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CRS Report for Congress

Regulation of Naked Short Selling

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Summary

Short sellers borrow stock, sell it, and hope to profit if they can buy back the same number of shares later at a lower price. A short sale is a bet that a stock's price will fall. A short sale is said to be "naked" if the broker does not in fact borrow shares to deliver to the buyer. When executed on a large scale, naked short sales can equal a large portion of total shares outstanding, and can put serious downward pressure on a stock's price. Critics of the practice characterize it as a form of illegal price manipulation. The Securities and Exchange Commission (SEC) in 2004 adopted Regulation SHO, a set of rules designed to control short selling abuses, focusing on small-capitalization stocks where the number of shares held by the public was relatively small. Until the current financial crisis, the SEC did not view short selling of large, blue-chip stocks as a problem. In July 2008, however, the SEC temporarily banned naked short sales of the stock of Fannie Mae, Freddie Mac, and 17 other large financial institutions. On September 18, 2008, the SEC banned all short selling of the shares of more than 700 financial companies in an emergency action that expired on October 8, 2008. On October 1, the SEC adopted a rule requiring short sellers' brokers to actually borrow shares to deliver to buyers, within the normal three-day settlement time frame. This report will be updated as events warrant.

Short selling was best described by Daniel Drew, the Gilded Age speculator and robber baron: "He that sells what isn't his'n, must buy it back or go to prison." Short sellers borrow shares from a broker, sell them, and make a profit if the share price subsequently drops, allowing them to buy back the same number of shares for less money. In other words, short selling is a bet that the price of a stock will fall.

Short sellers have always been unpopular on Wall Street. Like skeletons at the feast, they seem to stand against rising share values, expanding wealth, and general prosperity. However, most market participants recognize that they provide a valuable service to the extent that they identify companies and industries that are overvalued by investors in the grip of irrational exuberance. By bringing such valuations down to earth, short selling can prevent economically wasteful over-allocation of resources to those firms and sectors.

Manipulation by Short Sellers

Another persistent complaint against short sellers is that they cause artificial price volatility. A form of manipulation common in the 19th century was the "bear raid" — a gang of speculators would sell a stock short, causing the price to drop. They would follow with another wave of short sales, depressing the price still further, and so on, until the stock's price was driven to the floor.

In the 1930s, the Securities and Exchange Commission (SEC) adopted a regulation to prevent bear raiding. The "uptick rule"[1] stated that a short sale may occur only if the last price movement in a stock's price was upward. This prevents short sellers from piling onto a falling stock and setting off a downward price spiral. In the words of a standard securities law textbook, the tick test (and related rules) "seem pretty well to have taken the caffeine out of the short sale."[2] In 2007, the SEC concluded that growth in the market made the rule unnecessary, and it was repealed.[3]

However, in recent years, complaints about manipulative short selling have reappeared. Many shareholders and officers of smaller firms have identified "naked" short selling as a source of price manipulation and have criticized the SEC's enforcement record. At the same time, the SEC has identified short selling in connection with spreading rumors as an abuse that may raise fears about the solvency of the target firm and cut off its access to credit, potentially leading to the destruction of the firm, as was the case with Bear Stearns in March 2008.

Naked Shorting

A short sale always involves the sale of shares that the seller does not own. The buyer, however, expects to receive real shares. Where do those shares come from? Normally, they are borrowed by the broker from another investor or from a brokerage's own account. This is usually not difficult to do if the shares are issued by a large company, where millions of shares change hands daily and where many shares are not registered to the actual owners, but are held in "street name," that is, in the broker's account. With smaller corporations, however, the number of shares in circulation may be limited, and brokers may find it difficult to locate shares to deliver to the buyer in a short sale transaction.

When shares are not located to "cover" a short sale, the short position is said to be naked. If shares are not found by the time the transaction must be settled, there is a "failure to deliver" shares to the buyer. If it occurs sporadically and on a small scale, naked short selling does not raise serious manipulation concerns. However, when the number of shares sold short represents a significant fraction of all shares outstanding, there may be a strong impact on the share price. In such cases, when naked short selling

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[1] Rule 10a-1(a). The rule technically applies only to exchange-listed stocks, but a comparable rule was extended to Nasdaq National Market System stocks in 1994.

[2] Louis Loss, *Fundamentals of Securities Regulation* (Boston: Little Brown, 1983), p. 717.

[3] Release No. 34-55970, "Regulation SHO and Rule 10a-1," June 28, 2007. See also CRS Report RL34519, *The Uptick Rule: The SEC Removes a Limit on Short Selling*, by Gary Shorter.

creates a virtually unlimited quantity of shares, a market based on supply and demand can be seriously distorted. The SEC notes that "naked short sellers enjoy greater leverage than if they were required to borrow securities and deliver within a reasonable time period, and they may use this additional leverage to engage in trading activities that deliberately depress the price of a security."[4]

The case against naked short selling has been that by permitting short sales to occur when there is no possibility of actually delivering shares to the buyers, brokers and dealers accommodate manipulation. When naked short selling drives prices down, holders of the stock understandably feel cheated. They do not believe the stock is overvalued; they are not selling; but the price drops anyway.

It is important to note that naked short selling is not always evidence of intent to manipulate prices. Under certain circumstances, a market maker[5] may engage in naked short selling to stabilize the market. For example, assume that there is a sudden flurry of buy orders for a stock. The market maker may judge the buying interest to be temporary and not justified by any real news about the company's prospects. It may be the result of a questionable press release or a rumor in an Internet chat room. The market maker may choose to sell short to avoid what in its view would be an unjustified run-up in the stock's price. In this situation, naked short selling by the market maker may protect investors against manipulation.

It is also worth noting that while restrictions on short selling discourage certain forms of manipulation, they may encourage or facilitate others. Manipulations that involve artificially inflating stock prices are probably more common than techniques (like naked shorting) that seek to depress them. Rumors, false press releases, and unexpected purchases may all cause sudden run-ups of stock prices, which may be followed (in the classic "pump-and-dump" fraud) by sudden collapse, as the manipulators sell their shares to the unwary. Without short selling as a counterweight, the magnitude and duration of such fraudulent run-ups are likely to be greater

Until July 2008, the SEC viewed the problem of naked shorting as largely confined to smaller firms, particularly small-capitalization "penny" stocks listed on the Nasdaq bulletin board market (OTCBB).[6] In these companies, the bulk of outstanding shares may be owned by corporate insiders or by securities dealers who act as market makers, so that relatively few shares are available for purchase on the open market. This means that transactions have a proportionately greater impact on the stock price than do trades of the same size in the shares of a larger company, making manipulation easier. In addition to OTCBB stocks, however, smaller companies listed on the exchanges or the Nasdaq national market may also be vulnerable to short selling abuse.

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[4] Release No. 34-48709, "Short Sales: Proposed Rule," October 28, 2003.

[5] Market makers are dealers who stand ready to buy or sell a stock at any time and who publish the prices at which they are willing to trade. They are the key intermediaries on the Nasdaq; on the New York Stock Exchange, they are called specialists.

[6] The uptick rule does not apply to OTCBB stocks.

Regulation SHO

After several years of deliberation, the SEC in 2004 adopted rules designed to control abusive naked short selling. Regulation SHO[7] took effect on January 3, 2005. The new regulation replaced existing exchange and Nasdaq rules with a uniform national standard. Under Regulation SHO, a broker may not accept a short sale order from a customer, or effect a short sale for its own account, unless it

- has either borrowed the security, or made a bona fide arrangement to borrow it; or
- has reasonable grounds to believe that it can locate the security, borrow it, and deliver it to the buyer by the date delivery is due; and
- has documented compliance with the above.

The appearance of a stock on an exchange's "easy to borrow" list constituted reasonable grounds for believing that the stock can be located. Stocks on such lists tend to be highly capitalized, with large numbers of shares in circulation.

If a broker executes a short sale, and then fails to deliver shares to the purchaser, further restrictions on short selling may come into force. If the "fail to deliver" position is 10,000 shares or more, for five consecutive trading days, and the position amounts to at least 0.5% of total shares outstanding, the stock becomes a *threshold security*. The exchanges and Nasdaq are now required to publish daily lists of threshold securities. Regulation SHO specifies that if a fail to deliver position in a threshold security persists for 13 trading days, the broker (or the broker's clearing house) must close the short position by purchasing securities of like kind and quantity. After the 13 days have elapsed, the broker may not accept any more short sale orders until the fail to deliver position is closed by purchasing securities.

The rules include exemptions for market makers engaged in bona fide market-making activities, and for certain transactions between brokers.

Effects of Regulation SHO

The adoption of Regulation SHO has not put an end to investor complaints about naked short selling. Complaints are heard that the SEC is not enforcing the rules vigorously enough, that short selling continues, and that some brokers evade the 13-day requirement by passing fail to deliver positions from one to another.[8]

The SEC staff has monitored the incidence of fail to delivers after the effective date of Regulation SHO, and, in July 2006, Chairman Cox reported that the rule "appears to

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[7] Release No. 34-50103, "Short Sales: Final Rule," July 28, 2004, available at [http://www.sec.gov/rules/final/34-50103.htm].

[8] "Of Stocks and Socks: Senator Bennett Bores In On SECs Dismal Naked Short Sales Record," *FinancialWire*, March 14, 2005, p. 1.

be significantly reducing fails to deliver without disruption to the markets."[9] Nevertheless, some further amendments to Regulation SHO were considered.

In July 2006, the SEC proposed rules to close two "loopholes" in Regulation SHO, which it called responsible for the persistence of fail to deliver positions in certain stocks. Under the proposed rules, the current exemption for options market makers would be restricted. Second, a "grandfather" provision in the original rule — which exempted short positions that had been established before a stock was placed on the threshold securities list from the requirement that fail to deliver positions be closed out after 13 consecutive trading days — would be eliminated.

In August 2007, the SEC adopted the proposed rule abolishing the grandfather provision. When a stock goes onto the threshold list, all short positions in the stock will be subject to the 13-day close-out requirement. The SEC did not adopt the proposal relating to options market makers.

The 2008 Emergency Orders

As financial companies came under pressure from tight credit markets in late 2007 and 2008, concerns emerged about manipulative short sellers spreading rumors about firms' creditworthiness and liquidity. Despite regulators' assurances that Bear Stearns, a leading investment bank, had adequate capital and liquidity reserves, the firm was destroyed in March 2008 by the equivalent of a bank run: market participants, fearing that the firm might not be able to meet its obligations, refused to extend credit. The Federal Reserve was forced to arrange a hasty merger with JP Morgan Chase, which acquired Bear Stearns on condition that the Fed purchase $29 billion of risky mortgage assets.

All large financial firms finance their operations by issuing short-term debt, which must be continually refinanced, or rolled over. Thus, they are vulnerable to "nonbank runs" — they cannot survive long if markets lose confidence and become unwilling to provide new funds. In July 2008, share prices of Fannie Mae and Freddie Mac, the two giant government-sponsored enterprises that hold about $1.5 trillion in mortgage-backed assets, plunged, and fears arose that they might go the way of Bear Stearns. On July 15, the SEC issued an emergency order banning naked short sales of the shares of Fannie, Freddie, and 17 other large financial institutions.[10]

Under the terms of the order, no short sale of the stock of any of the 19 listed firms may occur unless the seller has actually borrowed (or arranged to borrow) the stock and delivers the stock to the buyer on the regular settlement date.

The SEC explained the rationale for its unusual action:

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[9] Chairman Christopher Cox, "Opening Statement at the Commission Open Meeting," July 12, 2006.

[10] "SEC Enhances Investor Protections Against Naked Short Selling," Press Release 2008-143, July 15, 2008. Available at [http://www.sec.gov/rules/other/2008/34-58166.pdf]. Ten of the 17 were foreign firms.

> False rumors can lead to a loss of confidence in our markets. Such loss of confidence can lead to panic selling, which may be further exacerbated by "naked" short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, this chain of events can threaten disruption of our markets.
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> The events preceding the sale of The Bear Stearns Companies Inc. are illustrative of the market impact of rumors. During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns' stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms. In light of the potentially systemic consequences of a failure of Bear Stearns, the Federal Reserve took emergency action.[11]

The SEC's intervention has been criticized by some who believe that financial stocks have been battered not by false rumors, but by realistic assessments of firms' underlying financial weakness. Short selling, in this view, is simply market discipline at work. One view is that the SEC's objective of raising financial stock prices itself amounts to market manipulation.[12]

The SEC's original order, issued on July 15, was extended through August 12, 2008.

On September 18, 2008, as financial stocks plunged, the SEC issued another, much more sweeping emergency order. All short selling (naked or not) of the shares of more than 700 financial firms was banned. The rationale was the same as for the earlier action: whatever benefits short selling might provide in terms of price efficiency were far outweighed by the possible damage to the financial system and the economy if major firms were swept away by panic. The emergency order expired October 8, 2008.

On October 1, 2008, in addition to extending the short sale ban announced on September 18, the SEC adopted a rule that in effect banned naked short selling in all stocks.[13] This order, in the form of an interim final rule, requires that when a failure to deliver shares within the normal three-day settlement period occurs, the seller's broker must immediately purchase or borrow securities and close out the fail to deliver position by no later than the beginning of trading on the next business day. Failure to comply means that the broker cannot sell that stock short either for its own account or for customers, unless the shares are not only located but also pre-borrowed.

The SEC also adopted Rule 10b-21, a naked short selling anti-fraud rule, covering short sellers who deceive broker-dealers or any other market participants about their intention or ability to deliver securities in time for settlement. The rule makes clear that such persons are violating the law when they fail to deliver.

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[11] Ibid.

[12] Lawrence Summers, "How to Build a U.S. Recovery," *Financial Times*, August 7, 2007, p. 5.

[13] Securities and Exchange Commission, "Amendments to Regulation SHO," [Release No. 34-58773], Oct. 1, 2008. See [http://www.sec.gov/rules/final/2008/34-58773.pdf].