Naked Shorting -- Why not just ignore the law?

by Margaret Jones, Wall-Street.com

Lately there's been a lot of discussion about naked shorting. Some people go as far as to call it "Stockgate". Others say it is no big deal. To understand the situation, first you have to understand the definitions of shorting and naked shorting.

The short seller sells stock that he does not own. He has borrowed it and will sooner or later need to return it. He assumes that the stock will fall in value and he'll be able to buy it back at a lower price when necessary to return it; thereby making a tidy profit. There have been market systems which did not allow shorting, citing various problems and abuses. However it is perfectly legal in our present system and many feel that shorting contributes to increased market stability.

Naked shorting, however, is not legal in our country at present. In this case, per the SEC's definition, "...the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a 'failure to deliver' or 'fail.'"

Now, there are some situations where a stock will, technically, be naked short temporarily while market makers juggle ownership and while paper certificates catch up to electronic-trading reality. This is practical and legal and is not a problem unless it is abused. However, when the stock is simply created electronically and time passes (sometimes ad infinitum) without the stock certificate being delivered, this is akin to counterfeiting!

Those journalists who say that naked shorting is not a problem point out that many of the vociferous critics are those whose companies are in trouble or whose stock has been overvalued by too-enthusiastic investors. Well, really -- what sort of company do you think will be impacted? Berkshire-Hathaway? Yes, a few CEOs use naked shorting as an excuse for poor stock performance but this does *not* mean that badly run companies and their shareholders are excluded from protection of the law. And who said that SEC regulations do not apply when trading a shaky stock?

So, two groups of people are complaining about naked shorting.

First, the companies whose stock is being naked shorted are upset. Of course they are not happy about the regular shorting that occurs but the naked shorting dilutes the stock further, drives the price down faster, and adds insult to injury.

Secondly, ordinary investors who play the game legally are rankled by the unfair advantage of those who can simply create stock out of thin air and sell it. Golly, I'd like to print some stock certificates on my inkjet and sell them but I'd land in jail faster than you can say "Martha Stewart"!

Everybody agrees that naked shorting exists. There have been blatant cases where the number of shares traded greatly exceeded the number of shares issued. However, the extent of the problem has been hard to measure. On January 3 of this year the SEC put into effect Regulation SHO, which sheds some light on the problem by mandating the publishing of a weekly "threshold list" of those stocks with a real "failure to deliver" problem. Well, the lists confirm that there are a lot of shorted stocks and they remain shorted week after week. But the lists do not reveal who is doing the shorting. And unfortunately Reg. SHO has no real teeth with which to effect a solution.

A number of media articles, columns and blogs have speculated on who is behind the naked shorting and various ways it may be accomplished. The writers often mention frustration in obtaining concrete data from the brokers, the exchanges and the DTCC. When researchers are stonewalled I get a whif of rotting fish from behind those walls.

Avoiding paranoid conspiracy theories and Chicken Little scenarios, there is still cause for concern. The rules are simply being ignored. Moreover, when there are loopholes through which illegal money can be extracted, an increasing number of leeches will gather with vacuum hoses. Do you remember the banking fiasco of the '80's? Bankers convinced the government that they were honest, responsible people and did not need so many rules. They forgot their group was upstanding because no criminal would bother with such a well-regulated industry. Once the rules were relaxed the sharks moved in and the honest bankers were no match for them.

And to make matters worse, the SEC is planning to do away with paper certificates completely. Although this is practical for the long run, we all know what happens when you go digital with a system which is already faulty on paper!

Whether or not naked shorting is at Stockgate crisis proportions right now, if we let the situation slide we will have deja vue all over again.

For links on this subject and more information than we can present, here, go to http://www.wall-street.com/nakedshorting.html.

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