

## NAKED SHORT SELLING: THE PROBLEM

- **Short selling** is a bet that a stock price will decline. A short seller borrows stock and then sells it, hoping to buy back the same amount of stock later, at a lower price, for return to the lender. Short selling is legal.

- **Naked short selling** involves selling stock without first borrowing (or sometimes even locating) the stock. If a naked short seller does not borrow the stock he sold, he will be unable to deliver that stock to the buyer to close the transaction. This is called a "**failure to deliver**" (**FTD**). Naked short selling is generally illegal, though market makers are allowed to temporarily naked short for the sake of *bona fide* market making. FTDs are always illegal when delivery failure exceeds 13 days.

- Exchanges do not disclose whether short sales are naked and supply no information on FTDs. Even worse, in transactions where shares are not delivered, brokerages issue stock IOUs called "**share entitlements**." Retail customers' account statements do not distinguish between real shares and share entitlements.<sup>1</sup> Thus, purchasers of securities not delivered have no way of knowing whether shares they bought actually exist in their accounts or are merely share entitlements.

- FTDs create **phantom shares** that circulate in the system as real shares. Just as counterfeit currency dilutes and destroys value, phantom shares deflate share prices by flooding the market with false supply.

- Some short sellers use naked shorting and oversupply of phantom shares to manipulate stock prices downward. Because regulations are loose and enforcement lax, they are unafraid of failing to deliver.

- Customers holding phantom shares can, and often do, re-sell those phantom shares as if they were real. Subsequent purchasers do not receive real shares; instead they receive only share entitlements. Phantom shares sold by naked short sellers are thus laundered in the market by subsequent transactions in which share entitlements come to resemble (but cannot become) real shares of stock.

- FTDs threaten market integrity in at least three ways:

1. **The corporate voting system is undermined by chronic over-voting.** The circulation of FTDs leads to more ownership than there are shares to own. As a result, brokers and transfer agents routinely mail out and receive back more proxy votes than there are shares to vote;<sup>2</sup>
2. **Companies and shareholder value are destroyed;**<sup>3</sup>
3. **Market integrity is threatened.** Large brokerage firms and hedge funds often use leverage to build naked short positions, a strategy that poses systemic risk to financial markets.

- What little is publicly known about FTDs is available as a result of **Regulation SHO**, implemented by the SEC in January, 2005, in order to curb abusive naked short selling and reduce FTDs. Regulation SHO requires exchanges (e.g., NYSE and NASDAQ) to publish daily a list of firms with FTDs above a calculated threshold. That list is known as the **Regulation SHO Threshold List**.<sup>4</sup>

- Since Regulation SHO was enacted two years ago, 5,839 companies have appeared on the Threshold List.<sup>5</sup> According to a recent Office of Economic Analysis report, 6,223 securities have graduated from the Threshold List, meaning thousands of companies have been on the Threshold List more than once.<sup>6</sup>

- Curiously, Regulation SHO only reports victim companies; there is no disclosure of either the amount of FTDs or of the institutions who fail to deliver. The size of past (but not current) FTDs can only be obtained through petition to the SEC's **Freedom of Information Act (FOIA)** office. Neither the SEC nor the exchanges will disclose the names of the institutions failing to deliver, even through FOIA petition, as "fails statistics of individual firms...is proprietary information and may reflect firms' trading strategies."<sup>7</sup>

- The SEC's prediction that firms could not remain on the Threshold List longer than 13 days was false:<sup>8</sup>

TOTAL # OF DAYS OR MORE ON THE THRESHOLD LIST	# OF COMPANIES <sup>9</sup>
13	3462
25	2226
50	1218
100	485
200	118
300	40
500	5

- FOIA data reveal significant FTDs as a percentage of average volume in select exchanges and issuers:

EXCHANGE	PEAK FTDs	PEAK DATE	AVERAGE VOLUME	FTDs AS A % OF AVG VOLUME
NYSE <sup>10</sup>	172,707,364	01/31/2006	1,701,643,478 <sup>11</sup>	10%
NASDAQ, OTCBB and Pink Sheets <sup>12</sup>	1,337,784,073	03/13/2006	15,455,938,738 <sup>13</sup>	9%

ISSUER	PEAK FTDs	PEAK DATE	AVERAGE VOLUME <sup>14</sup>	FTDs AS A % OF AVG VOLUME	TOTAL DAYS ON THRESHOLD LIST <sup>15</sup>
Cal-Maine (CALM) <sup>16</sup>	2,498,529	01/10/2005	430,102	581%	192
Global Crossing (GLBC) <sup>17</sup>	2,387,641	01/21/2005	660,604	361%	383
Global Links (GLLC) <sup>18</sup>	27,287,714	02/04/2005	28,865,952	95%	242
iMergent (IIG) <sup>19</sup>	289,054	05/02/2005	303,852	95%	412
Inhibitex (INHX) <sup>20</sup>	3,129,627	04/07/2006	20,738	15,091%	27
Krispy Kreme (KKD) <sup>21</sup>	4,652,372	03/28/2005	4,359,081	107%	547
Netflix (NFLX) <sup>22</sup>	4,959,482	01/03/2005	2,578,794	192%	385
Novastar Financial, Inc. (NFI) <sup>23</sup>	3,223,846	11/10/2004	409,272	788%	609
Overstock.com (OSTK) <sup>24</sup>	3,800,172	03/20/2006	932,835	407%	626
Vonage (VG) <sup>25</sup>	5,662,925	05/30/2006	1,681,333	337%	59

- Regulation SHO "**grandfathered**" FTDs older than January 2005 *and* new FTDs prior to an issuer's appearance on the Threshold List, thus pardoning sales for which money was paid but no stock delivered. While publicly downplaying the issue,<sup>26</sup> the SEC has quietly admitted to adopting the grandfather clause because of concern about "creating volatility where there were large pre-existing open positions."<sup>27</sup>

- Scholars have shown that many FTDs are strategic—that is, used to manipulate prices.<sup>28</sup> In other industries, failure to deliver products with knowledge and intent to defraud buyers is prosecuted as fraud.

- Large U.S. brokerages collectively own and operate the **Depository Trust and Clearing Corporation (DTCC)**. The DTCC operates with little SEC oversight and consistently denies the existence of a systemic problem<sup>29</sup> while simultaneously fighting public disclosure of even minimal FTD data.<sup>30</sup>

- What little data the DTCC does disclose is misleading.<sup>31</sup> For example, the DTCC claims failed trades sum to \$6 billion daily, or 1.5% of the dollar volume.<sup>32</sup> But that \$6 billion is only the *present* ("marked to market") value of failed trades; many have gone undelivered for months, diluting prices with false supply.

- The true magnitude of FTDs is obscured by **Continuous Net Settlement (CNS)**, which nets failures against shares held by brokers.<sup>33</sup> The DTCC asserts that CNS has "eliminated the need to settle 96% of total obligations."<sup>34</sup> If the DTCC processes \$400 billion in trades daily as claimed, then \$384 billion are netted out and only \$16 billion require delivery.<sup>35</sup> Thus, the \$6 billion in FTDs that exist on any given day is 37.5% of the trades that require delivery—*twenty-five times* the 1.5% reported by the DTCC.<sup>36</sup>

- The statistics above ignore "**ex-clearing**"—that is, trades cleared directly by brokers bypassing the DTCC. Some scholars believe that "fails occurring through ex-clearing may elude the [reporting] requirements of Regulation SHO."<sup>37</sup> FTDs in ex-clearing may be four times as great as quantities discussed above. The DTCC's **Stock Borrow Program (SBP)** adds additional mystery to the situation.<sup>38</sup>

## NAKED SHORT SELLING: THE SOLUTION

- The FTD problem can be solved by four rules. All are simple, easy to implement, and fair:

**G:** eliminate the **G**randfather provision of Regulation SHO;

**O:** eliminate the **O**ptions market maker exception;<sup>39</sup>

**L:** require those who sell short to first **L**ocate and actually borrow *bona fide* shares; and

**D:** require full and prompt **D**isclosure of FTDs by broker-dealer and by company.

Comments by SEC Chairman Christopher Cox heighten concern about "abusive naked short selling" and "persistent failures to deliver."<sup>40</sup> State and federal law makers, industry experts, academics, public companies, and the U.S. Chamber of Commerce are urging the SEC to accept the four GOLD rules above.<sup>41</sup> The SEC recently adopted 'G' but is considering only weak versions of the 'O' and 'D' rules.<sup>42</sup>

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- <sup>1</sup> Arne Alsin, “The story brokers don’t want you to read,” *Financial Times* (October 20, 2006).
- <sup>2</sup> Bob Drummond, “Corporate Voting Charade,” *Bloomberg Markets Magazine* (April 2006).
- <sup>3</sup> Bob Drummond, “Games Short Sellers Play,” *Bloomberg Markets Magazine* (November 2006).
- <sup>4</sup> Securities and Exchange Commission, Final Rule: Short Sales, Release No. 34-50103 (July 28, 2004), <http://www.sec.gov/rules/final/34-50103.htm>.
- <sup>5</sup> Data from Buyins.net as of August 19, 2007.
- <sup>6</sup> Office of Economist Analysis, “Fails to Deliver Pre- and Post-Regulation SHO” (August 21, 2006).
- <sup>7</sup> Securities and Exchange Commission, “Division of Market Regulation: Key Points about Regulation SHO” (April 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm>.
- <sup>8</sup> Securities and Exchange Commission, Key Points about Regulation SHO.
- <sup>9</sup> Data from Buyins.net as of August 19, 2007.
- <sup>10</sup> SEC, Response to Freedom of Information Act (FOIA), 5 U.S.C. § 552, Request No. 06-06997-FOIA. Data is for January 1, 2005 through May 31, 2006.
- <sup>11</sup> Average daily volume for January, 2006 from [www.nyse.com](http://www.nyse.com).
- <sup>12</sup> SEC FOIA Response to Request No. 06-07003-FOIA. Data is for January 3, 2005 through May 31, 2006.
- <sup>13</sup> Average daily volume for March, 2006 from [www.nasdaqtrader.com](http://www.nasdaqtrader.com), [www.otcbb.com](http://www.otcbb.com), and [www.pinksheets.com](http://www.pinksheets.com).
- <sup>14</sup> Average daily volume for the month in which FTDs peaked. All data from Bloomberg.
- <sup>15</sup> Data from Buyins.net as of August 19, 2007.
- <sup>16</sup> SEC FOIA Response to Request No. 06-04383-FOIA. Data is for January 3, 2005 through May 31, 2006.
- <sup>17</sup> Ibid, Request No. 06-05781-FOIA. Data is for January 3, 2005 through December 30, 2005.
- <sup>18</sup> Ibid, Request No. 06-06551-FOIA. Data is for February 4, 2005 through December 30, 2005.
- <sup>19</sup> Ibid, Request No. 07-00092-FOIA. Data is for August 18, 2004 through July 31, 2006.
- <sup>20</sup> Ibid, Request No. 06-07592-FOIA. Data is for January 4, 2006 through May 25, 2006.
- <sup>21</sup> Ibid, Request No. 06-07071-FOIA. Data is for January 3, 2005 through May 1, 2006.
- <sup>22</sup> Ibid, Request No. 06-06541-FOIA. Data is for January 1, 2005 through December 30, 2005.
- <sup>23</sup> Ibid, Request No. 06-02679-FOIA. Data is for April 1, 2004 through February 3, 2006.
- <sup>24</sup> Ibid, Request No. 06-07006-FOIA. Data is for FTDs from March 22, 2004 to May 1, 2006.
- <sup>25</sup> Ibid, Request No. 06-08046-FOIA. Data is for FTDs from May 30, 2006 to June 14, 2006.
- <sup>26</sup> Steve Letzler, “Regulators Say Reg SHO Is Working,” <http://www.dtcc.com/Publications/dtcc/jan06/sho.html>.
- <sup>27</sup> Securities and Exchange Commission, Key Points about Regulation SHO.
- <sup>28</sup> Leslie Boni, “Strategic Delivery Failures in US Equity Markets,” University of New Mexico and the SEC (November 2004), [http://www.unm.edu/~boni/Fails\\_paper\\_Nov2004.doc](http://www.unm.edu/~boni/Fails_paper_Nov2004.doc). See also John D. Finnerty, “Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation,” Fordham University (March 2005), <http://www.businessjive.com/nss/jdfinnerty050505.pdf> and Richard B. Evans et al, “Failure is an Option: Impediments to Short Selling and Options Prices,” The Wharton School at the University of Pennsylvania (May 5, 2003), <http://www.businessjive.com/nss/failureoption.pdf>.
- <sup>29</sup> Larry Thompson, DTCC First Deputy General Counsel, “Naked Short Selling and the Stock Borrow Program” (March 2005), [http://www.dtcc.com/Publications/dtcc/mar05/naked\\_short\\_selling.html](http://www.dtcc.com/Publications/dtcc/mar05/naked_short_selling.html).
- <sup>30</sup> Robert Shapiro, “Comments on Proposed Amendments to Regulation SHO” (September 14, 2006), <http://www.sec.gov/comments/s7-12-06/rjshapiro5967.pdf>.
- <sup>31</sup> Robert Shapiro, letter to Jill M. Considine, Chairman and CEO, Depository Trust and Clearing Corporation (April 13, 2005), <http://www.ncans.net/files/Response%20to%20DTCC%20Deputy%20Counsel%20Thompson%20-%20Robert%20Shapiro%20-%20April%2013%202005.pdf>.
- <sup>32</sup> Larry Thompson, DTCC First Deputy General Counsel, “Naked Short Selling and the Stock Borrow Program.”
- <sup>33</sup> Depository Trust & Clearing Corporation, “Continuous Net Settlement (CNS),” <http://www.dtcc.com/ProductsAndServices/clearing/cns.html>.
- <sup>34</sup> <http://formats.nsc.com/index12191.html>.
- <sup>35</sup> Larry Thompson, DTCC First Deputy General Counsel, “Naked Short Selling and the Stock Borrow Program.”
- <sup>36</sup> Robert Shapiro, letter to Jill M. Considine, Chairman and CEO, DTCC (April 13, 2005).
- <sup>37</sup> Robert Shapiro, “Comments on Proposed Amendments to Regulation SHO” (September 14, 2006).
- <sup>38</sup> Larry Thompson, DTCC First Deputy General Counsel, “Naked Short Selling and the Stock Borrow Program.”
- <sup>39</sup> See Securities and Exchange Commission, Final Rule: Short Sales, Release No. 34-50103, Rule 203, Section 1b, “Exemptions from the Locate Requirement: Bona-fide Market Making.” (July 28, 2004), <http://www.sec.gov/rules/final/34-50103.htm>.
- <sup>40</sup> Christopher Cox, Chairman, SEC, “Opening Statements at the Commission Open Meeting” (July 12, 2006), <http://www.sec.gov/news/speech/2006/spch071206cc2.htm>.
- <sup>41</sup> See Securities and Exchange Commission, “Comments on Proposed Rule: Amendments to Regulation SHO,” <http://www.sec.gov/comments/s7-12-06/s71206.shtml> and David Chavern, COO and Senior Vice President, US Chamber of Commerce, Letter to Senator Christopher Dodd and Representative Barney Frank (February 16, 2007).

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<sup>42</sup> Securities and Exchange Commission, "SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate "Tick" Test," <http://www.sec.gov/news/press/2007/2007-114.htm> .