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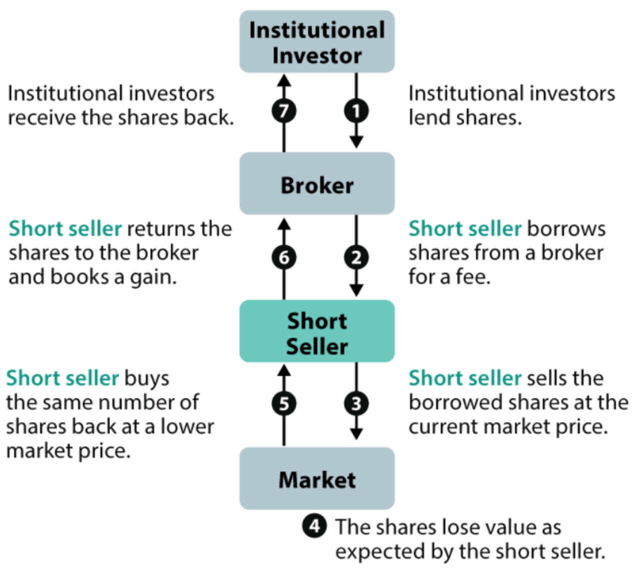
Short Selling: Background and Policy Issues

Short selling generally involves the sale of a stock that the seller does not own (and instead borrows and must return at a later date) with an intent to profit if the stock declines in value. The practice has generated policy attention because of its risks and potential association with market manipulation. This In Focus discusses the mechanics and regulation of short selling along with associated policy issues.

Short-Selling Operations

Short selling generally refers to the sale of a security that the seller does not own or does not deliver. A short-selling transaction often initiates with the short seller borrowing a security from a broker-dealer or an institutional investor and selling the borrowed security in the open market. The short seller then purchases the security at a later time in order to return it (**Figure 1**). A short sale becomes "covered" once the short seller purchases the security to return to the lender.

Figure 1. Example of How Short Sellers Make Money



Source: CRS.

If the price of the security decreases (as expected by the short seller), the short seller profits by returning the security after purchasing it at a lower price than it was sold. The short seller loses money if the share price increases. From this perspective, short selling is potentially riskier than long-only investing. The maximum loss for a long investor is 100% of a stock's value. In contrast, short sellers face unlimited losses because, in theory, there is no limit to a stock's potential price appreciation and so no limit on the price at which short sellers may be obliged to purchase shorted stock to deliver to a lender.

Benefits and Concerns

Benefits of short selling include (1) **Pricing efficiency**. Efficient markets require that securities prices fully reflect available information, including all buying and selling interests. Short selling allows market participants, who believe that a security is overvalued, to express their views in market transactions. These transactions help the markets arrive at more efficient prices by allowing market participants with negative information about stocks to trade based on that information even if they do not have pre-existing long positions. In addition, arbitrageurs could use short selling to profit based on price discrepancies between positions that generate similar economic exposures, such as between securities and certain derivatives instruments (that derive value from underlying securities). (2) **Market liquidity**. *Liquidity* refers to how quickly and easily transactions can occur without affecting a security's price. A high level of liquidity indicates market health and efficiency. Short-selling operations contribute to market liquidity by supplying securities available for trading and potentially offsetting imbalances between supply and demand. (3) **Market discipline**. Some academic research has found negative correlation between the threat of short selling and earnings management (the use of accounting techniques to manipulate a company's earnings). Short selling may thus have the effect of disciplining corporate management.

Short selling has also generated criticism. Some contend that short selling is often a form of market manipulation. Some short sellers may, for example, spread false rumors to drive down share prices or collude with one another to move prices lower (a strategy that is often called a "bear raid"). Abusive short-selling activities, such as coordinated transactions to depress the price of a security for a short sale gain, are illegal. In 2008, during the Great Recession, the United States and other countries imposed bans on certain short-selling activities, hoping to mitigate share price declines and reduce market volatility. Section 12(k) of the Securities Exchange Act of 1934 gives the Securities and Exchange Commission (SEC) the authority to temporarily prohibit short selling in certain emergencies.

"Naked" Shorts

A "naked" short is a short sale conducted without borrowing or arranging to borrow the relevant shares (but agreeing to deliver them at a later date). Naked shorting may result in a failure to deliver the shares to the buyer. For example, the short seller, who trades illiquid shares, may have trouble buying the securities when the time for delivery comes up. Some naked shorts are in violation of securities laws. But not all naked shorts are illegal. For example, certain market maker activities that involve broker-dealers making a market by committing to continually buy and sell securities even without other buyers or sellers (i.e., “bona fide market making”) generally do not violate securities regulation.

Regulatory Frameworks

SEC Regulation SHO (Reg SHO), pursuant to the Securities Exchange Act of 1934 (P.L. 73-291), establishes the framework for short-selling regulation. Reg SHO’s key provisions include

Rule 201, also called the alternative uptick rule, is triggered when a stock’s share price falls at least 10% during intraday trading. If that occurs, short selling in the stock is allowed for the remainder of the day and the following trading day only if the price of the stock is above the current National Best Bid and Offer (the best prevailing offers to buy or sell shares for a stock on stock exchanges). This places restrictions on short selling when a stock faces significant downward price pressure, potentially stabilizing market conditions during episodes of distress.

Rules 203(b)(1) and (2) establish what is known as the “locate requirement” for short sales. Subject to certain exceptions, these regulations prohibit a broker-dealer from accepting a short-sale order unless it has borrowed the relevant security, has entered into a bona fide arrangement to borrow the security, or has reasonable grounds to believe that the security can be borrowed so that it can be delivered by the delivery due date. The rules also require documentation of compliance with these requirements. These rules are intended to curtail naked shorting outside of certain recognized exceptions.

Rule 204 establishes the “close-out requirement,” requiring a firm that clears and settles trades to deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any security by the settlement date. Alternatively, the firm must take actions to close out failures to deliver by borrowing or purchasing similar securities within a certain time. This requirement is intended to curtail failures to deliver due to abusive naked shorting.

Case Study: GameStop in 2021

Short selling has drawn policy attention during periods of abnormal trading. For example, a market frenzy occurred in early 2021 when the stock price of video game store chain GameStop rapidly increased from around $18 to well over $400 in intraday trading. The developments soon spread to some other stocks and markets. The episode raised several policy issues, including the role of short selling in equity markets. At the time, many traders reportedly targeted GameStop’s stock because it was heavily shorted. Some speculated that retail traders sought to engineer a “short squeeze”—a phenomenon whereby an increase in a stock’s price prompts short sellers to buy the stock to cover their positions, leading to a spiral of further price increases and further short covering. Hedge funds that had shorted GameStop shares reportedly incurred losses of around $20 billion as of the end of January 2021. Because at one time, 140% of GameStop’s outstanding stock had been shorted, some have raised concerns that the episode involved naked shorting that warrants regulatory review. Others deny that high short interest necessarily indicates naked shorting.

Congress held several hearings and considered multiple legislative proposals associated with GameStop-related developments in 2021. For example, the Short Sale Transparency and Market Fairness Act (H.R. 4618 in the 117th Congress) proposed reducing the reporting time window and expanding reporting content for certain short positions. It would have also required the SEC to promulgate rules that would mandate public disclosure of certain short-selling activities by asset managers.

The SEC published a staff examination of the situation titled *Staff Report on Equity and Options Market Structure Conditions in Early 2021*. Among other things, the report found that short selling was a significant part of the GameStop story. However, a short squeeze was not seen to have been a main driver of the GameStop stock behavior in January 2021. The report identified several areas for further regulatory consideration, including improving the reporting of short sales. While the report acknowledged that some had raised concerns about naked short selling, it indicated that members of the National Securities Clearing Corporation did not experience persistent failures to deliver GameStop stock during the relevant period—a fact against the theory that naked shorting played a major role in the GameStop episode.

SEC Short Selling Disclosure Proposals

Section 929X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203) requires the SEC to prescribe rules to make more short-selling data publicly available. On February 25, 2022, the SEC commissioners unanimously approved proposed rules aimed at fulfilling Section 929X’s mandate. The proposed rules would add a new rule, Rule 13f-2, and a new disclosure form, Proposed Form SHO, under the Securities and Exchange Act (P.L. 73-291). As proposed, Rule 13f-2 would require institutional asset managers, who exercise investment discretion over short-selling positions and meet specific thresholds, to report information on the Proposed Form SHO. The new reporting includes the asset managers’ end-of-the-month short positions and certain daily activities affecting those short positions. The SEC would then aggregate the resulting data by individual security and disseminate the data publicly on a monthly basis. This new data would supplement the short-sale data that is currently publicly available from Financial Industry Regulatory Authority and national stock exchanges.

The SEC also proposed several other provisions to amend Reg SHO and the Consolidated Audit Trail, a trading order data tracking system. These amendments would require broker-dealers to collect and submit additional data on purchases to cover short sales, among other requirements. The new data would provide more transparency on market activity related to short selling and help regulators to reconstruct market events and identify potential abusive trading practices.

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