

number of Nasdaq securities trading away from the Nasdaq market (and thus not subject to any price test), the advent of security futures trading, and decimalization have caused the Commission to reexamine short sale regulation. At a minimum, the Commission believes that adjustments to short sale regulation are required to keep pace with these market developments.

II. Naked Short Selling

A. Background

Many issuers and investors have complained about alleged "naked short selling," especially in thinly-capitalized securities trading over-the-counter.²⁷ Naked short selling is selling short without borrowing the necessary securities to make delivery, thus potentially resulting in a "fail to deliver" securities to the buyer.

Naked short selling can have a number of negative effects on the market, particularly when the fails to deliver persist for an extended period of time and result in a significantly large unfulfilled delivery obligation at the clearing agency where trades are settled.²⁸ At times, the amount of fails to deliver may be greater than the total public float. In effect the naked short seller unilaterally converts a securities contract (which should settle in three days after the trade date) into an undated futures-type contract, which the buyer might not have agreed to or that would have been priced differently. The seller's failure to deliver securities may also adversely affect certain rights of the buyer, such as the right to vote. More significantly, naked short sellers enjoy greater leverage than if they were required to borrow securities and deliver within a reasonable time period, and they may use this additional leverage to engage in trading activities that deliberately depress the price of a security.²⁹

The Commission recently brought an enforcement action against certain parties, alleging manipulative naked short selling, in a scheme sometimes

termed as a "death spiral." These schemes generally involve parties arranging financings in public companies that are unable to obtain more conventional financing in the capital markets due to their precarious financial condition. The party providing financing receives from a public company debentures that are later convertible into the stock of the issuer. The terms typically provide that the conversion ratio will be tied to a fixed value of the aggregate underlying shares (typically a discount from the market price of the security at the time of the conversion rather than a conversion price per share).³⁰ In some cases the parties providing financing have engaged in extensive naked short selling designed to lower the price of the issuer's stock, thus realizing profits when the debentures are converted to cover the short sales.³¹

Naked short selling has sparked defensive actions by some issuers designed to combat the potentially negative effects on shareholders, broker-dealers, and the clearance and settlement system.³² Some issuers have taken actions to attempt to make transfer of their securities "custody only," thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (DTC) or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities

depository.³³ Withdrawing securities from DTC or requiring custody-only transfers undermine the goal of a national clearance and settlement system, designed to reduce the physical movement of certificates in the trading markets.³⁴

B. Current Regulatory Requirements

The SROs have adopted rules generally requiring that, prior to effecting short sales, members must "locate" stock available for borrowing.³⁵ For example, NYSE Rule 440C.10 states that no NYSE member or member organization should "fail to deliver" against a short sale of a security on a national securities exchange until a diligent effort has been made by such member or member organization to borrow the necessary securities to make delivery.³⁶ An NYSE interpretation to the rule further states that member organizations effecting short sales for their own account or the accounts of customers must be in a position to complete the transaction. The interpretation states that no orders to sell short should be accepted or entered unless prior arrangements to borrow the stock have been made or other acceptable assurances that delivery can

³³ The Commission recently approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. *See* Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003) (File No. SR-DTC-2003-02).

³⁴ *See* Section 17A(e) of the Exchange Act. 15 U.S.C. 78q-1(e). The Commission noted in the order approving the DTC rule change that the use of certificates can result in significant delays and expenses in processing securities transactions and can raise safety concerns associated with lost, stolen, and forged certificates. *See, supra* n. 33.

³⁵ In 1976 the Commission proposed the adoption of Rule 10b-11. Rule 10b-11 would have prohibited any person from effecting a short sale in any equity security (*i.e.*, not just exchange-traded securities) for his own account or the account of any other person unless he, or the person for whose account the short sale is effected (i) borrowed the security, or entered into an arrangement for the borrowing of the security, or (ii) had reasonable grounds to believe that he could borrow the security so that, in either event, he would be capable of delivering the securities on the date delivery is due. Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976). In 1988, the Commission withdrew proposed Rule 10b-11, noting that since the time the rule was proposed, the NYSE and the NASD had adopted interpretations specifying that members should not accept or enter a short sale order unless prior arrangements to borrow the stock have been made, or other acceptable assurances that delivery can be made on settlement date have been obtained. The Commission also stated that it believed the general antifraud provisions of the federal securities laws were applicable to activity addressed by proposed Rule 10b-11. Securities Exchange Act Release No. 26182 (October 14, 1988), 53 FR 41206.

³⁶ *See* NYSE Rule 440C.10.

³⁰ For more information, *see* "Convertible Securities" on the Commission's Web site at www.sec.gov/answers/convertibles.htm

³¹ The Commission recently settled a case against parties relating to allegations of manipulative short selling in the stock of Sedona Corporation, a Nasdaq Small Cap company. The action alleged that the defendants engaged in massive naked short selling that flooded the market with Sedona stock, and thus depressed its price. The defendants thereby profited by subsequently exercising the conversion rights under the debenture. *See* Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (February 27, 2003); *see also* SEC v. Rhino Advisors, Inc. and Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (Southern District of New York).

³² There have been press reports concerning the actions of some issuers, and questioning whether the cause of declines in their stock prices can be attributed to naked short selling, or to fundamental problems with the company. *See, e.g.*, Carol S. Remond, *Universal Blames Shorts, But What of Dilution?*, *Dow Jones Newswires* (October 6, 2003); Rob Wherry, *Wall Street's Next Nightmare?*, *Forbes.com* (October 6, 2003); *see also* Gretchen Morgenson, *If Short Sellers Take Heat, Maybe It's Time to Bail Out*, *NY Times* (January 26, 2003) (citing a study by Professor Owen A. Lamont that analyzed returns at companies that waged public battles with short sellers, and found that their stocks lagged the market by 2.34 percent in each of the twelve months after the battles began). As a matter of practice, the Commission does not opine on the content or accuracy of such reports.

²⁷ For example, *see* comment letters from John Henry Austin (2675), Bridget Thomas (2297), James McCaffery (492), Richard Ballard (507), and Ken Klaser (596).

²⁸ "Clearing agency" is defined in Section 3(a)(23)(A) of the Exchange Act, 15 U.S.C. 78c(a)(23)(a).

²⁹ The Commission issued a prior statement cautioning broker-dealers that where the broker-dealer has sold short, but did not, for a substantial period of time, effect the offsetting purchase transactions for purpose of delivery, this could generally involve violations of the anti-fraud provisions of the Federal securities laws. *See* Securities Exchange Act Release No. 6778 (April 16, 1962).