Financial Crisis Leads to Restrictions on Short Sales

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Last week, the SEC made an emergency order to ban short sales in certain commercial and investment bank stocks unless the seller has borrowed or arranged to borrow the security. The order reflects the broad disintegration of the market in the stocks of financial institutions in the wake of news that Freddie Mac might not have enough capital on hand to cover mandatory reserves for mortgage commitments.

The ink was not quite dry on the order when industry groups clamored for some exemptions. Market makers in the derivative and cash markets pointed out that they could no longer make markets unless they received an exemption. At first, the SEC agreed that there should be an exemption for market makers in the cash markets, but was reluctant to grant an exemption for options market makers engaged in hedging activities. Eventually, both groups received an exemption. But, and it is a very big but, market makers have to deliver for settlement regular way, meaning th third day after the trade takes place (T+3). As a result, market makers will either need to flatten their positions by the end of the trading day or borrow the shorted securities.

The SEC has been quite active in making rules governing short sales in recent years. This most recent emergency order, and its exemptions, provides some hints about where the SEC is headed in the regulation of short sales. As we write, there have been calls to extend the emergency order to all securities.

Prior to the adoption of Reg SHO in 2005, the SEC primarily regulated short sales through the "tick test," which was intended to prevent short sales when the market was falling. Bear markets present the greatest opportunity for manipulative short sales, sometimes called "bear raids." The SEC has now entirely abandoned the tick test, despite calls from the NYSE and its lawyers to resurrect it. The current market crisis has not resulted in any change of heart by the SEC. So, it is safe to assume that the tick test has gone the way of the dinosaur and will never be seen again on this planet.

In Reg SHO, the SEC focused on the effect of short sales on clearance and settlement. Bear raids generally involve selling a large amount of stock, frequently more than has ever been issued. Moreover, when a short seller fails to deliver, the buyer is deprived of her ownership rights. Requiring delivery regular way addresses both of these ills. Reg SHO represented a shift away from market regulation to control over the back office.

Prior to 2005, broker-dealers were required by FINRA and other SROs to locate securities or borrow them prior to the execution of a short sale. These locate requirements generally were satisfied by borrowing the securities. There were liberally construed exceptions to the borrow requirement, and back offices tended to be flexible in their insistence that securities be delivered for timely settlement. As a result, naked shorts – shorting the stock without borrowing – were fairly commonplace. With the adoption of Reg SHO, the SEC took over the regulation of short sales from FINRA and other SROs.

For the most part, the SEC stuck with FINRA's locate or borrow requirements in Reg SHO. Exceptions were granted to positions established by market makers. Then the SEC added some teeth to the rule.

The big change required positions in certain "threshold securities" to be closed out within 13 days, which significantly reduced back office flexibility. A security qualifies as a threshold security when the issuer is an Exchange Act reporting company and aggregate fails are greater than half a percent of the shares outstanding and more than 10,000 shares for more than five days. FINRA or another SRO then adds the security to a list of threshold securities. Exceptions were granted for certain "grandfathered" positions created before the security becomes a threshold security. However, market makers in the cash markets were not exempt from the 13-day close-out rule in threshold securities, unless their position was "grandfathered." And options market makers selling the underlying security short as a hedge also were not subject to the close-out rule. The close-out rule severely penalizes naked short sellers in threshold securities.

Fails in threshold securities nonetheless remained higher than acceptable to the SEC. As a result, further refinements in 2006 and 2007 eliminated "grandfathering," except for options market makers. The most recent proposals would eliminate the options market makers exception and declare it a fraudulent practice to state falsely that the securities can be located. A locate requirement has been proposed for long sales, as well as shorts.

The emergency order moves the goal posts ever so slightly. First, for the securities covered by the order, the locate method of ensuring timely settlement is removed. Instead, the executing broker must borrow or arrange to borrow. This eliminates the potential for fraudulent locates. Second, the market maker exception is significantly restricted. Market makers are not required to borrow or arrange to borrow prior to an execution, but must deliver regular way. Finally, some of the securities on the SEC's list are not issued by reporting companies. The application of Reg SHO has found its way into the vast OTC market for unregistered securities.

At first blush, one would think that a change in settlement procedures would not have much effect on the markets. However, as anyone who lived through the back office crisis of 1970 can testify, the back office is a sleeping dragon, which, when aroused, can devastate markets.

The ability to obtain a borrow and its price have a significant effect on the ability of short sellers to ply their trade. Strongly enforced, the borrow requirement would eliminate short sales in hard to borrow securities. Market makers would be reluctant to accommodate customer purchase orders through sales from inventory, knowing that the resulting short must be covered somehow by the end of the day. In addition, options market makers are creating derivatives, which might be thought of as securities that were never produced by their issuers. The hedging of options by shorting the underlying stock soaks up the pool of an issue that can be borrowed. This naturally limits the amount of options that can be issued in any security. All of this reduces the opportunity for profits on the trading desk.

The emergency order is best thought of as a pilot program. The trading industry has seen many pilot programs introduced by regulators in recent years. With a few notable exceptions, most of the programs have ended up as market structure changes in some form.

As strange as it seems, there is an important lesson in this. We should be careful what we wish for.

For many years, traders have yearned for T+0, when settlement would occur instantaneously with the trade. The elimination of costs and hassle would remove much of the annoyance out of working on the desk. But, the only way to achieve T+0 universally is to eliminate fails to deliver.

Reduced profits on the desk is the price for T+0.