THE DANGER OF SELLING YOURSELF SHORT: DIVERGING REGULATORY SCHEMES FOR NAKED SHORT SELLING IN THE U.S. AND U.K.

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I. INTRODUCTION

Seven years after the original founding of the Amsterdam Exchange in 1602, a small group of business adventurers, led by Isaac Le Maire, one of the original shareholders of the Dutch East India Company, created an organization called the “Groot Companie” (ironically translated as the “large company” in English) to short the shares of the East India Company in anticipation of the formation of a rival French trading company.¹ Le Maire sold forward shares of the East India Company contracting to purchase those shares one to two years in the future. Thus, the first naked short sale was completed. Throughout the ensuing year, the profits of Groot Companie soared as East India Company shares declined 12%.² As can be imagined, shareholders of the East India Company were outraged and blamed the rouge short sellers for their


² See id.
shares’ lost market value. Authorities responded and in 1610 the first regulations were enacted against short selling, the rival French company was never formed, and shares in the East India Company rebounded.

As the above example illustrates, short sale regulations are as old as the exchanges themselves, and yet the argument continues to rage over their harmful effects. Indeed, today there exists a poignant debate in financial circles concerning the nature of short selling and its alleged harmful economic consequences. One side maintains that national regulatory agencies and their law enforcement counterparts are not adequately protecting their nation’s capital markets and their participants from the risk of manipulation and fraud caused by short selling practices of rouge hedge funds. As a result, this group alleges that numerous public companies’ stock prices are plummeting and nations’ capital markets are in jeopardy of eroding market confidence and creating market inefficiencies. The other side denies the prevalence of illegal and harmful short selling and the pervasiveness of the practice in the capital markets. This group condemns companies that accuse short sellers of manipulating their stock price and of using the allegations

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3 See id.
4 See id.
as a smokescreen to mask their companies’ poor financial performance.

According to the National Securities Clearing Corporation (NSCC), on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities, fail to settle. In other words, 99% (by dollar value) of all trades settle on time. But when trading volume amounts to billions if not trillions of dollars, it can be easily seen why a 1% failure to settle rate could become a large problem.

Both the United States (U.S.) and the United Kingdom (U.K.) have experienced a sharp increase in hedge fund activity within their markets. As a result, both sides of

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6 The SEC estimates that there are 8,800 hedge funds, with approximately $1.2 trillion of assets. This implies a remarkable growth in hedge fund assets of almost 3,000% in the last 16 years. Much of this growth is attributable to increased investment by institutions. This includes not only investment companies and investment banks, but also private and public pension plans, endowments, and foundations. Last year, an estimated 2,000 new hedge funds were started with just over 2,500 hedge fund advisers registered with the Commission as of June 2006. The vast majority of the registered hedge fund advisers, 88% of them, are domiciled in the United States. Although hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume. They are particularly active in the convertible bond market and the credit derivatives market. U.S. Securities and Exchange Commission Chairman Christopher Cox, Testimony Concerning the Regulation of Hedge Funds, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs (July 25, 2006).
the debate within these respective countries agree that these relatively unregulated investment vehicles deserve regulatory attention. One potential problem has been hedge funds use of naked short selling practices. However, in recognizing and subsequently dealing with the problem of naked short selling the U.S. and the U.K. have taken divergent paths. In the U.K., the Financial Services Authority (FSA) decided to address the issue by deferring to a market solution and by working with its exchanges to provide increased information to companies and potential investors. The FSA “considered that greater transparency for short selling might benefit market users and improve market confidence by providing information that would further facilitate efficient markets.” By contrast, when the potential harmful effects of naked short selling first became known in the U.S., its regulators relatively ignored the naked short selling issue. The Securities and Exchange Commission (SEC) did enact Regulation SHO in 2004, but failed to provide the market with the level of transparency that the U.K. offered.

Fortunately, at the time of the writing of this paper, many U.S. regulators have realized this potential harm, but have yet to act legislatively. SEC Chairman Christopher Cox

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referred to "the serious problem of abusive naked short sales" in the U.S. as one of the SEC's top priorities and "as a tool to drive down a company's stock price to the detriment of all of its investors." He further stated that "[t]he Commission is particularly concerned about persistent failures to deliver in the market for some securities that may be due to loopholes in the Commission's Regulation SHO, adopted just two years ago." The FSA, on the other hand, recently released a statement saying that currently "[t]here does not appear to be any strong evidence to suggest that short selling is damaging to the [U.K.] market."

The question is then posed: Why are the U.S. financial system and U.S. companies apparently experiencing more negatives affects from abusive naked short selling practices than their U.K. counterparts? And what can U.S. regulators

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8 "The Commission is particularly concerned about persistent failures to deliver in the market for some securities that may be due to loopholes in the Commission's Regulation SHO, adopted just two years ago. At the Commission's request, the Division of Market Regulation has prepared proposed changes in Rule 203 under Regulation SHO to cut down on failures to deliver. The need for Regulation SHO grew out of long-standing and growing problems with failures to deliver stock by the end of the standard three day settlement period for trades, some of which were symptoms of abusive "naked" short selling. Selling short without having stock available for delivery, and intentionally failing to deliver stock within the standard three-day settlement period, is market manipulation that is clearly violative of the federal securities laws. U.S. Securities and Exchange Commission, Speech by SEC Chairman: Opening Statements at the Commission Open Meeting, http://www.sec.gov/news/speech/2006/spch071206cc2.htm, (July 12, 2006).

9 Id.

now do to remedy the problem? In order to counteract the negative economic effects posed by illegal naked short selling the U.S. regulatory bodies should adopt a similar approach to that of the U.K. – enabling more transparency within the short selling process.

This paper will examine the intricacies of the naked short selling practices within the U.S. and the U.K., the practice’s potential harm to each nation’s capital markets, and how the current regulatory schemes in both the U.S. and the U.K. have affected the pervasiveness of the practice, comparing and contrasting the two approaches. A conciliatory solution of creating a more transparent short sale market in the U.S., similar to the regime used in the U.K. is then offered.

II. DESCRIPTION OF NAKED SHORT SELLING

Some forms of naked short-selling are legal and some are not. In a legitimate short sale, when investors believe a security is overvalued they will take a short position in that security, meaning that they will borrow the shares from a broker in order to immediately sell those shares in the market. When the price of the shares decreases, the investor will buy additional shares in the market at that lower price
and cover their short position, meaning return the like shares to the broker from whom they originally borrowed the shares. The investor profits the difference between the price for which they originally sold the borrowed shares and the price they later bought the shares that they returned.\footnote{11}{"For example, an investor believes that there will be a decline in the stock price of Company A. Company A is trading at $60 a share, so the investor borrows shares of Company A stock at $60 a share and immediately sells them in a short sale. Later, Company A's stock price declines to $40 a share, and the investor buys shares back on the open market to replace the borrowed shares. Since the price is lower, the investor profits on the difference -- in this case $20 a share (minus transaction costs such as commissions and fees). However, if the price goes up from the original price, the investor loses money. Unlike a traditional long position -- when risk is limited to the amount invested -- shorting a stock leaves an investor open to the possibility of unlimited losses, since a stock can theoretically keep rising indefinitely." See generally U.S. Securities and Exchange Commission, Division of Market Regulation: Key Points about Regulation SHO (April 11, 2005), available at http://www.sec.gov/spotlight/keyregshoissues.htm.}

Naked short selling is a controversial form of selling shares of securities short. Short selling is the practice of borrowing shares of stock, then selling it in hopes that the price will go down and it can be bought back at a lower price, generating profit and allowing one to return like shares for the borrowed ones.\footnote{12}{See id.} The term, Naked short selling, typically is used to have any of the following meanings:

1. Selling stock short without having located stock for delivery at settlement.
2. Selling stock short and failing to deliver shares at the time of settlement.

3. Selling stock short and failing to deliver at settlement with the purpose of driving down the security’s price.

The third definition of naked short selling refers to manipulating a stock price without incurring risk. When one sells short a non-borrowed stock, one is selling something that one does not possess. A practice that if not regulated (or at least not enforced) could undermine small public companies and harm average investors.

Creating a short position and borrowing shares is very expensive. Stock loan agreements typically require the borrower to reimburse the lender in full for any dividends or other distributions the issuer makes to its stockholder.\(^{13}\) The IRS also taxes all profits from short sales at the short-term capital gains rate, regardless of the length of time the position is open.\(^{14}\) Additionally, the short seller must place the proceeds from the short sale in an escrow account, which collateralizes the stock loan.\(^{15}\) The short seller cannot use

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\(^{13}\) John D. Finnerty, Short Selling, Death Spiral Convertibles, and the Profitability or Stock Manipulation, Fordham University, 11 (2005).

\(^{14}\) See id. at 9.

\(^{15}\) See id.
the short sales proceeds to hedge the short position.\textsuperscript{16} The short seller also receives interest from the stock lender at a below-market interest rate, called the rebate rate, with the difference between the market rate and the rebate rate, the rebate spread, compensating the lender.\textsuperscript{17} Additionally, Federal Reserve Regulation T requires short sellers to post additional collateral in a margin account when the stock is shorted and large broker dealers typically require at least 30 percent equity.\textsuperscript{18} This great expense for undertaking short positions could create an incentive to increase the profitability of short sales and motivate individuals to take unethical steps to realize a greater profit.

The National Coalition Against Naked Short Selling (NCANS) issued a statement on their website stating that in certain limited circumstances naked short selling is a legal practice.\textsuperscript{19} The statement said that it is legal for a market maker that needs to “provide shares in a fast moving market for a thinly traded security” to engage in naked short selling as well as an “options market maker to hedge its sale of put options.”\textsuperscript{20} These activities however, are limited-time

\begin{flushleft}
\textsuperscript{16} See id. \\
\textsuperscript{17} See id. \\
\textsuperscript{18} See id. \\
\textsuperscript{19} The National Coalition Against Naked Short Selling, An Introduction to Naked Short Selling – Failing to Deliver, 2 (2005). \\
\textsuperscript{20} Id.
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frame exceptions. Moreover, the Securities and Exchange Act of 1934 stipulates a settlement period of borrowed stock up to three days (t+3) - meaning that any stock can technically be a “naked short” for three days because after selling a stock that the investor does not own, that investor has three days to find a stock to borrow.\textsuperscript{21} Many brokers, in an effort to increase their volume of transactions and create more liquidity in their portfolios, act first and settle later, and at times brokers cannot find another stock to cover their position.\textsuperscript{22} With this mentality comes a “certain amount of slop” that has always been tolerated by the SEC, and “where there is slop, there is opportunity.”\textsuperscript{23} The risk that one may not be able to then acquire the shares needed to deliver on the sale is a contributing factor to the controversy surrounding this practice.

If the investor has not acquired the stock to give to the purchaser within those three days then they “fail to deliver” the stock.\textsuperscript{24} Failure to deliver - that is, settlement failure - could be the result of more than just market manipulation. The SEC has stated that this activity does not necessarily

\textsuperscript{21} U.S. Securities and Exchange Commission, Division of Market Regulation: Key Points about Regulation SHO, April 11, 2005, at 8-9.
\textsuperscript{22} Karl Thiel, The Naked Truth on Short Selling, 3 (2005), available at www.cnbc.com.
\textsuperscript{23} Id. at 4.
\textsuperscript{24} Id.
violate any rules, because there are legitimate reasons why a seller may not have the stock available on settlement day. These reasons include (1) delays in customers delivering their shares to a broker-dealer, (2) the inability to obtain borrowed shares in time for settlement, (3) issues related to the physical transfer of securities, or (4) the failure of a broker-dealer to receive shares it had purchased to fulfill its delivery obligations. Failures to deliver can result from both long and short sales.\(^{25}\)

A consistent failure in large volume would appear to indicate more nefarious behavior, or at least a system failure in need of repair. Many contend that numerous failures to deliver exist because hedge funds use naked short selling to purposefully manipulate the market.\(^{26}\) Manipulation is the “intentional interference with the free forces of supply and demand.”\(^ {27}\) Indeed, selling stock short and failing to deliver at settlement with the purpose of driving down the security’s price would constitute manipulation. This activity would generally violate various securities laws in both the U.S. and the U.K., including the general anti-fraud and anti-


\(^{27}\) Pagel, Inc. v. SEC, 803 F. 2d 942, 946 (8th Cir. 1986).
manipulation provisions, Rule 10b-5 under the Exchange Act of 1934, as well as securities laws in the U.K.\textsuperscript{28}

III. THE PRACTICE OF NAKED SHORT SELLING IN THE U.S.

How do investors successfully perform a naked short sale in the U.S. without ever intending to settle their position? NCANS states that the naked short sale is manipulative in that it “takes advantage of a structural deficiency in the system that allows a transaction to occur, and all moneys to be paid, before delivery occurs.”\textsuperscript{29} The transaction, according to the NCANS article, “goes by on the tape - a sale - and it is processed, and has an effect on the price of the stock, but the delivery portion of the transaction is left for days later.”\textsuperscript{30}

John D. Finnerty, a Professor of Finance from Fordham University, expands on this structural deficiency and points the blame to the National Securities Clearing Corporation (NSCC), a subsidiary of the Depository Trust and Clearing Corporation (DTCC), where most common stock transactions in the U.S. are cleared. Another member of the DTCC, the Depository Trust Company (DTC), the world’s largest

\textsuperscript{29} The National Coalition Against Naked Short Selling, \textit{An Introduction to Naked Short Selling - Failing to Deliver}, 2 (2005).
\textsuperscript{30} \textit{Id.}
securities depository, which serves as the clearing house for most trades of registered shares in the U.S., retains physical possession of stock certificates for all the major broker-dealers and records the transfer of securities by electronically debiting the seller’s DTC account and crediting the buyers DTC account. Physical transfers are available only on request. The NSCC and the DTC work in conjunction to provide centralized clearance and settlement for broker-to-broker stock trades. Professor Finnerty explains how naked short selling can routinely occur within the NSCC with the aid of the DTC.

The NSCC operates a stock borrow program that allows its members to cover their end-of-day open short positions. According to Professor Finnerty, this can facilitate naked shorting in two ways: First, sellers can continue to fail to deliver because the “NSCC can borrow the shares it needs to meet its clearing obligations through the stock borrow program. It does not have to force the seller who fails to deliver to buy in shares, nor does it have to go into the market to buy the shares.” Second, the stock borrowing

31 Finnerty at 35.
32 Depository Trust and Clearing Company, DTCC’s Updated Critique of Section 4.1 of Professor Finnerty’s Paper: Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation, 4 (2006).
33 Finnerty at 35.
34 Id. at 37.
program effectively “creates additional unauthorized shares of the issuer’s stock.”

This can occur because the NSCC’s lending pool is replenished as shares are borrowed, delivered to the buyer’s broker, then put back into the pool by the new broker to be lent out again, thereby causing a “phantom” share of the original.

The DTCC maintains that it “does not release the [short] seller from its delivery obligation, and it remains subject to a buy-in or to regulatory or enforcement action by the proper authorities.” However, the DTCC does not address how long someone can maintain that obligation without covering it. The NCANS believes that period to be years.

The DTCC also argues that it never lends more shares than exist in customer accounts. In a written statement addressing Professor Finnerty’s paper, the DTCC stressed that whenever shares are lent, “there is, by definition, another selling broker that has an obligation to deliver that amount of shares” and therefore, “there is always a parity of the number of shares long, and the number of shares short. There

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35 Id.
36 Id.
37 Depository Trust and Clearing Company, DTCC’s Updated Critique of Section 4.1 of Professor Finnerty’s Paper: Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation, 7 (2006) [hereinafter Professor Finnerty Critique].
38 NCANS, supra note 23.
39 Professor Finnerty Critique, supra note 32.
is only a need to have more borrowing when there are more sales. It is thus entirely inaccurate" to say shares are "recycled."40 However, the DTCC fails to address the problem of when a buyer re-deposits the lent shares into his DTCC account, available for loan. Can those shares be re-lent to another buyer before the original loan of shares is settled? If so, then it appears “phantom” shares could possibly be created.

However, the SEC has approved the stock borrow program and has publicly stated that the NSCC’s stock borrowing program allows members to “borrow securities from its participants for the purpose of completing settlement only if participants have made those securities available to NSCC for this purpose and those securities are on deposit in the participant’s account at DTC.”41

IV. THE PRACTICE OF NAKED SHORT SELLING IN THE U.K.

In the U.K., the practice of naked short selling can occur in a similar manner as in the U.S. The fundamentals of the practice are the same. Similar to the U.S., the FSA has instituted a t+3 settlement timeframe where short sellers can

40 Id.

sell a stock they do not own and then have three days to find that stock to borrow. In that sense the mechanism for naked short selling – oversight in the clearing and settlement of the securities – can occur.

The main exchange for short selling in the U.K. is the London Stock Exchange (LSE). The LSE is Europe's largest stock market. It can trace its history back more than 300 years, becoming the world’s first modern exchange by creating the first codified rule book in 1812, and thereafter becoming a benchmark for quality regulation and service. LSE uses an order-driven trading system, the Stock Exchange Electronic Trading Service (SETS), which eliminates the need for a traditional trading floor. LSE's business is built around three main activities: issuer services, broker services, and

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43 Ironically, as of October 10, 2006, the London Stock Exchange was one of the most shorted stocks on the U.K. market. Additionally, NASDAQ has taken a 25% share in the London Stock Exchange and it appears that NASDAQ and LSE could merge in the near future. It is unclear how this merger would affect naked short selling regulation on the LSE.
information services that provides both market information and trading services for equity and derivative markets.\textsuperscript{47}

CRESTCo, Ltd. is the Central Securities Depository for the U.K. market and Irish equities, and operates the CREST system and plays a similar role to that of the DTCC in the U.S by allowing equity and debt holders to hold those assets in electronic form.\textsuperscript{48} When parties to a transaction make a deal, they both electronically confirm their sides of the transaction via file transfer. Both parties are required to submit confirmation details to CREST who simultaneously debits and credits its CREST members’ accounts to reflect the transaction.\textsuperscript{49} The London Clearing House, which recently merged with Clearnet to form LCH.Clearnet, is the U.K.’s - as well as the EU’s - largest and most important clearing house, which is a financial services company that provides clearing and settlement services for financial transactions.\textsuperscript{50}

In the U.K., unlike the U.S., settlement and clearing of securities is divided between two separate and independent corporate entities from the securities depository. This

\textsuperscript{49} See id.
\textsuperscript{50} LCH.Clearnet, http://www.lchclearnet.com/home.asp (November 14, 2006).
separation could create a buffer between naked short sellers
and their goals of not being required to settle their short
positions.

V. THE IMPACT OF NAKED SHORT SELLING ON CAPITAL MARKETS AND
PUBLIC COMPANIES

Many argue that the practice of short selling plays a
pivotal role in maintaining efficient markets. Proponents
point to the high volume of short positions in tech and
dot.com stocks before the bubble burst in late 2001 as
evidence these positions helped mitigate an even greater
downturn when the bubble burst. However, Arturo Bris, William
N. Goetzman, and Ning Zhu qualify this notion in their 2005
paper, *Efficiency and the Bear: Short Sales and Markets
Around the World*, stating that “despite the relationship
between short sales constraints and skewness at the market
level, we find little compelling evidence that short sales
constraints prevent or mitigate severe price declines at the
individual stock level.”\(^{51}\) They continued to state though that
when they studied the five countries that changed their short
sales regulation and practice—Hong Kong, Norway, Sweden,

\(^{51}\) *Bris supra* note 1, at 4.
Malaysia, and Thailand—they found “significant increases in efficiency ... once short sales are allowed and practiced in these countries.” This finding seems to suggest that while the notion that short selling contributes to markets discovering efficient pricing is less robust, overall efficiency is promoted. Therefore, an outright banning of short selling should not be advocated, rather greater scrutiny and transparency in the short sale practices should be enacted.

On the other hand, the current speculation by NCANS, the financial media, and Patrick Byrne, CEO of Overstock.com, concerning how a transaction of naked short sales occurs becomes rather sinister in its details. They allege that some large hedge funds will target a smaller, often illiquid company in a poorly understood sector. The hedge fund will then enable that company to be listed on foreign exchanges and sell shares of that company that it neither owns nor borrows. After three days the hedge fund will report to the DTCC that it borrowed the shares on a foreign exchange and that the borrowed shares are delayed in arriving. Allegedly the DTCC allows the hedge fund to borrow shares from their

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52 Id. at 5.
NCSS stock borrow program in order to settle with the individuals who originally purchased the shares.\textsuperscript{53}

Subsequently, the hedge fund solicits several of its media connections to "do a hatchet job" on the company.\textsuperscript{54} The hedge fund will use its connections throughout the media and the analyst community to persuade those information sources to disseminate negative information about their target. The combination of bad publicity coupled with downward pressure created by the large short position drives the stock of that company down to the point where the hedge fund covers their borrowed shares at the DTCC (profiting the difference in the stock prices) or the company goes bankrupt or remains a penny stock, in which case the hedge fund never has to cover its short position and never pays taxes.\textsuperscript{55}

Many agree with this flow of events. Marc Kasowitz, Senior Partner at Kasowitz, Benson, Torres & Friedman LLP, testified before the Senate Judiciary Committee:

"we have seen, in increasing frequency, orchestrated efforts by short-selling hedge funds to drive down stock prices through surreptitious campaigns aimed at disseminating unfounded or grossly exaggerated disinformation. Such disinformation is spread in the financial press or internet chat boards, in investor conference calls, at analyst presentations, and at industry conferences. There are organized campaigns to communicate egregiously false information to a target

\textsuperscript{53} NCANS, Dr. Patrick Byrne's Summary of the Naked Shorting Problem, March 13, 2005, at 4.
\textsuperscript{54} Id.
\textsuperscript{55} See id.
Also, Gary J. Aguirre, a former SEC investigator, stated in agreement with the above scenario that “hedge funds’ dominance of the capital markets creates the power to abuse them.” Patrick Byrne has stated that without his knowledge his company, Overstock.com, was listed on “five exchanges in Germany and one in Australia” and that numerous reporters have been “intent on going far out of their way to write uncharitable articles” about his company. Additionally, Kim D. Blickenstaff, Chairman and CEO of Biosite, Inc., also testified that his company had been a target illegal short selling.

As recently as November 3, 2006, Fairfax Financial reported that since it filed a $5 billion law suit against several prominent hedge funds in July alleging the funds’ aggressive short-selling was driving down the price of its shares, its stock has increased over 36 percent. Lawyers for Fairfax

58 NCANS, Dr. Patrick Byrne’s Summary of The Naked Shorting Problem, March 13, 2005, at 6.
60 See Ben White, Hedge Fund Law Suit Stopped ‘Dirty Tricks,” https://registration.ft.com/registration/barrier?referer=&location=http%3A//w
Financial said that the price increase was a result of the hedge funds ceasing their “dirty tactics” of, after taking large short positions in Fairfax Financial’s stock, “generat[ing] bogus analyst reports critical of the company,” mailing threatening letters to Fairfax executives and their family and friends, and “tr[y]ing to intimidate employees into providing sensitive inside information and attempt[ing] to plant negative news stories about the company.” Fairfax asserts that the negative reports immediately declined following the lawsuit and the allegedly threatening behavior also ceased. Marc Kasowitz, Fairfax’s attorney, said “What we have come to learn in doing our investigation and since we filed the suit is that this is a pervasive problem in the markets.”

Additionally, Kasowitz has filed a similar suit on behalf of Canadian drugs group Biovail and stated that “[a] number of companies have investigated how this market manipulation has been carried out against them,” adding that it was “logical to expect” that more lawsuits would soon be filed. These occurrences tend to lend real-world credibility to the

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61 “Andrew Berry, an attorney for SAC, declined to comment on the assertion that the lawsuit had ended alleged dirty tricks. David Zensky, an attorney for Exis, also declined to comment.” Id.

62 Id.

63 Id.

64 Id.
accusations of naked short seller’s dubious behavior and provide evidence of the negative impact naked short selling and rouge hedge funds are having on the market.

Although acknowledging the existence of naked short selling, the DTCC denies allegations that their stock borrowing program facilitates the practice. The DTCC maintains that their borrowing system is computerized and automatically “credits a member’s account when they fail to deliver. This system helps maintain liquidity in the market and neither the NCSS nor the DTC “monitor[s] or regulate[s] that activity. It is done by the Self Regulating organizations (SRO’s) and the SEC.”65 Therefore, the DTCC maintains that if any illegal short selling occurs it is without their knowledge and beyond their control and that the SEC has the responsibility of controlling illegal and manipulative behavior.

V. GOVERNMENT REGULATION OF NAKED SHORT SELLING IN THE U.S.

A. SEC’S REGULATION SHO:

To combat the perceived problem of naked short selling on September 7, 2004, the SEC adopted Regulation SHO under the

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65 DTCC, Naked Short Selling and the Stock Borrow Program, March 5, 2006, at 4.
Securities Exchange Act of 1934. Regulation SHO defines ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities “long,” “short,” or “short exempt.” Moreover, Regulation SHO requires all short sellers to locate securities to borrow before selling, and also imposes additional delivery requirements on broker-dealers after a substantial number of failures to deliver have occurred. Specifically, Regulation SHO requires a broker-dealer to have “reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security.” To accomplish this, firms prepare “easy to borrow lists” that indicate a firm’s ability to supply a particular security and can be used to determine a reasonable basis for the locate requirement.

Moreover, after a substantial number of failures to deliver a particular security have occurred, that company’s security is deemed a threshold security and is placed on the Regulation

67 Id.
68 See id.
SHO list. Any equity security becomes a threshold security if it has an aggregate fail to deliver position for:

1. five consecutive settlement days at a registered clearing agency
2. totaling 10,000 shares or more; and
3. equal to at least 0.5% of the issuer’s total shares outstanding

Threshold securities that have persisted for 13 consecutive days prevents all broker-dealers trading in that security from effecting further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security. The SEC points out that a security’s appearance on a threshold list does not “mean that any improper activity has occurred or is occurring.”

Criticisms of Regulation SHO have stressed that the regulation has failed to eliminate substantial fails to deliver. To address this issue the SEC has proposed amending Regulation SHO to eliminate any grandfathered short positions and to curb the option market maker exception. These

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71 See U.S. Securities and Exchange Commission, Division of Market Regulation: Key Points About Regulation SHO, April 11, 2005, at 3.

72 Id. at 5.

73 Proposed Amendments to Regulation SHO, supra note 5, at 5. “The Securities and Exchange Commission is proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 (Exchange Act). The proposed amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities, by eliminating the grandfather provision and narrowing the options market maker exception. The proposals also are intended
regulations do not go far enough to open up the short sale process and allow companies to know how extensive the naked short positions are in their securities and what level of short sales are not settling.

B. NYSE REGULATIONS

Although the New York Stock Exchange (NYSE) has found no evidence of widespread naked short selling, the NYSE has acknowledged that the practice can be problematic and has been discussing “cracking down” on short sellers, saying that it was “poised to take action against illegal trades.” 74 Richard Ketchum, head of regulation for the NYSE, told reporters that “he was concerned about short selling during stock offerings.” 75 What was concerning was the appearance of “instances where active traders are selling short before an offering and covering in the offering …. that type of behavior is specifically prohibited and potentially manipulative.” Moreover, the NYSE has discussed “baring short sellers from

75 Id.
covering sales with shares from secondary offerings." The NYSE has been in contact with the SEC regarding its concerns.

C. CONGRESSIONAL REGULATIONS

On June 28, 2006 the Committee on the Judiciary held a hearing entitled “Hedge Funds and Independent Analysts: How Independent are their Relationships?” Senator Orrin Hatch called for an investigation into the activities of hedge funds with relation to short selling. In a statement, Senator Hatch said, “that I am not necessarily calling for new regulations here. But we need to monitor this field and make sure that our markets have the integrity that our investors need to continue investing and maintain our vibrant economy.” Senator Hatch made it clear that the Senate investigation was not a moratorium on short selling and recognized the respectable and important role hedge funds and short sellers play in “keep[ing] prices honest and help[ing] to maintain market balance.” But he did call hedge funds the “wild west of our financial markets” and vowed to address concerns that hedge funds are colluding with so called independent analysts to

76 Id.
77 See id.
80 Id.
offer subscribers negative reports on publicly traded companies so that the “hedge fund can take a short position in the stock that will supposedly decline as a result of the negative report.”\textsuperscript{81} Senator Hatch called this activity “slam and Jam schemes” and referenced them as the “flip side of the pump and dump schemes” that the Sarbanes-Oxley legislation addressed.\textsuperscript{82}

The purpose of the hearing was to investigate illegal short selling to determine if the activity was occurring, whether the Justice Department is actively looking into the matter, and whether it has the tools to be effective in its investigations. At this time, no published conclusions have been determined as a result of the hearing and investigation.

VI. GOVERNMENT REGULATION OF NAKED SHORT SELLING IN THE U.K.

A. FSA REGULATION

In response to the potential hazard of naked short selling, in April 2003, the FSA published its findings concerning the practice of naked short selling and its plan of action in addressing the problem.\textsuperscript{83} In that publication, the FSA stated that “short selling is a legitimate investment activity that

\begin{itemize}
  \item \textsuperscript{81} \textit{Id.}
  \item \textsuperscript{82} \textit{Id.}
  \item \textsuperscript{83} Financial Services Authority, \textit{Short Selling: Feedback on DP17}, 1 (April 2003). This Feedback Statement Reports on the main issues arising from Discussion Paper 17: Short selling (DP17).
\end{itemize}
plays an important role in supporting efficient markets.” 84 Thus, the FSA believed that due to the positive market contributions of naked short selling no blanket prohibition of the practice was warranted. Instead, the FSA took steps to “increase transparency surrounding short selling” in an effort to curb “concern[s] about specific circumstances in which settlement disruption caused by naked short selling may contribute to a potentially disorderly market or may impact negatively on investors.” 85

To specifically accomplish these goals, the FSA enacted measures to “improve general transparency” by publishing “data on securities lending as a proxy for short selling.” 86 The FSA believed this data would be useful to the market and, given that it was already collated by CRESTCo, would not be very costly to publish. 87 Additionally, the FSA took the following steps to increase transparency of short selling in the market: (1) The publication by CRESTCo of data on settlement failures in individual securities; (2) Measures to notify market participants and warn investors in circumstances where settlement problems are building in particular illiquid securities; and (3) Shortening the timeframe for requesting

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84 See id. at 3.
85 See id. at 6.
86 See id. at 3.
87 See id.
buy-in for particular illiquid securities that are experiencing concentrated settlement failures.\textsuperscript{88}

Also, the London Stock Exchange has agreed to “issue market status messages notifying their members when specific illiquid securities are experiencing a significant build-up of settlement failures.”\textsuperscript{89} The FSA believes that these measures will ensure that investors receive “information about settlement failures where this may affect investors’ investment decisions” and that it is “preferable to devise a market-based solution to this issue.”\textsuperscript{90} Apparently, at the time of the writing of this paper these regulatory measures have been effective. There does not appear to be the extensive naked short selling practices in the U.K. as in the U.S. This is probably in part is due to the greater transparency in the U.K.’s short selling market that has allowed the market to make efficient adjustments to this perceived problem.


In recognizing and subsequently dealing with the problem of naked short selling the U.S. and the U.K. have taken divergent paths. In the U.K., the Financial Services

\textsuperscript{88} Id. at 6.
\textsuperscript{89} Id.
\textsuperscript{90} Id.
Authority (FSA) decided to address the issue by deferring to a market solution and by working with its exchanges to provide increased information to companies and potential investors, while the U.S. has relied on Regulation SHO as its only substantive response. Even while including the proposed amendments to Regulation SHO, the SEC has failed to provide the market with the level of transparency that the U.K. has done.

Specifically, by publishing CRESTCo’s data on settlement failures, the U.K. has helped provide information to the market and helped to indicate settlement pressure that was building up in certain securities. Informed investors have the ability to make informed decisions to eliminate that settlement pressure. This type of disclosure is akin to Regulation SHO, but the FSA has gone further. By warning investors and companies of settlement problems in their securities, the U.K. will give their investors the needed information to either move out of that stock, or endure the increased risk. Also, for company management, this procedure will help them to determine whether the downward pressure on their stock is artificially coming from outside short positions or by their own lack of performance. It will empower companies and investors with the information to act appropriately. Also, by shortening the buy-in timeframe the
FSA will help prevent market disruption by naked short sellers by forcing them to act quickly to settle their short positions.

Additionally, and perhaps more importantly, the FSA is working with the London Stock Exchange to provide its investors with market status messages to notify them of build up in settlement failures. This collaboration will go a long way to boosting confidence in the U.K. capital markets by guaranteeing investors and companies that they will be notified of naked short sale abuses. This transparency will increase market information, and provide greater market confidence, both of which are necessary elements in maintaining efficient markets. The NYSE does not currently provide this service for its investors.

VIII. CONCLUSION

Given the potential problems that naked short selling presents capital markets of undermining fragile investor confidence, putting artificial downward pressure on company

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91 The Efficient Market Hypothesis is a bedrock principle of modern finance theory. Economists often define three levels of market efficiency, which are distinguished by the degree of information reflected in security prices. In order to reach the third and highest level of efficiency, called the strong form of efficiency, prices must fully reflect all the information that can be acquired by painstaking analysis of companies and the economy. Richard A. Brealey & Stewart C. Myers, Principals of Corporate Finance, (7th ed. 2003). Although costly, information regarding short sales positions can only help by providing more valuable price information to the market.
stock prices, especially fragile start-up companies in less understood industries, and contributing to less than efficient markets, it is important that the U.S. regulatory agencies enact measures to curb the advancement of the naked short selling practice. This paper does not advocate the complete disclosure of the names of individuals holding short or naked short positions because that could open those individuals to increased risk of a “bear squeeze,” yet the U.S. should adopt measures similar to those of the U.K. that would increase the transparency of the short sale process.

Specifically, as in the U.K., the SEC and the NYSE should collaborate to better inform investors and companies of large build-ups in short positions and provide companies with information from the DTC on how many failures to settle are occurring in their stock. These two remedies will go a long way to dispelling the clouds of suspicion hanging over the practice of short selling, by helping to shed a light on and eliminate abusive naked short selling. Ever since Isaac Le Maire and his Groot Companie, abusive short selling has hurt companies and angered investors, its time the practice was stopped.

92 “Bear squeezes” or “short squeezes” occur during a period of sharply rising prices caused by short sellers trying to cover their positions. As prices rise, short sellers are forced to cover their short positions and realize their losses.