“Naked short selling” is often claimed by struggling public companies to be the source of their woes. But there have been relatively few cases addressing naked short selling. Recently, however, on May 19, 2021, the SEC charged a broker-dealer (“BD”) with violating the order-making and locate provisions of Regulation SHO. Regulation SHO regulates short sales of securities and, broadly speaking, is aimed at minimizing naked short selling, failures to deliver, and other practices.

What is Short Selling?

According to the SEC’s Complaint, “[s]hort selling occurs when an investor borrows a security and sells it on the open market, planning to buy it back later for less money.” Thus, short-sellers profit from a decline in the price of a security. This is in contrast to “long” investors, who profit from an increase in the price of a security. Short selling is very risky: losses are unlimited because the price of a security can always increase.

What is Regulation SHO?

Regulation SHO, enacted in 2005, established “locate” and “close-out” requirements. Rule 200(g) of Regulation SHO requires BDs to mark all orders to sell...
stock as “long,” “short,” or “short-exempt.”[3]

A sale order can be marked “long” only if two conditions are met. First, a seller must be deemed to own the security, which occurs only to the extent that it has a net long position in the security. Second, the BD must either (a) have possession or control of the security to be delivered, or (b) reasonably expect that the security will be in its physical possession or control no later than the settlement date of the transaction.

Rule 203(b)(1) of Regulation SHO requires BDs to “locate” the securities being sold, before effecting a short sale.[4] This “locate” requirement means that BDs must (a) borrow the securities; (b) enter into a bona fide arrangement to borrow the securities, or (c) have a reasonable basis to believe that the securities can be borrowed so that they can be delivered on the delivery due date.

What is “Naked” Short Selling?

Naked short selling is unlawfully short selling shares that have neither been borrowed nor located. If sellers are engaged in naked short selling, then the volume of stock may be larger than the tradeable shares in the market, which can lead to sellers failing to deliver securities sold by the settlement date.

What Did the BD Allegedly Do Wrong?

According to the Complaint, the BD mismarked 96% of a certain hedge fund’s short sale orders of two separate issuers’ stock, totaling more than $250 million, as “long” or “short-exempt.” This mismarking allegedly generated $1.6 million in brokerage fees to the BD. The effect of the mismarking was that the hedge fund was able to sell the securities short even though it already had a short position in the securities and did not borrow or locate additional shares to sell short.

The SEC alleges that the BD ignored multiple red flags, including:

- that the BD was aware of prior compliance concerns regarding the hedge fund;
- the hedge fund’s net short position in the securities it was selling in its brokerage account;
  statements by hedge fund employees that they did not expect to deliver the securities by the settlement date;
- the hedge fund’s failure to provide documentation showing that it owned the securities on the trade date; and
- the hedge fund’s repeated failure to deliver the securities by the settlement date.

Despite these and other red flags, the BD allegedly continued to mark the hedge fund’s orders as “long” and “short exempt” without taking reasonable steps to determine whether those order markings were correct. The BD also allegedly failed to borrow or locate the shares before effecting what were, in reality, short sales.
The BD has not made its position clear yet, but it is contesting the SEC’s Complaint. The SEC is seeking an injunction, disgorgement of the $1.6 million in fees, and civil penalties. The unmistakable message to BDs is to strictly comply with Regulation SHO and pay attention to potential red flags. The message to the public markets is that naked short selling can indeed be a practice used to drive down the price of an issuer’s stock. This will be an interesting case to watch.


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