Short Selling:
10 Recommendations for Improving the SEC's Regulatory Framework

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He who sells what isn't his'n, must buy it back or go to pris'n.
Daniel Drew (1797–1879)

The recent trading frenzy in Gamestop and other so-called "Reddit Rebellion" stocks has brought attention to longstanding deficiencies in the transparency framework, regulatory guardrails, and operational practices governing short selling in our securities markets. It has also brought attention to the fact that both monitoring and enforcement of short-selling abuses remain challenging due to multiple factors, including deliberate flexibilities built into U.S. regulatory standards. In this fact sheet, we recommend 10 regulatory enhancements that the U.S. Securities and Exchange Commission ("SEC") must implement to improve transparency, increase market stability and efficiency, reduce operational risk, and prevent abusive trading and manipulation.

Long before the SEC implemented its first short-selling regulation in 1938, the Uptick Rule (*see* recommendations *below*), due to concerns about abusive short selling, the practice had both critics and proponents. The academic literature, policy debate, and industry commentrary on short selling is extensive, diverse, and contradictory, and a comprehensive review of the many nuanced views expressed is beyond the scope of this brief fact sheet. However, we would like to make two essential points.

- First, short selling ***can*** be one component of a well-functioning, liquid securities market and ***can*** contribute useful information to the price discovery process, *under the right regulatory conditions*.

- Second, short selling ***can*** interefere with fair, orderly, and efficient markets and substantially distort the price discovery process, *under the wrong regulatory conditions*. It thereby can adversely impact the operation and price of capital for companies, especially early stage companies vulnerable to unlawful or abusive short-selling practices.

The SEC's current regulatory framework, unfortunately, does not meritoriously balance these considerations but rather, all but ensures that certain short-selling practices can continue to impose harms on companies, investors, and markets. Fortunately, the SEC has broad authorities to find a better balance for our securities markets, and it can and should do so through surgical rulemakings.

<u>Summary of Recommendations</u>

For short selling to serve a constructive—as opposed to destructive—role in our securities markets, Better Markets recommends that the SEC commence rulemakings consistent with the following:

- **Public Transparency:** The SEC must dramatically improve short-interest reporting. All short interests must be publicly reported in a (1) timely, (2) comprehensive, and (3) standalone manner designed to maximize the informational value that rationalizes short selling (and other short interests) in the securities markets.

  Recommendations:

  1. Form 13F: The SEC must implement a long overdue Form 13F filing requirement for institutional investment managers that (1) includes a standalone short-interest schedule as a supplement to existing long-position reporting, (2) contemplates public reporting of all threshold short interests, including those involving securities lending/borrowing, options, and equity derivatives positions, and (3) is published on at least a monthly (as opposed to quarterly) basis, with an appropriately minimal delay calibrated solely to protect trading strategies.

  2. Securities Lending Reporting: The SEC must implement section 984(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which instructed the commission to "increase the transparency of information available to brokers, dealers, ***and investors***, with respect to the loan or borrowing of securities" and which was supposed to be completed "[n]ot later than 2 years after the date of [the Dodd-Frank Act's] enactment" in July 2010.[1] This flagrant disregard of a Congressional directive must be remedied with a securities-lending regulatory and public reporting framework (*see also* comments relating to the consolidated audit trail *below*).

  3. FINRA Broker-Dealer Reporting: The SEC must require the Financial Industry Regulatory Authority ("FINRA") to implement daily aggregate short interest reporting for broker-dealers, as it has implemented for the equity trade reporting facilities (*see* footnote 2 *below*). Presently, FINRA Rule 4560 requires broker-dealers to report total short positions in all customer and proprietary accounts in all equity securities only twice per month. As *above*, we encourage the SEC and FINRA to require broker-dealer short interest reporting with an appropriately minimal delay.

  4. FINRA Equity Trade Reporting Facilities & Exchange Reporting: The SEC must implement regulations requiring FINRA to continue to publish daily short-interest volume and monthly short-interest transaction files, in a format and with content acceptable to the SEC. The SEC must similarly implement regulations requiring the securities exchanges to continue to publish daily short-interest volume and monthly short-interest transaction files, in a format and with content acceptable to the SEC. The SEC must also consider consolidating information in a descriptive monthly short-sale report and making some portion of the data available through its data visualization tools.[2]

- **Regulatory Safeguards:** The SEC must ensure that short selling is subject to a reasonable, unambiguous regulatory framework that restricts and deters short-selling practices that interfere with fair, orderly, and efficient markets.

  Recommendations:

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1 *See* Section 984(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111–203 (2010) (emphasis added).

2 In the aftermath of the 2008 financial crisis, FINRA began publishing certain short-sale information reported to equity trade reporting facilities in satisfaction of an SEC "request." The *Monthly Short Sale Transaction File* includes information on off-exchange short-sale transactions in listed stocks and is broken down separately in the *Monthly Trade Reporting Facilities ("TRFs") Report* and the *Monthly Alternative Display Facility ("ADF") Report*. FINRA also publishes a *Daily Short Sale Volume File*, which provides aggregate daily short sale volume data by security for off-exchange trades in listed stocks as well as trades in non-listed securities reported to the TRFs, the ADF, and the Over-the-Counter Reporting Facility.

5. Eliminate Market-Maker Exception to the Locate Requirement: The SEC must institute a broad prohibition on naked short selling (*see* Appendix A *below*) and abandon the market-making exception to the Locate Requirement in Regulation SHO.[3] That loophole permits the largest proprietary trading firms to engage in naked short selling on the theory that it facilitates trading in hard-to-borrow securities. However, the SEC's settlement regulations with respect to mandatory buy-ins already provide special accommodations to market-makers that cannot close out their short positions within the failure-to-delivery ("FTD") close-out timeframe.

6. Short Position Accountability and Limits: The SEC must implement a net short position accountability and position limits framework, along with a special filing requirement for market participants that have net short positions at least in hard-to-borrow equities deemed excessive (*i.e.,* exceeding an SEC-determined threshold) relative to the total tradeable float in a security. Stocks experiencing aggregate short interest in excess of 90 percent of the tradeable float in the security, for example, should trigger imposition of this position limits framework.

7. Uptick Rule: The SEC should reinstitute the Uptick Rule, which ameliorated price declines associated with short-selling for almost 70 years without significant effects on the development of the U.S. capital markets. The SEC's elimination of that rule prior to the 2008 financial crisis was unnecessary and poorly conceived. Although there is merit to the Alternative Uptick Rule, we are not persuaded that a single-day 10 percent downturn in a company's share price should be required to reinstate uptick restrictions on short selling.

- **Operational Integrity:** The SEC must ensure that operational integrity is maintained throughout the clearing and settlement system.

8. Mandatory Buy-Ins and Punitive Fee Assessments: The SEC must continue to require clearing broker-dealers to immediately close out failures-to-deliver ("FTDs") during the settlement process,[4] which should include mandatory (1) buy-in processes on T+2 for short sales (in a T+1 settlement framework); and (2) fee assessments designed to punish and deter firms with FTDs that are not closed out timely under Regulation SHO. Fee assessments should climb as the outstanding period for a short-selling-related FTD lengthens.

9. T+1 Settlement: The SEC must shorten the settlement cycle to T+1 (*i.e.,* trade-date-plus-one-trading-day), which would reduce operational and other risks in our settlement system, including risks associated with FTDs and naked short selling. The securities markets currently operate on a T+2 time horizon. Because margin models at the National Securities Clearing Corporation account for risks during the period of time that elapses between the trading and settlement of transactions, a shorter time horizon for settlement—like T+1—would not only reduce risks to the clearing and settlement system but also generally reduce liquidity demands and risks to clearing firms that must meet margin calls calibrated to the risks and volatilities expected for the firm's overall portfolio during the unsettled risk period. In addition to these benefits, the shortened T+1 settlement period may diminish the number of unsettled transactions arising from the re-lending process, which has been characterized as creating temporary "phantom" or "duplicate" shares.

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[3] The Locate Requirement under Regulation SHO prohibits broker-dealers from accepting short sale orders in equity securities or effecting short sales in equity securities for its own account unless the broker-dealer has (1) borrowed the security, (2) entered into a *bona fide* arrangement to borrow the security, or (3) has "reasonable grounds" to believe the security can be borrowed and delivered by settlement. Reg SHO requires the broker-dealer to document its compliance with the "locate" requirement, which is usually done through a "locate log" that documents the basis for each locate provided.

[4] Most relevantly for present purposes, an FTD occurs when a short seller fails to deliver shares supposedly sold to the unsuspecting buyer on or before the settlement date for the transaction. There are other reasons for FTDs as well.

- **Monitoring and Enforcement:** The SEC must ensure that the Division of Enfrocement ('DOE") has the information to protect investors and markets and punish and deter unlawful short selling practices, including manipulation and fraud.

    10. Consolidated Audit Trail: Short selling information will be part of the CAT, once operationalized. The SEC therefore must promptly implement the long-overdue and industry-delayed CAT, so that its divisions can analyze timely and comprehensive information on short-selling for oversight, enforcement, and policy purposes. *See* our [CAT fact sheet]. The SEC also must require regulatory and public reporting of certain information relating to securities-lending activities. Thus, it must explore requiring securities-lending reporting as part of the CAT.

Recent data analyzed by the SEC suggests that short selling may comprise as much as half of all listed equity share volume.[5] Despite this fact, the practice is subject to a rudimentary regulatory framework. Our recommendations for reasonable short-selling transparency requirements, regulatory safeguards, operational improvements, and monitoring and enforcement measures would enhance the current SEC framework, protect fair, orderly, and efficient trading, level the informational and trading playing field for investors, and better serve issuers (companies), investors, and the purposes of the securities markets—*i.e.,* to support capital formation and the integrity of the price discovery process that informs capital allocation.

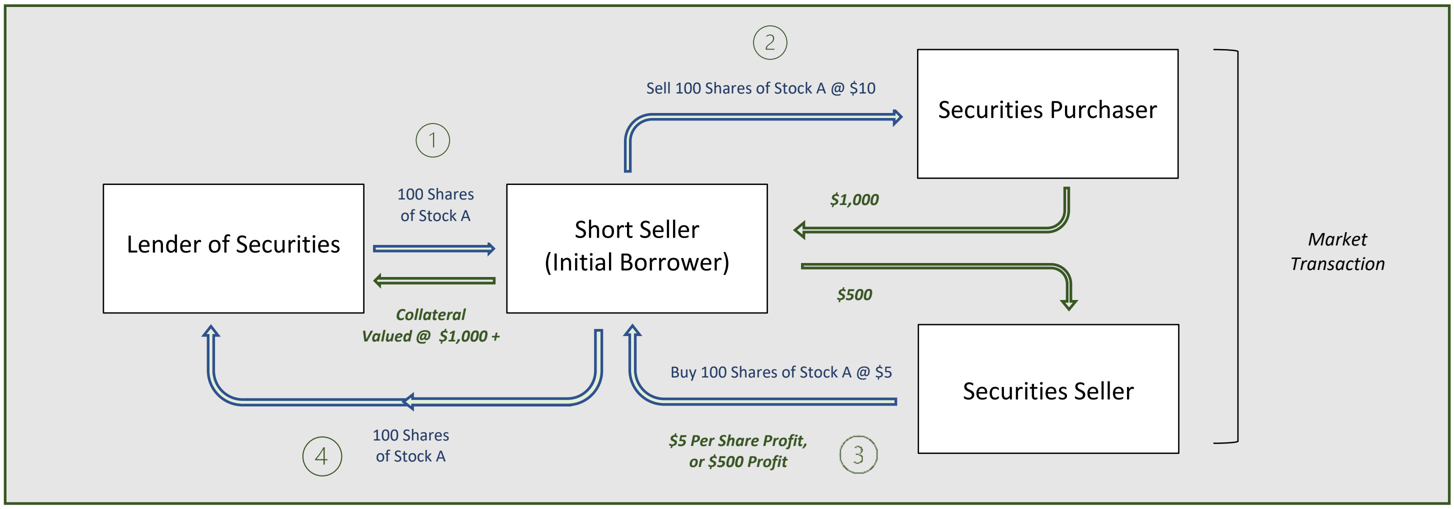
Unless the SEC makes significant progress in each of the four identified areas, certain short selling practices in the U.S. securities markets will continue to undermine investor and issuer confidence, as well as the fundamental purposes of our markets.

[5] *See* Staff of the Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission, *Short Sale Position and Transaction Reporting*, at 4 (June 5, 2014).

Appendix A

The term "short sale" generally refers to a person's sale of a security that such person does not own. In simple terms, a "covered" short sale usually involves four distinct transactions. First, a short seller borrows identified securities from a broker-dealer and posts securities or other collateral to a margin account sufficient to meet the broker-dealer's required margin amount.[6] Second, the short seller sells these borrowed securities into the market. Third, the short seller purchases (or borrows) like/fungible securities at a later point in time. Fourth, and finally, the short seller delivers the purchased (or borrowed) like/fungible securities to the lending broker-dealer to close out the transaction. *See* Figure 1 *below*. Borrowing identified securities to sell them and then set in motion this series of legitimate transactions is usually what is meant by "going short."

Figure 1. **Covered Short Sale**
Simplified Four-Part Transaction Flow



Investors often use short sales to express a negative view about a company's valuation and to profit from an expected eventual decline in that company's share price. This may reflect a conclusion about the fundamental value of the company, namely that its reasonably expected future profits from providing goods and services do not support the price of the company's shares, which represent a claim on those profits. By introducing information on negative market sentiment to a company's share price, short selling is often exalted as an important part of the price discovery process, a disciplining factor for companies, and a stabilizing influence on securities involved in speculative frenzies.

However, abusive and unlawful short selling practices—which historically have flourished in the absence of reasonable regulatory guardrails and enforcement—not only diminish the integrity of the price discovery process but harm companies that may be targeted, in large part, for their vulnerability to short selling. In addition, contrary to the romaticised defense of short selling by some in the financial industry and their allies, short selling can exacerbate volatility and precipitate *destabilizing* collapses in share prices. It is also often unavailable in the very market conditions in which short selling would be most beneficial.

There are more complex trading and hedging strategies that involve short selling as well. For example, short selling is used to facilitate market-making activities in certain types of stocks, and short positions are often taken to offset

[6] In a covered short sale, the broker-dealer involved in the transaction sources the securities it lends from its own securities inventory, another customer of the broker-dealer with securities available in a margin account, or another broker-dealer or institutional investor with securities to lend. The terms of these securities lending transactions depend on whether the borrowed securities are considered easy-to-borrow or hard-to-borrow.

(hedge) risks arising from long exposures and the markets more generally. Short selling also is used in certain arbitrage strategies involving related corporate securities. These uses do not arise from negative sentiment about the relevant companies, however, and they therefore provide the markets little useful information on the valuation of the relevant securities. Nevertheless, these short-selling activies, like others, have the potential to affect the short-term balance of buy and sell orders in the markets and therefore can affect perceptions about the market sentiment for particular securities.

The SEC's longstanding regulatory approach to short selling has been far too passive. The recently adopted Regulation SHO provides the core framework for regulating short sales, and it represents the only significant change to short-sale regulation in 68 years—dating back to the initial reforms, like the Uptick Rule, implemented in the aftermath of the Great Depression.[7] Regulation SHO was motivated, in part, by so-called "naked" short selling, which is an abusive form of short selling conducted without the securities-lending transaction in step one of our simplified transaction flow (*see* Figure 1). In a naked short sale, a person does not borrow (or arrange to borrow) identified securities to sell at the outset of the transaction. Instead, the person sells a security into the market and hopes to "cover" the sale (secure a like/fungible security for delivery to the buyer) by settlement. Because the naked short seller sold something it did not possess (and may not exist, much less be available), there is a risk the short seller will not be able to secure the security by settlement.

For more information on short selling and/or other securities issues, please visit our website at www.bettermarkes.com or contact us at press@bettermarkets.com.

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7 *See* SEC, Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (codified at 17 C.F.R. 242.200-203). The Regulation SHO framework has two core mechanisms for bringing discipline to short-selling practices and limiting naked short selling. First, SEC Rule 203(A)—the "locate" requirement—ostensibly requires that short sellers and broker-dealers *locate* shares of stock that are "available to borrow" *before* they actually short-sell shares into the market. Second, SEC Rule 203(B) provides trading limits on "Threshold Securities," which are securities with significant FTDs within the settlement system.