A Review of Equity Short Sales and Abuses by Short Sellers

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Legitimate Short Sales

Efficient equity markets require legitimate short sales. As long sales provide markets with positive information about investors' positive of a company's outlook, short sales inject information about investors' negative views of a stock's prospects. The value and credibility of that information is based on the cost and risk borne by the sellers and purchasers in the trading. In a legitimate short sale, the investor who expects stock A to decline directs his broker-dealer to short the stock by borrowing shares of the stock, selling them to another investor, waiting for the stock to decline by some amount, and then directing the broker to buy shares of the stock at the lower market price and use them to replace the shares borrowed for the short sale. Until the shares are replaced, broker dealer for the short seller generally retains the funds from the short sale as collateral. The short seller's profit is the difference between the price he receives for selling the borrowed share and the price he pays for the shares used to replace those borrowed shares.

The short seller bears the risk that the stock will increase in value instead of declining, and therefore the cost if he has to replace the borrowed shares with shares purchased at a higher price. The short seller also bears the costs of the trading commission and a fee or interest rate applied to the price of the borrowed shares, although that borrowing fee is often offset by the interest the short seller earns on the proceeds from the short sale being held as collateral (a "rebate"). When the demand by short sellers for borrowed shares in a stock is high, the fee to borrow them increases, and the interest on the collateral may not offset the fees and commissions (a "negative rebate").

Abusive Short Sales

The most common short sale abuse is naked short selling, in which as short seller and his broker dealer sell shares that the broker dealer fails to borrow and deliver, producing a "fail to deliver" or FTD. The purchaser pays for the shares, and the broker dealer for the short sale retains the payment as collateral (earning interest for the naked short seller) until the naked short seller covers the transaction by buying shares (presumably at a lower price) that the broker belatedly transfers to the seller's account. Such naked short sales are possible, because broker dealers are required only to "locate" shares that can be borrowed before short selling the stock and are not required to deliver the shares for three days (T or trading day +2 days).

The naked short sellers and his broker dealer face no penalty or significant risk for failing to borrow and deliver the shares; and the Depository Trust and Clearly Corporation (DTCC), the entity that clears and settles all equity (and bond) trades on behalf of broker dealers (wholly owned by those broker dealers) covers the shortfall from its own inventory Under current SEC regulation (Reg SHO), the only risk and potential cost facing the naked short seller and his broker dealer arise when at least 10,000 shares of a particular stock or 0.5 percent of its outstanding shares have been designated as FTDs for five consecutive days, and the naked short seller fails to settle the trade for

an additional 10 days. At that point, the broker-dealer must enter the market and buy the shares on behalf of its client, regardless of price.

Naked short sales can be used directly to depress a stock's price. Since the naked short seller with a compliant broker does not locate and borrow the shares and pay any borrowing cost, he or she can sell short the number of shares required to depress to the stock's price, eliminating economic risk and guaranteeing a profit. This illegal strategy is most effective when the stock has a relatively small number of shares available for trading (its float), a record of moderate trading volume, and is not widely followed on Wall Street. The small float and moderate trading volume allow the naked short seller to depress the share price with waves of sales; and because the stock is not followed widely, the depressed price may not attract bargain hunters who could drive up the price.

In some cases, large-scale naked short sales have been sustained for long periods, crippling a company. As we will see, naked short sales can occur through private trades not processed through by the DTCC or by using complex combinations of derivatives and short sales to depress a stock's price without formally breaching Reg SHO. Reg SHO also does not prevent a naked short seller from depressing a stock's price for several days, covering his naked short sales, and repeating the process to further depress the price. In addition, largescale naked short sales can be used to depress a stock's price for short periods (less than T+2), including with through high frequency trading.

The Dimensions of the Problem

Starting in the early 1990s, shareholder activists and smaller companies attacked by short sellers urged the SEC to investigate, but to no avail. For more than a decade, the DTCC insisted that naked short sales were a minor short-term phenomenon that arose mainly from administrative problems regarding the transfer of stock certificates (97 percent of stocks already were held and transferred electronically). In this period, the DTCC also refused to make public any data to support its claims, including the number of naked shorts or the companies subject to them.

In 2004, the SEC directed that an economist named Leslie Boni examine the DTCC's records and establish the dimensions of the problem. Boni selected randomly several days to examine short sales and FTDs and found that they were pervasive and substantial. On a given day, 80% of the 6,100 NYSE and Nasdaq stocks had FTDs totaling 120 million to 180 million shares, as did 58% of OTC stocks with FTDs totaling 300 million to 420 million shares. All told, daily outstanding naked shorts totaled 420 million to 600 million shares, an average of 510 million shares.

Most of these FTDs persisted for substantial periods. Boni found that the naked shorts of NYSE and Nasdaq stocks persisted for an average of 13 days; and 1,000 listed stocks had FTDs lasting for at least one month, and 700 had FTDs of 100 million to 120 million shares lasting two months or longer. For OTC stocks, over 900 had FTDs that persisted for at least one month, and 800 OTC stocks had FTDs lasting two months or longer. Boni concluded that largescale FTDs were not inadvertent or the result of administrative errors, but rather "deliberate and strategic."

The SEC responded with Reg SHO, the first new regulation of short sales since the 1930s. The regulation initially contained large exceptions that allowed largescale FTDs to persist, and analysis showed that the average number of FTDs had not declined significantly. Further study (by this author) also showed that the naked shorts were highly concentrated: On any given day, 50 to 80 companies accounted for 95% of the outstanding FTDS of NYSE and Nasdaq stocks, 20 or fewer companies accounted for 75% of all FTDs in listed stocks, and 60 to 80 OTC stocks accounted for

65% of all FTDs of unlisted stocks. All told, 15 to 33 NYSE and Nasdaq stocks and 27 to 45 OTC stocks each had naked shorts of more than 1 million shares. Those findings established that naked short sales were being used to depress the share prices of selected stocks.

By 2008, the SEC acknowledged that Reg SHO was not working and that naked short sales were "abusive" and used to "manipulate" stock prices. The Commission therefore issued new amendments to Reg SHO that did substantially reduce the official tally of naked shorts. Nevertheless, abusive naked short sales that evade Reg SHO persist. Numerous hedge funds focus on shorting stocks in large quantities, sometimes using techniques that effectively involve naked shorts – for example, through large scale private trades not processed through the DTCC clearing and settlement process, called "*ex clearing*." Manipulators also may use complex combinations of derivatives and legitimate short sales to artificially depress a stock's share price. Further, while regulations stipulate, in effect, that most shares can be borrowed only from the accounts of institutional investors, the SEC and DTCC have not set out rules that ensure that brokers dealers use only lendable shares for their clients' short sales, resulting in effective naked shorting.

What Could be Done?

Given the large potential profits from using naked shorts to depress a company's share price, manipulators prepared to assume some legal risk – and avoid any economic risk -- continue to use naked short sales to manipulate stock prices of targeted companies. One approach to reduce such manipulation would involve increasing the legal risk and linking it closely to new economic risk. For example,

1) Replace the current requirement that broker dealers "locate" lendable shares before undertaking a short sale with a new "pre-borrow" requirement that they borrow the shares before undertaking a short sale.

2) Stipulate that all trades, including short sales, must be settled electronically on the day of the trading or before markets open the following day, and so replace T+2 with T.

3) Require that broker dealers report all short sale trades to the SEC on a daily basis, including those occurring *ex clearing*, providing the names of the stocks shorted, the number of shares sold short in each stock, and the sources of the borrowed shares.

4) Stipulate that a broker violating these rules may face a month-long suspension from trading and fines equaling the initial proceeds from a short sale in violation of the rules and that a broker who falsifies the required reporting to the SEC in order to hide violations of these rules may be subject to indictment and imprisonment. Stipulate further that a broker dealer whose employees have violate these rules on a persistent basis may face a suspension of the firm's right to carry out short sales for some period.