Coming Up Short On Share Lending

A look at Regulation SHO and its effect on ETF share lending

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On January 3, 2005, the Securities and Exchange Commission's (SEC) Regulation SHO[2] went into effect, reflecting significant amendments to longstanding short sale regulations regarding securities trading. Many short sale regulations have never have been imposed on exchange-traded funds (ETFs), and this continues to be the case following Regulation SHO's enactment. Regulation SHO, however, imposes a new SEC "locate rule" on both stocks and ETFs, which requires short sellers to document that they can borrow ETFs before engaging in a short sale. Depending upon the ETF or stock, borrowing may be impossible or very expensive. Without the ability to borrow, market participants will be restricted from short selling, thereby raising questions about Regulation SHO's effect on marketplace liquidity and pricing efficiency for many stocks and ETFs. Added pressure is being placed on antiquated industry conventions and a structure for securities borrowing (aka stock loans) that is desperately in need of restructuring, transparency, exchange pricing efficiency and general overhaul. With the number and types of ETFs expanding rapidly, and with the continued explosion in trading volumes, an analysis of Regulation SHO's impact on both ETFs and equities is critical. This article reviews and critiques this important new regulation.

Short-Sale Primer

Regulation SHO is the latest move by the SEC to establish controls over short selling, whose real and perceived abuses the SEC has been combating for more than 70 years. In enacting the Securities Exchange Act of 1934 (the "Exchange Act"), Congress directed the SEC to "purge the market" of short selling abuses. Congress, however, wisely elected not to prohibit short selling, but rather provided the SEC with broad authority to develop regulations that would curb abuse. The SEC early on adopted Rule 10a-1 under the Exchange Act, prohibiting, with certain exceptions, exchange-listed securities from being sold short unless the price of the short sale was above the price of the immediately preceding sale (a plus tick), or at the same price if that price was higher than the price it preceded (a zero-plus tick). These provisions of SEC Rule 10a-1 are commonly referred to as the "tick test." Nasdaq securities were not subject to similar short sale regulations until the NASD, the self-regulatory organization (SRO) overseeing Nasdaq securities, adopted Rule 3350 in 1994. Rule 3350 prohibits short sales in Nasdaq securities at prices at or below the best current bid price when that bid is lower than the previous best bid price. This provision of Rule 3350 is commonly referred to as the "bid test." Both the bid test and the tick test were developed to preclude short sales in declining markets.

A brief primer on the mechanics of short sales or short selling is appropriate. A short sale is the sale of any security that the seller does not own at the time of the sale. To facilitate delivery of a security that is being sold short, the seller will borrow the security, typically from a broker-dealer. The broker-dealer holds the securities for long investors, who make their shares available for borrowing. Later, the short seller closes out, or "covers," the short position by purchasing the security in the open market—and these shares are returned to the long investor. The short seller pays the long investor for the right to borrow the shares. Such short selling has provided liquidity and pricing efficiency to the marketplace.

In contrast, short selling can also be used for manipulative purposes. An example of the improper use of short selling is what is referred to as the "bear raid." Here, a stock is aggressively sold short with the goal of driving down the price thereby creating downward momentum and negative psychology in the market. Other investors, not knowing the real reason for the price decline, may panic and sell their long positions in the stock, thus exacerbating the decline. After the raider's short selling and impact on the security has run its course, the raider will profit on his scheme by covering his short sales by buying the stock at the depressed prices.

Like stocks, ETFs are listed on an exchange or Nasdaq and can be traded intraday. Through ETFs, retail and institutional investors can buy or sell shares in the collective performance of an entire stock portfolio as a single security. Unlike stocks, however, ETFs are exempt from short-sale price test restrictions. In codifying this ETF exception in Regulation SHO, the SEC noted that ETFs' index and derivative nature make their pricing influenced by the underlying securities' net asset value and, that therefore, ETFs are less susceptible to direct manipulative schemes. The SEC stressed that an ETF's underlying securities were not exempt from short-sale price test restrictions.

Naked Short Selling

Many issuers and investors have bitterly complained to the SEC about what is referred to as "naked short selling." Naked short selling occurs when a stock or ETF is sold short, but the seller does not or cannot borrow the security sold, thereby creating what's known as a "fail-to-deliver" or a "fail." There are potential negative effects on the market from naked short selling. When fails persist and increase over a period of time, the quantity of fails in a stock may become greater than the public float, which would otherwise not be possible if selling pressure was controlled by the availability of shares to borrow. The SEC has stated that the impact of allowing a naked short to persist beyond settlement equates with converting the sale into an undated futures-type contract, which the buyer of the stock has not agreed to or, if he did, would have priced differently. The seller's failure to deliver may also impact the rights of the buyer by denying him the right to vote the stock, because the buyer is not the record holder or beneficial holder. Additionally, naked short sellers are provided additional leverage when they are not required to borrow, because they avoid the costs of borrowing. They are able to use this additional leverage to engage in higher and more aggressive levels of trading, which may be used to deliberately depress the price of an ETF or stock.

Locate And Close-Out Rules

Prior to the adoption of Regulation SHO, short sales were regulated by a combination of federal and SRO rules. Federal and SRO regulation of short sales has, and continues to be, focused upon two primary areas. One area of regulation, as described earlier, has been the mechanical restriction of short selling in declining markets by the establishment of the tick and bid tests. The other area of regulation has been the imposition of rules requiring the borrowing of securities in advance of a short sale, and the closing out of short positions in certain securities after a short sale. For example, the NASD had a separate rule, Rule 3370, requiring a short seller to "locate" or "affirmatively determine" that he could borrow a stock by the settlement date prior to engaging in a short sale of said stock. Another NASD rule, Rule 11830, established a "close-out" procedure for certain short positions in specific securities, requiring short sales to be closed out ten business days after the normal settlement date if delivery of the borrowed securities has not occurred.

SRO locate and close-out rules did not apply to ETFs, and also afforded a number of key exceptions. For example, the NASD rules contained an express exception for short sales fully hedged by certain public-company-issued warrants and rights. This so-called "bona fide hedge exception" provided important marketplace benefits in the areas of volatility, price discovery and capitalization, and, properly followed, the exception did not lead to short selling abuse since the short sale position is at least fully hedged by the long position in an offsetting convertible security.

Significantly, Regulation SHO, while co-opting the locate and close-out rules into SEC regulations, dropped all of the established NASD bona fide hedge exceptions and mandated application of the new locate rule to all ETF transactions. By not extending the same exceptions, the adoption of Regulation SHO and the repeal of certain SRO rules that Regulation SHO generally duplicates may have created significant adverse impacts on ETF trading liquidity. It may also have adversely impacted capital formation and pricing efficiency, particularly for small and emerging companies. The SEC and the securities industry must monitor these matters as closely as they are monitoring the continued need for a tick or bid test, which is the primary focus of a pilot program that started on May 2, 2005.

Understanding Regulation SHO

With the adoption of Regulation SHO, the SEC has begun to consolidate the rules related to short selling under a single regulatory framework, primarily the locate and close-out rules for now. Importantly, in adopting Regulation SHO, the SEC elected not to implement the uniform bid test that was in the SEC's original October 2003 proposal until after it receives the results from the ongoing pilot program.

Although Regulation SHO did not immediately implement a single market-wide uniform bid test, it did implement a number of new and modified regulatory requirements;

- As previously mentioned, broker-dealers must locate or borrow securities, including ETFs, prior to executing short sales for their own account or the account of a customer;
- Participants in a registered clearing agency (clearing brokers) must close-out any fail-to-deliver positions ten business days after settlement in securities that have a substantial number of fails-to-deliver and, as a result, are classified as "threshold securities."
- Broker-dealers must mark sell orders in all equity securities either "long," "short" or "short exempt."

The bill also established new definitions of ownership for certain securities for the purpose of determining delivery and close-out requirements, and eliminated the shelf offering exception contained in Rule 105 of Regulation M.

Some of the more important aspects of these regulations are discussed below.

SEC Locate Requirement

Rule 203 of Regulation SHO prohibits a broker-dealer from effecting a short sale for his own account, or the account of another, unless the broker-dealer has borrowed, agreed to borrow, or has reason to believe the security in question can be borrowed to effect delivery when due. Rule 203 contains some exceptions, the most important of which permits a broker-dealer to accept a short-sale order from another broker-dealer without satisfying the locate requirement, and to accept short sales made by a market maker provided that the market maker, specialist or options market maker in question is engaged in bona-fide market making activities. "Bona-fide market making" narrows the definition of market making to exclude market makers engaged in trading for speculative or other investment purposes. For short sales from another broker-dealer, the broker-dealer giving the order must comply with the locate requirement. Additionally, the rule requires broker-dealers to maintain and retain documentation showing their compliance with the rule.

As previously mentioned, when transforming the locate rule from an SRO rule to an SEC rule, the SEC dropped certain bona fide hedge exemptions, including one with respect to warrants and rights. The latter exemption permitted the purchase of a company's warrants offset by a short sale of the company's stock, without advance requirements to borrow the stock. The exemption was crafted to promote capital formation, particularly for small issuers, who frequently use warrants and rights in public offerings to enhance the marketability of their common stock. They also have the further strategic objective of raising additional capital in a highly efficient manner as the company grows and its stock price appreciates over time, as the exercise of a warrant or right infuses immediate capital into the company. When a warrant holder exercises warrants or rights, the company receives cash in an amount equaling the number of warrants or rights exercised times the exercise price. This is an extremely efficient way to raise capital, as secondary offering and/or private placement legal, accounting, underwriter and placement agent fees are avoided. Moreover, if warrants and rights are exercised gradually over time, they can act as "shock absorbers" to cushion the adverse supply impact that can be caused by a shelf or secondary offering of stock coming to the market all at once.

Finally, the SEC declined to include an express exception from the locate requirements for ETF transactions. In this regard, several influential SROs had advocated such an exception on the basis that ETFs have the ability to continuously create and redeem shares. The SEC had observed high levels of fails in some ETFs and decided, "[r]ather than providing a blanket exception from the requirements of Rule 203, we would prefer instead to address the treatment of ETFs through the exemptive process. … [i]n considering any exemptive request, the Commission would evaluate the cause of large fails in certain ETFs, as well as potential remedies to resolve such fails, if necessary.”

SEC Close-Out Requirement

Rule 203 requires clearing brokers to close out positions for which they are responsible in securities designated as “threshold” securities after ten consecutive days. Threshold securities are those that have experienced a substantial number of fails; specifically, five consecutive days of aggregate fails-to-deliver at a registered clearing agency of 10,000 shares or more per security, or a level of fails equal to at least one-half of one percent of the issuer’s total shares outstanding. Threshold securities will be flagged on a list prepared and distributed by SROs. If a clearing broker has a fail-to-deliver position for 13 consecutive settlement days, the clearing broker and any broker-dealer for whom it clears, including any market maker that would otherwise be able to rely on an exception, may not effect a short sale for its own account or for the account of another without complying with the locate requirement of the rule. As a former NASD rule, the close-out rule also contained bona fide hedge exemptions. As an SEC rule, those exemptions have been dropped.

Marking Sell Orders And Ownership Determination

Rule 200 requires broker-dealers to mark all sell orders in exchange-listed and over-the-counter equity securities as either “long,” “short” or “short exempt.” Directly related to marking an order is determining what defines security ownership, which is necessary to enable investors to calculate whether they are net long or net short a security when entering a sell order. The SEC has incorporated the definition of ownership previously contained in Rule 3b-3 of the Exchange Act, with some amendments. Regulation SHO also incorporates the block-positioner exception into Rule 200, because it directly impacts a broker-dealer’s calculation of its net position. Rule 200 also codifies the SEC’s prior interpretations related to the ownership of security futures products and the ownership of a security. Lastly, although broker-dealers are required to aggregate positions on a firm-wide basis when calculating their net positions, the SEC has incorporated into Regulation SHO its no-action position that permits broker-dealers to aggregate long and short positions on an independent trading desk or unit basis provided that certain conditions are met.

Pilot Program

In proposing Regulation SHO, the SEC had proposed adopting Rule 201, which would have established a uniform “bid” test that would have been applicable to all exchange-listed and many Nasdaq securities. As proposed, the bid test would require short sales to be effected at a price at least one cent above a security’s best consolidated bid at the time of execution. With the adoption of Regulation SHO, the SEC elected not to adopt Rule 201 pending the results of a pilot program to be established by the SEC. Instead, Regulation SHO provides the SEC with authority to establish a pilot program that would enable the SEC to assess whether further changes in short-sale regulations are necessary.

The pilot program commenced on May 2, 2005, and suspends for one year the application of the SEC and NASD tick and bid tests to a pilot group of 1000 stocks selected from the Russell 3000 Index. Fifty percent of those stocks are listed on the New York Stock Exchange, 47.8 percent are listed on Nasdaq and 2.2 percent are listed on the American Stock Exchange. The securities represent a cross-section of various capital weightings, trading levels and liquidity, which will allow the SEC to determine how a short-sale tick, bid or other price test effects different stocks. Originally scheduled to commence on January 3, 2005, the SEC delayed the pilot to afford the broker-dealer community additional time to prepare. The tick and bid tests will continue to apply to nonpilot group stocks; as previously noted, ETFs already are exempt from such short-sale price tests.

Impact On ETF Trading

While Regulation SHO is intended to address problems caused by chronic fails-to-deliver, in many cases it has made it more expensive for market makers to trade and hedge ETFs, which can lead to increased costs to investors looking for liquidity. Depending on the kind of ETF or the index being tracked, there may be significant costs and minimum requirements to create an ETF to address a short sale if borrowing is not possible. Since units of 50,000 shares or more are typically required to create many ETFs, a market maker who is short, say, 20,000 shares of a Regulation SHO threshold ETF, may be forced to create much earlier than desirable, often at a higher cost.

Secondly, hedging ETF positions with the underlying basket (a common practice for ETFs without highly correlated futures) is more difficult as well, due to the locate requirements for each of the stocks in the basket. In addition, the lack of transparency in the stock loan market contributes to an uneven playing field for market makers, since hard-to-borrow securities or ETFs are typically sourced from the largest prime brokers, clearing firms and broker-dealers. Therefore, the relationship of a market maker, hedge fund or broker-dealer to the source of supply becomes an even more important factor during the allocation process of scarce securities.

Concluding Remarks

The pilot study is well engineered to discern the effects of removing the tick and bid test rules from a proper sampling of stocks. Answers derived from the pilot may finally put to rest the recent debate about whether these rules continue to be a premier investor protection plan or merely passé prophylactics that do more harm than good. The pilot, however, has not been engineered to answer another lively debate: whether the SEC’s jettisoning of longstanding exceptions to the locate and close-out rules are having an adverse impact on the ETF marketplace, as well as the capital formation market, particularly for small and emerging companies. The SEC should consider broad exemptive relief for ETFs, and should look at re-establishing the bona fide hedge exception for a pilot period or for a select group of stocks, to evaluate the effect of these exceptions on capital formation. In the meantime, the SEC has reserved exemptive authority to restore exceptions from the locate and close-out rules, and has promised to do so on a case-by-case basis.

Congress and the SEC never outlawed short selling, and the outcome of the current pilot certainly is not expected to change this view. The question, however, is whether the SEC has outlawed short sales through a backdoor approach. Regulation SHO's locate and close-out rules are intent on making it impossible to engage in a short sale unless the security can effectively be borrowed. Depending upon the stock or ETF, it may be impossible or very expensive to borrow. The industry structure, mechanisms and conventions for stock borrowing or "stock loans" are in desperate need of transparency, restructuring, exchange pricing efficiency and general overhaul. Where Congress and the SEC have treated the nation's stock market as the favored child, they have paid little attention to the orphaned stock/ETF loan marketplace. Accordingly, there have been no National Market System ("NMS") and efficiency reforms in this latter area. Today's stock/ETF loan marketplace can be likened to the over-the-counter market before Nasdaq—fragmented and devoid of both keen competition and pricing efficiency. Now that Regulation SHO is live, stock/ETF loans must be addressed by the SEC and the industry immediately, in accordance with the lessons learned over the past 30 years in creating the NMS for securities.

Endnotes

1. William Uchimoto's biography can be found in the Contributors page in the front of this issue. Following are bios of the other contributors:

Michael Traynor is a founding partner at MindCapital Group, LP, a consulting and advisory firm. Previously, he was responsible for new product and business development at Susquehanna International Group, LLP, focusing on ETFs, index derivatives and other investment products. He has also worked at Vanguad implementing new fund initiatives and directing the retail and institutional brokerage strategy. Mr. Traynor earned an MBA from Villanova University and is a Chartered Financial Analyst.

James Connolly is an associate at Saul Ewing LLP, where he is a member of the Securities Transactions Practice Group, which focuses on on compliance, market structure and regulatory matters. Prior to his legal career, Connolly spent more than 20 years serving as vice president of several major investment banking firms, including J.P. Morgan & Co., Morgan Stanley & Co. and Nomura Securities International.

Joseph S. Rizzello is a founding partner of MindCapital Group, LP, a consulting and advisory firm. He has more than 30 years of experience in the financial services industry, and has served in senior positions at the Philadelphia Stock Exchange, The Vanguard Group and Pershing Trading Company, LP. Mr. Rizzello is responsible for the creation of some of the financial industry's most successful new products (THAT's quite a statement), and has designed and implemented highly successful new brokerage businesses and operating models.

2. The SHO in Regulation SHO is simply shorthand for "short selling," according to the SEC.

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10. InterSec's "EAFE Plus" investment universe measures the performance of asset managers with an EAFE benchmark but with a mandate that gives them freedom to go beyond the benchmark into non-index stocks and markets. Generally, the investment guideline for such mandates allowed "dabbling" of up to 10 percent in emerging markets.
11. "The Role of Style in International Investment" InterSec Research Corp., February, 2002.
12. There remain quite substantial performance gaps between various international growth and value indexes, although the extreme differences in methodology have been attenuated over the past few years, especially after MSCI adapted a more sophisticated, multifactor approach to defining value/growth for their flagship global indexes.
13. Steven A. Schoenfeld, "Index-Based Investment in Emerging Stock Markets," *Emerging Markets Quarterly,* Spring 1998.
14. The term "Active-Index"or Active Indexing, which is explained in detail in chapter 18 of *Active Index Investing* (Wiley Finance, 2004), refers to investment approaches which use index vehicles such as index funds, ETFs and index derivatives in "non-passive" or non-static ways, such as with active size/style/sector/country allocation or systematic rebalancing among these segments. NTGI's Emerging Market indexation estimate, includes institutional and retail emerging market index funds and ETFs available in developed markets (mainly in North America, Europe and Japan). Total estimate does not include indexed assets managed within Emerging Markets (i.e, domestic products such as ETFs, even if used by foreign investors).
15. For more on the concept of "Indexing at the Core," see Chapter 30 of *Active Index Investing* (Wiley Finance, 2004).
16. Survey of Plan Sponsor participants at the Institute for Fiduciary Education's Market Makers conference, Los Angeles, Calif., June 2005.