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Regulation of Naked Short Selling

Mark Jickling
Specialist in Public Finance
Government and Finance Division

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. In effect, 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 rules designed to control short selling abuses, but calls for further restrictions on the practice continue. In July 2006, the SEC proposed regulations that would close two "loopholes" in the regulations. This report describes the mechanics of short selling, summarizes the new SEC rule, and analyzes the impact of short selling in the marketplace. It will be updated if 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] states 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]

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.

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 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 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."[3]

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.

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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. 34-48709, "Short Sales: Proposed Rule," Oct. 28, 2003.

It is important to note that naked short selling is not always evidence of intent to manipulate prices. Under certain circumstances, a market maker[4] 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.

The problem of naked shorting is largely confined to smaller firms, and is particularly acute in small-capitalization "penny" stocks listed on the Nasdaq bulletin board market (OTCBB).[5] 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.

Regulation SHO

After several years of deliberation, the SEC in 2004 adopted rules designed to control abusive naked short selling. Regulation SHO[6] took effect on January 3, 2005. The new regulation replaces 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 constitutes 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.

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[4] 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.

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

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

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.[7]

There is anecdotal evidence that Regulation SHO has unintentionally created opportunities for a new type of manipulation, known as the short squeeze. The threshold securities list identifies stocks where short sellers are active. Certain traders have reportedly made large purchases of stocks listed as threshold securities.[8] When these purchases drive the price up, pressure increases on short sellers as their positions lose money. (If prices rise, a short seller must pay more than the proceeds of the short sale to replace the borrowed shares.) Brokers issue margin calls to ask for more collateral to protect themselves against default. If the short sellers cannot meet those demands, they must close out their positions, which requires the purchase of shares, driving the price still higher.

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 be significantly reducing fails to deliver without disruption to the markets."[9]

Is Further Action Needed?

Critics of short selling have continued to press for more stringent restrictions or even an abolition of the practice. There might be significant costs to such actions.

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

[8] Dean Foust, "Why the Shorts Have Long Faces," *Business Week*, Feb. 28, 2005, p. 86.

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

First, as noted above, short selling can improve the functioning of the market's price setting mechanism. Unless they engage in illegal manipulation, short sellers can stay in business only if they successfully identify overvalued stocks. Without the information provided by short sellers, the market might allocate capital less efficiently.

Second, 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.

In July 2006, the SEC proposed rules that would 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.