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Fail(ed) To Deliver: Naked Short Selling & The Erosion of Shareholder Democracy

Max Nedanovich*

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INTRODUCTION

During the late seventeenth century, stock manipulators operating on the Amsterdam Stock Exchange found that they could defeat any opposition by employing “tricks that only sly and astute speculators invent and introduce....”¹ When similar manipulation occurred on the London Stock Exchange in the early eighteenth century, the British parliament passed a law outlawing short selling in 1734; however, the law was repealed in 1860. Short selling was specifically authorized under English law in 1893.² While ordinary short selling may serve some beneficial purposes to America’s capital markets, this morally scrupulous trading

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1. John D. Finnerty, *Short Selling, Death Spiral Convertibles, and the Profitability Of Stock Manipulation* 1 (Mar. 24, 2005) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=687282 [<https://perma.cc/L99L-L6N6>].

2. *Id.*

practice gives sophisticated stock brokerages, market makers, and hedge funds an unfair advantage over individual investors. Today, individual investors may find it difficult to gather compelling evidence of short selling rule violations, given that stock brokerages and financial regulators are not forthcoming with specific information about delivery failures.³ A delivery failure, or failure-to-deliver (FTD), refers to a situation where one party in a trading contract (the buyer or the seller) does not deliver on their obligation.⁴

Unlike an ordinary short sale in which the short seller borrows the stock and then sells it, a naked short sale occurs when the short seller sells the stock first without ever borrowing the shares.⁵ Astonishingly, naked short selling is not necessarily illegal. Regulation SHO (Reg SHO), a set of rules implemented by the Securities and Exchange Commission (SEC) in 2005 to regulate short sales, allows market makers⁶ to sell securities

3. See Alexis Brown Stokes, *In Pursuit of the Naked Short*, 5 N.Y.U. J.L. & BUS. 1, 25 (2009). For example, the Depository Trust and Clearing Corporation (DTCC), which processed \$2.3 quadrillion in securities in 2020, argues that the trading data they receive is prohibited from being released to anyone other than participating firms, regulators, or self-regulatory bodies because such data could be used to manipulate the market, as well as reveal trading patterns of individual firms. See *id.* at 14; *Introducing DTCC*, DTCC, <https://www.dtcc.com/clearance-settlement-guide/#/chapterOne> [<https://perma.cc/5AJX-S2N8>] (last visited Dec. 23, 2023).

4. Gordon Scott, *What Is Failure to Deliver, and What Happens With FTDs?*, INVESTOPEDIA (updated July 13, 2022), <https://www.investopedia.com/terms/f/failuretodeliiver.asp> [<https://perma.cc/A3CU-MHJ3>]. Delivery failures occur when a buyer (the party with a long position) does not have enough money to take delivery and pay for the transaction at settlement. *Id.* A failure can also occur when the seller (the party with a short position) does not own all or any of the underlying assets required at settlement, and so cannot make the delivery. *Id.* A long position means an investor has bought and owns shares of a stock, whereas a short position means an investor owes stock to another person but has not actually bought them yet. Leslie Kramer, *Long Position vs. Short Position: What's the Difference?*, INVESTOPEDIA (updated May 19, 2023), <https://www.investopedia.com/ask/answers/100314/whats-difference-between-long-and-short-position-market.asp> [<https://perma.cc/JN6K-XYRQ>].

5. James W. Christian et. al., *Naked Short Selling: How Exposed Are Investors?*, 43 HOUS. L. REV. 1033, 1044 (2006). In an ordinary short sale, the seller sells stock they do not own (usually borrowed shares), with a belief that the price of the stock will decrease. If the price decreases, the seller can now buy the stock at the lower price and earn a profit. But if the price increases, the seller incurs a loss if he buys at the higher price.

6. A market maker is an individual participant or member firm of an exchange that provides the market with liquidity and depth while profiting from

short without arranging to borrow shares.⁷ This type of market activity results in a *temporary*, legitimate FTD that is usually corrected when the market maker covers the naked short by purchasing equivalent shares in the marketplace and delivering them to the buyer.⁸ The *prolonged* FTDs caused by manipulative naked short selling are concerning, not the temporary FTDs.⁹ These prolonged FTDs can reach such high levels that the total amount of FTDs in stock may be greater than the total available public float of the security.¹⁰

A renowned lawyer in this space, James W. Christian, analogized naked short selling to photocopying your car title 100 times and selling that car to 100 people, but you only have one car.¹¹ Christian believes manipulative naked short selling is the largest commercial fraud in U.S. history that “makes the Bernie Madoff scheme look like a gnat on an elephant’s behind.”¹² Moreover, due to lax enforcement on the part of regulatory agencies, big banks are incentivized to turn a blind eye to these

the difference in the bid-ask spread. Andrew Bloomenthal, *Market Maker Definition: What It Means and How They Make Money*, INVESTOPEDIA (updated Dec. 17, 2023), <https://www.investopedia.com/terms/m/marketmaker.asp> [<https://perma.cc/BJ9X-RPZM>].

7. S.E.C., Key Points About Regulation SHO (modified May 31, 2022), <https://www.sec.gov/investor/pubs/regsho.htm> [<https://perma.cc/8VUN-4K7W>] [hereinafter Key Points About Regulation SHO]. Market liquidity refers to the extent to which the stock market allows assets to be bought and sold at stable, transparent prices. Adam Hayes, *Understanding Liquidity and How to Measure It*, INVESTOPEDIA (updated Sept. 28, 2023), <https://www.investopedia.com/terms/l/liquidity.asp> [<https://perma.cc/LER7-66S4>].

8. Christian et. al., *supra* note 5, at 1045 (emphasis added).

9. *Id.* (citing Regulation SHO Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62972, 62975 (Nov. 6, 2003) (expressing the SEC’s concern with prolonged FTDs) (emphasis added)).

10. *See id.* The term ‘float’ refers to the regular shares a company has issued to the public that are available for investors to trade. Mary Hall, *What Exactly Is a Company’s Float?*, INVESTOPEDIA (updated July 13, 2022), <https://www.investopedia.com/ask/answers/what-is-companys-float/> [<https://perma.cc/UAS5-ZL5Q>]. A company’s float is an important number for investors because it indicates how many shares are actually available to be bought and sold by the general investing public. *Id.*

11. *See* Jaclyn Jaeger, *DOJ Probe Into Shadowy Underworld of Short Selling ‘Long Overdue’*, COMPLIANCE WEEK (Jan. 11, 2022, 12:17 PM), <https://www.complianceweek.com/risk-management/doj-probe-into-shadowy-underworld-of-short-selling-long-overdue/31237.article> [<https://perma.cc/6TRG-HSPC>].

12. *Id.*

borderline illegal tactics and be willing participants by funding shorts because of the large trading fees they collect.¹³

The Depository Trust and Clearing Corporation (DTCC), a financial self-regulatory organization (SRO),¹⁴ is a perfect example of the fox guarding the hen house. While DTCC describes itself as providing settlement services for the financial markets, it has allowed the number of prolonged FTD trades to skyrocket. Now, FTDs are so prevalent that the DTCC has created its ‘obligation warehouse,’ where FTDs essentially go to die.¹⁵ More recently, this morally hazardous market activity has been called into question by individual investors, members of Congress, and SEC regulators.¹⁶ In January 2021, more than 100 stocks, including GameStop Corp. (GME), experienced large price moves or increased

13. *Id.*

14. A financial self-regulatory organization (SRO) is an entity that has the power to create and enforce stand-alone industry and professional regulations and standards on its own. Adam Hayes, *Self-Regulatory Organization (SRO): Definition and Examples*, INVESTOPEDIA (updated June 30, 2021), <https://www.investopedia.com/terms/s/sro.asp> [<https://perma.cc/4HQ3-WWKU>]. In the case of financial SROs, such as a stock exchange, the priority is to protect investors by establishing rules, regulations, and set standards of procedures that promote ethics, equality, and professionalism. *Id.* As an example, the Financial Industry Regulatory Authority (FINRA), a private organization populated by member firms that consist of financial institutions, like broker-dealers and financial professionals, has the power to license securities dealers under the auspices of a self-regulatory framework. *Id.* The SEC oversees FINRA and acts as the first level of appeal for actions brought by FINRA. *Id.*

15. See Jaeger, *supra* note 11. Obligation Warehouse (OW) is a non-guaranteed, automated service of the National Securities Clearing Corporation (NSCC) that facilitates the matching of broker-to-broker ex-clearing trades and provides Members with the ability to track, manage and resolve their failed obligations in real-time. *Obligation Warehouse*, DEPOSITORY TRUST & CLEARING CORP., [https://www.dtcc.com/clearing-services/equities-clearing-services/ow#:~:text=Obligation%20Warehouse%20\(OW\)%20is%20a,failed%20obligations%20in%20real-time](https://www.dtcc.com/clearing-services/equities-clearing-services/ow#:~:text=Obligation%20Warehouse%20(OW)%20is%20a,failed%20obligations%20in%20real-time) (last visited Dec. 23, 2023). OW stores eligible unsettled obligations (including securities exited from NSCC’s Continuous Net Settlement (CNS) system in a central location and provides on-going maintenance and servicing of such obligations, including daily checks for CNS-eligibility and periodic updates for certain mandatory corporate actions, until such obligations are settled, cancelled, or otherwise closed in the system. *Id.*

16. See generally SEC. & EXCH. COMM’N, STAFF REPORT ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021 (Oct. 14, 2021), <https://www.sec.gov/files/staff-report-equity-options-market-struction-condition-s-early-2021.pdf> [<https://perma.cc/4XQY-RW5W>] [hereinafter STAFF REPORT].

trading volume that significantly exceeded broader market movements.¹⁷ Notably, SEC staff observed GME as the only stock having a short interest greater than its shares outstanding in January 2021,¹⁸ meaning more GME shares were shorted than actually available to trade.¹⁹

On January 28, a multitude of stock brokerage firms, including Robinhood Markets Inc. (Robinhood), Webull Financial LLC (Webull), E*Trade Financial Corp. (E-Trade), and Interactive Brokers Group Inc. (IBKR), controversially prohibited their users from purchasing shares of GME stock.²⁰ Later that day, financial regulators waived Robinhood's margin requirements as the brokerage was facing a multi-billion dollar margin call far exceeding its excess net capital.²¹ In finance, the margin is the collateral that an investor has to deposit with their broker or exchange to cover the credit risk the holder poses for the broker or the exchange.²² Since then, GME shareholders have taken unprecedented

17. *Id.* at 16.

18. *Id.* at 25. Suppose that a stock has 100 shares outstanding and one is sold short. *Id.* at 25 n.75. The stock will have a short interest ratio of 1%. *Id.* If the individual who purchases the share from the short seller then lends it out, there will be two investors with a short position based on the same share. *Id.* That is, there will be one share sold short twice, and so short interest will be 2%, even though 99 of the 100 shares are not being sold short. *Id.* If this process occurs enough times, then short interest can exceed 100%. *Id.*

19. On January 22, the price of GME rose from \$43 to \$72 (a 71% increase) in approximately three hours, and by January 27, GME closed at a high of \$347.51 per share, representing a more than 1,600% increase from its closing price on January 11. *Id.* at 18.

20. See Caitlin McCabe, *Robinhood, Other Brokerages Restrict Trading on GameStop, AMC*, WALL ST. J. (updated Jan. 28, 2021, 9:05 PM ET).

21. See Tom Osborn, *Games of hazard: NSCC's margin waiver sets bad precedent*, RISK.NET (Apr. 5, 2021), <https://www.risk.net/our-take/7817696/games-of-hazard-nscs-margin-waiver-sets-bad-precedent> [<https://perma.cc/J67L-JRJ3>]. As Robinhood's risk ramped up dramatically, its risk-based margin requirements at NSCC exceeded its excess net capital, triggering in an extra \$2.2 billion add-on, on top of its existing \$1.4 billion obligation that day. *Id.*

22. See Jason Fernando, *Margin and Margin Trading Explained Plus Advantages and Disadvantages*, INVESTOPEDIA (updated May 26, 2023), <https://www.investopedia.com/terms/m/margin.asp> [<https://perma.cc/D7M5-RUMW>]. A margin call refers specifically to a broker's demand that an investor deposit additional money or securities into the account so that the value of the investor's equity (and the account value) rises to a minimum value indicated by the maintenance requirement. James Chen, *Margin Call: What It Is and How to Meet One with Examples*, INVESTOPEDIA (updated Dec. 17, 2023), <https://www.investopedia.com/terms/m/margincall.asp> [<https://perma.cc/YTM9-YEQY>]. The maintenance requirement is the minimum equity an investor must hold in the

action against naked short sellers in utilizing the Direct Registration System,²³ which removes their shares from brokerages and allows their shares to be held in their own names rather than under something called a “street name.”²⁴ Indeed, “[h]istory might consider the GameStop and meme stock trading frenzy as a watershed moment setting forth a chain of events that shifts corporate governance forever.”²⁵

Theoretically, done legally, ordinary short selling can be beneficial to the markets by holding companies accountable when they do not properly represent their financial statements or when they fail to disclose certain other matters that could affect stock prices.²⁶ However, this is not what is happening; rather, prime brokers, hedge funds, and market makers are rigging the system to guarantee they will be able to make money off their shorts.²⁷ Without drastic regulatory reform, manipulative naked short selling will continue to cause FTD trades to remain unsettled indefinitely. This results in artificially depressed share prices, impaired market efficiency, and the creation of phantom shares—ultimately giving rise to inevitable corporate governance and shareholder voting rights issues. A voting right is the right of a shareholder of a corporation to vote on matters of corporate policy, including decisions on the makeup of the board of directors, issuing new securities, initiating corporate actions like mergers

margin account after the purchase has been made. See Julia Kagan, *Maintenance Margin: Definition and Comparison to Margin Accounts*, INVESTOPEDIA (updated Apr. 1, 2022), <https://www.investopedia.com/terms/m/maintenancemargin.asp> [<https://perma.cc/FNV9-VKA7>].

23. See *Why Do GME (GameStop) Investors Direct Register Their Shares?*, DRSGME, <https://www.drsgme.org/why-gme> [<https://perma.cc/8D5U-N24U>] (last visited Dec. 23, 2023) (explaining how individual investors are directly registering their GME shares using the DRS in order to reduce the total amount of GME shares available that naked short sellers could potentially use to artificially depress GME's stock price).

24. When shares are held in “street name” it means the brokerage holds the security on behalf of a client, so the name that appears on the stock or bond certificate is that of the broker. See Daniel Liberto, *Street Name Meaning, Overview, Advantages, and Disadvantages*, INVESTOPEDIA (updated May 12, 2023), <https://www.investopedia.com/ask/answers/185.asp>.

25. Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors* 22 NEV. L.J. 51, 52 (2021).

26. Jaeger, *supra* note 11.

27. *Id.*

or acquisitions, approving dividends, and making substantial changes in the corporation's operations.²⁸

This Article proposes an amendment to Reg SHO²⁹ to include a truly mandatory buy-in rule – forcing participants of the National Securities Clearing Corporation's (NSCC) Continuous Net Settlement (CNS) system who borrow and lend shares to close out (buy-in) long-term outstanding stock loans and FTDs *without exception*. Such action is necessary to ensure individual investors are protected from the economic harms of manipulative naked short selling and other stock manipulation techniques. This Article argues that the extension or modification of Reg SHO will reduce the occurrence of FTDs and circulation of phantom shares by ensuring prompt delivery, clearing, and settlement of stock trades, in turn leveling the playing field between individual investors and sophisticated Wall Street behemoths.

Part I of this Article provides an overview of central counterparty clearing and summarizes the mechanics of short selling and naked short selling, stock lending, as well as how the current securities trading system allows for the circulation of phantom shares throughout the markets.³⁰ Part II outlines the statutory background, regulatory framework, and federal agencies that govern short sales, stock borrowing/lending, and trade settlement.³¹ Part III proposes amending the current regulatory framework to ensure individual investors are protected from manipulation in the U.S. equities markets by imposing a mandatory buy-in rule.³²

I. OVERVIEW: CENTRAL COUNTERPARTY CLEARING, SHORT SELLING, STOCK LENDING, AND TRADE SETTLEMENT FAILURES

To grasp how the above-mentioned market activities harm individual investors and interfere with basic supply-and-demand principles, it is useful to understand how central counterparty clearing operates, the basic

28. Adam Hayes, *What Are Stockholder Voting Rights, and Who Gets a Vote?*, INVESTOPEDIA (updated Mar. 21, 2021), <https://www.investopedia.com/terms/v/votingright.asp> [<https://perma.cc/E4PZ-SSZP>]. Unlike the single-vote right that individuals commonly possess in democratic governments, the number of votes a shareholder has corresponds to the number of shares they own. *Id.* Thus, somebody owning more than 50% of a company's shares can effect a majority of the vote and is said to have a controlling interest in the firm. *Id.*

29. Regulation SHO is the SEC's regulatory framework governing short selling of securities in the stock market. *See* 17 C.F.R. § 242.200–04.

30. *See infra* Part I.

31. *See infra* Part II.

32. *See infra* Part III.

mechanics of short and naked short-selling, stock lending, and post-trade settlement, as well as how these activities can produce phantom shares giving rise to corporate governance and shareholder voting issues. From the perspective of individual investors, the lifecycle of a stock trade starts with an investor placing an order through an account they establish with a broker-dealer (for example, Robinhood).³³ The broker-dealer then routes the order for execution to a trading center, such as a national securities exchange (for example, the New York Stock Exchange), an alternative trading system (for example, a ‘dark pool’), or an off-exchange market maker (for example, Citadel Securities, LLC).³⁴ Once a trading center executes the order, the customer receives a confirmation and the trade is reported to a securities information processor that collects, consolidates, and publishes the price and volume data to market data vendors and others.³⁵ The processor will publicize the trade details (i.e., that the buyer and seller both report the same security, price, shares, and dollar amount), and the trade details are sent to the clearing broker, who affirms the trades by verifying the trade details.³⁶

The clearing broker must “settle” an equity trade within two days of the trade date (called “T+2”) by officially moving the stock from the seller’s brokerage firm’s account and moving the money from the buyer’s brokerage firm to the seller’s brokerage firm.³⁷ Clearing agencies act as the central counterparty for almost all equities and options trades in the U.S. markets by functionally serving as the buyer to every seller and the

33. STAFF REPORT, *supra* note 16, at 3.

34. *Id.* Exchanges play a central role in price discovery, as the exchange quotes (composed of interest from registered market makers and displayed orders from non-market makers) are the reference price for trades that execute off exchange. *Id.* at 10–11. Stock prices are reflected in the best priced “bid” (order to buy, e.g., at \$10) and the best priced “offer” (order to sell, e.g., at \$10.05) resting on exchange order books. *Id.* at 11 n.34. The difference between the bid and offer is known as the “bid-ask spread.” *Id.* While each exchange has its own best bid and offer, all such prices across all exchanges collectively enter into the National Best Bid and Offer (NBBO). *Id.* Less than 60% of overall equities volume is typically executed on exchanges. *Id.* at 11. Additionally, off-exchange market makers have more flexibility compared to on-exchange participants because they are not subject to the rules of the exchanges on which they quote. *Id.* For example, exchanges are required under Rule 612 of Regulation NMS to price displayed orders for stocks in penny increments, whereas wholesalers can execute more freely in sub-pennies when transacting off exchange. *Id.*

35. *Id.* at 3–4.

36. *Id.* at 4.

37. *Id.* This process is facilitated by clearing agencies registered with the SEC under the Exchange Act. *Id.*

seller to every buyer to lessen the risks associated with one counterparty to the trade failing to perform (i.e., deliver the securities or the money to pay for them).³⁸ The clearing agency for the U.S. equities markets, NSCC, a subsidiary of the DTCC, maintains a “Clearing Fund” into which its member broker-dealers contribute margin to protect NSCC from potential losses arising from a defaulted member’s portfolio until it can close out that member’s positions.³⁹ Pursuant to its existing rules, NSCC can also impose excess capital premium (ECP) charges for members who present a degree of margin exposure for their cleared positions that exceed those members’ excess net capital.⁴⁰

Settlement failures (FTDs) increase when broker-dealers, hedge funds, and off-exchange market makers engage in manipulative naked short selling.⁴¹ Ordinary short selling involves the sale of a stock that the seller does not own.⁴² In a short sale transaction, the investor will enter an order to sell the security at the current price with the understanding that the investor is to fulfill that obligation at a later date by purchasing the security at a lower price.⁴³ Short selling is typically done: (1) when a person expects a stock to decline and borrows the stock from someone else to sell it at a current high price and later “cover” the sale by purchasing it at a lower price to give back to the lender; (2) by a market maker selling to a customer that wants to buy at a time when the firm does not have

38. *Id.* at 14. There are two main types of registered clearing agencies: depositories and clearing corporations. *Id.* at 14 n.48. Depositories—namely, The Depository Trust Company—hold securities certificates for their participants, transfer positions between participants, and maintain ownership records. *Id.* Clearing corporations—such as the National Securities Clearing Corporation—often act as intermediaries in making securities settlements, comparing member transactions, clearing those trades, and preparing instructions for automated settlement of those trades. *Id.*

39. *Id.* at 15.

40. *Id.* In other words, the ECP charge operates to collect additional margin if a member’s exposure to NSCC based on its clearing activity is out of proportion to its capital. *See* Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3, To Revise the Excess Capital Premium Charge, 88 Fed. Reg. 8013 (February 7, 2023), <https://www.govinfo.gov/app/details/FR-2023-02-07/2023-02509> [<https://perma.cc/7SVX-RXHA>] [hereinafter 88 Fed. Reg. 8013].

41. However, fails to deliver can occur with short or long sales, making them an imperfect measure of naked short selling. *See* STAFF REPORT, *supra* note 16, at 29.

42. *Id.* at 24 n.74.

43. 5 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 14:159 (Dec. 2022 Update).

enough of the stock in its inventory to fill the customer's order; or (3) to hedge (i.e., reduce the economic exposure of) a long position in the same or a related security.⁴⁴ Short selling is uniquely risky because stock prices can potentially rise indefinitely, in which case the short seller can lose more than the value of their original investment.⁴⁵

Naked short selling is the equivalent of selling counterfeit shares by entering into a short sale without borrowing the necessary securities to make delivery, thus potentially resulting in an FTD to the buyer,⁴⁶ the securities equivalent of an IOU.⁴⁷ FTDs occur when a broker-dealer fails to deliver securities to the party on the other side of the transaction on the settlement date.⁴⁸ The SEC contends that naked short selling has no effect on a company's total shares outstanding (i.e., the total number of shares of stock issued by a company), and that FTDs can occur for a variety of legitimate reasons, reasoning that flexibility is necessary in order to ensure an orderly market and to facilitate liquidity.⁴⁹ Notably, in its proposal to adopt Reg SHO, the SEC noted that a naked short seller unilaterally converts a securities contract into an undated futures-type contract, which the buyer might not have agreed to or that would have been differently priced.⁵⁰ The SEC also noted that naked short selling can cause the amount of FTDs to exceed the total public float and that FTDs may also adversely affect the buyer's right to vote.⁵¹

44. STAFF REPORT, *supra* note 16, at 24 n.74.

45. *Id.* Recognizing this risk, broker-dealers typically require that the short selling investor post collateral in a margin account of at least 50% of the shorted position in addition to the cash obtained from the short sale. *Id.*

46. Hazen, *supra* note 43, at § 14:165.

47. *See* Stokes, *supra* note 3, at 6.

48. Key Points About Regulation SHO, *supra* note 7. *Settlement date* means any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency. *Id.*

49. *See* S.E.C., Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO (modified Oct. 15, 2015), <https://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> [<https://perma.cc/BE6V-DPSH>] [hereinafter Responses to Frequently Asked Questions Concerning Regulation SHO].

50. Regulation SHO Proposal, Exchange Act Release No. 48,709, 68 Fed. Reg. 62972, 62975 (Nov. 6, 2003) [hereinafter Regulation SHO Proposal].

51. *Id.* *See also* Mary Hall, *What Exactly Is a Company's Float?*, INVESTOPEDIA (updated July 13, 2022), <https://www.investopedia.com/ask/answers/what-is-companys-float/> [<https://perma.cc/UAS5-ZL5Q>]. For example, undelivered shares may not be counted toward a shareholder's overall voting stake in the company, which in turn dilutes the shareholder's voting power and diminishes influence on corporate election outcomes.

Susanne Trimbath⁵² believes that any time a share is sold short, there will ultimately be more shares in circulation than outstanding shares.⁵³ She explained that in the naked short sale, the buyer believes she own shares that, in fact, do not exist, and thus, a short sale that remains open indefinitely is essentially a fraudulent sale because the seller never intended to deliver the shares to the buyer.⁵⁴ Since there is at least some evidence suggesting that prolonged FTDs resulting from naked short selling create phantom shares, it logically follows that such activities violate basic supply-and-demand principles governing a fair market structure. For example, the circulation of phantom shares via stock lending leaves individual investors with no method of discerning whether the shares of stock they have purchased through their brokers are legitimate shares or phantom shares. These phantom shares artificially inflate the number of a company's total outstanding shares, which in turn reduces the voting power of legitimate shares.

In the context of stock lending, the short seller contacts a broker who either owns or has a client who owns the shares.⁵⁵ It is worth noting that share lending, referred to as “hypothecation,” is usually only available to customers holding their shares in a margin account.⁵⁶ For example, when individual investors open an account with Robinhood, the language contained within the customer agreement permits Robinhood to borrow or lend out any shares held in an investor's margin account without any notice.⁵⁷ The broker then lends the investor's shares to the short seller, and the borrowed shares are delivered to the buyer at settlement.⁵⁸

52. DR. SUSANNE TRIMBATH, NAKED, SHORT AND GREEDY: WALL STREET'S FAILURE TO DELIVER 2 (2020).

53. *Id.* at 19–20. Ordinary short sales will be covered with “borrowed” shares (i.e., not “naked”) and the borrowed shares leave the lender with the “extra” shares (also referred to as phantom shares). *Id.*

54. *Id.* at 19.

55. *Id.* at 20.

56. “Margin account” refers to a brokerage account in which an investor's broker-dealer lends them cash to purchase stocks or other financial products, which allows the investor to borrow funds from a broker, thus extinguishing the investor's need to put up the entire value of a trade. Cory Mitchell, *Margin Account: Definition, How It Works, and Example*, INVESTOPEDIA (updated Oct. 30, 2023), <https://www.investopedia.com/terms/m/marginaccount.asp> [<https://perma.cc/JVT3-7JLS>].

57. Robinhood Financial LLC & Robinhood Securities, LLC Customer Agreement 25 (revised Nov. 12, 2023), <https://cdn.robinhood.com/assets/robinhood/legal/Robinhood-Customer-Agreement.pdf> [<https://perma.cc/R6JU-YSRV>].

58. *See* Trimbath, *supra* note 52, at 20.

At this point, the original owner may or may not be aware that their shares have been loaned.⁵⁹ The broker will record the shares as a long position in the investor's account and as a fail to receive (FTR) on its books.⁶⁰ While the shares are out on loan, the broker will receive instructions to vote in corporate elections, but the broker cannot turn in the vote to the company and is under no obligation to tell the investor that their vote will not be counted.⁶¹

The voting rights go to the buyer who received the borrowed shares at settlement.⁶² In other words, the buyer of the phantom shares usually does not realize they are not real shares and believes she has the same voting rights as the holders of legitimate shares.⁶³ If brokers send the proxy materials to owners of phantom shares who then vote them, there could be more votes cast for directors than actually exist.⁶⁴ For example, in 2005, the Securities Transfer Association reviewed 341 votes in different shareholder meetings held during proxy season that year and uncovered an over-voting issue in every one of the 341 shareholder votes.⁶⁵ Five years after that review, STA commented that stock lending and FTDs were still causing broker-dealers to send out proxy materials and requests for voting instructions to beneficial owners who are not eligible voters at shareholder meetings.⁶⁶

Furthermore, the broker will receive a fee for lending the shares, and the broker will not share that fee with an individual investor.⁶⁷ The longer the loan remains outstanding, the more fees the broker will collect for lending shares that belong to individual investor account holders.⁶⁸ Thus, the broker has no incentive to get the shares back from the borrower – *the longer the short sale position stays open, the longer the loan is outstanding, and the more money the lending broker makes on the shares individual investors entrust to them for safekeeping.*⁶⁹ Because the

59. *Id.*

60. Finnerty, *supra* note 1, at 6 n.9.

61. Trim bath, *supra* note 52, at 20.

62. *Id.*

63. Finnerty, *supra* note 1, at 6 n.9.

64. *Id.*

65. See STA Comment Letter on SEC Concept Release on the U.S. Proxy System, Exchange Act Release No. 34-62495 (Oct. 19, 2010), at 2 (citing The Securities Transfer Association, *Street Proxy Tabulation Results*, STA Newsletter, Issue 4, 2005, at 1.).

66. See *id.*

67. See Trim bath, *supra* note 52, at 22.

68. See *id.*

69. See *id.* (emphasis added).

difference in price from short sale to buy-to-replace is taken as profit, an unscrupulous short seller has an economic incentive to sell as much as possible – to attempt to drive the price down – in order to increase profits.⁷⁰ Through naked shorting, the manipulator realizes these returns without investing any cash (provided the market price never rises above the sale price).⁷¹

A basic principle of economics is that price decreases as supply increases. In the context of stocks, this price decrease is called “dilution of share value” since the price of the shares is falling not because of the company performing badly, but because there are simply more shares in circulation (an increase in supply).⁷² The same price decrease could be seen if the company issued extra shares, but in a short sale, the money for the extra shares goes to the short seller and their broker to do with as they please rather than to the company itself to use for capital investments.⁷³ Notably, the SEC expressed concern over price dilution when it initially proposed Reg SHO, stating that 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.⁷⁴ In other words, naked short selling can be detrimental to a company’s share price when unrestrained because ignoring the regulatory requirement to borrow the shares eliminates the main quantitative constraint on the amount of short selling and intensifies the resulting downward pressure on price.⁷⁵

In a legitimate, covered short sale, the seller pays to borrow the shares, so the cost and fees associated with that loan put pressure on the seller to close out their position.⁷⁶ However, in a naked short sale, the shares are not borrowed: there is no additional expense or incentive to close out the short sale.⁷⁷ With legitimate short selling (naked or otherwise), the dilution

70. *Id.* at 23.

71. Finnerty, *supra* note 1, at 34.

72. Trim bath, *supra* note 52, at 23.

73. *Id.*

74. See Regulation SHO Proposal, *supra* note 50, at 62975.

75. See Finnerty, *supra* note 1, at 33.

76. Trim bath, *supra* note 52, at 23. The seller may incur additional costs if the share price rises against the short bet. *Id.* In that case, the short seller is subject to a “margin call” where they have to keep the cash on deposit within a certain “margin” of the original price when the shares were sold short. *Id.* This is to ensure that the short seller will have sufficient means to purchase shares to cover the short sale (i.e., repay the stock loan). *Id.*

77. *Id.*

of share value and shareholder rights will be corrected when the short positions are closed: the market price of the shares will move toward the real value of the firm as shares are borrowed to cover the short sale and ultimately as shares are purchased to repay the loan.⁷⁸

When FTDs are added to the picture, none of the short sellers have an incentive to cover because *the trade may be allowed to remain unsettled indefinitely*.⁷⁹ The phantom shares being put in circulation because of unsettled FTDs not only negatively impact individual investors, but also publicly-traded companies issuing shares, as well as governments that use debt to finance deficits, (the federal government and most states, counties, cities, school districts).⁸⁰ The economic impact on the government, in turn, affects all citizens whether or not they are investors.⁸¹ Thus, an extension or modification to the current statutory framework including a mandatory buy-in rule is necessary to address indefinitely unsettled FTDs.

II. STATUTORY BACKGROUND

A. *The Securities Exchange Act*

Congress enacted the Securities Exchange Act of 1934 to protect investors against stock price manipulation through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.⁸²

The Exchange Act serves to . . . remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to . . . insure the maintenance of fair and honest markets in such transactions.⁸³

78. *Id.*

79. *Id.* at 24 (emphasis added).

80. *See id.*

81. *Id.*

82. *See Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing S.Rep. No. 792, 73d Cong., 2d Sess., 1–5 (1934)).

83. 15 U.S.C. § 78b.

In carrying out its mission, the SEC oversees self-regulatory organizations⁸⁴ such as the national securities exchanges, the clearing agencies (NSCC and DTCC), and the national securities association (namely, the Financial Industry Regulatory Authority,⁸⁵ or “FINRA”), all of whom act as regulators of their broker-dealer members.⁸⁶ The SEC helps investors gain access to materially complete and accurate information about companies and the securities they offer and sell; oversees investment companies and investment advisers; and investigates and brings civil charges in federal district court or administrative proceedings based on violations of federal securities laws.⁸⁷ Under the Exchange Act, manipulative naked short selling is prohibited.⁸⁸

Broker-dealers generally must register with the SEC under the Exchange Act and are subject to the federal securities laws as well as rules and oversight of their respective SROs.⁸⁹ Notably, the Exchange Act authorizes the NSCC or DTCC to refuse membership to brokers that fail to deliver securities by suspending and closing a participant’s account when in default of any delivery of funds or securities to the clearing agency.⁹⁰ In general, broker-dealers that deal with the public in securities

84. Hayes, *supra* note 14. In the case of financial SROs, such as a stock exchange, the priority is to protect investors by establishing rules, regulations, and set standards of procedures that promote ethics, equality, and professionalism. *Id.*

85. The Financial Industry Regulatory Authority (FINRA) is an independent, nongovernmental organization that writes and enforces the rules governing registered brokers and broker-dealer firms in the United States. Liz Manning, *Financial Industry Regulatory Authority (FINRA) Definition*, INVESTOPEDIA (updated Aug. 4, 2023), <https://www.investopedia.com/terms/f/finra.asp> [<https://perma.cc/8HFP-DR74>].

86. STAFF REPORT, *supra* note 16, at 4.

87. *Id.* at 4 n.6.

88. See 15 U.S.C. § 78i(d) “It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange to effect, alone or with one or more other persons, a manipulative short sale of any security. The Commission shall issue such other rules as are necessary or appropriate to ensure that the appropriate enforcement options and remedies are available for violations of this subsection in the public interest or for the protection of investors.”

89. STAFF REPORT, *supra* note 16, at 5.

90. See 15 U.S.C. § 78q-1(b)(5)(C)(ii). However, the NSCC or DTCC refusing membership for brokers who fail to deliver is a rare occurrence and highlights a prevailing enforcement issue with financial SROs and potential conflicts of interest.

must become members of FINRA⁹¹ and are subject to certain conduct requirements including the duty of “best execution,” which generally requires a broker-dealer to execute customer orders at the most favorable terms reasonably available under the circumstances.⁹²

B. Regulation SHO

The SEC has plenary authority under Section 10(a) of the Exchange Act to regulate short sales of securities registered on a national securities exchange as necessary or appropriate in the public interest or for the protection of investors.⁹³ Regulation SHO (Reg SHO) was adopted to update short sale regulation in light of numerous market developments (since short sale regulation was first adopted in 1938), as well as to address concerns regarding persistent FTDs and potentially abusive naked short selling.⁹⁴ In order to promote market stability and preserve investor confidence, the SEC has amended Reg SHO several times since 2005 to eliminate certain exceptions and strengthen certain requirements.⁹⁵ The SEC enacted such amendments in part because the SEC was concerned about the negative effect that FTDs may have on the markets and shareholders.⁹⁶ For example, prolonged FTDs may deprive shareholders of the benefits of ownership, such as voting; and sellers that fail to deliver securities on the settlement date may attempt to use this additional freedom to engage in trading activities to improperly depress the price of a security.⁹⁷

Reg SHO imposes four general requirements with respect to short sales of equity securities: (1) a marking requirement (Rule 200); (2) a short sale price test circuit breaker (Rule 201); (3) a locate requirement (Rule

91. See, e.g., § 15(b)(8) of the Exchange Act, 15 U.S.C. § 79o(b)(8) (concerning membership in a registered securities association).

92. See “FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow,” FINRA Regulatory Notice 21–23 (June 23, 2021) (stating that “firms that provide payment for order flow for the opportunity to internalize customer orders cannot allow such payments to interfere with their best execution obligations[,]” and that “inducements such as payment for order flow and internalization may not be taken into account in analyzing market quality.”).

93. Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 50.

94. Key Points About Regulation SHO, *supra* note 7.

95. *Id.*

96. Responses to Frequently Asked Questions Concerning Regulation SHO, *supra* note 50.

97. See *id.*

203); and (4) a close-out requirement (Rule 204).⁹⁸ Rule 200 requires that orders placed with broker-dealers be marked “long,” “short,” or “short exempt.”⁹⁹ Rule 201 requires that trading centers establish and enforce policies reasonably designed to prevent the execution or display of a short sale at an impermissible price.¹⁰⁰ Rules 203 and 204 are perhaps the most important and relevant rules this Article addresses. Rule 203 governs the requirements imposed on broker-dealers who borrow stock to satisfy outstanding short-sale delivery obligations, and Rule 204 governs the close-out (buy-in) process.¹⁰¹

Rule 203 requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed (located) so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security.¹⁰² The security must be located and documented prior to effecting the short sale.¹⁰³ Rule 203(b)(3) requires that participants of a registered clearing agency *must immediately purchase shares to close out* failures to deliver in securities with large and persistent failures to deliver, referred to as “threshold securities,” if the FTDs persist for 13 consecutive settlement days.¹⁰⁴ Generally, through Rule 204 compliance, a participant’s FTD position will not remain for 13 consecutive settlement days. If a participant has an FTD position in a threshold security for 13 consecutive days, the requirement to close out such position under Rule 203(b)(3) remains in effect.¹⁰⁵

Rule 204 requires brokers and dealers that are participants of a registered clearing agency to take action to close out failure to deliver

98. *Id.*

99. 17 C.F.R. § 242.200(g). Market makers and hedge funds abuse this rule, and the penalties and civil fines are meaningless to enforce the purpose of this marking rule. Strategically mis-marking a short as a long is an effective naked shorting technique that is a violation of Rule 200.

100. 17 C.F.R. § 242.201.

101. *See* 17 C.F.R. §§ 242.203–04.

102. *See* 17 C.F.R. § 242.203(b)(1)–(2). This rule is ineffective in enforcing short sales that should not occur do not. Broker-dealers can almost always have confidence they can locate a borrow somewhere or somehow. Moreover, this vague standard makes meaningful enforcement nearly impossible; the “reasonable grounds” condition is easy to meet and difficult for a prosecutor to refute. John W. Welborn, *The Phantom Shares Menace*, 31 REGULATION 52, 57 (2008).

103. *See* 17 C.F.R. § 242.203(b)(1)–(2).

104. *See id.* at § 242.203(b)(3) (emphasis added); *see also* Key Points About Regulation SHO, *supra* note 7.

105. *See id.*

positions.¹⁰⁶ That is, the participant must close out an FTD for a short sale transaction by no later than the beginning of regular trading hours on the settlement day following the settlement date.¹⁰⁷ If a participant can demonstrate that an FTD resulted from a long sale or is attributable to bona fide market-making activities, the participant must close out the FTD by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date.¹⁰⁸ If the position is not closed out, the broker-dealer may not effect further short sales in that security without borrowing or entering into a bona fide agreement to borrow the security until the broker-dealer purchases shares to close out the position, and the purchase clears and settles.¹⁰⁹

At first glance, Rules 203 and 204 imply that there is a mandatory buy-in requirement contained within the regulatory framework, but this is not the case. On its face, Rule 203 should reduce FTDs, but it may not eliminate them entirely because it still provides a market-maker exception and does not control short positions that occur ‘ex-clearing,’ i.e., outside the NSCC.¹¹⁰ Rule 204 is completely ineffective because close out does not guarantee purchase security. The broker-dealer can satisfy a close-out with cyclical borrowing, simply kicking the can down the road.¹¹¹ Loopholes in Rules 203 and 204 allow endless naked short selling and prolonged FTDs and, consequently, broker-dealers are not forced to purchase securities in order to satisfy delivery obligations.¹¹²

106. *See id.* at § 242.204. Closing out requires the broker or dealer to purchase or borrow securities of like kind and quantity. Key Points About Regulation SHO, *supra* note 7.

107. *See* 17 C.F.R. § 242.204; *see also* Key Points About Regulation SHO, *supra* note 7.

108. *Id.* This is known as the “market-maker” exception.

109. *Id.* This is known as the “pre-borrowing” requirement.

110. *See* Finnerty, *supra* note 1, at 34 n.50.

111. For example, on day 1, Short Seller A would be forced to close out X number of shares. Short Seller B sells/lends X number of shares to Short Seller A and fails to deliver, extending the close out due date a couple of days (T+2). Once Short Seller B is due for close out, Short Seller A sells/lends X number of shares to Short Seller B, and fails to deliver. And so on, and so on. The SEC’s FTD data only shows the aggregate amount, but not which short seller FTD, nor how much, at what time, and especially not when what is due for close out. *See Fails-to-Deliver Data*, S.E.C. (modified Dec. 30, 2023), <https://www.sec.gov/data/foiadocsfailsdatahtm> [<https://perma.cc/6K23-26XE>].

112. There is evidence that broker-dealers rarely request buy-ins and that market-makers strategically fail to deliver shares whose borrowing costs are high in order to avoid paying the rebate spread. *See* Finnerty, *supra* note 2, at 33–34.

C. Continuous Net Settlement and Clearing

Section 17A(e) of the Exchange Act directs the SEC to use its authority to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities.¹¹³ Section 17A(b)(3)(F) of the Exchange Act requires the rules of a clearing agency be designed to promote prompt and accurate settlement of securities transactions.¹¹⁴ In 1974, the clearing organizations for the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD) (now FINRA),¹¹⁵ adopted a Continuous Net Settlement (CNS) system for clearing stock transactions effected by their members.¹¹⁶ In 1977, the SEC authorized consolidating those three clearing organizations into the National Securities Clearing Corporation (NSCC).¹¹⁷

The CNS system is a settlement process in which the NSCC is the counterparty for members (brokers and market makers) whose positions are netted into a single long position and a single short position at the end of the day, thereby eliminating counterparty risk.¹¹⁸ Naked short selling could not occur, or at least not persist, if the stock purchaser or the clearing house *insisted* on taking delivery of the shares.¹¹⁹ Most stock trades clear through the NSCC, with the DTC serving as the clearing house.¹²⁰ Both the NSCC and the DTC are subsidiaries of DTCC.¹²¹ The NSCC works in

113. See 15 U.S.C. § 78q-1(e).

114. See *id.* at § 78q-1(b)(3)(F).

115. See Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change To Amend the By-Laws of NASD To Implement Governance and Related Changes To Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., 72 Fed. Reg. 42169 (Aug. 1, 2007).

116. See Exchange Act Release No. 11555, 7 SEC Docket 467 (July 28, 1975).

117. See Exchange Act Release No. 13163, 11 SEC Docket 1448 (Jan. 13, 1977).

118. See Will Kenton, *Continuous Net Settlement (CNS): Overview, Advantages, Example*, INVESTOPEDIA (updated Apr. 18, 2022), [https://www.investopedia.com/terms/c/cns.asp#:~:text=Continuous%20Net%20Settlement%20\(CNS\)%20is,money%20balances%20orderly%20and%20efficient](https://www.investopedia.com/terms/c/cns.asp#:~:text=Continuous%20Net%20Settlement%20(CNS)%20is,money%20balances%20orderly%20and%20efficient) [https://perma.cc/NLF7-9YF8].

119. Finnerty, *supra* note 1, at 34 (emphasis added).

120. *Id.*

121. See *id.* Another subsidiary of DTCC, the Depository Trust Company (DTC), is the world's largest securities depository and serves as the clearing house for most trades of registered shares in the United States. *Id.* DTC was formed to

conjunction with the DTC to provide centralized clearance and settlement for broker-to-broker stock trades in the United States through the CNS system.¹²² During the trading day, the CNS continually nets all trades by its members in each security.¹²³ Additionally, each member's previous trading day's closing net long or short position is continually updated with that day's purchases and sales.¹²⁴

Since the adoption of Reg SHO and the CNS system, regulators have had ample time to remedy prolonged FTDs but have fallen short of enacting a true mandatory buy-in rule, as FTDs are seemingly satisfied with continuous borrowing and lending of shares. For example, in 2005, the NSCC approached the SEC for rulemaking to protect its members (broker-dealers) against a mandatory buy-in requirement.¹²⁵ Instead of mandating guaranteed delivery, the SEC approved the rule, which provides discretion to the NSCC, stating in pertinent part:

[A]n NSCC member which has a long position in CNS at the end of any day (i.e., a fail to receive) and which is in receipt of a buy-in notice for securities of the same CUSIP that was initiated outside of the CNS System may submit a 'Buy-In Retransmittal Notice' to NSCC. If the Buy-In Position (or a portion thereof) that is the subject of the Buy-In Retransmittal Notice is not satisfied by 3:00 p.m. on N+1, the buy-in can be executed.¹²⁶

The rule's text stating that members "may submit" a buy-in notice is indicative of a discretionary rule, and moreover, does not mandate the

eliminate the need for physical delivery of securities to settle trades. *Id.* DTC retains physical custody of stock certificates on behalf of its members, which include all the major broker-dealers. *Id.* Stock certificates for registered securities are deposited with the DTC and are held in the name of Cede & Co., DTC's nominee name. *Id.* DTC records the transfer of securities by book entry; electronically it debits the seller's DTC account and credits the buyer's DTC account. *Id.* at 34–35. No physical transfer ever occurs. *Id.* at 35.

122. *Id.* at 35. While physical payment and stock transfer occur within the DTC, it is the NSCC that provides final settlement instructions to customers and participant firms. Welborn, *supra* note 102, at 54.

123. Finnerty, *supra* note 1, at 35.

124. *Id.*

125. See Notice of Filing of Proposed Rule Change Relating To Buy-Ins in Its Continuous Net Settlement System, S.E.C., Exchange Act Release No. 34-52976 (Dec. 19, 2005), at 1.

126. See Order Approving Proposed Rule Change Relating To Buy-Ins in Its Continuous Net Settlement System, S.E.C., Exchange Act Release No. 34-53528 (Mar. 21, 2006), at 3.

NSSC or its members to actually *initiate* the buy-in process, as discussed below.

Irving Pollack, a former SEC staff member and commissioner, submitted his report (the Pollack Report) on short-selling transactions to the NASD in 1986.¹²⁷ The Pollack Report found that even concentrated short-selling activity in one stock was not necessarily illegal or repugnant.¹²⁸ However, the Pollack Report did object to the ability of short sellers to carry a short position *indefinitely* under the CNS system *without* being required to *actually deliver stock* until it determined that it was *in its best interest* to do so.¹²⁹ Of the settlement regime, Pollack cautioned that it “effectively insulates the clearing corporation and brokers from fails to deliver and receive by contra-parties; but it permits fails to deliver and receive to develop without an automatic check.”¹³⁰

As mentioned in the Pollack Report, under the CNS system a naked short seller usually has little incentive to go out and buy or borrow the stock sold short for delivery.¹³¹ If the short seller buys the stock for delivery, the short seller is no longer in a position to profit from further price declines in the security.¹³² On the other side of the transaction, the broker-dealer who either has purchased the securities sold short or is acting as an agent for the purchaser also has little incentive to demand delivery of the shares.¹³³ If delivery is demanded, and a buy-in transaction is required, it is the purchasing broker-dealer (or the broker-dealer acting as agent for the purchaser) that is required to effect the buy-in.¹³⁴ Moreover, a purchaser affecting a buy-in might actually end up buying the shares

127. See Irving M. Pollack, SHORT-SALE REGULATION OF NASDAQ SECURITIES 64 (July 1986) [hereinafter POLLACK REPORT]. Pollack concluded that short selling was a vital source of liquidity and a valuable mechanism for efficient price discovery. Welborn, *supra* note 102. He added, however, that without proper institutions to guarantee prompt clearance and settlement of short sales, short selling was open to abuse. *Id.*

128. David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255, 1277 (1990).

129. *Id.* (emphasis added).

130. Welborn, *supra* note 102. Additionally, Pollack warned that while the evidence does not suggest that delivery problems exist in many securities, the fact that there is no automatic mechanism preventing the substantial buildup of short positions at the clearing corporation and of fails to receive in brokerage firms carries the potential for serious problems. See *id.*

131. See Worley, *supra* note 128, at 1279.

132. *Id.*

133. *Id.*

134. *Id.*

from the original short seller or another short seller who was merely *rolling over* a short position.¹³⁵

In light of these findings, the Pollack Report recommended that a mandatory buy-in requirement be adopted for guaranteed delivery.¹³⁶ The Pollack Report pointed out that a mandatory buy-in requirement would force short sellers to deliver or cover, and guaranteed delivery would prevent short sellers from again selling short to the brokers executing the buy-in.¹³⁷ In response, the SEC approved NASD's rule proposal for a mandatory buy-in requirement, however, it merely mandated buy-ins only for public customer accounts,¹³⁸ meaning the requirement does not apply to purchases made by a broker-dealer for its own account or for the account of another broker-dealer.¹³⁹ Furthermore, the rule does not require a customer's broker to *initiate* the buy-in process.¹⁴⁰ Rather, it only requires the broker to *affect* a buy-in if its own buy-in notice goes unheeded.¹⁴¹

Today, there is no rule mandating a broker-dealer buy-in for purchases made by its own account or for the account of another broker-dealer; therefore, nothing is requiring these borrowers to initiate the buy-in process to close out prolonged FTD positions. DTCC and its subsidiaries claim that they have no legal authority to regulate or stop the practice of lending stock without a close-out requirement (i.e. no due date for the loans) and no power to force their member firms to close out or resolve FTDs.¹⁴² However, since the NSCC makes itself the counterparty to both sides of every transaction involving a FTD, the DTCC indeed has the same power and authority to compel a resolution or close out as would an original customer who does not receive the shares he pays for.¹⁴³ Thus, it

135. *See id.* "Rolling over" a short position refers to the practice of a short seller closing out an existing short position by buying back the shares, but then immediately opening a new short position by short selling more of the same stock. This allows the short seller to maintain their overall short exposure without delivering the shares back to the lender to close out the original short position. By continually rolling over their short positions in this way, short sellers can avoid delivering shares back to lenders for extended periods of time.

136. *Id.* at 1279–80.

137. *See* POLLACK REPORT, *supra* note 127, at 68–69.

138. *See* Exchange Act Release No. 26694, 43 SEC Docket 931 (Apr. 4, 1989).

139. *See* Worley, *supra* note 128, at 1282.

140. *See id.* (emphasis in original).

141. *Id.*

142. *See* Trimboth, *supra* note 52, at 12.

143. *See id.*

is more correct to say that DTCC *chooses* not to resolve or buy-in trades where the seller fails to deliver the shares they sold.¹⁴⁴

III. PROPOSAL TO AMEND REGULATION SHO BY ADDING A MANDATORY BUY-IN RULE

The current regulatory framework strips individual investors of their shareholder voting rights, thereby obstructing their ability to exercise control over companies.¹⁴⁵ The failure to enforce the close out of stock lending and to enforce final settlement is generating phantom shares, which, through the basic laws of supply and demand, depresses stock prices by increasing the supply of shares.¹⁴⁶ Moreover, lax regulation harms businesses seeking access to the brightest capital markets in the world by allowing unsettled trades to be covered with borrowed shares that are then re-sold and re-loaned until the number of phantom shares in circulation surpasses the number allowed by a company's articles of incorporation.¹⁴⁷ In light of this regulatory crisis, this Article proposes amending Regulation SHO by adding a mandatory buy-in.

This requirement would force all CNS system participants who borrow shares to *initiate* the close out (buy-in) process for long-term outstanding stock loans and prolonged FTDs. A mandatory buy-in would reflect supply and demand dynamics more accurately. Moreover, it would serve to ensure individual investors and the companies they support are able to participate in a marketplace free of manipulation by sophisticated, deep-pocketed stock brokerages and market makers.

Mandatory buy-in rules are not unheard of across the global securities markets, and thus, there is no practical reason why such a rule should not or could not be implemented in the U.S. equities markets. For example, the Singapore Exchange (SGX) implements mandatory buy-ins itself as an exchange, and under its rules, unless there are sufficient securities and cash positions, settlement will not occur.¹⁴⁸ Furthermore, unsettled trades are priced at two minimum bids above the previous day's closing price.¹⁴⁹ SGX has the absolute discretion to raise the price bid by two minimum

144. *Id.* It is worth noting that the DTCC and its subsidiaries can and do change their own rules and procedures after notice to the public and approval by the SEC. See 15 U.S.C. § 78s(b)(1)–(2).

145. See Trimboth, *supra* note 52, at 13.

146. *Id.*

147. *Id.*

148. See *Clearing Information*, SGX, <https://www.sgx.com/securities/clearing-information> [<https://perma.cc/XP9Y-QVZF>] (last visited Mar. 12, 2024).

149. *Id.*

bids at any time throughout the buy-in until the securities are bought.¹⁵⁰ Importantly, SGX imposes penalty fees of SGD 1,000 or 5% of the value of the contract, whichever is higher.¹⁵¹ If the securities are to settle a novated contract arising from a trade on the buy-in market, a minimum of SGD 5,000 or 10% of the contract value (whichever is higher) will be levied.¹⁵² After completion of the buy-in, SGX publishes the list of securities bought-in (which includes individual counters).¹⁵³

The Singapore Exchange's settlement regime is beneficial to individual investors because the mandatory buy-in rule and the penalties imposed on participants who fail to deliver serve as a deterrent to manipulative conduct. As a result, Singapore is one of the few Asian countries with an "AAA" rating.¹⁵⁴ The discretion given to SGX to initiate a buy-in is the focal point of the rule, as it permits the exchange to force its participants to resolve unsettled FTD trades, whereas Reg SHO does not allow the same for exchanges such as NYSE or Nasdaq. Moreover, the publication of the securities bought-in reveals which brokers, hedge funds, and market makers are consistently failing to deliver, further discouraging manipulative conduct by participants. Additionally, the settlement risk in Singapore is minimal as most trades are settled internally (not ex-clearing) and cash settlement takes place simultaneously.¹⁵⁵

CONCLUSION

A mandatory buy-in rule is absolutely viable in the U.S. and should be integrated into Reg SHO to increase market transparency and fairness.

150. *Id.* See also SGX CDP Rule 6.7.2, SGX GROUP, <https://rulebook.sgx.com/rulebook/672-buying> [<https://perma.cc/P6F5-CG4T>] (last visited Mar. 12, 2024).

151. *Market Profiles*, ROYAL BANK OF CANADA INVESTOR SERVICES, <https://www.rbcits.com/en/gmi/global-custody/market-profiles/market.page?dcr=templatedata/globalcustody/marketprofiles/data/singapore> [<https://perma.cc/53JD-NEQH>] (last visited Mar. 12, 2024). As of Dec. 24, 2023, 1,000 SGD is equal to \$755.37 (converted using Google conversion tool).

152. *Id.*

153. *Id.*

154. See *Why List on SGX*, SGX, <https://www.sgx.com/securities/why-list-sgx#A%20Trusted%20Regulatory%20Regime> [<https://perma.cc/2V4X-VTD6>] (last visited Mar. 12, 2024).

155. *Market Profiles*, *supra* note 151. *Settlement risk* refers to the possibility that one or more parties will fail to deliver on the terms of a contract at the agreed-upon time. See Julia Kagan, *Settlement Risk: Definition, 2 Main Types, and How To Reduce It*, INVESTOPEDIA (updated May 25, 2022), <https://www.investopedia.com/terms/s/settlementrisk.asp> [<https://perma.cc/JBP7-5NJQ>].

While SEC Chairman Gary Gensler seems to be ruffling some feathers in adopting new rules¹⁵⁶ related to short selling and securities lending,¹⁵⁷ a mandatory buy-in rule is nevertheless necessary to ensure individual investors have access to a fair and transparent marketplace free of manipulation, rather than the current rigged system. However, regulatory reform takes time, and Gensler seems to be ushering in an era of increased regulation of the American equities market. Thus, although recent SEC rule proposals have not included a mandatory buy-in rule, there is at least some hope that such a rule could be enacted in the near future.

For example, in October 2023, the SEC adopted new Rule 13f-2 to provide greater transparency to investors and other market participants by increasing the public availability of short sale related data.¹⁵⁸ Rule 13f-2 requires institutional investment managers (including hedge funds) that meet or exceed certain thresholds to report on Form SHO specified short position data and short activity data for equity securities.¹⁵⁹ Likewise, the SEC also adopted an amendment to the National Market System (NMS) Plan governing the consolidated audit trail (CAT), requiring each CAT reporting firm that is reporting short sales to indicate when it is asserting use of the bona fide market making exception in Rule 203(b)(2)(iii) of Reg SHO.¹⁶⁰ These recent reforms indicate that Gensler's SEC is ready to level the playing field between Wall Street behemoths and individual investors.

Unless action is taken to reform regulations governing the settlement system, unsettled trades will multiply.¹⁶¹ As they do, voting will be further corrupted, companies will be destroyed, and the pre-conditions for a systemic event will be fed.¹⁶² Thus, to deter naked short sellers from using prolonged FTDs to manipulate the market, the SEC should not only enact a mandatory buy-in rule within Reg SHO, but also implement more meaningful penalties for violations of existing Regulation SHO requirements. However, whether the SEC will close the loopholes giving vague license to a highly profitable crime is yet to be determined.¹⁶³

156. Short Position and Short Activity Reporting by Institutional Investment Managers, 88 Fed. Reg. 75100 (Nov. 1, 2023) [hereinafter 88 Fed. Reg. 75100].

157. See Paul Kiernan, *Legal Hurdles Stack Up for Gensler's SEC*, WALL ST. J. (Dec. 12, 2023, 12:39 PM), <https://www.wsj.com/finance/regulation/legal-hurdles-stack-up-for-genslers-sec-355efdb3>.

158. 88 Fed. Reg. 75100, *supra* note 156.

159. See *id.*

160. *Id.*

161. Welborn, *supra* note 102.

162. *Id.*

163. *Id.*