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Highlights

Highlights of GAO-09-483, a report to congressional requesters

Why GAO Did This Study

The Securities and Exchange Commission (SEC) adopted Regulation SHO to, among other things, curb the potential for manipulative naked short selling in equity securities. Selling a security short without borrowing the securities needed to settle the trade within the standard 3-day period, can result in failures to deliver (FTD), and can be used to manipulate (drive down) the price of a security. To further address this concern, SEC recently issued an order amending Regulation SHO. This report (1) provides an overview of Regulation SHO and related SEC actions, (2) discusses regulators' and market participants' views on the effectiveness of the rule, and (3) analyzes regulators' efforts to enforce the rule.

To address these objectives, GAO reviewed SEC rules and draft industry guidance, analyzed FTD data, reviewed SEC and self-regulatory organization (SRO) examinations, and interviewed SEC and SRO officials and market participants.

What GAO Recommends

GAO recommends that the SEC Chairman expedite the review and approval of the draft guidance and develop a process to respond to implementation issues that arise from temporary rules. SEC stated that it would consider addressing the intent of the draft guidance in the temporary rule and evaluate how it can further address implementation concerns raised by the industry.

View GAO-09-483 or key components. For more information, contact Orice M. Williams at (202)-512-8678 or williamso@gao.gov.

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REGULATION SHO

Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance Is Needed

What GAO Found

To address FTD and curb the potential for manipulative naked short selling in equity securities, Regulation SHO required broker-dealers to (1) locate securities available for borrowing before effecting short sales in that security and (2) close out FTD lasting ten consecutive settlement days in securities for which a substantial number of FTD accumulated (threshold securities). SEC imposed the close-out requirement only on threshold securities because it believed high levels of FTD could indicate potential manipulative naked short selling. Increasing market volatility led SEC to issue a September 2008 emergency order requiring broker-dealers to close out FTD resulting from short sales in any security the day after the settlement date. SEC extended this requirement until July 2009 in an interim final temporary rule. GAO found that the number of threshold securities declined after the implementation of the stricter close-out requirement, but it is not clear whether this trend can be sustained.

Some market participants believe that the stricter close-out requirement does not prevent manipulative trading from occurring within the 3-day settlement period. They recommend that SEC address potential abuse by requiring all short sellers to borrow securities before a short sale. As the Commission considers whether to finalize the temporary rule, SEC staff said that they are continuing to evaluate the appropriateness of a preborrow requirement for addressing FTD and market manipulation related to naked short selling. However, SEC staff said that the costs of a preborrow requirement might outweigh the benefits because FTD represent 0.01 percent of the dollar value of trades, and that a small group of securities (small market capitalization, thinly traded, or illiquid) are likely to be the target of any manipulative scheme.

SEC and SRO examiners have found that some broker-dealers do not monitor whether the source a broker-dealer uses to locate available securities is reasonable (i.e., does not result in FTD). The broker-dealers may not have done so because firms do not expect that the source from which it obtained the locate will be used to obtain shares for settlement. In some cases, the executing broker-dealer may lack information needed to establish whether the locates were reasonable. SEC staff worked with the industry to draft guidance in 2007 to clarify communication responsibilities in such instances, but SEC has not finalized it. As a result, some firms may continue to be noncompliant with the locate requirement. Furthermore, SEC sometimes did not provide interpretive guidance for questions on the implementation of Regulation SHO and temporary rule-related requirements, or did so after lengthy delays. SEC does not have formal processes for determining which requests for guidance merit a formal response, nor does it have a process by which implementation issues that arise from temporary rules can be readily addressed. Without timely and clear guidance to the industry, SEC cannot ensure the consistent implementation of its rules or help address the unintended consequences of operational issues that occur while awaiting rule expiry or finalization.