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Tracking the Numbers / Street Sleuth: Despite SEC Rules, a Small Amount Of Naked Shorting Appears to Persist

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A LITTLE MORE than a year ago, new federal rules changed the way short sellers go about the timeless but much-maligned business of betting on stock declines.

The Securities and Exchange Commission's primary goal with those rules, known collectively as Reg SHO (for short sales), was to clean up abusive practices by some short sellers who trade shares they never actually hold -- a tactic dubbed "naked shorting." Market watchers say the rules have helped combat the practice, but a small band of short sellers persist in flouting the rules in their trading of a few hundred or so stocks.

Shorts, as they are referred to colloquially, have continued to crop up in the news, often in a negative light: Several small companies are waging legal and public-relations battles against some of these bearish traders, and in at least one case the complaining has led to a SEC investigation. Regulators are considering more rules, and NYSE Group Inc.'s New York Stock Exchange plans to fine and censure several brokerage firms for their apparent mishandling of some short sales.

Rule makers are "making some good strides," says Bill Rhodes, who has studied heavily shorted stocks at the research firm he runs, Rhodes Analytics. "But they're still trying to get their hands around some of the issues."

Short sellers pay a fee to a brokerage or other trading firms to borrow shares, then sell them. The goal is to buy the same stock later in the open market once the price has dropped. At that point, short sellers would return the borrowed shares and pocket the difference between their buying and selling prices as profit.

The technique has been used for generations and is popular again amid market uncertainty: "Short interest" at the NYSE -- the number of shares accounted for by shorts who have yet to close out those trades -- stands at 8.2 billion, down 6% from the record last November but double the number in late 1999, near the stock market's peak.

Short sellers can keep overvalued stocks in check, and many professional short sellers, including hedge funds that specialize in the trade, are known for the quality of their research. Some have gotten credit for sounding early warnings on corporate disasters in the making, like Enron Corp.

Some executives at public companies, however, allege that shorts stretch the truth to crush a company's stock. Even more unscrupulous, critics contend, is naked shorting, or shorting a stock without actually borrowing it to deliver to the buyer, usually in violation of securities law.

The SEC's answer to the issue -- Reg SHO -- went into effect in January 2005. Rules from other regulators already in place at the time had not "fully addressed the problems of naked short selling," the SEC said.

Reg SHO holds brokerage firms responsible for locating shares for a short trader rather than just processing the trade on faith that the shares can be delivered to the buyer. The broker either takes the stock out of its own inventory or makes a reasonable assumption it can get the stock elsewhere for delivery to the brokerage firm acting on behalf of the stock buyer.

The SEC regulation also established "threshold" lists, published daily by stock-market operators like the Big Board and Nasdaq Stock Market Inc., to identify stocks that appear to have slipped through the initial safeguard. These stocks are the ones thought to be the target of naked shorts. If at least 10,000 shares and 0.5% of a company's shares outstanding fail to be delivered to buyers for five consecutive business days, that company's stock is added to a threshold list. At that point, any broker that has new short sales that have failed to deliver have to close out the failed trade after 13 business days.

The month Reg SHO was implemented, 371 securities were on the threshold list, according to data provided by Merrill Lynch. Since then, the number has fallen 16%. The decline indicates the rule is having an effect, but skeptics say the presence of more than 300 companies on the list shows more work needs to be done. There are more than 6,000 stocks listed on all the markets that publish threshold lists, many of them small.

At the NYSE, the number of companies on the list has decreased more sharply, to 49 from 78; many are the baskets of stocks or other securities known as exchange-traded funds, says Anand Ramtahal, a vice president at the NYSE's regulation unit.

While some companies come and go from the threshold list, others are "perpetually" on it, says James Angel, associate

professor of finance at Georgetown University. "This raises serious questions," he says, about how trades are handled.

The SEC is weighing whether to expand Reg SHO rules to force brokers to cancel some trades on threshold-listed stocks that were made even before the stocks went on the list.

Such a change could affect several heavily shorted stocks like online retailer Overstock.com Inc., Martha Stewart Living Omnimedia Inc. and Krispy Kreme Doughnuts Inc. that have been on threshold lists for several months.

Authorities seem certain that at least some improper trading has continued, though many violations appear to be technical glitches. The National Association of Securities Dealers says it has more investigations of improper naked short sales than in the past, says Steve Luparello, head of the NASD's market regulation. The NYSE's cases against the brokerage firms, expected to be announced in coming weeks, concern firms that allegedly mislabeled short sales on regulatory forms or failed to monitor or verify whether short-selling customers were actually borrowing securities.

Not all the new rules on shorting make it harder to employ the trading strategy. For example, a year ago the SEC also put in place a pilot program eliminating "price tests" on some stocks. The commission soon will decide the fate of those tests, which include the NYSE's "up-tick rule." That stricture prevents a stock from being shorted in a down market, specifically if the current bid is below the stock's previously traded price. Proponents of such rules say they limit runaway market dives. Economists complain the price tests distort the market.

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