in the trading of tulips. Again, short-selling raised the ire of regulators, many of whom saw it as magnifying the effect on the Dutch economic downturn. As a result, England banned short-selling outright.

Almost 420 years later – in the late 1920s – short-sellers warned of the consequences of speculation. But in the aftermath of the Wall Street crash of 1929, many blamed them and the uptick rule – which banned short-selling on downticks – was instituted (and stayed in effect until 2007). More regulation governing short-selling came into force in 1940, with a ban on mutual funds from short-selling (though that law was lifted in 1997). In early 2005, the SEC again sought to restrict the practice.

Yet short-sellers have served as financial watchdogs, as many of their warnings have been spot on. The delusional dotcom boom in the late 1990s brought Cassandra-like utterings from the short-selling cabal that proved insightful but were largely ignored. After the subsequent 75 per cent collapse of the Nasdaq, a bull market in corporate fraud emerged and short-sellers such as David Rocker, founder of Rocker Partners, highlighted accounting problems at companies such as Sunbeam, Tyco and Lernout & Hauspie. Kynikos' Jim Chanos played a role in uncovering the largest fraud in history when his contrary-minded analysis warned of Enron's accounting shenanigans – which were emulated (but ignored by investors) in the banks' recent dalliance with structured investment vehicles.

By the middle of the decade the property cycle was in full bloom and David Tice of the Prudent Bear Fund warned of the dire ramifications of a downward spiral in home prices on the levered balanced sheets of Fannie Mae and Freddie Mac. Soon thereafter, Nouriel Roubini, the economist, voiced particularly pessimistic forecasts about the housing market's impact on credit.

Drawing a line between economic and market progress as against fantasy is a role taken by the few. Short-sellers provide an anchor of objectivity in an investment world populated by those more interested in rewards than in uncovering systemic risks. This week, Mr Cox said the SEC would announce new regulations to restrict short-selling. Instead of more regulation, the chairman and investors should begin listening to what short-sellers have to say about our economy and credit markets.

The writer is founder and president of Seabreeze Partners Management, which manages Seabreeze Partners Short and Seabreeze Partners Short Offshore, two dedicated short hedge funds