

# ARTICLE

## NAKED SHORT SELLING: HOW EXPOSED ARE INVESTORS?<sup>+</sup>

*James W. Christian,\* Robert Shapiro,\*\* & John-Paul Whalen\*\*\**

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+ One of the Authors of this Article is plaintiff's counsel in a series of litigation involving naked short selling. The Houston Law Review invited a response from defense counsel, who elected not to submit a response.

\* Managing Partner, Christian Smith & Jewell, Bachelor of Science, West Texas State A&M University, 1975; J.D. South Texas College of Law, 1977, in only two years. In addition to being licensed by the Texas State Bar, Mr. Christian is also licensed by the New York State Bar. He is admitted to practice in all state courts in Texas and New York and before the United States District Court for the Southern District of Texas, the United States District Court for the Northern District of Texas, the United States Court of Appeals for the Fifth Circuit, the United States Tax Court, the United States Court of Claims, the United States Court of Customs and Patent Appeals, and the United States District Court for the Western District of Colorado. I thank John M. O'Quinn for being my partner and inspiration in these stock fraud cases; John and I believe our pursuit could result in exposing the largest commercial fraud in U.S. history involving hundreds of billions of dollars.

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## I. INTRODUCTION

In early 2005, an investor named Robert Simpson quietly orchestrated a stock trade that may have exposed serious problems in America's securities markets.<sup>1</sup> Using a single broker, Simpson purchased all 1,158,209 of the outstanding shares of stock in a small real estate company named Global Links Corporation<sup>2</sup> for a grand total of \$5,205.<sup>3</sup> Simpson properly completed this transaction and filed the appropriate paper work with the Securities and Exchange Commission (SEC) denoting his ownership interest in Global Links.<sup>4</sup> Simpson then placed all of the shares from his newest investment in his sock drawer for what he thought would be safe keeping.<sup>5</sup>

Simpson's first indication that this did not constitute an ordinary stock purchase was when he completed an order for 1,158,209 shares of Global Links shares on the market even though the company's total number of shares available for purchase amounted to only 1,158,064 shares—a small but significant difference of 145 shares.<sup>6</sup> The strange circumstances surrounding Simpson's purchase continued as he watched while shares in the company continued to trade at high volumes in the

1. See Global Links Corp., Schedule 13D, at 3-4 \*\*Feb. 3, 2005), available at <http://www.sec.gov/Archives/edgar/data/949728/000101540205000967/doc1.txt> [hereinafter Global Links Schedule 13D]; see also Helen Avery & Peter Koh, *The Curious Incident of the Shares That Didn't Exist*, EUROMONEY, Apr. 2005, at 32 (recounting Mr. Simpson's purchase of Global Links stock).

2. See Global Links Corp. Home Page, <http://www.globallinkscorp.com> (last visited Oct. 28, 2006) (providing information on Global Links and its assets).

3. See Global Links Schedule 13D, *supra* note 1, at 3 (noting Mr. Simpson's purchase of all 1,158,209 outstanding shares of Global Links).

4. See 17 C.F.R. § 240.13d-1(a) (2006) (mandating that a Schedule 13D be filed when an investor has acquired more than 5% of a company's shares of stock).

5. Karl Thiel, *The Naked Truth on Illegal Shorting*, THE MOTLEY FOOL, Mar. 24, 2005, <http://www.fool.com/news/commentary/2005/commentary05032407.htm> (describing Mr. Simpson's actions after purchasing all of the available shares of Global Links, which did, in fact, include him putting them in his sock drawer).

6. Compare Global Links Schedule 13D, *supra* note 1, at 3 (denoting Simpson's ownership of 1,158,209 shares of Global Links Corp.), with Global Links Corp., A Letter to Our Shareholders (Mar. 15, 2005), [http://www.investorshub.com/boards/board.asp?board\\_id=3439](http://www.investorshub.com/boards/board.asp?board_id=3439) [hereinafter Shareholder Letter] (stating that only 1,158,064 shares were available for purchase on the market). At the time of this transaction, Global Links had recently completed a one for 350 reverse stock split. *Id.*

over-the-counter stock market.<sup>7</sup> Despite Simpson's ownership of 100% of the outstanding shares, 37 million Global Links shares traded the next day, followed by another 22 million on the following trading day, all without Simpson selling a single share of stock.<sup>8</sup> Incredibly, every share of Global Links stock had changed hands sixty times in the two days following Simpson's acquisition, even though he supposedly had every single outstanding share of the stock in his sock drawer.<sup>9</sup>

At roughly the same time but in another financial universe,<sup>10</sup> Patrick Byrne, the CEO of NASDAQ company Overstock.com,<sup>11</sup> began to notice strange trading patterns in his company's stock. Byrne noticed that on certain days the number of shares traded in Overstock.com's common stock amounted to four to five times the total number of shares outstanding.<sup>12</sup> These high trading volumes persisted even though Byrne, his family, and ten allied financial institutions supposedly held close to ninety-nine percent of the outstanding shares.<sup>13</sup> With this large block of

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7. See Avery & Koh, *supra* note 1, at 32 (describing the events surrounding Simpson's purchase of all the shares of Global Links). Global Links Corp. is an Over the Counter Bulletin Board (OTCBB) company, which means that it does not trade on one of the nation's larger stock exchanges, such as the New York Stock Exchange (NYSE) or the NASDAQ. See Overview and History of the OTCBB, <http://www.otcbb.com/aboutOTCBB/overview.stm> (last visited Nov. 11, 2006) (describing the OTCBB market and explaining that it has no affiliation with the NYSE and the NASDAQ). However, OTCBB companies are subject to Securities and Exchange Commission (SEC) reporting requirements. *Id.* Generally, companies like Global Links are risky investments that present a higher possibility of fraud to investors. See Amendments to the Penny Stock Rules, Exchange Act Release No. 49,037, 69 Fed. Reg. 2531, 2532 (Jan. 16, 2004) (to be codified at 17 C.F.R. pt. 240) (discussing the added risks associated with small-cap companies).

8. See Avery & Koh, *supra* note 1, at 32.

9. Thiel, *supra* note 5. There are other possible explanations for the strange patterns in Global Links stock. See Karl Thiel, *Who's Behind Naked Shorting*, THE MOTLEY FOOL, Mar. 30, 2005, <http://www.fool.com/news/commentary/2005/commentary05033008.htm> (providing alternative theories for the trading patterns in Global Links' stock).

10. Compare Overstock.com, Annual Report (Form 10-K), at 31 (Mar. 16, 2005), available at <http://www.sec.gov/Archives/edgar/data/1130713/000104746905006713/a2153715z10-k.htm> [hereinafter Overstock.com Annual Report] (disclosing Overstock.com's nearly \$500 million in revenue for 2004), with Global Links Corp., Annual Report (Form 10-KSB) (Apr. 11, 2005), <http://www.sec.gov/Archives/edgar/data/949728/000094972805000010/doc1.txt> (showing Global Links' total revenue for 2004 to be only \$113,000).

11. See Overstock.com, Management Profiles, Dr. Patrick M. Byrne, <http://investors.overstock.com/> (follow "Management Profiles" hyperlink) (last visited Nov. 11, 2006) (noting Dr. Patrick Byrne's status with the company and giving his biography).

12. Thiel, *supra* note 5; see also Historical Prices for Overstock.com, <http://finance.yahoo.com/q/hp?s=OSTK&a=5&b=21&c=2002&d=0&e=6&f=2006&g=d&z=66&y=198> (last visited Nov. 11, 2006) (documenting very high trading volumes in Overstock.com's shares reaching up to nine million shares on January 28, 2005).

13. Interview by Ron Insana with Patrick Byrne, Chairman & CEO, Overstock.com,

shares metaphorically tucked away in Byrne's sock drawer,<sup>14</sup> such high trading volumes seemed highly irregular, if not impossible.

Along with their unusually high trading volumes, Global Links and Overstock.com share another unsettling characteristic: over the past year, both companies have experienced a dramatic drop in the price of their common stock.<sup>15</sup> Is there a link between the strange trading patterns exhibited by Global Links and Overstock.com and the downward pressure on the two companies' share prices?<sup>16</sup> Both Simpson and Byrne adamantly contend that the link between their depressed stock prices and the high trading volumes is not mere coincidence.<sup>17</sup> Byrne, Simpson, and many others<sup>18</sup> believe that Global Links, Overstock.com, and many other companies, both large and small,<sup>19</sup> are victims of a trading strategy known as naked short selling.<sup>20</sup>

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for CNBC/Dow Jones Business Video (Aug. 12, 2005), available at <http://www.highbeam.com/doc/1P1:112119789/Overstock%7eR%7ecom++Chmn%7eR%7e+%7eA%7e+Pres%7eR%7e+Interview.html> (documenting Byrne's claim that he, his relatives, and ten financial institutions owned 18.5 out of 18.7 million shares of outstanding common stock (98.9%)); see also Overstock.com Annual Report, *supra* note 10, at F-4, F-6 (noting that Overstock.com has issued 19,390,000 shares of common stock).

14. See Thiel, *supra* note 5 (introducing the sock drawer metaphor by telling Simpson's original story of the shares in the sock drawer).

15. See Basic Chart for Overstock.com, <http://finance.yahoo.com/q/bc?s=OSTK&t=5y&l=on&z=m&q=l&c=> (last visited Nov. 11, 2006) (showing a drop from over \$60 per share to under \$30 per share in 2005); see also Shareholder Letter, *supra* note 6 (documenting the drop in Global Links shares from \$0.10 per share to a low of \$0.0008).

16. See Avery & Koh, *supra* note 1, at 38 (hypothesizing that excess shares could harm a company by increasing the number of shares that could be sold if the company reported bad news).

17. See *id.* at 32 (noting Simpson's belief that his main corporation, Zann Corp., suffered a 98% drop in its share price despite relatively good financial performance due in part to naked short selling); Thiel, *supra* note 5 (noting Byrne's belief that his company has been victimized by naked short selling).

18. See Liz Moyer, *Crying Foul in Short-Selling Land*, FORBES.COM, June 21, 2006, [http://www.forbes.com/2006/06/20/naked-short-selling-overstock-cx\\_lm\\_0621short.html](http://www.forbes.com/2006/06/20/naked-short-selling-overstock-cx_lm_0621short.html).

19. Naked short selling affects both large and small cap companies. See NYSE, Inc., Threshold Securities List (Mar. 6, 2006), available at <http://www.nyse.com/threshold/> (follow the "03/06/2006" hyperlink) (documenting that large cap stocks such as General Motors can appear on threshold securities lists designed to track stocks that might be victims of manipulative naked short selling); NASDAQ, Inc., Threshold Securities List (Mar. 3, 2006), available at <ftp://ftp.nasdaqtrader.com/symboldirectory/regsho/nasdaqth20060303.txt> (noting that large cap technology companies such as online movie retailer NetFlix appear on threshold securities lists). Stocks that appear on threshold securities lists are experiencing persistent high levels of failures to deliver commonly associated with manipulative naked short selling. See *infra* Part V.B.2 (examining in depth the relationship between a stock's appearance on threshold securities lists and manipulative naked short selling).

20. Not all naked short selling is manipulative; however, this Article will use the term "naked short selling" to refer to instances where the naked short seller's failure to

Naked short selling is a perversion of an ordinary trading strategy known as traditional short selling.<sup>21</sup> Traditional short selling involves selling shares that the seller does not own but has borrowed with the requirement that the short seller purchase equivalent shares on the market and return them to the lender at a later date.<sup>22</sup> The traditional short seller anticipates that the share price will drop and that he can then make a profit by buying equivalent shares at a lower price, returning them to the lender, and keeping the difference.<sup>23</sup> In contrast, naked short selling is basically “make-believe short-selling.”<sup>24</sup> “[N]aked short sellers sell shares of stock they haven’t borrowed, have no intention of borrowing, and that may not even exist.”<sup>25</sup> Often, naked short sellers have no intention of ever delivering the actual shares that the unfortunate buyer on the other end of the transaction thinks he has purchased.<sup>26</sup> Therefore, unlike a traditional short sale, a naked short sale results in a failure to deliver the actual shares sold, and the shares eventually received by the buyer in the original transaction represent nothing more than an electronic book entry.<sup>27</sup>

The addition of the word “naked” into the debate surrounding abusive short selling practices has made this once obscure area of the financial markets a heated issue.<sup>28</sup> The debate over naked short selling has garnered attention

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deliver the shares sold is intentional and results in long term failures to deliver. *See infra* Part II.B (explaining the difference between legal and manipulative naked short selling).

21. *See* S.E.C., Division of Market Regulation: Key Points About Regulation SHO (Apr. 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm> [hereinafter Key Points About Regulation SHO] (contrasting traditional legal short selling to naked short selling).

22. *See* Short Sales Concept Release, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996, 57,996 (Oct. 28, 1999) (describing traditional short sales).

23. *See id.* (explaining how traditional short sellers attempt to profit from shorting stock).

24. Kevin Kelleher, *Naked Before Byrne*, THESTREET.COM, Aug. 18, 2005, <http://www.thestreet.com/tech/kevinkelleher/10238633.html>.

25. Thiel, *supra* note 5.

26. Leslie Boni, Strategic Delivery Failures in U.S. Equity Markets 11–12 (June 25, 2005) (unpublished manuscript), available at <http://www.unm.edu/~boni/RPAWP/FailsPaperJun25.pdf> (noting the views of a former SEC economist that failures to deliver shares are often caused by intentional acts of market participants).

27. *See* Zachary T. Knepper, *Future-Priced Convertible Securities and the Outlook for “Death Spiral” Securities-Fraud Litigation*, 26 WHITTIER L. REV. 359, 380 (2004) (describing the phenomenon in naked short selling whereby on settlement date there may be no securities available for delivery).

28. *See* Thiel, *supra* note 5 (commenting on how the word “naked” has transformed “the mundane act of borrowing and selling shares of stock in hopes of buying them back later at a lower price into a raging controversy fraught with conspiracy, secret identities, public recriminations, foreign intrigue, sports team owners, and now some of the top regulators in the land”).

from successful investors,<sup>29</sup> corporate executives,<sup>30</sup> U.S. Senators,<sup>31</sup> securities regulators,<sup>32</sup> and a mysterious internet-based investor advocate.<sup>33</sup> However, despite its growing coverage in the mainstream press<sup>34</sup> and its cult-like status on the internet,<sup>35</sup> naked short selling has remained beyond the awareness of most American investors.

Part of the reason that this growing problem remained relatively unknown until recently is that it involves highly technical financial concepts<sup>36</sup> and an alphabet soup of quasi-governmental corporations.<sup>37</sup> This Article will attempt to unravel

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29. See Rick Casterline, *Berkshire Behind the Scenes: Part 5*, THE MOTLEY FOOL, June 1, 2006, <http://www.fool.com/news/commentary/2006/commentary06060104.htm> (noting Warren Buffett and Charlie Munger's opinions regarding naked short selling and their former employee, current Overstock.com CEO Patrick Byrne).

30. See *supra* notes 11–14 and accompanying text (discussing Overstock.com President and Chairman Patrick Byrne's involvement in the naked short selling debate).

31. See Thiel, *supra* note 5 (documenting Utah Senator Robert Bennett's involvement in the controversy); see also Liz Moyer, *Congress Weighs in on Shorts*, FORBES, June 27, 2006, [http://www.forbes.com/2006/06/27/naked-shorts-senate-hearing-cx\\_lm\\_0627naked.html](http://www.forbes.com/2006/06/27/naked-shorts-senate-hearing-cx_lm_0627naked.html) (commenting on the Senate Judiciary Committee's role in investigating manipulative short selling practices); Compliance Reporter, *Two More Lawmakers Question Reg SHO Failure* (May 25, 2005), available at <http://www.compliancereporter.com/default.asp?page=1&SID=508468&ISS=16028> (noting Senator Richard Shelby's and Senator Susan Collins's accusations that recent SEC measures have done little to curb naked short selling).

32. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–.203) (noting the SEC's response to the debate over naked short selling); see also News Release, N. Am. Sec. Adm'r's Ass'n, *NASAA to Host Forum on Naked Short Selling* (Nov. 17, 2005), [http://www.nasaa.org/NASAA\\_Newsroom/Current\\_NASAA\\_Headlines/3923.cfm](http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/3923.cfm) (illustrating the response of state securities regulators to the naked short selling debate).

33. See Sanity Check, *Who's Bob O'Brien, AKA, "The Easter Bunny"?*, <http://www.thesanitycheck.com/AboutthisWebsite/tabid/71/Default.aspx> (last visited Nov. 11, 2006) (describing Bob O'Brien's mysterious involvement in the naked short selling debate).

34. See Daniel Kadlec, *Watch Out, They Bite!*, TIME: INSIDE BUSINESS, Dec. 2005, at A13 (demonstrating how the mainstream press is beginning to cover naked short selling); see also Ellen Simon, *'Naked Short-Sellers' Target Overstock*, ABC NEWS, Feb. 4, 2006, <http://abcnews.go.com/Business/wireStory?id=1581047&CMP=OTCRSSFeeds0312&ad=true> (discounting claims that manipulative naked short selling is widespread).

35. See Online Petition Against Naked Shorting, <http://www.investigatethesec.com> (last visited Nov. 11, 2006) (counting members of an internet community dedicated to bringing naked short selling abuse to an end).

36. See *Miller v. Asensio*, 101 F. Supp. 2d 395, 398 n.3 (D.S.C. 2000) (noting, comically, the technical nature behind naked short selling by exclaiming that “the practice of selling short naked is rather less fun than might be imagined”). Short selling in general is a highly technical and often difficult area of the financial markets to understand. See H.R. REP. NO. 102-414, at 1 (1991) (noting the complexity of short selling by stating that “the effects of short selling on the securities markets are not widely understood”).

37. See Avery & Koh, *supra* note 1, at 36–37 (identifying some of the clearing

the confusion surrounding naked short selling and examine an argument that stock clearing houses such as the Depository Trust and Clearing Corporation (DTCC) and its subsidiaries—the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC)—have tacitly allowed unscrupulous traders to manipulate their Stock Borrow Program to facilitate naked short selling.<sup>38</sup> By not instituting proper controls, the DTCC and its subsidiaries have permitted the creation of millions of “phantom” shares in companies targeted by naked short sellers.<sup>39</sup>

Manipulative naked short selling is taking place in America’s stock markets today, and the stakes could not be higher. Naked short selling has caused damages estimated at close to \$100 billion,<sup>40</sup> destroyed companies that could have made valuable contributions to the economy both in terms of new technologies and jobs,<sup>41</sup> and reduced or wiped out investors’ savings and retirement accounts.<sup>42</sup> This trading strategy exists due to a serious flaw in the infrastructure of our securities markets and, when the strategy is implemented, it can destroy companies and completely wipe out shareholder value. Central to this growing scandal are the DTCC, the NSCC, and the Stock Borrow Program they operate.

This Article presents a theory that attempts to explain how the DTCC and the NSCC’s mismanagement of the Stock Borrow Program allows unscrupulous market participants to target companies by creating “phantom” shares of stock that are owned

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corporations allegedly involved in the process).

38. See *id.* at 34–38 (describing the role of the Depository Trust and Clearing Corporation (DTCC) and the National Securities Clearing Corporation’s (NSCC) stock borrow program in naked short selling); see also Depository Trust & Clearing Corporation, <http://www.dtcc.com> (last visited Nov. 11, 2006) (providing a general description of the Depository Trust Clearing Corporation’s purpose in America’s securities markets); National Securities Clearing Corporation, <http://www.nsccl.com/> (last visited Nov. 11, 2006) (providing a description of the NSCC’s role in the securities markets).

39. See John D. Finnerty, Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation 37 (Mar. 2005) (unpublished manuscript), available at <http://www.sec.gov/rules/petitions/4-500/jdfinnerty050505.pdf> (describing the theory of how the DTCC’s Stock Borrow Program leads to the creation of phantom shares).

40. Rob Wherry, *Wall Street’s Next Nightmare?*, FORBES, Oct. 13, 2003, at 66, 66.

41. See, e.g., *Dateline NBC: Broken Dreams* (NBC television broadcast July 31, 2005) (transcript on file with the Houston Law Review) (reporting on how naked short selling caused the destruction of the telecommunications start-up company Eagletech Communications); cf. Avery & Koh, *supra* note 1, at 32–33 (noting that Microsoft and Cisco Systems started out as small cap companies, the type that are frequently victimized by naked short selling).

42. See *Dateline NBC: Broken Dreams*, *supra* note 41 (commenting on the impact naked short selling can have on ordinary investors).



by more than one person. Part II of this Article compares traditional short selling to naked short selling. Part III details the infrastructure of America's security markets and explains the role of the DTCC, the NSCC, and the Stock Borrow Program. Part IV examines the negative effects that naked short selling can have on targeted companies, focusing on both the financial impact and corporate governance issues while providing an example of the theory presented in this Article. Part V details the SEC's efforts to limit the manipulative effects of naked short selling through its newly adopted Regulation SHO. Part VI surveys the current legal environment surrounding naked short selling and examines alternate theories put forth to explain long term failures to deliver.

## II. TRADITIONAL SHORT SALES VERSUS NAKED SHORT SALES

### A. *What Is a Traditional Short Sale?*

Traditional short selling is a legitimate trading strategy regulated by the SEC.<sup>43</sup> A traditional short sale involves the sale of a security that the seller does not own, but has borrowed for delivery to the buyer.<sup>44</sup> The short seller will usually borrow the security from a broker-dealer and then deliver the security to the buyer in exchange for payment, thereby completing the initial part of the transaction.<sup>45</sup> The short seller is then required, at a later date, to return an equivalent security to the lending party. This is called "closing out" the position or "covering" the short sale.<sup>46</sup> When the time comes to return the securities, the short seller is required to buy equivalent securities at the current market price and deliver these replacement securities to the original lender.<sup>47</sup> Closing out, or covering, the short sale

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43. 17 C.F.R. § 240.10a-1 (2006) (providing the legal standards that govern short selling).

44. See 17 C.F.R. § 240.3b-3 (2004) (defining a traditional short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller"); see also Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200--203) (describing the concept of a traditional legal short sale).

45. See Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

46. Knepper, *supra* note 27, at 368-69.

47. See Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (detailing the process of returning securities to the original lender in a traditional short sale).

completes the traditional short sale transaction because now the lending party and the purchasing party both own equivalent shares in the same security.<sup>48</sup>

The short seller of a given security is speculating that the price of the security will decline. If the price of the security does fall, the short seller can purchase an equivalent security at the new lower price, return it to the original lender, and keep the difference as profit.<sup>49</sup> This trading strategy is risky because traditional short sellers also face the risk of a price increase that would require them to purchase the shares to return to the lender at a higher price, causing them to suffer a loss.<sup>50</sup> This potential for the borrowed stock to appreciate before the short is covered could create very large losses for the short seller if the bet on the stock price is wrong.<sup>51</sup>

Despite the risks associated with it, traditional short selling has positive benefits for securities markets.<sup>52</sup> The SEC has documented the market benefits associated with traditional short selling and sanctioned the practice.<sup>53</sup> The two main benefits usually associated with traditional short selling are increased market liquidity and pricing efficiency.<sup>54</sup>

Traditional short selling improves market liquidity by increasing the number of sellers in the market at any given time.<sup>55</sup> This increase in market liquidity occurs when market makers<sup>56</sup> use short sales to offset temporary contractions in the available supply of a security.<sup>57</sup> This added selling interest makes more shares available to purchasers, lowering the risk that the price paid for the

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48. Knepper, *supra* note 27, at 368.

49. Key Points About Regulation SHO, *supra* note 21 (providing an example of traditional legal short selling); *see also* Knepper, *supra* note 27, at 368–69.

50. *See* Knepper, *supra* note 27, at 368–69.

51. *See id.* at 369 (explaining that a short sellers' potential loss could be large because "there is theoretically no limit to how high a stock can climb").

52. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (listing the positive market benefits traditional short selling can have).

53. *See id.* (documenting the SEC's approval of the legitimate benefits of traditional short selling).

54. *Id.*

55. Knepper, *supra* note 27, at 369.

56. SEC Answers, Market Maker, <http://www.sec.gov/answers/mktmaker.htm> (last visited Nov. 11, 2006) (defining the term "market maker" as "a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price"); *see also* 17 C.F.R. § 240.3b-8 (2006) (providing a more thorough definition of "market maker").

57. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (documenting how market makers can benefit the market by keeping prices in line with market supply).

shares will be artificially high due to a temporary shortage in the available supply of shares.<sup>58</sup>

Traditional short selling also improves pricing efficiency.<sup>59</sup> Efficient markets require that security prices incorporate all buying and selling interest present in the market.<sup>60</sup> Therefore, when a trader sells a security short, pricing efficiency is increased because the bet that the price of the stock will drop informs the market of the trader's selling interest.<sup>61</sup> The market price of the security then reflects the short seller's prediction of the security's lower future value and increases the pricing efficiency of the overall market.<sup>62</sup>

While the market benefits associated with traditional short selling are significant, the practice also has manipulative potential.<sup>63</sup> This potential for abuse has led to the regulation of short sales throughout the history of organized markets.<sup>64</sup> Concern over abusive short selling and its role as a possible catalyst behind the market crash of 1929 played an important part in the formation of the original U.S. securities regulations.<sup>65</sup> The regulatory structure governing short sales that emerged from the stock market crash of 1929 remained mostly unchanged for over sixty years.<sup>66</sup> However, additional reform became necessary as trading technology and strategies progressed.<sup>67</sup> The SEC responded in 2004 by adopting Regulation SHO—the first major change to short sale regulation since the Great

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58. *Id.*

59. Short Sales Concept Release, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996, 57,997 (Oct. 28, 1999).

60. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

61. *Id.*

62. *Id.*

63. *See, e.g.,* United States v. Russo, 74 F.3d 1383, 1392 (2d Cir. 1996) (finding that the defendant's short sales constituted a violation of the antifraud provisions of the securities laws); SEC v. Gardiner, 48 SEC Docket 811, 812 (S.D.N.Y. 1991) (illustrating manipulation where a sales representative induced customers to sell stock short in order to lower the stock's price).

64. *See* Finnerty, *supra* note 39, at 1 (noting short sale regulation as early as the eighteenth century in the London Stock Exchange).

65. Short Sales Concept Release, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996, 57,996–97 (Oct. 28, 1999).

66. *See id.* at 57,996; *see also* Knepper, *supra* note 27, at 374–82 (providing a detailed discussion of current SEC, NYSE, and NASDAQ short sale regulations).

67. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,974–75 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (listing “naked short selling, the increasing number of Nasdaq securities trading away from the Nasdaq market . . . , the advent of securities futures trading, and decimalization” as examples of developments that inspired the SEC's reexamination of its regulations).

Depression.<sup>68</sup> The primary impetus for this change in the regulations was concern over naked short selling.<sup>69</sup>

*B. What Is a Naked Short Sale?*

In the simplest terms, naked short selling occurs when a short seller sells shares of stock to a buyer and receives payment, but fails to ultimately complete the trade by delivering the shares to the buyer.<sup>70</sup> In fact, “the [naked short] seller does not borrow or arrange to borrow the shares in time to make delivery to the buyer . . . .”<sup>71</sup> This failure to deliver the sold shares occurs because—unlike a traditional short sale where the short seller borrows the stock and *then* sells it—a naked short sale occurs when the short seller sells the security *first* without ever borrowing the security.<sup>72</sup>

Naked short selling is not always a violation of securities laws.<sup>73</sup> There are times when naked short selling, resulting in a *temporary* failure to deliver, is permitted because allowing the practice increases market liquidity.<sup>74</sup> For example, the presence of bona fide market makers improves market liquidity.<sup>75</sup> As discussed earlier, a market maker must be ready to trade a security on a constant basis at a quoted price, even though there are no other buyers or sellers in the market.<sup>76</sup> Bona fide market makers operating in a fast-moving market may naked short a stock when they agree to sell a security immediately to maintain market liquidity, even if they cannot locate the shares to deliver

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68. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008–09 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (adopting Regulation SHO and doing away with some of the older short sale regulations).

69. See Key Points About Regulation SHO, *supra* note 21; see also Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (noting the widespread interest in naked short selling as evidenced by the 462 letters the SEC received on the proposed Regulation SHO).

70. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

71. Key Points About Regulation SHO, *supra* note 21.

72. See Will Shanley, *Outcry Grows over Naked Short Sales*, DENVER POST, Oct. 15, 2006, at K-01, available at [http://www.denverpost.com/ci\\_4494028?source=rss](http://www.denverpost.com/ci_4494028?source=rss).

73. Key Points About Regulation SHO, *supra* note 21. Naked short selling is not the only cause of failures to deliver; such factors as human error can contribute to *temporary* failures to deliver. See Depository Trust & Clearing Corp., Naked Short Selling and the Stock Borrow Program, [http://www.dtcc.com/Publications/dtcc/mar05/naked\\_short\\_selling.html](http://www.dtcc.com/Publications/dtcc/mar05/naked_short_selling.html) [hereinafter Larry Thompson Interview] (listing errors such as a lost certificate and an investor’s failure to sign a stock certificate among the legal reasons for failures to deliver).

74. Key Points About Regulation SHO, *supra* note 21.

75. *Id.*

76. *Id.*

to the buyer at that time.<sup>77</sup> This type of market activity results in a *temporary* failure to deliver that is legitimate and usually corrected within three days<sup>78</sup> when the market maker covers the naked short by purchasing equivalent shares in the market place and delivering them to the buyer.<sup>79</sup>

It is not these temporary failures to deliver that cause the concern; rather it is the prolonged failures to deliver caused by manipulative naked short selling.<sup>80</sup> The prolonged failures to deliver resulting from naked short selling can reach such high levels that the total amount of failures to deliver in a stock may be greater than its total available public float of the security.<sup>81</sup> When there is a prolonged failure to deliver the shares, "in effect the naked short seller [has] unilaterally convert[ed] a securities contract (which should settle in three days after the trade date) into an undated futures-type contract," allowing the naked short seller to deliver the shares at a future date when it is in his own best interest to do so.<sup>82</sup> Naked short selling also allows manipulative traders to flood the market with sales of the targeted company's shares.<sup>83</sup> The presence of excess shares in the market increases selling pressure on the stock, thereby driving

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77. *Id.*

78. Trades are required to be settled within three days of the trade date, according to a Federal Reserve requirement, known as "T+3." *See id.* (detailing T+3 settlement requirements); *see also* 17 C.F.R. § 240.15c6-1 (2006) (establishing the settlement timeframe not to exceed three days); SEC, About Settling Trades in Three Days: T+3, <http://www.sec.gov/investor/pubs/tplus3.htm> (last visited Nov. 11, 2006).

79. *See Avery & Koh, supra* note 1, at 39 (noting that most market makers are "good guys" and that they only use naked short selling for legitimate reasons).

80. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (expressing the SEC's concern with prolonged failures to deliver).

81. *Id.* (documenting that failures to deliver in a company's stock can reach such impossible numbers); *see also* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Web Site Access to Reports, Securities Act Release No. 8,128, Exchange Act Release No. 46,464, 67 Fed. Reg. 58,480, 58,481 n.24 (Sept. 16, 2002) (to be codified at 17 C.F.R. pts. 210, 229, 240, 249) (defining a securities public float as "the aggregate market value of a company's outstanding voting and non-voting common equity (i.e., market capitalization) minus the value of common equity held by affiliates of the company").

82. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm>. *See generally* Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 10 (1996) (providing a thorough explanation of futures contracts).

83. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 n.31 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (discussing a recent SEC case in which the defendants used "massive naked short selling that flooded the market [with the targeted company's stock], and thus depressed its price").

down the price while allowing the naked short seller to cover his short at a profitable price.<sup>84</sup>

This type of manipulative naked short selling is a violation of the federal securities laws.<sup>85</sup> The ability of the naked short seller to avoid delivering the security for a prolonged period of time effectively prevents the buyer on the other side of the transaction from owning any actual shares.<sup>86</sup> The buyer receives an electronic book entry denoting ownership of the stock, but no actual shares support the entry.<sup>87</sup> The reason that buyers in these transactions do not object and demand delivery of actual shares is that their brokerage account statements indicate that they own the shares sold by the naked short seller.<sup>88</sup> The problem with naked short selling is that the shares behind the electronic entry are not delivered because someone else still owns and holds those shares.<sup>89</sup> To fully understand the problem of naked short selling and how two people can own the same shares of stock in electronic form requires an examination of the infrastructure of the equity clearing and settlement procedures.

### III. THE SYSTEM

Trying to understand the clearance and settlement systems used in today's modern market is a bit like falling into the rabbit

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84. *Id.* at 62,975.

85. See 17 C.F.R. § 240.10b-5 (2006) (making it illegal to manipulate a stock using "any device, scheme, or artifice to defraud"); see also Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,014 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (regulating manipulative naked short selling that is caused by intentionally maintaining long term failures to deliver); Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 n.29 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (reaffirming the SEC's position from 1962 that deliberately entering into this type of naked short sale violates the federal securities laws); Securities Act Release No. 4476, Exchange Act Release No. 6,778, 27 Fed. Reg. 3991, 3991 (Apr. 26, 1962) (codified at 17 C.F.R. pt. 241) (cautioning broker-dealers that selling short a security, but not purchasing the security for delivery for a long period of time, could violate the antifraud provisions of the securities laws).

86. See David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255, 1278–80 (1990) (explaining why the naked short seller has "little incentive to go out and buy or borrow the stock sold short for delivery").

87. See Nat'l Coalition Against Naked Short Selling, *An Introduction to Naked Short Selling—Failing to Deliver*, <http://www.ncans.net/intro%20to%20naked%20short%20selling.htm> (last visited Oct. 17, 2006) [hereinafter *Failing to Deliver*] (discussing the extensive use of IOUs between brokers and how it results in a "float of electronic book entries in the system, with stock existent to support the transactions . . .") (on file with the Houston Law Review).

88. Cf. Avery & Koh, *supra* note 1, at 37 (explaining how the shares end up in the buyer's brokerage account statement).

89. See *id.* (revealing the dual ownership problem created when manipulative naked short selling is allowed to persist in the market).

hole.<sup>90</sup> The current clearing and settlement system is complex, involving countless market participants and billions of shares changing hands every day.<sup>91</sup> The SEC and major market participants created the current infrastructure in an attempt to ensure that at the end of the day, all transactions clear and settle in an efficient manner.<sup>92</sup> In other words, the system is designed to guarantee that sellers receive prompt payment for the securities they sell and buyers promptly receive the securities they purchase.<sup>93</sup> To quote the institution that the SEC has entrusted to run our nation's market infrastructure, the DTCC, "[h]ow this [clearance and settlement] process works is not always easily understood."<sup>94</sup>

The clearing and settlement procedures used to be much simpler. Prior to the advent of the current system, when a trade occurred the buyer would physically send the seller a check for the required amount, and the seller would send the buyer the physical stock certificates transferring ownership to the new buyer.<sup>95</sup> However, as trading volumes increased, this manual form of clearing and settlement became unworkable and led to repeated paperwork crises on Wall Street.<sup>96</sup>

In response to this problem, Congress passed legislation in 1975 that paved the way for the modern clearance and settlement system.<sup>97</sup> The solution for the paperwork problem originally took two forms. First, market participants agreed that the physical movement of stock certificates was no longer necessary and that all of the actual physical stock certificates should be stored in a central location.<sup>98</sup> Further reform occurred after the immobilization of the physical stock certificates, when all record keeping pertaining to the transfer of ownership took

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90. LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND & THROUGH THE LOOKING GLASS 10 (1949).

91. See Depository Trust & Clearing Corp., Following a Trade, <http://www.dtcc.com/AboutUs/followtrade.htm> (last visited Nov. 11, 2006).

92. See *id.* (explaining the clearance and settlement goals of the DTCC's current system).

93. *Id.*

94. *Id.* (expressing the DTCC's views on the complicated nature of the current clearance and settlement procedures).

95. See Depository Trust & Clearing Corp., Evolution of DTC and NSCC, <http://www.dtcc.com/AboutUs/history.htm> (last visited Nov. 11, 2006) [hereinafter Evolution of DTC and NSCC].

96. See *id.* (noting the old manual system resulted in excessive trade backlogs and the stock exchanges often had to close on Wednesdays and shorten trading hours on other days to deal with the paperwork backlogs).

97. See 15 U.S.C. § 78q-1(a) (2000).

98. Evolution of DTC and NSCC, *supra* note 95.

the form of electronic book entry accounting.<sup>99</sup> This first reform process sped up settlement by making it unnecessary for physical stock certificates to change hands when a trade occurred.<sup>100</sup> In addition, to lessen the complexity of parties' financial obligations, market participants agreed to net all trades out against each other, with only the difference between the two parties' positions becoming a true financial obligation.<sup>101</sup> The netting process resulted in a sharp reduction in the amount of paperwork required to clear and settle trades because on settlement date a party only has to write a single check to cover its obligation.<sup>102</sup>

The following section is an overview of the current complex clearance and settlement infrastructure, an understanding of which is essential to appreciate the significance of the naked short selling debate.<sup>103</sup>

#### A. Depository Trust Clearing Corporation—DTCC

The DTCC and its subsidiaries make up "the largest financial services post-trade infrastructure organization in the world."<sup>104</sup> The DTCC is a holding company that consists of two main subsidiaries: the DTC and the NSCC.<sup>105</sup> The DTCC came into existence in 1999 when the DTC and NSCC integrated their operations.<sup>106</sup>

The main purpose of the DTCC is to provide clearance and settlement services through its subsidiaries for stocks, bonds, government and mortgage-backed securities, and other financial instruments.<sup>107</sup> In 2004, the DTCC, through its subsidiaries, settled \$1.1 quadrillion<sup>108</sup> worth of securities

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99. *Id.*

100. *See id.*

101. *See id.* (explaining how netting reduced the movements of a stock to a minimum each day).

102. *Id.*

103. For a quick reference guide regarding the complex makeup of the clearing and settlement system, see *infra* Appendix I.

104. Depository Trust & Clearing Corp., Fast Facts, <http://www.dtcc.com/PressRoom/stats.htm> (last visited Nov. 11, 2006) [hereinafter Fast Facts].

105. *See* Depository Trust & Clearing Corp., Subsidiaries and Joint Ventures, <http://www.dtcc.com/AboutUs/affiliates.htm> (last visited Nov. 11, 2006) [hereinafter Subsidiaries and Joint Ventures] (describing the DTC, the NSC, and the DTCC's various other clearance and settlement companies).

106. Global Joint Venture Matching Services—US, LLC; Order Granting Exemption From Registration as a Clearing Agency, Exchange Act Release No. 44,188, 66 Fed. Reg. 20,494, 20,495 n.8 (Apr. 23, 2001).

107. Depository Trust & Clearing Corp., About DTCC: Who We Are, <http://www.dtcc.com/AboutUs/index.htm> (last visited Nov. 11, 2006).

108. A "quadrillion" is a 1,000 trillion or 1,000,000,000,000,000. *See* 12 THE OXFORD



transactions.<sup>109</sup> In other words, the DTCC settled \$4.5 trillion of securities transactions each business day.<sup>110</sup>

Managing the DTCC and overseeing this massive operation are a senior management team<sup>111</sup> and board of directors made up of representatives from some of Wall Street's most prestigious investment banks, securities houses, and stock exchanges.<sup>112</sup> As a result of this management team's efforts, the DTCC recorded over \$1 billion in revenue in 2004 for its administrative role.<sup>113</sup> These large revenues mean that, despite its goal of operating as an "at cost" corporation which strives to keep revenues in line with expenses, the DTCC reported net income of over \$34 million in 2004.<sup>114</sup> The DTCC distributes a portion of its revenues to its brokerage industry client-owners.<sup>115</sup> These refunds amounted to \$219 million in 2004 and \$252 million in 2003.<sup>116</sup> Although classified as refunds, these payments are—for all intents and purposes—dividends because the true owners of the DTCC are the same brokerage houses it serves.<sup>117</sup>

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ENGLISH DICTIONARY 961 (2d ed. 1989).

109. DEPOSITORY TRUST & CLEARING CORP., ANNUAL REPORT 3 (2004) [hereinafter DTCC 2004 ANNUAL REPORT], available at [http://www.dtcc.com/AboutUs/2004annual/DTCC\\_2004\\_Annual\\_Report.pdf](http://www.dtcc.com/AboutUs/2004annual/DTCC_2004_Annual_Report.pdf) (recording the massive amount of business the DTCC does each year through its subsidiaries).

110. *Id.*

111. See Depository Trust & Clearing Corp., DTCC Management Team, <http://www.dtcc.com/AboutUs/managebio.htm> (last visited Nov. 11, 2006) (listing the senior management group responsible in part for running the DTCC).

112. See DTCC 2004 ANNUAL REPORT, *supra* note 109, at 44, 46 (listing the members of the Board of Directors as representatives from institutions such as Merrill Lynch, Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, and Credit Suisse First Boston, among others).

113. See *id.* at 51 (noting that the DTCC earned total revenues of \$1,054,792,000 in 2004).

114. Compare *id.* at 51 (reporting net income for the year 2004 of \$34,075,000), with Larry Thompson Interview, *supra* note 73 (claiming that the DTCC tries to run as a "not for profit" corporation by keeping expenses in line with revenues).

115. See Depository Trust & Clearing Corp., Our Business—Whom We Serve, <http://www.dtcc.com/AboutUs/weserve.htm> (last visited Nov. 11, 2006) (identifying the DTCC's clients); see also DTCC 2004 ANNUAL REPORT, *supra* note 109, at 3 (noting the amount of rebates paid for the years 2003 and 2004). The DTCC and its subsidiaries count most of the nation's largest banks and brokerage houses among their clients. See DTC Participant Accounts in Alphabetical Sequence, [http://www.dtc.org/dtccpublic/pdf/participantlisting/participants\\_alpha.pdf](http://www.dtc.org/dtccpublic/pdf/participantlisting/participants_alpha.pdf) (last visited Nov. 11, 2006) (providing a client list from the DTCC's subsidiary, the DTC, which includes large brokerage houses and investment banks such as Citibank and Goldman Sachs).

116. DTCC 2004 ANNUAL REPORT, *supra* note 109, at 3 (stating the amounts of rebates paid to clients in 2003 and 2004).

117. See Fast Facts, *supra* note 104 (noting that the DTCC is actually owned by its primary users).

*B. Depository Trust Company—DTC*

The first goal of modernizing the clearing and settlement system was to immobilize the millions of physical stock certificates previously held by investors.<sup>118</sup> The brokerage industry accomplished this goal by establishing the DTC.<sup>119</sup> The DTC is set up as a subsidiary of the DTCC to help the DTCC efficiently clear and settle trades by reducing the need for the physical movement of actual stock certificates to complete a trade.<sup>120</sup>

In its vaults, the DTC holds the physical stock certificates that represent the actual shares traded in the market.<sup>121</sup> Participants in the DTC (broker-dealers and banks) deposit shares in the DTC's vaults which then become a credit in the participant's account at the DTC.<sup>122</sup> The physical shares in the vaults are not actually titled in the name of the investors on whose brokerage account statements they appear; instead, most stocks are held in "street name," meaning that the broker is holding the stock in its DTC account on behalf of the actual shareholders.<sup>123</sup> Although the broker holds the certificates for its customers in street name, the DTC maintains custody of, officially owns, and physically controls these certificates under the name of its nominee, Cede & Co.<sup>124</sup>

Immobilizing and dematerializing all of the shares of a company enables the markets to carry out purely electronic exchanges, using only book entries to the participants' DTC

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118. Depository Trust & Clearing Corp., About DTCC: The Origin of Our Business, <http://www.dtcc.com/AboutUs/origins.htm> (last visited Nov. 11, 2006).

119. See Depository Trust & Clearing Corp., About DTC, <https://login.dtcc.com/dtcorg/home/page18832.html> (last visited Nov. 11, 2006) (providing a description of the duties of the DTC).

120. See Subsidiaries and Joint Ventures, *supra* note 105 (describing the DTC's relationship to the DTCC and its subsidiary status).

121. See *id.* (describing the DTC's role as the holder of the physical stock certificates that underlie the electronic shares traded in the market).

122. See Self-Regulatory Organizations; The Depository Trust Company, Order Granting Approval of a Proposed Rule Change Concerning Requests for Withdrawal of Certificates by Issuers, Exchange Act Release No. 47, 978, 68 Fed. Reg. 35,037, 35,041 (June 11, 2003) [hereinafter *Withdrawal Requests*], available at [http://www.sec.gov/rules/sro/34-47978.htm#P99\\_35479](http://www.sec.gov/rules/sro/34-47978.htm#P99_35479) (detailing how the DTC operates and how shares are put into the DTC and assigned to that participant's account).

123. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,023 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200--203).

124. See *Withdrawal Requests*, *supra* note 122, at 35,041 (illustrating the lack of control issuers have over their own physical stock certificates); see also Martin Mayer, *Comments on Lynn A. Stout's The Investor Confidence Game*, 68 BROOK. L. REV. 449, 451-52 (2002) (explaining the DTC's role in the security markets and the role of Cede & Co.).

accounts to denote changes in ownership.<sup>125</sup> This system has lessened settlement risk for the majority of the securities held by the DTC, allowing the DTC to become the largest stock depository in the world.<sup>126</sup> This system has also made the DTC a profitable subsidiary of the DTCC, reporting over \$500 million in revenue and over \$20 million in net income for the year 2004.<sup>127</sup>

*C. National Securities Clearing Corporation—NSCC*

The NSCC helped the banking industry accomplish the second reform that came out of the paperwork crisis: the move towards a single net settlement system.<sup>128</sup> In the past, the New York Stock Exchange (NYSE), NASDAQ, and the American Stock Exchange each had their own clearing corporations that settled trades in their respective markets.<sup>129</sup> In 1976, those three exchange-run clearing corporations merged to create the NSCC.<sup>130</sup> Eventually, the smaller regional stock exchanges also joined the NSCC to create a central clearing and settlement corporation for nearly all securities trading in the United States.<sup>131</sup> Being at the crossroads of almost every trade completed in the United States,<sup>132</sup> the NSCC has become a profitable subsidiary of the DTCC.<sup>133</sup>

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125. See Securities Transactions Settlement, Securities Act Release No. 8398, Exchange Act Release 49,405, 69 Fed. Reg. 12,922, 12,931 (Mar. 18, 2004) (commenting on the success of the DTC in its goal to immobilize most of the physical stock certificates in the market).

126. See *id.* (noting that the DTC provides depository and settlement services for a "vast majority" of transactions in the United States).

127. See DEPOSITORY TRUST CO., ANNUAL FINANCIAL STATEMENTS 4 (2005), available at [http://www.dtcc.com/AboutUs/2004annual/DTC\\_2004\\_Financials.pdf](http://www.dtcc.com/AboutUs/2004annual/DTC_2004_Financials.pdf) (noting that in 2004 the DTC earned revenues of \$501,026,000 and net income of \$20,675,000 for trading, custody, network, and other services provided).

128. Evolution of DTC and NSCC, *supra* note 95.

129. *Id.*

130. *Id.*

131. See *id.* (describing the consolidation of the different regional stock exchanges' clearing corporations into the NSCC); see also Depository Trust & Clearing Corp., Welcome to National Securities Clearing Corporation, <http://www.nsc.com> (last visited Nov. 11, 2006) (noting that the NSCC controls the clearance and settlement for nearly all securities trades in the United States).

132. See Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45, 115 (1999) (noting that the NSCC handles most trades in equity and bond securities in the United States).

133. NAT'L SEC. CLEARING CORP., ANNUAL FINANCIAL STATEMENTS 5 (2004), available at [http://www.dtcc.com/AboutUs/2004annual/NSCC\\_2004\\_Financials.pdf](http://www.dtcc.com/AboutUs/2004annual/NSCC_2004_Financials.pdf) (reporting the NSCC brought in \$283,165,000 in revenues during 2004, making \$9,875,000 in net income in 2003).

The NSCC currently carries out its clearance and settlement duties as a subsidiary of the DTCC.<sup>134</sup> The NSCC provides clearance and settlement services through a system called multilateral netting.<sup>135</sup> A simplified example of multilateral netting illustrates the process: if Broker A buys one hundred shares of a security from Broker B in the morning, and then later sells one hundred shares of that same security to Broker B in the afternoon, the two trades are netted out, requiring no movement of the actual shares or their electronic signification between the two brokers' DTC accounts.<sup>136</sup> In the actual stock market, however, brokers "trade[] a single security with many different brokers during a trading day," allowing for few chances to easily net trades as described above.<sup>137</sup>

The NSCC is able to net trades in much more complex ways through a system called "Continuous Net Settlement" (CNS).<sup>138</sup> Parties that trade using the CNS system are required to be members of the NSCC and the DTC.<sup>139</sup> The NSCC guarantees completion of trades made using the CNS system by taking on all of the payment and delivery obligations of the buyers and sellers.<sup>140</sup>

Using the CNS system, the NSCC continually nets all trades made by its members in a security to come up with net long positions (purchases) and net short positions (sales) for each participant.<sup>141</sup> The net positions of a member represent the amount of each security that a member owes or is owed to effectuate settlement.<sup>142</sup> A net long position represents securities

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134. Subsidiaries and Joint Ventures, *supra* note 105.

135. See Evolution of DTC and NSCC, *supra* note 95 (noting that multilateral netting is a way to reduce paperwork in the securities industry).

136. See *id.* (providing an example of the NSCC's multilateral netting system for settling trades).

137. *Id.* (noting the complexities that make multilateral netting difficult in today's market).

138. See Depository Trust & Clearing Corp., Continuous Net Settlement, <http://www.dtcc.com/ProductsAndServices/clearing/cns.html> (last visited Nov. 11, 2006) (explaining the NSCC's Continuous Net Settlement system); see also Willa E. Gibson, *Banks Reign Supreme Under Revised Article 9 Deposit Account Rules*, 30 DEL. J. CORP. L. 819, 850 (2005) (describing the NSCC's continuous net settlement procedures).

139. See Continuous Net Settlement, *supra* note 138 (noting that the continuous net settlement process is only available to NSCC and DTC members).

140. See Nat'l Sec. Clearing Corp., Clearance and Settlement, <http://www.nsccl.com/clearandset.html> (last visited Nov. 11, 2006) (describing how the NSCC guarantees trades).

141. See Continuous Net Settlement, *supra* note 138; see also Mayer, *supra* note 124, at 451-52 (giving an example of the NSCC's role in the settlement process).

142. See Continuous Net Settlement, *supra* note 138.

owed to the member by the NSCC and a net short position represents securities owed to the NSCC by the member.<sup>143</sup>

After determining the member's net position, the position—either net long or net short—passes on to the DTC for processing.<sup>144</sup> The DTC then compares the member's share delivery obligations (a net short position) to that member's DTC account to determine if the account at the DTC holds enough shares in it to settle the position.<sup>145</sup> If there are enough shares in the member's DTC account to settle the trade, delivery of those shares occurs by sending the shares through the NSCC to the DTC account of the party owed the securities (the corresponding net long position).<sup>146</sup> If the member does not have enough shares in its DTC account to cover its obligation—i.e., the member has sold more shares than it has—the NSCC can attempt to borrow shares through the Stock Borrow Program to cover the unfulfilled obligation.<sup>147</sup>

#### *D. The Stock Borrow Program*

The Stock Borrow Program enables NSCC and DTC members to lend shares from their accounts at the DTC to cover another member's failure to deliver shares through the CNS system.<sup>148</sup> The Stock Borrow Program provides this covering function mainly when shares are illiquid and otherwise hard to borrow.<sup>149</sup> These same conditions, however, are ripe for manipulative behavior.<sup>150</sup> The extent to which the Stock Borrow Program is used to cure failures to deliver is a point of

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143. *See id.* (explaining the difference between a net long and a net short position in the Continuous Net Settlement system).

144. *See id.* (demonstrating how the DTC interacts with the NSCC in operating the Continuous Net Settlement system).

145. *Id.*

146. *See id.* (detailing how trades are settled when there are enough shares in a member's DTC account to cover its short position).

147. *See* Depository Trust & Clearing Corp., Stock Borrow Program, <http://www.dtcc.com/ProductsAndServices/clearing/stock.html> (last visited Nov. 11, 2006) [hereinafter Stock Borrow Program] (describing how the DTCC's Stock Borrow Program operates).

148. *See id.* (describing how the Stock Borrow Program attempts to cure failures to deliver).

149. *See* Letter from Robert J. Shapiro, Chairman, Sonecon LLC, to Jill M. Considine, Chairman and Chief Executive Officer, Depository Trust & Clearing Corp. 3 (Apr. 13, 2005), available at [http://www.ncans.net/files/Response to DTCC Deputy Counsel Thompson - Robert Shapiro - April 13 2005.pdf](http://www.ncans.net/files/Response%20to%20DTCC%20Deputy%20Counsel%20Thompson%20-%20Robert%20Shapiro%20-%20April%2013%202005.pdf) (responding to claims made by DTCC Managing Director and First Deputy General Counsel Larry Thompson) (on file with the Houston Law Review).

150. *Id.*

contention.<sup>151</sup> However, the NSCC admits to using the Stock Borrow Program to settle roughly 20% of the failures to deliver present in the system.<sup>152</sup>

The Stock Borrow Program operates by allowing members who want to loan securities to “inform the NSCC each day of the number of shares of each stock . . . they are willing to lend.”<sup>153</sup> The NSCC then determines how many shares it needs to borrow to cover the outstanding failures to deliver.<sup>154</sup> Once the NSCC establishes the number of shares it needs to borrow to cure the failures to deliver, it uses a formula to decide which of its members will provide the necessary shares.<sup>155</sup>

When the NSCC borrows the shares from the lending member, the NSCC credits that member’s account with the full market value of the securities borrowed, enabling the lending member to earn interest on that money while the loan remains outstanding.<sup>156</sup> Then, “the NSCC debits the lending member’s DTC account” for the amount of shares loaned out to record the reduction in that member’s total amount of shares available for future lending.<sup>157</sup> At the same time, however, the NSCC also credits the lending member’s special sub-account set up under the Stock Borrow Program with a position equal to that of the securities lent out.<sup>158</sup> This credit to the lending member’s special

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151. Compare Larry Thompson Interview, *supra* note 73 (arguing that the Stock Borrow Program does not play a major role in America’s securities markets), with Letter from Robert J. Shapiro to Jill M. Considine, *supra* note 149, at 3 (rebutting the DTCC’s claims that the Stock Borrow Program only plays a limited role in attempting to cure failures to deliver).

152. Larry Thompson Interview, *supra* note 73. The other 80% of failures to deliver are likely settled using a process known as “ex-clearing,” literally meaning that those trades settle outside of the formal clearing system. See Failing to Deliver, *supra* note 87 (alleging that ex-clearing accounts for the other 80% of failures to deliver and that the process hides failures to deliver by making them look like settled trades). This process takes place outside of the confines of an organized clearing house such as the DTCC and involves the two brokers in a transaction settling a failure to deliver on their own. See Brokerage101.com, Securities Settlement, <http://www.brokerage101.com> (follow “Securities Settlement” hyperlink) (last visited Nov. 11, 2006) (explaining the process of ex-clearing). The potential for manipulation is just as great, if not greater, in an ex-clearing situation due to the backroom nature of such deals and the fact that the process merely involves the moving of electronic IOUs between trading partners. See Dr. Jim DeCosta’s Blog, <http://www.thesanitycheck.com/Blogs/DrJimDeCostasBlog/tabid/99/EntryID/80/Default.aspx> (Feb. 17, 2006, 12:50 P.M.) (explaining the theory that ex-clearing presents another manipulative tool for parties that have failed to deliver stock).

153. Finnerty, *supra* note 39, at 36.

154. *Id.*

155. See *id.* (commenting that “[t]he formula favors members who have the lowest stock loans from the NSCC and who pay the most clearing fees to the NSCC”).

156. See Stock Borrow Program, *supra* note 147.

157. See Finnerty, *supra* note 39, at 36.

158. See *id.* (discussing the complex transactions that take place during the NSCC’s

sub-account represents a promise by the NSCC to return the shares at a later date.<sup>159</sup>

The NSCC then uses the borrowed shares to offset the short position in the security and transfers the shares into the borrowing party's DTC account.<sup>160</sup> The broker representing the buyer of the stock now has the shares in its account at the DTC, and the buyer, who originally placed the order that the broker could not fill, now has an account statement showing delivery of the shares.<sup>161</sup> The NSCC eventually repays the loan by returning the shares to the lending party at a later date when it receives repayment of the security from the original borrowing member.<sup>162</sup>

#### IV. THE PROBLEM

The complex arrangements of the DTC and NSCC accomplished the goals set by the brokerage industry following the paperwork crisis of the 1960s.<sup>163</sup> Today, very few physical certificates ever move when a trade occurs, electronic book entry trading is the norm, and settlement risk is generally lower due to quicker settlement times.<sup>164</sup> However, despite all the advances, the added complexity has also increased the risk of market manipulation through naked short selling.<sup>165</sup>

At the center of this manipulative potential is the Stock Borrow Program run by the DTCC and its subsidiary the NSCC.<sup>166</sup> Critics of the Stock Borrow Program claim that it facilitates naked short selling in two ways.<sup>167</sup> First, critics contend that the Stock Borrow Program allows naked short sellers to hide long-term failures to deliver by disguising the delivery of stock borrowed from the lending pool as a legitimate

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use of the Stock Borrow Program); see also Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 796-97 (noting the use of the loaning member's special CNS sub-account to record long positions for securities that have been lent out).

159. See Finnerty, *supra* note 39, at 36 (describing the credit in the lending member's sub-account as an "undated stock futures contract with the NSCC as the obligor").

160. See *id.*

161. See Avery & Koh, *supra* note 1, at 37 (chronicling the supposed delivery of shares to the buying party on the other side of a naked short sale).

162. See Finnerty, *supra* note 39, at 36 (detailing what must occur for the NSCC to repay the shares to the lending party borrowed using the Stock Borrow Program).

163. See Evolution of DTC and NSCC, *supra* note 95.

164. See Finnerty, *supra* note 39, at 34-36 (illustrating how the NSCC expedites the settlement process through the Continuous Net Settlement system).

165. Avery & Koh, *supra* note 1, at 36.

166. See *id.* at 34-36 (hypothesizing that the NSCC's Stock Borrow Program is utilized to carry out widespread manipulative naked short selling).

167. Finnerty, *supra* note 39, at 37.

delivery.<sup>168</sup> Second, critics contend that the lack of controls put in place by the DTCC has allowed for the creation of phantom shares, thereby increasing the amount of stock available for trading beyond a company's authorized number of registered shares.<sup>169</sup>

*A. An Example of the Stock Borrow Program in Action*

The following is an example of the dilutive effects of the DTCC's Stock Borrow Program.<sup>170</sup> The parties in this example are Investor A, Broker A, Investor B, Broker B, a market maker,<sup>171</sup> and the DTCC and its subsidiaries.<sup>172</sup> The process begins when Investor A places a buy order with his broker (Broker A) to purchase 1,000 shares of XYZ Corporation at one dollar per share.<sup>173</sup> Broker A takes Investor A's order and transmits a buy order to a market maker in XYZ Corporation's stock, if the broker itself is not a market maker in XYZ Corporation's stock.<sup>174</sup> The market maker confirms immediately to Broker A that the trade is complete without first locating the shares.<sup>175</sup> After the trade is confirmed, Broker A takes Investor A's \$1,000 and transfers it to the market maker.<sup>176</sup>

If for some reason the market maker has not purchased and delivered the shares of XYZ Corporation to Investor A's account at Broker A, the market maker can, after three days, use the

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168. *See id.*

169. *See id.* (detailing how manipulative sellers can create phantom shares in a company); *see also* Thiel, *supra* note 5 (noting the impossibly high trading volumes of certain stocks that are alleged victims of naked short selling).

170. A chart providing a visual illustration of the alleged dilutive effects of the DTCC's Stock Borrow Program is provided in Appendix II, *infra*.

171. The market maker in a manipulative naked short sale may actually be a hedge fund masquerading as a bona fide market maker. *See* News Release, Nat'l Ass'n of Sec. Dealers, NASD Charges Pennsylvania's Scott W. Ryan, Ryan & Company with Impermissible Short Selling Scheme for Hedge Fund Clients (June 13, 2005), [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_014364](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_014364) (explaining that hedge funds are restricted from selling short); *see also infra* notes 302-05 and accompanying text (explaining further the role hedge funds often play in manipulative naked short selling).

172. *See* Avery & Koh, *supra* note 1, at 37 (providing the parties involved in the hypothetical transaction).

173. *Id.*

174. *Id.*

175. *Id.* This is, by definition, a naked short sale; however, it is legal and legitimate for the market maker to make a naked short sale in this instance in order to maintain a liquid market. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008-09, 48,015 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-203) (explaining the need for a naked short selling regulation and limited market maker exception).

176. *See* Avery & Koh, *supra* note 1, at 37.



Stock Borrow Program to make delivery.<sup>177</sup> When the request is received, the DTCC, using its formula, locates 1,000 shares of XYZ Corporation held in Broker B's account at the DTC that are designated as being available for lending.<sup>178</sup> The DTCC then takes the \$1,000 received by the market maker and transfers it to Broker B's account at the DTCC in exchange for Broker B's 1,000 shares in XYZ Corporation.<sup>179</sup> The 1,000 shares of XYZ Corporation are then transferred to Broker A, who holds Investor A's account.<sup>180</sup> Broker B now has \$1,000 in its account at the DTCC, on which it earns interest until the market maker purchases 1,000 shares of XYZ in the market (covering its short position) and returns them to the DTCC, which in turn enables the DTCC to return the 1,000 loaned shares of XYZ Corporation to Broker B.<sup>181</sup>

The dilutive effect of the Stock Borrow Program becomes evident by identifying the source of the 1,000 shares of XYZ Corporation. The 1,000 shares lent by Broker B to make good on the market maker's delivery obligation do not belong to Broker B; rather they belong to Investor B, who is holding the 1,000 shares of XYZ in a margin account with Broker B.<sup>182</sup> Investor B does not usually know that his shares have been lent out by his broker,<sup>183</sup> and this lack of knowledge does not matter if the market maker's failure to deliver to Investor A and Broker A is very brief.<sup>184</sup> However, if the short position is allowed to remain naked, and the market maker is not forced to cover its position, when

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177. *Id.*

178. *See id.*; *see also* Finnerty, *supra* note 39, at 36 (describing the formula used by the NSCC in its Stock Borrow Program lending activities).

179. Avery & Koh, *supra* note 1, at 37.

180. *Id.*

181. *Id.*

182. *Id.*; *see also* 15 U.S.C. § 78h(b) (2000) (placing limits on when a broker can lend an investor's shares).

183. Brokerage houses often place disclosures in the fine print of their margin account agreements, warning investors that the shares in their margin accounts can be lent out. *See, e.g.*, Vanguard Brokerage Servs., Margin Account Agreement, <http://www.vanguard.com/pdf/v793.pdf> (last visited Nov. 11, 2006) (waiting until the very last clause of the agreement to make the investor aware that shares in this margin account may be loaned out). Further, nowhere in a typical margin agreement does the brokerage firm notify the client that it will lend their shares primarily to short sellers, thereby causing the price of the stock they bought on margin to decrease, while increasing the chance they will face a margin call. *See id.* (neglecting to inform investors of the likely recipients of shares loaned from their account); *see also* SEC, Investor Tips, Margin: Borrowing Money to Pay for Stocks, <http://www.sec.gov/investor/pubs/margin.htm> (last visited Nov. 11, 2006) (explaining the concept of a margin call and other dangers associated with margin accounts).

184. *See* Avery & Koh, *supra* note 1, at 37 (noting that if a naked short seller quickly covers his short and completes delivery then there is a lower chance of manipulation).

account statements are sent out from Broker A to its client (Investor A) and from Broker B to its client (Investor B), each statement will record that each investor owns 1,000 shares of XYZ Corporation.<sup>185</sup> The problem is that they both own the same 1,000 shares.<sup>186</sup>

The absence of any controls by the DTCC to restrict re-lending of the same shares can further dilute the rights of XYZ Corporation, Investor A and Investor B.<sup>187</sup> When Broker A receives the shares of XYZ Corporation via the Stock Borrow Program, there is no bar to Broker A putting those same shares up for lending again via its DTC account.<sup>188</sup> Consequently, the next time a market maker, or anyone else for that matter, fails to deliver XYZ Corporation's stock, they could borrow through the Stock Borrow Program the same shares from Broker A's account to complete delivery.<sup>189</sup>

The original 1,000 shares of XYZ have already been loaned once—unknowingly from Investor B's account to Investor A in order to satisfy the market maker's delivery requirements—so there should be 1,000 fewer shares available for lending.<sup>190</sup> However, the result of the re-lending is that not only do Investor A and Investor B own the same shares, but Investors C, D, and E could also electronically own those same shares.<sup>191</sup> Therefore, if the same shares are available for re-lending, the naked short seller (the market maker in the example) can use the DTCC's Stock Borrow Program to create additional phantom shares of XYZ Corporation.<sup>192</sup>

### *B. The Effects of Naked Short Selling*

Naked short selling carried out through the Stock Borrow Program can have several adverse effects on a target company and its shareholders.<sup>193</sup> These negative effects include increased manipulative power for naked short sellers, difficulty in receiving

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185. *See id.*

186. *Id.* (making the allegation that the DTCC-run Stock Borrow Program allows two parties to own the same shares at the same time).

187. *See* Finnerty, *supra* note 39, at 37 (describing the creation of phantom shares).

188. *Id.*; *see also* Avery & Koh, *supra* note 1, at 37–38 (presenting the claim that the DTCC's system allows for borrowing parties to re-loan borrowed shares).

189. *See* Avery & Koh, *supra* note 1, at 37.

190. *Id.*

191. *See id.*

192. *Id.*

193. *See* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

physical stock certificates, a possible “run on the bank” situation at the DTCC, and possible dilution of shareholder’s governance rights.<sup>194</sup>

1. *Increased Manipulative Power.* The first serious problem associated with the creation of phantom shares is that the naked short seller now has the ability to manipulate the targeted company’s stock price.<sup>195</sup> When actual delivery of sold shares is not required, the naked short seller can exert levels of selling pressure beyond what would normally be possible.<sup>196</sup> This increased selling power allows naked short sellers to flood the marketplace with excess or phantom shares, thereby driving down a targeted company’s stock price.<sup>197</sup>

This ability to drive down a stock’s price is amplified in circumstances where the naked short seller would normally find it very expensive to borrow shares to short a stock.<sup>198</sup> Often shares of small companies (such as those traded on smaller markets) are hard to find because founders and other initial investors hold the most of the shares in restricted form. Therefore, it becomes expensive to borrow the relatively small number of available shares.<sup>199</sup> However, if delivery will always occur via the Stock Borrow Program, naked short sellers can continue to sell short regardless of what the cost of borrowing normally would be.<sup>200</sup>

This increased number of shares can especially harm targeted companies when they report bad news.<sup>201</sup> With an artificially high number of shares available for sale in the marketplace, the bad news may trigger a much larger sell-off than would otherwise be possible.<sup>202</sup> In our example, Investor A

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194. See *id.* (explaining how illegal naked short selling adds to the manipulative powers of the short seller); Martin & Partnoy, *supra* note 158, at 798 n.109 (describing problems faced in voting when illegal naked short selling has occurred).

195. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

196. See Finnerty, *supra* note 39, at 37 (noting that illegal naked short selling allows short sellers to sell short more shares than would be possible if delivery requirements were enforced).

197. See Letter from Robert J. Shapiro, Chairman, Sonecon, LLC, to the SEC Rules Comm. 1–2 (Dec. 24, 2003), available at <http://www.sec.gov/rules/proposed/s72303/rshapiro122403.htm> (describing the effect of illegal naked short selling on a target’s stock price).

198. See Finnerty, *supra* note 39, at 37 (describing the effect naked short selling has on increasing short seller’s profitability when shares would otherwise be hard to borrow).

199. *Id.*

200. *Id.* at 37–38.

201. Avery & Koh, *supra* note 1, at 38.

202. *Id.*

and Investor B can both sell their 1,000 shares in XYZ Corporation when XYZ reports bad news.<sup>203</sup> This increased selling pressure can cause a disproportionately large drop in the XYZ Corporation's share price, allowing the market maker who originally naked shorted the shares to repurchase the shares in the market at a depressed price, increasing his profit.<sup>204</sup>

2. *Not Enough Certificates for Requests.* A second serious problem associated with naked short selling and the creation of phantom shares is that shareholders who request their physical share certificates from the DTC may not be able to get them.<sup>205</sup> The Stock Borrow Program, by allowing the creation of phantom shares, can lend out more shares of a security than the DTC physically holds in its vaults.<sup>206</sup> This presents a problem because investors who want to hold the physical certificates that signify their ownership of the company may not be able to get them from the DTCC.<sup>207</sup>

Investors have a right to receive their physical certificates from the DTCC.<sup>208</sup> This transaction should be relatively routine, involving minimal cost and aggravation to the party requesting the shares.<sup>209</sup> However, receiving physical certificates has proven very difficult for some investors.<sup>210</sup>

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203. *Id.*; see also *supra* notes 170–86 and accompanying text (explaining how hypothetical Investor A and hypothetical Investor B came to hold the same shares in XYZ Corporation).

204. See Letter from Robert Shapiro to the SEC Rules Comm., *supra* note 197 (describing how naked short sellers profit from the increased number of shares available for sale).

205. See Avery & Koh, *supra* note 1, at 38 (describing investors' difficulties when asking the DTCC to deliver their physical share certificates).

206. Letter from Dr. Jim DeCosta and Associates to Jonathan G. Katz, Sec'y, SEC (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s72303/decosta122203.htm> (complaining about excess shares being lent out through the Stock Borrow Program).

207. See Avery & Koh, *supra* note 1, at 38 (commenting on the difficulties investors have had in obtaining their physical stock certificates).

208. See 17 C.F.R. 240.15c3-3(l) (2006) (stating that investors are entitled to physical delivery of their stock certificates).

209. See Avery & Koh, *supra* note 1, at 38 (reporting that it costs about forty dollars to get the physical certificates in a security); Depository Trust & Clearing Corp., Custody Service, <https://login.dtcc.com/dtcorg/prod-serv/page18908.html> (last visited Nov. 11, 2006) (claiming that physical stock certificates are available for pick-up forty-five minutes after they are requested).

210. After asking to receive their certificates, investors reportedly have been misinformed and told that the company whose shares they own is being reorganized so they cannot get their shares, that the transfer agent is not currently issuing shares, and that the company is in a "chill" mode and not giving out certificates at this time. See Avery & Koh, *supra* note 1, at 38 (describing investor's difficulties in receiving their shares of Global Links Corp.); see also Posting of Bob O'Brien to Faulking Truth, We Definitely Aren't in Kansas Anymore: Fraud Wall Street Style, <http://www.faulkingtruth.com>.

3. *Possible "Run on the Bank" Situations.* The creation of phantom shares also means that if there were ever a "run on the bank"<sup>211</sup> situation in which every shareholder requested his certificate at the same time, the DTCC could not meet all of the requests.<sup>212</sup> Using our example, it is clear why physical delivery of the share certificates to every shareholder would be impossible. Assume that Investor A and Investor B both file requests with the DTCC for delivery of their 1,000 shares of XYZ Corporation at the same time.<sup>213</sup> The DTCC could not immediately comply with their request by providing the physical certificates because they both own the same shares. There simply would not be the physical certificates of XYZ Corporation in the vault at the DTC to fill the requests.<sup>214</sup>

4. *Corporate Governance Issues.* Naked short selling that leads to the creation of long-term failures to deliver can create additional problems when it comes time for a targeted company's shareholders to vote.<sup>215</sup> Normally, each share of common stock in a corporation represents one vote.<sup>216</sup> Each share represents fractional ownership of the corporation, and each share also conveys a bundle of rights including the right to vote, the right to any potential dividends, and the right to sue the company in a class action.<sup>217</sup> Yet when delivery occurs through the Stock Borrow Program, there often are two people claiming to hold the same bundle of rights arising from the same shares.<sup>218</sup>

Investors can only vote shares that they have in their possession and control on the date voting occurs or on the date of

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com/Articles/Investing101/1042.html (Nov. 3, 2005) (documenting the struggles of members of the Byrne family to get physical certificates for their shares in Overstock.com).

211. Cf. Mary Williams Walsh, *2 Republicans to Propose Fix for Private Pension Woes*, N.Y. TIMES, June 9, 2005 at C6, (using the phrase "run on the bank" in the context of pension funds).

212. See Avery & Koh, *supra* note 1, at 38–39 (recounting the DTCC's acknowledgement that if everyone asked for their physical share certificates the demands could not be met).

213. See *supra* notes 170–86 and accompanying text (discussing the problem of dual ownership presented by the present clearing system).

214. See *id.*

215. Martin & Partnoy, *supra* note 158, at 798 n.109 (describing problems faced in voting when illegal naked short selling has occurred).

216. See DEL. CODE ANN. tit. 8, § 212 (2001) (stating the presumption of one share, one vote for all Delaware corporations); see also Martin & Partnoy, *supra* note 158, at 781–84 (explaining the development of the one share, one vote principle).

217. Failing to Deliver, *supra* note 87.

218. Cf. Avery & Koh, *supra* note 1, at 37.

record set by the corporation.<sup>219</sup> In a traditional short sale, the lending party gives up his right to vote when he lends the shares to the short seller for delivery to the buyer.<sup>220</sup> In a traditional short sale, the buyer of the shares sold by the short seller is the shareholder of record and therefore the only person who can vote those shares.<sup>221</sup>

In a naked short sale, however, voting problems often arise.<sup>222</sup> These problems often occur when brokers wrongly represent to all investors that they have the right to vote, regardless of whether or not their shares are out on loan.<sup>223</sup> In our example, both Investor A and Investor B would vote the same 1,000 shares of XYZ Corporation, creating 2,000 votes, even though there are only 1,000 shares in the vault at the DTC.<sup>224</sup> The voting of the 2,000 shares of XYZ Corporation, when only 1,000 shares exist, would seem to suggest massive over-voting in companies with large amounts of phantom shares created by naked short selling.<sup>225</sup> However, in practice, brokers have created fraudulent mechanisms to counter this potentially embarrassing problem.<sup>226</sup>

One way that brokers sidestep reporting too many votes is to use a percentage approach to offset and ultimately cover up the artificially high vote totals.<sup>227</sup> First, every shareholder votes,

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219. See generally DEL. CODE ANN. tit. 8, § 213 (2001) (explaining the normal voting processes for most corporations).

220. See Martin & Partnoy, *supra* note 158, at 797–99 (describing the interaction between short selling and voting rights).

221. *Id.* at 798.

222. *Id.* at 798 n.109 (commenting on the voting problems associated with a market which allows naked short selling).

223. See Letter from Bob O'Brien, Nat'l Coalition Against Naked Short Selling, to the SEC 1–2 (Dec. 12, 2005), available at <http://www.sec.gov/rules/proposed/s71005/robrien8713.pdf> (alleging that brokers' practices have violated the one share, one vote principle).

224. See *supra* notes 170–86 and accompanying text (describing how Investor A and Investor B came to own the same shares).

225. See Martin & Partnoy, *supra* note 158, at 798–99 (noting that problems with over-voting should be common in circumstances where there has been extensive stock borrowing to cover short sales).

226. See Nat'l Am. Sec. Adm'rs Ass'n, Transcript of NASAA Conference on Naked Short Selling, at 45 (Nov. 30, 2005) [hereinafter NASAA Transcript], available at <http://www.ncans.net/files/NASAAtrans.pdf> (describing ways in which brokers allegedly let all shareholders vote—even those whose shares have been lent out—without reporting an artificially high number of votes); see also Letter from Bill Hawes to the SEC (Dec. 8, 2000), available at <http://www.sec.gov/rules/concept/s72499/hawes1.txt> (providing anecdotal evidence of brokers' willingness to allow investors whose shares have been lent out to still vote).

227. See Letter from Bob O'Brien to the SEC, *supra* note 223, at 2. Brokers also allegedly use a netting approach to avoid reporting artificially high numbers of shares; this approach nets all yes and no votes (both legitimately and illegitimately cast) on a

whether they should be able to or not, and the broker calculates the percentage of votes for or against a proposition using the artificially high total number of shares voted.<sup>228</sup> To avoid reporting the artificially high number of votes, the broker applies the yes and no percentages to the actual number of physical shares it has in its DTCC account.<sup>229</sup>

The dilutive effect of this practice is evident in our example. Assume that XYZ Corporation has only 2,500 shares outstanding: 1,000 shares actually owned by Investor B, whose broker allows him to vote even though his shares have been lent through the Stock Borrow program; 1,000 phantom shares allegedly owned by Investor A, delivered through the Stock Borrow Program; and the remaining 1,500 real shares owned by Investor C, who is the controlling shareholder with sixty percent ownership of the stock.<sup>230</sup> If the percentage allocation method is used, and Investors A and B both vote yes on a proposition while Investor C votes no, the proposition would pass based on Investor A and Investor B's vote.<sup>231</sup> This effectively takes control of XYZ Corporation away from Investor C.<sup>232</sup>

A recent incident involving three major Wall Street investment banks shows that over-voting is more than a mere hypothetical problem.<sup>233</sup> In 2006 the New York Stock Exchange fined UBS, Goldman Sachs and Credit Suisse \$1.35 million for over-voting abuses.<sup>234</sup> Although the banks were not specifically charged with violating any specific short sale regulation, the two

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proposition to a single number of yes or no votes which is then the amount of shares voted by the broker. *See id.*

228. *See* NASAA Transcript, *supra* note 226, at 45.

229. *See id.*; Letter from Bob O'Brien to the SEC, *supra* note 223, at 2.

230. Generally investors who control over 50% of a corporation's stock hold a controlling interest. *See* Commissioner v. Fink, 483 U.S. 89, 99 n.15 (1987).

231. The total votes counted would amount to 3,500 (1,000 from Investor A, 1,000 from Investor B, and 1,500 from Investor C). Of the 3,500 votes cast 2,000/3,500 or 57% (legitimately representing Investor A's vote and erroneously representing Investor B's vote) would be for the proposition while 1,500/3,500 or 43% (representing Investor C's vote) would be against it. Using the percentage allocation method the brokerage house would vote 57% of its actual physical shares in the DTCC account (1,425 shares) for the proposition, and 43% of its actual physical shares (1,075 shares) against the proposition.

232. *See, e.g., Fink*, 483 U.S. at 99 n.15 (explaining that in a simple example such as the one presented here, a shareholder with less than 50% control does not have control of a corporation); *see also* Martin & Partnoy, *supra* note 158, at 781-84.

233. Lauren Rae Silva, *NYSE Fines Firms in "Over-Voting,"* THESTREET.COM, June 13, 2006, <http://www.thestreet.com/stocks/brokerages/10291435.html> (presenting an example of a recent over-voting case).

234. *Id.* (quoting an NYSE official stating that the banks were fined for "operational deficiencies and supervisory violations concerning the submission of proxy votes").

issues remain closely linked.<sup>235</sup> This recent action further illustrates that over-voting is a very real problem for investors and that, if mixed with abusive short selling practices, it can potentially be used to violate the fundamental principle of one share, one vote.<sup>236</sup>

### C. Incentives to Allow Naked Short Selling

To justify exposing themselves to potentially large damage judgments, the market participants involved in naked short selling must have strong monetary incentives to carry out naked short sales.<sup>237</sup> One incentive may be the rebates received by DTCC client-owners whenever the DTCC earns a profit from its operations.<sup>238</sup> However, there are other, more powerful incentives built into the market infrastructure, in the form of increased revenues from commissions and interest for brokers on both sides of a naked short sale transaction.<sup>239</sup>

1. *Increased Commission Revenues for Brokers.* The first incentive for brokers to allow naked short selling is to increase the revenues they earn from commissions.<sup>240</sup> This incentive involves the timing of when brokers receive their commissions for performing the trades.<sup>241</sup> The timing of commission payments can corrupt brokers by aligning their interests not with their clients'

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235. *Id.* (commenting on the relationship between over-voting and abusive short selling practices).

236. *See* Martin & Partnoy, *supra* note 158, at 781–84 (explaining the one share, one vote principle).

237. *See* Wherry, *supra* note 40, at 66 (estimating the amount of damages to be in the billions of dollars); NASAA Transcript, *supra* note 226, at 6–10 (explaining some of the incentives that may lead market participants to allow naked short selling even though it causes long-term failures to deliver).

238. *See supra* notes 109–17 and accompanying text (explaining how the DTCC's client-owners get rebates when the DTCC's revenues exceed its operating costs); *see also* DTCC 2004 ANNUAL REPORT, *supra* note 109, at 55 (noting that the DTCC paid out \$162 million in rebates in 2004 alone).

239. *See* Avery & Koh, *supra* note 1, at 37; NASAA Transcript, *supra* note 226, at 7–10 (describing how brokers can increase their revenues by allowing naked short selling to occur and explaining marking to market and how it increases funds available to naked short seller).

240. *See* NASAA Transcript, *supra* note 226, at 7–8. Commission revenues can be very important to large brokerage firms, regardless of any illegal naked short selling activity. *See* Merrill Lynch, Annual Report (Form 10-K), at 49 (2004), *available at* [http://www.ml.com/annualmeetingmaterials/2004/ar/pdfs/annual\\_report\\_2004\\_financials.pdf](http://www.ml.com/annualmeetingmaterials/2004/ar/pdfs/annual_report_2004_financials.pdf) (noting that commissions represented Merrill Lynch's second highest source of revenue for 2004).

241. *See* NASAA Transcript, *supra* note 226, at 7–8.



(the investors) interests, but with those of the naked short sellers.<sup>242</sup>

The brokers involved in a naked short sale transaction receive their commissions from the trade on the date the trade settles.<sup>243</sup> By SEC regulation, delivery and settlement are supposed to occur no later than on the third day after of the trade occurs.<sup>244</sup> Often in a naked short sale, delivery occurs (if at all) through the use of the Stock Borrow Program, so that when the trade settles and commissions are paid, only the phantom shares have been delivered.<sup>245</sup> Using our example, Broker A, who is supposed to represent Investor A in his purchase of 1,000 shares of XYZ Corporation, receives his commission for performing the trade three days after the transaction, regardless of the fact that the market maker has only delivered phantom shares.<sup>246</sup> This mitigates Broker A's interests because he has received his commission for the trade and therefore has no monetary incentive to force the market maker (the naked short seller) to purchase real shares in the market to repay the loan.<sup>247</sup>

2. *Increased Funds Available to Lending Broker Leads to Possible Conflicts of Interest.* The next monetary incentive to facilitate naked short selling also involves both brokers in a transaction.<sup>248</sup> The broker in the transaction who lends out its client's shares through the Stock Borrow Program receives money in the form of interest on that loan.<sup>249</sup> The lending broker is then able to earn interest on this loan until the naked short seller covers his position and returns the shares to the lending broker.<sup>250</sup>

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242. See *id.* (demonstrating the conflict of interest brokers face when dealing with a naked short sale situation).

243. *Id.*

244. See *supra* note 78 and accompanying text (explaining that trades are supposed to settle three days after the transaction occurs).

245. See NASAA Transcript, *supra* note 226, at 7; see also *supra* notes 148–62 and accompanying text (explaining how the Stock Borrow Program is manipulated to allow it to appear to the buyer that delivery has occurred on the third day).

246. See *supra* notes 148–62 and accompanying text (documenting the relationship between Broker A and the market maker who uses the Stock Borrow Program to deliver borrowed shares).

247. See NASAA Transcript, *supra* note 226, at 7–8 (noting that the brokers receive payment when the trade settles).

248. See Finnerty, *supra* note 39, at 36 (describing how a broker can make money by lending out shares that may be part of an illegal naked short sale transaction).

249. Stock Borrow Program, *supra* note 147.

250. See Avery & Koh, *supra* note 1, at 34–36 (illustrating that the lending broker earns interest on the proceeds from the naked short sale in its account at the DTCC until the naked short seller covers the position).

This ability to continually earn interest creates an environment in which a broker's financial interest may diverge from the financial interest of its client. The broker's and client's interests diverge because the broker can further increase its profits by reloaning the same shares and not demanding the prompt return of shares already lent out.<sup>251</sup> A broker can also increase its profits by lending out shares that are not technically eligible for lending.<sup>252</sup> These strategies can increase the broker's revenues from interest but can also potentially harm clients.<sup>253</sup>

This potential conflict of interest is also evident in our example, in which both brokers in the transaction can benefit from the current system by earning interest on loaned shares.<sup>254</sup> In the original transaction involving XYZ Corporation, Broker A, who receives electronic delivery of 1,000 shares of XYZ Corporation from the Stock Borrow Program, has a monetary incentive to reloan those same 1,000 shares.<sup>255</sup> If Broker A alerts the NSCC that it has shares available for lending it may be able to reloan the 1,000 shares of XYZ Corporation through the Stock Borrow Program and earn interest on the loan.

The original lending broker in a transaction may also have an incentive to facilitate naked short sales that result in long term failures to deliver because the longer the shares are on loan, the more interest the lending broker will earn on the loan.<sup>256</sup> In our example, Broker B, who has lent out 1,000 shares of XYZ Corporation, has no incentive to force the market maker to buy the shares in the market and repay the loan.<sup>257</sup> Like a credit card company collecting late fees, Broker B benefits from allowing the shares to remain on loan indefinitely, since it increases its

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251. See Finnerty, *supra* note 39, at 36–37 (noting that the lending broker earns interest when the stock loan is outstanding and that brokers allegedly may reloan shares through the Stock Borrow Program, thereby increasing interest revenues); Avery & Koh, *supra* note 1, at 36 (same).

252. See Avery & Koh, *supra* note 1, at 39 (alleging that brokers will put shares that should not be available for lending into the Stock Borrow Program to increase the amount of interest they can earn on shares lent out).

253. See Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (explaining how illegal naked short selling hurts investors in a targeted company's stock).

254. See *supra* notes 170–86 and accompanying text (describing the original transaction); see also *infra* Appendix II.

255. See Avery & Koh, *supra* note 1, at 34 (describing a broker's incentives to reloan shares acquired through the Stock Borrow Program).

256. See *supra* notes 248–53 and accompanying text (explaining the economic benefits of having higher levels of loans outstanding).

257. See *supra* notes 170–86 and accompanying text; see also *infra* Appendix II.

revenues from interest earned on the funds it received from the market maker.<sup>258</sup>

The current arrangements also create an incentive for brokers to lend as many shares as possible through the Stock Borrow Program to increase their interest revenues.<sup>259</sup> Legally, only shares held in margin accounts are available for lending through the Stock Borrow Program.<sup>260</sup> However, evidence suggests that brokers lend out shares that would otherwise be ineligible for the Stock Borrow Program in order to increase their interest revenues.<sup>261</sup>

In our example, it is clear that if Broker A and Broker B are not limited in the type of accounts from which they can lend shares, they can substantially increase the interest revenues they earn from stock lending.<sup>262</sup> The current arrangements—in which a large portion of shares is held in nonmargin accounts and neither the DTCC nor the SEC monitor the accounts from which shares are lent—create the incentive and opportunity for brokers to aggressively lend as many shares as possible.<sup>263</sup> By lending shares from both non-margin and margin accounts, brokers can tap a much larger pool of shares from which to earn interest revenues.<sup>264</sup> Once again, these arrangements align the broker's financial interest with those of the naked short sellers, rather than with the interests of their clients.<sup>265</sup>

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258. See, e.g., Kathleen Day & Caroline E. Mayer, *Credit Card Penalties, Fees Bury Debtors*, WASH. POST, Mar. 6, 2005, at A1 (describing why credit card companies prefer late repayments because of the resulting increased interest payments they receive).

259. See Avery & Koh, *supra* note 1, at 39 (noting that greed may cause brokers to put legally unavailable shares into the Stock Borrow Program).

260. See 12 C.F.R. § 220.8 (2006) (listing the allowable transactions from a cash account); Avery & Koh, *supra* note 1, at 39 (noting that stock held in cash, retirement, or institutional accounts cannot legally be lent through the Stock Borrow Program). Disclosure of the status of shares in margin accounts is often lacking. See *supra* note 183 and accompanying text.

261. Avery & Koh, *supra* note 1, at 39 (suggesting aggressive lending policies on the part of brokers have led to the loaning of ineligible shares).

262. See *supra* notes 170–86 and accompanying text; *infra* Appendix II (illustrating how Broker A and Broker B could increase interest revenues by raising the amount of stock lending they participate in).

263. See Nat'l Ass'n of Sec. Dealers, *Margin Statistics*, [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_005923](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_005923) (last visited Nov. 11, 2006) (providing information on the amount of money in cash and margin accounts as compared to the amount of money in other accounts, and showing that, on average, the cash and margin account balances are less than half the balance of the other accounts).

264. See Avery & Koh, *supra* note 1, at 39 (discussing the trading of unmarginable shares).

265. See Thiel, *supra* note 5 (reasoning that “when a stock goes into naked short territory,” brokers can take advantage of higher demand to earn higher commission on

In addition to brokers, other market participants can profit from facilitating naked short selling,<sup>266</sup> although these other parties do not have the same fiduciary responsibilities to their clients as their clients' brokers do.<sup>267</sup> The current financial incentives for brokers to forsake their clients' interests represent a critical flaw in the current structure of our financial markets and have drawn broad comment and criticism.<sup>268</sup>

## V. THE SEC'S RESPONSE: REGULATION SHO

Faced with an increasing number of complaints about abusive short sale practices and calls for reform, the SEC recently revised its short sale regulations.<sup>269</sup> These reform efforts culminated in 2004 with the adoption of Regulation SHO.<sup>270</sup> Regulation SHO represents the first major change to SEC short sale regulation since the SEC first regulated the practice in 1938.<sup>271</sup> The adoption of Regulation SHO also represented a significant change of direction for the SEC in combating naked short selling abuses, following years in which the SEC took no action despite numerous small investors' reports of problems.<sup>272</sup>

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loaned shares); *see also* Avery & Koh, *supra* note 1, at 38 (alleging that aggressive stock lending practices can harm investors).

266. *See supra* notes 170–86 and accompanying text (identifying the DTCC and market makers as other possible market participants). Incentives for other market participants include increased funds available to market makers who naked short a stock and the possibility of increased revenues for the DTCC. *See* NASAA Transcript, *supra* note 226, at 8–10 (describing “marking to market” and how it increases funds available to naked short sellers).

267. Brokers may have a fiduciary obligation to act in their clients' best interest depending on the state they are located in and the amount of control they have over the account. *See, e.g.,* Walston & Co. v. Miller, 410 P.2d 658, 660 (Ariz. 1966) (“[W]hen a broker serves as a customer's agent, he is a fiduciary and owes his principal a duty to communicate certain information to him.”); *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 751 (Ct. App. 1989) (holding that a broker has a fiduciary duty to a client). *But see* *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (holding that a broker's fiduciary duty to his client in an account over which the broker did not have control is more limited).

268. *See* Avery & Koh, *supra* note 1, at 39 (commenting on the conflict of interest created by the potential gains for brokers, much to the detriment of clients); Finnerty, *supra* note 39, at 35–38 (criticizing a system that rewards brokers for acting contrary to their clients' interests).

269. *See* Short Sales Concept Release, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996 (Oct. 28, 1999) (noting that when the SEC took comments on short selling reform, it received approximately 2,200 letters or comments from individual investors complaining of abusive short selling practices, including naked short selling).

270. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–.203).

271. Short Sales Concept Release, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996 (Oct. 28, 1999).

272. *See* E-mail from Alden James to the SEC (Dec. 9, 2003), *available at*

The SEC adopted Regulation SHO, at least in part, to deal with the problem of naked short selling.<sup>273</sup> During the formation of Regulation SHO, diverse parties suggested various approaches for dealing with naked short selling.<sup>274</sup> At the conclusion of the comment phase, the SEC enacted what they believed to be a practical approach for addressing the problem.<sup>275</sup>

Regulation SHO adopts a two-part approach for dealing with manipulative naked short selling.<sup>276</sup> In the first part, Regulation SHO creates “locate requirements” for brokers participating in short sales.<sup>277</sup> The second part of Regulation SHO aims to curb manipulative naked short selling by placing limits on trading in certain “threshold securities” that already have substantial failures to deliver.<sup>278</sup>

#### A. *Locate Requirements*

1. *Rule 203(A)*. The first line of defense against naked short selling in Regulation SHO is Rule 203(A), the locate

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<http://www.sec.gov/rules/proposed/s72303/ajames121103.htm> (representing the concerns expressed by average investors over naked short selling before the passage of Regulation SHO); *see also* Letter from Dr. Jim DeCosta to Jonathan G. Katz, *supra* note 206 (chronicling the frustration that individual investors have experienced in attempting to get the SEC to address the naked short selling issue).

273. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,009 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (stating that certain new requirements of Regulation SHO are meant to curtail the practice of naked short selling); Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 63,003 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (proposing changes in short sale regulations due to complaints regarding naked short selling).

274. *Compare* Letter from George R. Kramer, Vice President and Acting Gen. Counsel, Sec. Ind. Ass’n, to Jonathan G. Katz, Sec’y, SEC (Jan. 30, 2004), *available at* <http://www.sec.gov/rules/proposed/s72303/sia013004.htm> (advocating a more cautious approach to reforming short sale regulations), *with* Letter from Robert J. Shapiro to the SEC Rules Comm., *supra* note 197 (calling for more immediate changes necessary to solve the problem of naked short selling).

275. The SEC carefully considered all comments, market implications, and current market practices and, in the end, decided to adopt some proposed regulations while deferring a decision on others until a later date. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (postponing action on some proposals until completion of the “pilot” of Regulation SHO).

276. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,013–18 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (setting out the two parts of Regulation SHO: locate requirements and limitations on threshold securities).

277. *Id.* at 48,013–16; *see also* Anthony W. Djinis et al., *Securities Regulation: SEC Revamps Provisions Governing Short Sales*, INSIGHTS, Nov. 2004, at 13, 15–17 (commenting on the locate and delivery requirements now placed on market participants under Regulation SHO).

278. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,016–18 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (limiting trading in stocks that have the characteristics of a security manipulated by naked short selling).

provision.<sup>279</sup> This provision attempts to curtail naked short selling by “requiring a broker-dealer, prior to effecting a short sale in any equity security, to ‘locate’ securities available for borrowing.”<sup>280</sup> This universally applicable locate provision is an improvement over the previous system, under which each self-regulatory organization (NYSE, NASDAQ, etc.) had its own rules governing a broker’s general requirement to “locate” a stock prior to executing a short sale.<sup>281</sup>

Having established the general rule, the SEC now faced the issue of defining how a broker-dealer could satisfy the requirement to “locate” shares prior to a short sale.<sup>282</sup> The SEC settled on a definition of “locate” wherein a broker can execute a short sale if that broker “has (1) borrowed the security or entered into an agreement to borrow the security, or (2) has *reasonable* grounds to believe that the security can be borrowed so that it can be delivered on the date the delivery is due.”<sup>283</sup> In determining what constitutes a reasonable belief that a stock can be borrowed prior to delivery, Regulation SHO permits brokers to rely on industry-generated “Easy to Borrow” lists.<sup>284</sup>

If a stock appears on an Easy to Borrow list that is less than twenty-four hours old, Regulation SHO permits a broker to sell that stock short without first locating the shares for delivery.<sup>285</sup> Relying on an Easy to Borrow list, however, is not an absolute guarantee of the reasonable belief required because Regulation SHO stipulates that if there are repeated failures to deliver in a

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279. See *id.* at 48,013.

280. See *id.* at 48,014.

281. See Letter from Christopher R. Concannon, NASDAQ Stock Market, to Jonathan G. Katz, Sec’y, SEC (Mar. 25, 2004), available at <http://www.sec.gov/rules/proposed/s72303/cconcannon03252004.htm> (demonstrating the desire of self-regulatory organizations to develop consistent short sale regulations in the various markets); see also Letter from James J. Angel, Associate Professor of Finance, Georgetown Univ., to Jonathan G. Katz, Secretary, SEC (Jan. 3, 2004), available at <http://www.sec.gov/rules/proposed/s72303/jjangel011004.htm> (providing academic support for uniform short sale regulations in place of the pre-Regulation SHO system).

282. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,013–14 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (attempting to define what it means for brokers to “locate” shares); see also E-mail from Darla C. Stuckey, Corporate Sec’y, NYSE, to Jonathan G. Katz, Sec’y, SEC (Mar. 1, 2004), available at <http://www.sec.gov/rules/proposed/s72303/dstuckey03012004.htm> (contributing to the debate over how to determine when a broker has “located” shares).

283. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,013–14 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (emphasis added) (mandating new limitations on borrowing requirements involved with short selling).

284. *Id.* at 48,014; see also Letter from George R. Kramer to Jonathan G. Katz, *supra* note 274 (describing how the brokerage industry compiles “Easy to Borrow” lists).

285. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,014 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203).

stock on an Easy to Borrow list, a broker's continued reliance on that list is no longer deemed reasonable.<sup>286</sup> The reasonable belief requirement is also not satisfied by a stock's absence from a broker's "Hard to Borrow" list.<sup>287</sup> Hard to Borrow lists are not as widely used in the brokerage industry, and the SEC determined that a stock's absence from a broker's Hard to Borrow list presented too low a standard to satisfy the reasonable belief requirement.<sup>288</sup>

2. *Potential Loophole in Locate Requirements.* The SEC's definition of reasonable belief appears to be a workable construction, but legitimate concerns remain that it includes a potential loophole for market participants intent on using naked short sales to manipulate stock prices.<sup>289</sup> The potential loophole lies in what constitutes a reasonable belief when a broker does not rely on an Easy to Borrow list.<sup>290</sup> Some commentators believe that despite the guidance provided by the SEC regarding Easy to Borrow and Hard to Borrow lists, the reasonable belief standard is still too subjective, with no firm guidelines to prevent manipulative behavior.<sup>291</sup> For example, manipulative naked short selling could still occur when a broker claims to have a reasonable belief that it can deliver the shares based on its ability to access the Stock Borrow Program to borrow the shares.<sup>292</sup> The SEC needs to address this potential loophole by providing more detailed guidance as to what constitutes a legitimate, reasonable belief.

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286. See *id.* (stating that, absent mitigating circumstances, a reasonable reliance on the "Easy to Borrow" list should create no problems in securing delivery at the designated time).

287. *Id.*; see also E-mail from Darla C. Stuckey to Jonathan G. Katz, *supra* note 282 (commenting that the major exchanges viewed the use of "Hard to Borrow" lists as a less efficient way to determine reasonable belief).

288. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,014 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-203).

289. See Letter from H. Glenn Bagwell, Jr. to Jonathan G. Katz, Sec'y, SEC (Nov. 21, 2003), available at <http://www.sec.gov/rules/proposed/s72303/hgbagwell112103.txt> (encouraging the SEC to adopt more effective controls to eradicate "loopholes and gray areas" in Regulation SHO).

290. See *id.* ("Reasonable grounds' is not an objective standard and there are too many dishonest market participants who will take advantage of this proposed subjectivity . . .").

291. See Letter from Dr. Jim DeCosta to Jonathan Katz, *supra* note 206 ("[P]eople that have made literally billions of dollars committing this fraud are looking for any potential loophole that will allow them to carry on the commission of this fraud ad infinitum.").

292. See Helen Avery, *SEC Seeks to Curb Naked Ambition*, EUROMONEY, Apr. 2005, at 40, 41.

3. *Problems with the Bona Fide Market Making Exception.* Regulation SHO's locate requirements also include several exceptions,<sup>293</sup> and the SEC's decision to exempt "bona fide" market makers from locate requirements is perhaps the most problematic.<sup>294</sup> The SEC exempted bona fide market makers, based on its view that such an exception was "necessary because [market makers] may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed 'locate' rule."<sup>295</sup> A limited exception for market making is necessary to maintain market liquidity in certain stocks, but the potential for abuse also arises in a gray area concerning what constitutes "bona fide" market making.<sup>296</sup>

Acknowledging the ambiguity surrounding this term, the SEC attempted to clarify what constitutes "bona fide" market making by listing certain conduct deemed to be outside the realm of bona fide market making.<sup>297</sup> Regulation SHO states first that trading activities that are part of "speculative selling strategies" do not qualify as bona fide market making.<sup>298</sup> Regulation SHO also warns market makers against transferring their exception to other market participants, stating that market makers cannot allow other broker-dealers or clients to use the market maker exception to avoid the locate requirements of Rule 203(A).<sup>299</sup> Despite these general and somewhat lenient guidelines as to what constitutes bona fide market making, several market makers argued for a broader approach that would have exempted more conduct.<sup>300</sup>

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293. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,015-16 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (listing bona fide market making and other exceptions to Regulation SHO's locate requirements).

294. See Letter from Robert J. Shapiro to the SEC Rules Comm., *supra* note 197 (noting concerns that there may be a thin line between bona fide market making activity and manipulative trading strategies).

295. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,977 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (discussing the SEC's reasons for exempting bona fide market making activities).

296. See generally Letter from John H. Blucher, Gen. Counsel of Knight Trading Group, to Jonathan G. Katz, Sec'y, SEC (Jan. 6, 2004), available at <http://www.sec.gov/rules/proposed/s72303/knight010604.htm> (lobbying for an exception for bona fide market making). *But see* Letter from Robert J. Shapiro to the SEC Rules Comm., *supra* note 197 (warning the SEC of the possible harms associated with an expansive view of the bona fide market maker exception).

297. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,015 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (providing initial guidance as to what will not constitute bona fide market making).

298. *Id.*

299. *Id.*

300. Letter from Am. Stock Exch. et al. to Jonathan G. Katz, Sec'y, SEC (Feb. 9, 2004), available at <http://www.sec.gov/rules/proposed/s72303/exchanges020904.htm>



These provisions attempt to limit the bona fide market making exception to legitimate market making activities, but the remaining ambiguity provides ample room for abuse.<sup>301</sup> Such abuse in this area frequently involves hedge funds improperly claiming the bona fide market maker exception to short stocks without first locating the shares.<sup>302</sup> When a hedge fund improperly masquerades as a bona fide market maker, it may be evident from the composition of the fund's short position.<sup>303</sup> A bona fide market maker should be short about 50% of the time, as most legitimate market makers try to close each trading day with roughly equivalent short and long positions.<sup>304</sup> However, if a so-called market maker is short to a disproportionate degree, it may be a hedge fund cloaking its activities under the bona fide market maker exception.<sup>305</sup>

In addition, abuses arising from this exception are difficult to identify because a bona fide market making transaction can morph into a manipulative naked short sale scheme over time.<sup>306</sup> Our earlier example illustrates the difficulty in differentiating bona fide market making from manipulative naked short selling.<sup>307</sup> In the example, the market maker naked shorted the

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(describing the perceived need to expand what constitutes bona fide market making beyond the SEC's original definition).

301. See Thiel, *supra* note 5 (criticizing the ambiguity present in the bona fide market making exception); see also Summary of Comments: Short Sales, at 13–14 (July 28, 2004), <http://www.sec.gov/rules/extra/s72303comsum.pdf> (listing commentators that criticized the bona fide market making exception).

302. See, e.g., News Release, *supra* note 171 (summarizing a scheme where a broker improperly allowed hedge funds to use his market maker exception to carry out a manipulative short selling scheme).

303. See Thiel, *supra* note 5 (noting that “[w]hen a hedge fund is actively shorting a number of stocks . . . on the Threshold Security List, it would seem to be good cause for an investigation); see also Posting of bobo to Bob O'Brien's Sanity Check Blog, <http://www.thesanitycheck.com/BobsSanityCheckBlog/tabid/56/EntryID/373/Default.aspx> (July 8, 2006 7:06 EST) (encouraging the SEC to establish meaningful penalties for market makers who are effectively “renting” their exemption to hedge funds).

304. See Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,977 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (noting the SEC's opinion that “most specialists and market makers seek a net ‘flat’ position in a security at the end of each day and often ‘offset’ short sales with purchases such that they are not required to make delivery under the security settlement system”).

305. See WILLIAM H. DONALDSON, CHAIRMAN, SEC, THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK 6 (2003), available at <http://financialservices.house.gov/media/pdf/052203wd.pdf> (testifying that “hedge funds sometimes engage in substantial short selling”).

306. See *supra* notes 73–89 and accompanying text (describing the difference between a legal naked short sale for market making purposes and an illegal long term failure to deliver that represents a manipulative trading practice).

307. See *supra* notes 170–92 and accompanying text; see also *infra* Appendix II.

1,000 shares of XYZ Corporation in much the same way that a bona fide market maker would. Only after the failure to deliver has persisted for an extended period of time might a transaction that was initially legitimate become a “speculative selling strategy[.]”<sup>308</sup> In order for Regulation SHO to achieve its goal, the SEC should address the considerable gray area surrounding the differences between bona fide market making and manipulative naked short selling.<sup>309</sup>

### B. *Threshold Securities*

1. *Rule 203(B)*. Regulation SHO’s second approach to protecting investors from manipulative naked short selling is Rule 203(B), which mandates the creation and operation of “threshold” securities lists.<sup>310</sup> Under this rule, the various major exchanges compile the necessary daily data used to create these lists and publish them on a daily basis.<sup>311</sup> In addition, the Rule requires that market participants undertaking short sales in securities that appear on a threshold list be subject to additional restrictions.<sup>312</sup>

A stock is designated as a “threshold security” when it experiences extended failures to deliver that make it susceptible to the adverse effects often associated with manipulative naked

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308. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,015 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (stating that speculative trading strategies are not covered by the bona fide market making exception); see also *supra* notes 170–92 and accompanying text; *infra* Appendix II (describing the hypothetical transaction in XYZ stock).

309. See Letter from Robert J. Shapiro to the SEC Rules Comm., *supra* note 197 (calling for the SEC to clear up the bona fide market making exception); see also Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,009 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (noting that the purpose of Regulation SHO was to curb naked short selling abuses).

310. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,016 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (enacting the threshold securities lists as part of the SEC’s attempt to curb naked short selling by identifying companies that have possibly been affected); see also Boni, *supra* note 26, at 8–9 (describing the threshold securities lists and their effects on short selling under Regulation SHO).

311. See NYSE Group, Threshold Securities, <http://www.nyse.com/Frameset.html?displayPage=/threshold/> (last visited Nov. 11, 2006) (listing all NYSE threshold securities); NASDAQ Trader, Regulation SHO Threshold Securities List, <http://www.nasdaqtrader.com/asp/regsho.aspx> (last visited Nov. 11, 2006) (including all NASDAQ, OTCBB, and other OTC securities); AMEX Trader, Trading Data—Regulation SHO, [http://www.amex.com/amextrader/?href=/amextrader/tradingData/RegSHO/TrDa\\_RegSHO.jsp](http://www.amex.com/amextrader/?href=/amextrader/tradingData/RegSHO/TrDa_RegSHO.jsp) (last visited Nov. 11, 2006) (listing all AMEX threshold securities).

312. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,017 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (listing additional restrictions placed on threshold securities).

short selling.<sup>313</sup> The SEC defines a threshold security as one in which “for five consecutive settlement days[,] there are aggregate fail[ure]s to deliver at a registered clearing agency [(the NSCC)] of 10,000 shares or more per security; [and] that the level of fail[ure]s is equal to at least one-half of one percent of the issuer’s total shares outstanding.”<sup>314</sup> Only companies listed on the NYSE, NASDAQ, or AMEX, or those included in the Over the Counter Bulletin Boards (OTCBB) are eligible to become threshold securities because the SEC deems these companies to be “reporting issuers” that produce sufficient data to be designated as threshold securities.<sup>315</sup>

These three requirements are much more stringent than the alternate definitions of what should constitute a threshold security proposed by some market participants.<sup>316</sup> The SEC adopted the stricter requirements to ensure that companies that were experiencing large amounts of failures to deliver often associated with manipulative naked short selling could be easily identified by their presence on threshold securities lists.<sup>317</sup> However, the SEC did not make the requirements for a threshold security overly low to ensure that the securities that do appear on a threshold securities list are in fact experiencing persistent failures that have manipulative potential, rather than temporary failures caused by innocent delivery problems or errors.<sup>318</sup> To further ensure that only securities with persistent, large-scale failures appear on the threshold lists, the SEC stipulated that a stock can be eliminated from the list only when its failures to

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313. See *id.* at 48,106 (noting the threshold securities are securities that have experienced high numbers of failures to deliver).

314. *Id.*

315. See *id.* at 48,016 n.82 (explaining that only security issuers reporting to the SEC pursuant to Section 12 or 15(d) of the Exchange Act of 1934 can be considered threshold securities); see also Boni, *supra* note 26, at 8–9 (noting that Pink Sheet companies that are often threatened by illegal naked short selling are not covered by the threshold securities lists of Regulation SHO).

316. See, e.g., Letter from John H. Blucher to Jonathan G. Katz, *supra* note 296 (proposing that a threshold security be defined as a stock “where the number of undelivered shares exceeds the greater of 30% of the stock’s public float or 3 times the stock’s average daily trading volume measured over a rolling four week period”); see also Barbara Eisner Bayer, *On Floats and Shares*, THE MOTLEY FOOL, Mar. 21, 2000, <http://www.fool.com/ddow/2000/ddow000321.htm> (explaining the difference between float and the number of outstanding shares).

317. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,017 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (establishing the requirements for a threshold security).

318. See *id.* (enacting the high requirements for a stock to become a threshold security in order to avoid “flickering,” whereby a company gets put on the list for one day due to an innocent delivery error).

deliver fall below the threshold requirements for five consecutive trading days.<sup>319</sup>

A stock's designation as a threshold security triggers several provisions of Regulation SHO designed to cure the stock's large number of failures to deliver.<sup>320</sup> First, if a security remains on a threshold list for thirteen days, whoever was responsible for delivering shares thirteen days earlier—likely a broker-dealer or market maker—must close out the failed position by purchasing equivalent shares in the market and delivering them.<sup>321</sup> Additionally, until the market participant responsible for those failures to deliver closes out that position, that market participant cannot enter into new short sales of the threshold security without having first borrowed or entered into a bona fide agreement to borrow the shares.<sup>322</sup> Unlike the previous locate requirements of Rule 203(A), market makers are not exempt from these close out and borrowing requirements.<sup>323</sup>

2. *Problems on the Threshold: Companies Staying on Threshold Lists for Long Periods of Time.* Under Rule 203(B), if a stock becomes a threshold security, a market participant responsible for an extended failure to deliver will have to purchase the equivalent securities on the market and deliver them.<sup>324</sup> Logically, this increased buying activity would put upward pressure on the security's price, and the new deliveries of stock should reduce the number of outstanding fails, causing the stock to drop off the threshold list.<sup>325</sup> In practice, though, most companies on the various threshold securities lists have not experienced increases in their share prices since the SEC enacted

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319. *See id.* (increasing the likelihood that a stock with only innocent failures to deliver will not remain on a threshold security list for a long period of time).

320. *See id.*

321. *See id.* (requiring the party responsible for the failure to cover its failure to deliver).

322. *Id.* at 48,017–18; *see also* Key Points About Regulation SHO, *supra* note 21 (explaining further restrictions on short sales of threshold securities).

323. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,018 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (refusing to exempt market makers from the threshold security restrictions). This nonexemption occurred despite strong objections from large market makers during the commentary stage of Regulation SHO. *See, e.g.,* Letter from Am. Stock Exch., et al. to Jonathan G. Katz, *supra* note 300 (lobbying unsuccessfully for exemptions for market maker exemptions in threshold securities).

324. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,017 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203).

325. *See* Henny Sender, *New Rules to Put Squeeze on Shorts*, WALL ST. J., Jan. 27, 2005, at C5 (reflecting the concerns of short sellers that Regulation SHO's requirements will cause threshold securities' stock prices to rise).

Regulation SHO.<sup>326</sup> To the contrary, companies such as Overstock.com have lost significant market value since first appearing on the threshold securities list.<sup>327</sup> Moreover, many companies have remained on the threshold list for months at a time, indicating high levels of failures to deliver for extended periods.<sup>328</sup>

Several explanations have been advanced to explain why companies have remained on the threshold lists for these extended periods.<sup>329</sup> One theory holds that brokers and other market participants are “rolling over” their failures to deliver.<sup>330</sup> This explanation was first offered publicly by Senator Robert Bennett of Utah in a Senate Banking Committee hearing in which he chastised then SEC Chairman William Donaldson about Regulation SHO’s apparent ineffectiveness.<sup>331</sup> Senator Bennett stated,

I am told that the way it works is that one brokerage house sells short, has 13 days under your rule under which to acquire the shares, and in that 13-day period hands the whole transaction off to another brokerage house, and they just keep moving it around, and nobody ever has to settle . . . .<sup>332</sup>

Using our example to illustrate this scenario, assume that XYZ Corporation was on a threshold securities list. After thirteen days, Regulation SHO would require the market maker that

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326. See Floyd Norris, *A New S.E.C. Rule Fails to Raise Share Prices, and Some Are Angry*, N.Y. TIMES, Feb. 18, 2005, at C1 (noting stocks that are consistently on the NYSE and NASDAQ threshold securities lists have “underperformed” since the beginning of 2005 when Regulation SHO took effect).

327. See Kadlec, *supra* note 34, at A14 (noting Overstock.com’s poor performance in the stock market since Regulation SHO was enacted); see also Buyins.net, Overstock.com Stock Chart, [http://www.buyins.net/tools/symbol\\_stats.php?sym=ostk](http://www.buyins.net/tools/symbol_stats.php?sym=ostk) (last visited Nov. 11, 2006) (providing a graphic example of Overstock.com’s loss of nearly half of its market value since its appearance on the threshold securities lists as of November 2006).

328. See, e.g., Avery, *supra* note 292, at 42 (noting that NovaStar Financial was on the first threshold security list and has not dropped off the list since that time).

329. See Key Points About Regulation SHO, *supra* note 21 (stating alternate reasons that securities may remain on the Threshold Securities List, including the fact that a broker-dealer only recently performed a close-out, that “new delivery failures resulting from long or short sales may have crossed the threshold,” or that “delivery failures . . . may have been established prior to a security’s appearance on the . . . list and are grandfathered from the close-out requirement”).

330. Thiel, *supra* note 5 (describing the allegations that market participants are rolling over failures to deliver, causing targeted securities to remain on the threshold lists).

331. *The State of the Securities Industry: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 22 (2005) (statement of Sen. Robert Bennett (R-Utah)).

332. *Id.*

naked shorted XYZ shares to buy equivalent shares and deliver them.<sup>333</sup> Under Senator Bennett's rolling over theory, though, before the close out requirements are triggered on day thirteen (which would require the failing party to buy the shares in the market), the market maker transfers the position to another willing market participant (another market maker or broker) and the thirteen-day countdown to a mandatory buy-in starts again.<sup>334</sup> The SEC has acknowledged that such rollovers may explain some instances in which stocks have remained on threshold securities lists and has pledged to further investigate this manipulative market behavior, noting that a transaction set up to intentionally roll over a failure to deliver would violate Regulation SHO.<sup>335</sup>

The SEC has offered several other possible explanations for why certain companies have remained on the threshold lists for extended periods.<sup>336</sup> The Commission has noted that securities on the threshold lists remain there for at least five trading days even if all its failures have been settled.<sup>337</sup> The SEC also notes that sufficient numbers of new delivery failures may occur while the old failures are being settled, keeping the stock on the threshold list for a prolonged period.<sup>338</sup> However, this explanation seems problematic because once a stock is designated a threshold security, the additional borrowing requirements should make it much more difficult for a short seller to fail to deliver its shares.<sup>339</sup> The third explanation offered by the SEC as to why

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333. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,017-18 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (mandating that market participants close out the failures to deliver of securities on threshold lists after thirteen days); see also *supra* notes 170-92 and accompanying text (detailing the hypothetical transaction in XYZ Corporation); *infra* Appendix II.

334. See Thiel, *supra* note 5 (explaining how rolling over failures to deliver avoids Regulation SHO's buy-in requirement and essentially restarts the thirteen-day countdown).

335. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,018 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (warning market participants that attempting to get around Regulation SHO's close out requirements for threshold securities will not make a party in compliance with the rule); Avery, *supra* note 292, at 42 (quoting James Brigagliano of the SEC's Division of Market Regulation as saying that rolling over failures could occur but that the SEC has no evidence of this illegal activity occurring).

336. See Key Points About Regulation SHO, *supra* note 21 (providing alternate theories on why some issuers are unable to get off the threshold securities lists).

337. See *id.*; Boni, *supra* note 26, at 8 n.11 (explaining the continued presence of stocks on threshold lists for at least five consecutive days regardless of the number of failures to deliver present in the market).

338. See Key Points About Regulation SHO, *supra* note 21 (noting that new failures may keep a security on the threshold lists).

339. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,016-18 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (placing limits on short

certain stocks have languished on a threshold securities list, which we will now examine, is the most troubling of all.<sup>340</sup>

3. *Grandfathering All Old Failures to Deliver Undercuts Regulation SHO's Effectiveness.* The third explanation provided by the SEC for persistent failures to deliver exceeding the threshold level involves the "grandfather" provisions of Regulation SHO, which exempt from buy-in requirements all failures to deliver that occur before a security is designated a threshold security.<sup>341</sup> In a few short lines of regulatory language, the SEC effectively granted amnesty for years of past, possibly illegal behavior by stating that "[t]he requirement to close out fail to deliver positions in threshold securities that remain for thirteen consecutive settlement days does not apply to any positions that were established prior to the security becoming a threshold security."<sup>342</sup> Under this provision, targeted companies can remain indefinitely on threshold securities lists because the offending naked short sellers do not have to cover the failures to deliver, often years old, that existed prior to the adoption of Regulation SHO.<sup>343</sup>

Significantly, these grandfather provisions were not included in the SEC's proposed draft of Regulation SHO provided to the public for comment.<sup>344</sup> Why did these provisions make it into the

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sales in threshold securities that should deter new failures in those securities); *see also* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,976-78 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (expressing that Regulation SHO was intended to reduce failures to deliver in threshold securities); Key Points About Regulation SHO, *supra* note 21 (describing the limitations placed on short sales of threshold securities).

340. *See* Key Points About Regulation SHO, *supra* note 21 (describing this exemption as one of the reasons why stocks consistently remain on threshold lists); *see also* Avery, *supra* note 292, at 43 (noting complaints regarding the SEC's decision to grandfather in old fails).

341. *See* Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,018 & n.97 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-203) (exempting all fails that occurred prior to Regulation SHO's implementation from the threshold security close out requirements); *see also* Key Points About Regulation SHO, *supra* note 21 (describing this exemption as one of the reasons why stocks consistently remain on threshold lists).

342. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,018 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-203). The SEC points out that the grandfathering provision is not complete amnesty for naked short sellers because, in theory, they can still bring other actions against market participants for manipulative behavior that occurred before Regulation SHO. *See* Key Points About Regulation SHO, *supra* note 21 (attempting to calm investors' concerns over the decision to grandfather old failures to deliver against Regulation SHO's regulatory provisions).

343. *See* Phyllis Berman & Ronit Addis, *Naked Came the Short-Sellers*, FORBES, Feb. 8, 1988, at 57 (reporting on naked short selling resulting in failures to deliver that occurred as far back as the early 1980s).

344. *See* Letter from David Patch to Jonathan G. Katz, Sec'y, SEC (Nov. 14, 2005),

final draft of Regulation SHO, like a last-minute legislative rider attached to an obscure bill in Congress?<sup>345</sup> The SEC's troubling answer is that "[they] were concerned about generating volatility where there were large pre-existing open positions, and [they] wanted to start afresh with new regulation, not re-write history."<sup>346</sup>

This decision to avoid rewriting history has drawn criticism from a broad range of market observers.<sup>347</sup> Much of this criticism rests on the principle that manipulative naked short selling is destructive and wrong no matter when it took place, and that the perpetrators should have to cover their failures to deliver regardless of when they originated.<sup>348</sup> Additional criticism of the SEC's decision to grandfather existing failures to deliver has focused on the period between the announcement of Regulation SHO and its actual implementation, which provided a window during which naked short sellers knew Regulation SHO's restrictions were going to be implemented, but they did not yet have to follow its rules.<sup>349</sup>

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*available at* <http://www.sec.gov/rules/sro/nasd/nasd2004044/dpatch3717.htm> (indicating that the grandfather clause was omitted in the proposed Regulation SHO that was issued for comment). *See generally* Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972 (Nov. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48709.htm> (proposing Regulation SHO without mentioning the plan to grandfather in past failures to deliver).

345. *See* Letter from David Patch to Jonathan Katz, *supra* note 344 (criticizing the SEC for not allowing public comment on the grandfathering provision of Regulation SHO).

346. Avery, *supra* note 292, at 43 (quoting James Brigagliano, Assistant Director of the SEC's Division of Market Regulation, as to the Commission's decision to exempt all fails prior to Regulation SHO's effective date from the threshold securities list close out requirements); *see also* Key Points About Regulation SHO, *supra* note 21 (describing further the SEC's desire to avoid volatility as their motivation behind grandfathering all fails prior to Regulation SHO's implementation).

347. *See* ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, SEC, RECORD OF PROCEEDINGS, 2ND DAY OF MEETING 131, 132 (Oct. 24, 2005), *available at* <http://www.sec.gov/info/smallbus/acspc/acspctranscript102505.pdf> (noting that many in the small business community believe that grandfathering all old fails was wrong and that this decision should be reconsidered); *see also* NASAA Transcript, *supra* note 226, at 52-53 (documenting the statements of Ralph Lambiase, Securities Director for the State of Connecticut, regarding the need to eliminate or phase out the grandfathering provisions in Regulation SHO).

348. *See* Avery, *supra* note 292, at 43 (expressing the views of Limelight Media CEO, David Lott, that naked short sellers should be forced to cover their shorts to maintain a fair market for everyone).

349. *See* Brett Goetschius, *SHO Fails to Deliver*, THE PIPES REPORT, Sept. 15, 2005, at 1, 19, *appended in* ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, SEC, RECORD OF PROCEEDINGS, 1ST DAY OF MEETING (Oct. 24, 2005), *available at* <http://www.sec.gov/info/smallbus/acspc/acspctranscript102405.pdf> (describing the problem with the window provided to naked short sellers by Regulation SHO's delayed implementation).



The SEC formally adopted Regulation SHO on July 28, 2004,<sup>350</sup> but its provisions restricting naked short selling did not take effect until January 3, 2005.<sup>351</sup> This five-month period between adoption and implementation, coupled with the SEC's decision to grandfather old failures to deliver, provided naked short sellers a window of opportunity during which they could continue their manipulative behavior and permanently escape the Regulation's buy-in requirements.<sup>352</sup> Evidence suggests that market manipulators took full advantage of this "heads up" from the SEC.<sup>353</sup> Data provided by the NSCC shows that during the period between the adoption and implementation of Regulation SHO, failures to deliver in AMEX, Bulletin Board, and Pink Sheet stocks rose 120%.<sup>354</sup> This increase in the number of failures to deliver strongly suggests that the SEC's decision to avoid market volatility by not immediately implementing Regulation SHO gave naked short sellers one last golden opportunity before the rules officially changed.<sup>355</sup>

4. *The SEC Must Dispense with the Grandfathering Provision of Regulation SHO.* There is some evidence to suggest that Regulation SHO is reducing the number of failures to deliver caused by naked short selling in large-cap NYSE stocks.<sup>356</sup> However, even in these highly visible markets, some well known stocks, including short seller favorites such as Martha Stewart Living Omnimedia and Krispy Kreme Doughnuts, continue to

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350. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,031 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200-.203) (noting the date on which Regulation SHO was formally adopted by the SEC).

351. See *id.* at 48,008 (mandating compliance with the close out and threshold securities requirements of Regulation SHO by January 3, 2005).

352. See Goetschius, *supra* note 349, at 19-20 (describing the complaints surrounding the lag in the time between adoption and enforcement of Regulation SHO).

353. See *id.* (providing evidence that naked short selling increased during the window period).

354. *Id.* at 19 (documenting the effects of the SEC's window period on naked short selling). Small cap companies such as the ones on the AMEX, OTCBB, and Pink Sheets are frequent targets of naked short sellers. See Letter from R. Cromwell Coulson, CEO, Pink Sheets LLC, to Jonathan G. Katz, Sec'y, SEC 1 (July 9, 2004), available at <http://www.sec.gov/rules/proposed/s72303/pinksheets060904.pdf> (thanking the SEC for implementing new short selling rules because companies on the Pink Sheets and the OTCBB are frequently targeted by naked short sellers).

355. See Goetschius, *supra* note 349, at 19 (arguing that the decision to delay the implementation of Regulation SHO was an error).

356. Compare NYSE Group, Threshold Securities, <http://www.nyse.com/threshold> (follow "02/06/2006" hyperlink) (listing thirty-nine securities as threshold securities), with NYSE Group, Threshold Securities, <http://www.nyse.com/threshold> (follow "01/07/2005" hyperlink) (listing seventy-three securities as threshold securities).

languish on the threshold lists.<sup>357</sup> Some modest success also has been achieved in the smaller markets traditionally targeted by naked short sellers.<sup>358</sup> But serious problems are still evident in these markets as evidenced by both the continuing large numbers of total failures to deliver and the persistence of stocks such as Global Links and Overstock.com on their respective exchanges' threshold lists.<sup>359</sup>

These initial successes should not satisfy the SEC; rather, the SEC should go further and completely remove the grandfathering provision from Regulation SHO.<sup>360</sup> By applying Regulation SHO retroactively, the SEC will be able to further reduce the number of companies on the threshold securities lists and the total number of outstanding failures to deliver.<sup>361</sup> Some of the companies on the current threshold lists were victims of naked shorting prior to Regulation SHO,<sup>362</sup> and the SEC's desire

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357. Compare NYSE Group, Threshold Securities for Feb. 6, 2006, *supra* note 356 (listing Martha Stewart Living Omnimedia and Krispy Kreme Doughnuts as threshold securities on February 6, 2006), with NYSE Group, Threshold Securities for Jan. 7, 2005, *supra* note 356 (listing Martha Stewart Living Omnimedia and Krispy Kreme Doughnuts as threshold securities over a year before on January 7, 2005); see also Matthew Goldstein, *Going Long the Short List*, THESTREET.COM, Jan. 4, 2005, [http://www.thestreet.com/\\_forbes/markets/matthewgoldstein/10201467.html](http://www.thestreet.com/_forbes/markets/matthewgoldstein/10201467.html) (noting that both companies appeared on the initial threshold lists and that they have been favorites of short sellers for some time).

358. See Press Release, Depository Trust & Clearing Corp., Regulators Say REG SHO Is Working (Jan. 24, 2006), available at <http://www.dtcc.com/PressRoom/2006/sho.html> (publicizing the successful results of Regulation SHO and quoting James Brigagliano, Assistant Director of Market Regulation at the SEC, that "99% of all trades . . . settle on time without incident"); Memorandum from the Office of Economic Analysis on Fails to Deliver Pre- and Post-Regulation SHO 1, 3 (Aug. 21, 2006), <http://www.sec.gov/spotlight/failstodeliver082106.pdf> (indicating statistical improvement in six key metrics after implementation of Regulation SHO); see also Avery & Koh, *supra* note 1, at 32 (observing that many victims of naked short selling are small cap and start-up companies).

359. Compare NASDAQ Threshold Securities List for Jan. 7, 2005, <ftp://ftp.nasdaqtrader.com/symboldirectory/regsho/nasdaqth20050107.txt> (listing 379 securities as threshold securities), with NASDAQ Threshold Securities List for Feb. 6, 2006, <ftp://ftp.nasdaqtrader.com/symboldirectory/regsho/nasdaqth20060206.txt> (listing only 196 stocks as threshold securities). The NASDAQ list encompasses securities from other exchanges including OTC stocks. See NASDAQ Trader, Regulation SHO Threshold Securities Lists, <http://www.nasdaqtrader.com/asp/regsho.aspx> (last visited Nov. 11, 2006) (describing the contents of the threshold securities lists supplied by NASDAQ).

360. See Letter from David Patch to Jonathan Katz, *supra* note 344 (calling for the SEC to remove the grandfathering provision).

361. See Avery, *supra* note 292, at 43 (explaining how the grandfathering of old failures has caused companies to remain on the threshold lists because buy-ins are not required for past failures to deliver).

362. See, e.g., Berman & Addis, *supra* note 343, at 59-60 (chronicling the creation of a brokerage that relied primarily on short selling strategies in the 1980s and inferring that the brokerage engaged in naked short selling); Thiel, *supra* note 5 (illustrating the claim of Robert Simpson who, in March 2005, watched every share of Global Links Corp.

to avoid market volatility cannot allow the market manipulation of the pre-Regulation SHO era to go unaddressed.<sup>363</sup> The SEC could phase in this change over a short period of time to limit possible market volatility.<sup>364</sup> If the various changes to Regulation SHO suggested in this Article are not implemented, its effectiveness will likely continue to be undermined and vulnerable companies will continue to be targets of manipulative naked short sellers.<sup>365</sup>

## VI. CURRENT LEGAL ENVIRONMENT

The fact that naked short selling is occurring in America's securities markets is not in dispute.<sup>366</sup> Evidence indicates that on certain days, the AMEX, OTCBB, and Pink Sheet markets have cumulative fails as high as nearly 2 billion shares,<sup>367</sup> while the NYSE and NASDAQ have experienced days in which the cumulative failures to deliver have totaled more than 250 million shares.<sup>368</sup> Despite these large numbers of failures to deliver, there remains a wide divergence of opinion about the prevalence of and damage incurred through naked short selling.<sup>369</sup> These divisions

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change hands nearly sixty times in the course of two days while he physically held the company's entire float).

363. See Key Points About Regulation SHO, *supra* note 21 (documenting the SEC's desire to avoid volatility by grandfathering past failures to deliver thereby exempting them from Regulation SHO's provisions). *But see* Key Points About Regulation SHO, *supra* note 21 (assuring investors that the Commission will pursue actions for any grandfathered positions that resulted from illegal activity).

364. See NASAA Transcript, *supra* note 226, at 52-53 (arguing for phasing in the removal of the grandfathering provision to avoid any unnecessary market volatility).

365. See Christopher Cox, Chairman, SEC, Opening Statements at the Commission Open Meeting (July 12, 2006), available at <http://www.sec.gov/news/speech/2006/spch071206cc2.htm> [hereinafter Opening Statements at Commission Open Meeting] (addressing the existing loopholes within Regulation SHO and summarizing the negative effects of prolonged failures to deliver and naked short selling on investors and the market).

366. See Larry Thompson Interview, *supra* note 73 (reporting that the DTCC's own General Counsel Larry Thompson has acknowledged that some level of illegal naked short selling has occurred).

367. See Total Aggregate Fails of Securities Listed on Amex, OTCBB, and Pink Sheets (on file with the Houston Law Review) (documenting that on August 30, 2004, the number of failures to deliver on the AMEX, OTCBB, and Pink Sheet markets totaled 1,929,682,002 shares).

368. See Freedom of Information Act Request No. 05-05810-FOIA, at 4 (June 22, 2005) (on file with the Houston Law Review) (recording that on December 22, 2004, the NYSE and NASDAQ markets suffered failures to deliver amounting to 259,414,671 shares).

369. See Letter from Robert J. Shapiro to the SEC Rules Comm., *supra* note 197 (estimating the damage caused by illegal naked short selling to be \$105 billion). *But see* Thiel, *supra* note 5 (noting that there is not a consensus on how prevalent illegal naked short selling is in the markets).

of opinion in the financial community have created a legal and regulatory environment rife with charges and allegations.<sup>370</sup>

#### A. *Denials Across the Board*

The DTCC and its subsidiaries have consistently denied the economic significance of failures to deliver and the analysis of manipulative naked short selling presented in this Article.<sup>371</sup> The DTCC has called analyses suggesting that naked short sellers have effectively used the Stock Borrow Program “either an intentional misrepresentation of the SEC-approved system, or a profoundly ignorant characterization of this component of the process of clearing and settling transactions.”<sup>372</sup> In an attempt to possibly discourage media coverage of these allegations, the DTCC has attacked media outlets that have reported on the DTCC’s role in the naked short selling story, calling such work “sloppy . . . journalism.”<sup>373</sup>

Other market participants have joined the DTCC in its criticism of suggestions that the DTCC’s system allows manipulative naked short selling to occur.<sup>374</sup> The critics of the analysis presented in this Article range from current and former hedge fund managers to more colorful characters such as billionaire Mark Cuban.<sup>375</sup> The SEC has also tacitly supported the

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370. See Larry Thompson Interview, *supra* note 73 (attacking the professional integrity of attorneys involved in representing plaintiffs in naked short selling litigation).

371. See Press Release, DTCC Announces Effort to Correct Record on Its Stock Borrow Program & Naked Short Selling (Mar. 30, 2005), [http://www.dtcc.com/PressRoom/2005/naked\\_short\\_statement.html](http://www.dtcc.com/PressRoom/2005/naked_short_statement.html) (denying that the Stock Borrow Program is used to facilitate naked short selling).

372. Larry Thompson Interview, *supra* note 73 (expressing the views of the DTCC’s First Deputy General Counsel Larry Thompson on the allegations).

373. Letter from Larry Thompson, First Deputy Gen. Counsel, Depository Trust & Clearing Corp., to Peter Lee, Editor, *Euromoney* 3 (Mar. 31, 2005), available at <http://www.dtcc.com/PressRoom/2005/Letter%20to%20Euromoney%20L%20Thompson%2003.31.pdf> (disputing many of *Euromoney*’s assertions in its report on the allegations involving the Stock Borrow Program); see also Depository Trust & Clearing Corp., Prof. Finnerty’s Paper, <http://www.dtcc.com/ThoughtLeadership/keyissues/finnerty.htm> (last visited Nov. 11, 2006) (discounting a scholarly article that presents the allegations against the DTCC).

374. See Kevin Keller, *The Naked Truth Dressed to Baffle*, THESTREET.COM, Aug. 29, 2005, [http://www.thestreet.com/\\_cnet/tech/kevinkelleher/10240003\\_4.html](http://www.thestreet.com/_cnet/tech/kevinkelleher/10240003_4.html) (reporting criticism of the theory that the DTCC’s system allows for illegal naked short selling).

375. See *id.* (describing skepticism by David Rocker, a hedge fund manager, of the theory that naked short selling is widespread in the market); Simon, *supra* note 34 (reporting on former hedge fund manager and stock market celebrity Jim Cramer’s views that naked short selling happens very rarely and that it is not a major issue in the market); Posting of Mark Cuban to BlogMaverick <http://www.blogmaverick.com/entry/1234000833040434/> (Apr. 16, 2005 20:46 CST) (expressing Mark Cuban’s view that naked short selling is not a widespread problem).

DTCC's position, stating it believes that the analysis implicating the DTCC and its Stock Borrow Program in widespread manipulative naked short selling is "flawed in important respects."<sup>376</sup> Yet, the SEC also has recently acknowledged that Regulation SHO, as currently written, has not prevented naked short selling from harming the market for numerous securities.<sup>377</sup>

The critics of the analysis presented in this Article do not deny that failures to deliver occur in America's securities markets; rather, they argue that widespread failures occur for reasons other than naked short selling and the DTCC's flawed Stock Borrow Program.<sup>378</sup> These other reasons often place the blame for failures to deliver on individual investors.<sup>379</sup> These critics claim that investors often cause failures to deliver by not providing their physical stock certificates to their brokers in time for settlement or by failing to properly sign their physical stock certificates.<sup>380</sup> Other human errors also play a role in the critics' alternative explanations, including claims that failures often occur when a broker accidentally sells the wrong stock or an investor realizes after a trade is completed that he or she has lost the physical stock certificates certifying ownership.<sup>381</sup> The logical question is: can these alternative explanations account for the large numbers of failures seen in the market place?

### B. *Alternative Theories Do Not Add Up*

Claims of paperwork problems and human error cannot explain the large numbers of failures to deliver present in the market.<sup>382</sup> Paperwork or lost physical certificates cannot account for hundreds of millions of shares that are not delivered, when

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376. See Brief for SEC as Amicus Curiae Supporting Respondents at 13–14, *Nanopierce Tech. v. Depository Trust & Clearing Corp.*, No. 45364 (Nev. Feb. 2, 2006), available at <http://www.sec.gov/litigation/briefs/nanopiercesecbrief.pdf> (2006) (expressing the SEC's views that the allegations against the DTCC are misguided).

377. See Opening Statements at Commission Open Meeting, *supra* note 365 (expressing concern that Regulation SHO contains loopholes that allow substantial and continued failures to deliver in some securities).

378. See Larry Thompson Interview, *supra* note 73 (admitting that some failures to deliver do occur, but providing alternate theories on how failures to deliver occur in the securities markets).

379. See Avery & Koh, *supra* note 1, at 39 (explaining the various ways an individual investor could cause a failure to deliver).

380. See Larry Thompson Interview, *supra* note 73 (expressing the DTCC's views of alternate theories that could account for failures to deliver).

381. See *id.* (noting that 1.7 million physical stock certificates were lost in 2005).

382. See Letter from Robert J. Shapiro to Jill M. Considine, *supra* note 149, at 2 (expressing the views of Robert Shapiro as to why the alternate theories behind failures to deliver cannot account for the large number of failures presently occurring in the system).

the DTCC itself estimates that its subsidiary, the DTC, holds ninety-seven percent of all physical stock certificates in its vault, with those shares trading only in electronic form.<sup>383</sup> It is also implausible that paperwork problems and human errors can account for hundreds of stocks experiencing the large and persistent number of failures to deliver required to be designated threshold securities under Regulation SHO.<sup>384</sup> The SEC deliberately set the threshold level high enough to exclude securities subject only to innocent and small-scale failures to deliver.<sup>385</sup>

These alternative explanations are even less persuasive in explaining the large-scale, long-term failures to deliver that present the greatest danger of manipulative naked short selling.<sup>386</sup> Failures to deliver totaling millions of shares have persisted for many months at a time.<sup>387</sup> Are these failures all caused by innocent paperwork or human error? Many stocks such as Overstock.com and Martha Stewart Living Omnimedia have remained on the threshold lists for extended periods.<sup>388</sup> Is it reasonable to believe that so many shareholders in those and other companies still hold physical certificates and have been careless in providing them to their brokers, or that they have all lost them?<sup>389</sup> Nor can the theories presented by the DTCC explain

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383. See *id.* (dismissing the DTCC's attempts to explain that large numbers of failures to deliver due to paperwork and human errors).

384. See *id.*; see also Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,016 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (detailing that a threshold security must have total failures to deliver of 0.5% of shares outstanding and 10,000 shares that persist for five consecutive days to become a threshold security).

385. See Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008, 48,016 (Aug. 6, 2004) (codified at 17 C.F.R. § 242.200–203) (making Regulation SHO's threshold requirements high enough that they do not ensnare innocent failures to deliver); see also *supra* notes 316–18 and accompanying text (elaborating on the SEC's rationale for making the threshold requirements high).

386. See Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972, 62,975 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (stating the risks posed by long term failures to deliver); Boni, *supra* note 26, at 11–12 (demonstrating disbelief that innocent reasons underlie long term failures to deliver).

387. See Boni, *supra* note 26, at 15, 41 fig.1, 42 fig.2 (providing evidence that failures to deliver can persist for months at a time); see also Comments of Knight Trading Group, *supra* note 296 (admitting that it sometimes takes market makers months to cover short sales in highly illiquid stocks).

388. See Thiel, *supra* note 5 (noting that both Overstock.com and Martha Stewart Living Omnimedia have remained on threshold securities lists for long periods of time).

389. Cf. Larry Thompson Interview, *supra* note 73 (presenting the DTCC's views that human error and lost certificates account for a large number of failures to deliver).

away the impossibly high trading volumes seen in several stocks.<sup>390</sup>

The much more reasonable and likely explanation is presented in this Article, and recent prosecutions and civil suits against naked short sellers have only scratched the surface of this systemic problem.<sup>391</sup> Given all of the data and other evidence,<sup>392</sup> the large-scale, extended failures to deliver present in the market today largely reflect strategic decisions by manipulative market participants to not deliver shares until it is profitable for them to do so, facilitated—however inadvertently—by the DTCC's current settlement and clearance arrangements.<sup>393</sup>

## VII. CONCLUSION

In 1934, in the wake of the stock market crash of 1929 and the Great Depression, Congress mandated that the SEC “purge the market’ of short selling abuses” that they believed had contributed to the nation’s economic ills.<sup>394</sup> Today, as advanced trading strategies become common, and the possibilities for manipulation increase, the SEC must be increasingly vigilant to ensure that short selling abuses do not make the stock market an un-level playing field.<sup>395</sup> Regulation SHO is a start, but in order to guarantee a fair market place, the SEC must close the loopholes in Regulation SHO and institute comprehensive reforms to the clearing and settlement system.<sup>396</sup> Until the SEC makes these

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390. See Thiel, *supra* note 5 (recognizing that the level of failures in some company’s stocks “go beyond any possible innocent explanation”).

391. See Kadlec, *supra* note 34, at A13 (reporting on claims that naked short selling was involved in the Refco scandal); see also John R. Emshwiller, *Naked Shorting’ Case Lurks in Refco’s Past*, WALL ST. J., Oct. 20, 2005, at C3 (alleging further that Refco may have been involved in widespread illegal naked short selling).

392. See Larry Thompson Interview, *supra* note 73 (discounting the importance of the \$6 billion worth of failures that occur each day); Letter from Robert J. Shapiro to Jill M. Considine, *supra* note 149, at 1–2 (refuting the DTCC’s contentions that the \$6 billion a day value of fails is not an alarming figure).

393. See Boni, *supra* note 26, at 11–12 (presenting a theory that long term failures are strategic decisions on the part of market participants).

394. Regulation SHO Proposal, Exchange Act Release 48,709, 68 Fed. Reg. 62,972 (Nov. 6, 2003), available at <http://www.sec.gov/rules/proposed/34-48709.htm> (recounting the SEC’s mission to regulate abusive short selling practices).

395. See Berman & Addis, *supra* note 343, at 58–59 (revealing the emergence of naked short selling and disclosing that the continuous net settlement system created new opportunities for market manipulation); Avery, *supra* note 292, at 43 (reporting that David Lott, CEO of Limelight Media, believes that the existing grandfathering of previous failures to deliver contributes to an unfair marketplace).

396. See National Securities Clearing Corporation, Proposed Rule Change, Exchange Act Release No. 34-17422, 46 Fed. Reg. 3104, 3104 (Jan. 13, 1981) (creating the current clearing and settlement system by making permanent the NSCC’s Stock Borrow Program).

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necessary reforms and addresses the DTCC's mismanagement of the Stock Borrow Program, investors will continue to be exposed to the manipulative potential of naked short selling.<sup>397</sup>

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397. See Letter from Robert J. Shapiro to Jill M. Considine, *supra* note 149, at 3-6 (disputing the claims of Larry Thompson and alleging failures due to the mismanagement of the Stock Borrow Program); Opening Statements at Commission Open Meeting, *supra* note 365 (expounding upon the negative effects of failures to deliver and naked short selling for investors and companies).



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## APPENDIX I

THE CLEARING AND SETTLEMENT SYSTEM OF AMERICA'S  
SECURITIES MARKETS – QUICK REFERENCE GUIDE TO THE  
ORGANIZATIONS & PROGRAMS INVOLVED*Depository Trust Clearing Corporation – DTCC:*

The DTCC is a holding company that provides clearance and settlement services for securities transactions. The DTC and the NSCC created the DTCC when they merged in 1999. Through its subsidiaries (mainly the DTC and the NSCC) the DTCC manages the settlement and clearance of nearly every security traded in the American securities markets. Some of the largest brokerage firms in the country own and run the DTCC and the DTCC frequently pays dividends to these firms in the form of rebates.

*Depository Trust Company – DTC:*

The DTC is a subsidiary of the DTCC. The DTC helps the DTCC clear and settle trades by practically eliminating the need for the movement of the actual physical stock certificates. By holding the physical stock certificates in its vault, the DTC has made it possible for trades to settle using only the movement of electronic book entries to denote ownership of shares.

*National Securities Clearing Corporation – NSCC:*

The NSCC is a subsidiary of the DTCC. The NSCC aids the DTCC in its clearance and settlement role by providing a service called the Continuous Net Settlement System. This system nets all of the DTCC member's trades against each other and determines whether a DTCC member is owed delivery of shares or owes shares to another DTCC member. The NSCC then compares these figures to what the DTCC member has in their account at the DTC's vault. If the member has enough shares in its account to cover an obligation delivery occurs, if not the member who is short shares can use the Stock Borrow Program to cover the obligation.

*Stock Borrow Program:*

The DTCC and its subsidiary the NSCC run the Stock Borrow Program. The program allows DTCC members to loan excess shares from their DTC accounts to other DTCC members

who have a net short position in the Continuous Net Settlement System. The loaning party is then able to earn interest on the value of the loan while the loan is outstanding. The borrowing party repays the loan by purchasing the equivalent shares in the market and returning them to the loaning party.

APPENDIX II

STOCK BORROW PROGRAM EXAMPLE

