

REGULATING SHORT SELLING ACTIVITIES

Regulation of Short Selling Transactions

A short sale describes a transaction in which an investor sells borrowed stock with the intention of buying it back later at a lower price. If the stock price drops, the investor buys the stock at a lower price and makes a profit. If the price of the stock rises, the investor incurs a loss. Short selling activities are federally regulated through a comprehensive set of regulations and reporting requirements designed to prevent abusive practices. The SEC regulates short sales primarily through Regulation SHO, which became effective in 2005 and was designed to modernize short selling regulations to address concerns associated with failures to deliver within the standard settlement period. The SEC further amended Regulation SHO in 2008 and 2010 to strengthen requirements and eliminate certain exceptions.

Under Regulation SHO a broker may not accept a short sale order from a customer to effect a short sale for its own account, unless the broker has:

- either borrowed or made *bona fide* arrangements to borrow the security;
- reasonable grounds to believe the borrower can locate, borrow, and deliver the security to the buyer by the date delivery is due ([Rule 203\(b\)\(1\)](#) and [\(2\)](#)); and
- documented compliance with these requirements.

Regulation SHO also includes provisions designed to protect against potentially harmful short selling practices. [Rule 204](#) reduces the market impact of fails to deliver and limits potential "naked" short selling abuses by requiring brokers-dealers to track all unsettled trades and then borrow or buy-in sufficient securities to close-out those failures at the beginning of the trading day following the settlement date. [Rule 201](#), the "alternative uptick rule," prevents the use of short selling to artificially force down the price of a security. It is triggered when a stock's price decreases by at least 10 percent in one day, and requires short-sale orders to include a price above the current bid, which prevents sellers from accelerating the downward decline of a security during periods of significant downward volatility.

In 2008, the SEC supplemented the Regulation SHO framework with an antifraud rule under the Securities Exchange Act of 1934 ("Exchange Act"). [Rule 10b-21](#) is the SEC's "naked" short selling antifraud rule and generally prohibits misrepresentations regarding a party's intent and ability to deliver securities in compliance with the settlement requirements of Regulation SHO.

In addition to Regulation SHO, parties engaged in short selling are subject to the broad antifraud and antimanipulation provisions of federal securities law. Section 10(b) of the Exchange Act is the primary antifraud statutory provision. [Sections 9\(b\)](#) and [10\(a\)\(1\)](#) of the Exchange Act specifically give the SEC authority to regulate short sales. [Rule 10b-5](#) gives the SEC broad authority to address the unlawful issuance of materially misleading statements or use of manipulative and deceptive devices in securities trading, including with respect to short sales. Rule 10b-5 also provides a private right of action for investors.

The CFTC also has authority to address fraudulent and manipulative behavior involving derivatives, including equity derivatives that establish a short hedge. [Rule 180.1](#), which is modeled on SEC Rule 10b-5, broadly prohibits manipulative and deceptive devices and contrivances regardless of whether the conduct in question was intended to or did create an artificial price. [Rule 180.2](#) codifies Section 6(c)(3) of the Commodity Exchange Act and makes it unlawful for any person to manipulate or attempt to manipulate the price of any swap or commodity in interstate commerce. The CFTC has used these authorities to bring enforcement actions for price manipulations.

The Regulation SHO framework has worked remarkably well in reducing failures to deliver. In 2011, the SEC's Division of Risk, Strategy and Financial Innovation found that since 2008 failures to deliver declines by 65.7 percent across all securities, and failures to deliver for threshold stocks (shares with persistent failure to deliver) declined by 85.1 percent.



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Customer protections are also built into borrowing transactions necessary to short selling. Broker-dealers that borrow securities from a customer are required to enter into a written agreement with the customer that specifies the broker-dealer must: (1) provide the lender collateral that fully secures the loan; (2) mark the loan to market not less than daily and provide additional collateral as necessary to fully collateralize the loan; and (3) contain prominent notice that Securities Investor Protection Act provisions may not protect the lender in securities loan transactions and that the collateral delivered may constitute the only source of satisfaction of the broker-dealer's obligation to return the securities.

As part of an effort to mitigate potentially crippling losses for investors and brokers, the Federal Reserve Board and FINRA regulate margin trading. Margin rules govern the amount of credit that brokers-dealers can extend to their customers for securities transactions.

- Under Section **220.10(a)** of Federal Reserve Board Regulation T, brokers can only borrow securities subject to the provisions of Regulation T without complying with those provisions, if the borrowing is "for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations."
- FINRA and the securities exchanges impose "**maintenance margin requirements**" on customer accounts. This "maintenance" requirement sets the minimum amount of equity a customer must maintain in their margin account at all times. FINRA requires the "maintenance" requirement to be at least 25 percent of the total market value of purchased margin securities.
- Broker-dealers may also establish more restrictive requirements. Many firms have established higher "maintenance" requirements of 30 to 40 percent.

Regulation of Participants in Short Selling Transactions

Short sales are thoroughly regulated at every step of the transaction:

- **Investment advisers** are regulated by the SEC or state regulators. Investment advisers who trade in derivatives are also subject to regulation by the CFTC and the National Futures Association (NFA).
- **Private funds, or hedge funds**, are regulated by the SEC or state regulators. Similar to investment advisers, commodity pool operators are subject to regulation by the CFTC and the NFA.
- **Broker-dealers**, who facilitate borrowing securities used in short sales, are regulated by the SEC, FINRA, and state regulators.
- **Custodian brokers**, who lend securities as a revenue stream, are regulated by the SEC and FINRA. Similarly, custodian banks to lenders are supervised, regulated, and examined by federal bank regulators.
- **Short sale transactions** are regulated by the SEC.
- **Exchanges**, where transactions occur, are supervised, regulated, and examined by self-regulatory organizations and the SEC.
- **Clearing houses**, where transactions are settled, are regulated by the SEC and the Federal Reserve.

Reporting Requirements

The **SEC** and **FINRA** have extensive reporting requirements for short sales, which gives regulators quick and easy access to aggregate, market-wide short sale information. Broker-dealers must also maintain additional information on the trading activity of large traders. The SEC also has broad authority to request short selling information from Investment Advisers Act registrants, which the SEC uses to investigate any potentially abusive practices.

Transaction Costs and Tax Treatment of Short Sales

- Stock lenders are typically institutional investors, such as pension funds, foundations, and endowments that hold large portfolios of securities. These investors lend stock to collect fees and enhance income on their stock holdings through collateralized loans.
- Gains from short sales are considered short-term capital gains and taxed as ordinary income. These gains do not benefit from the preferential tax treatment of long-term capital gains.
- Short sellers must post collateral, pay ongoing margin costs, and comply with applicable regulatory requirements.

