

## Naked Shorts

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This week, the SEC announced that it was planning to adopt a rule that would specifically declare abusive “naked” short selling to be a fraud.

For any reader who hasn't been on a trading desk for awhile, a short sale occurs when the seller sells stock that she doesn't have. The “fully clothed” short seller borrows stock to sell, and delivers using the borrowed stock. At some future time, the short seller “covers” by buying the stock in the market and delivering it back to the lender. In contrast, the “naked” short seller doesn't borrow the stock and covers to make delivery to the original purchaser. Of course, the goal of all this is to profit from declines in the value of the stock because the delivery, whether to the lender or the original purchaser, will be accomplished with less expensive stock than was originally sold.

Rules against naked short selling have been on the books for many decades. However, they lacked teeth. In the first place, the short seller never needed to deliver unless the back office got sticky about it. Most back offices in the past tended to be “gentlemen,” who generally didn't insist on delivery from other back offices, unless, to quote the Koran, “necessity was laid upon them.” Second, there has always been an exception on the books for “bona fide” market making activity. None of the regulators thought it was a good idea to knock a market maker out of the box when the only way he could honor his quote was to short the stock. But, the definition of “bona fide” market maker generally was stretched to include any broker-dealer active in the stock. The definition was particularly murky in the over-the-counter market where market makers are not required to maintain a two-sided market.

The modern evolution of the rules against naked short selling begins with the 1998 case of John Fiero and the firm of Hanover Sterling & Co., Inc. Fiero was the sole owner, sole registered employee, head trader, chief cook and bottle-washer of Fiero Brothers, a broker-dealer and market maker in over-the-counter securities. Hanover was an underwriter of obscure over-the-counter securities. The two firms were a train wreck waiting to happen.

Fiero largely made a business short selling penny stocks. As any veteran trader can tell you, shorting penny stocks is dangerous business. From time to time, one of them discovers the next cure for cancer or another big thing, and the resulting rise in the stock's price has caused more than one well-capitalized firm to descend into the pit of insolvency. Fiero knew this, but tried to avoid this risk by identifying those penny stocks that were issued by fraudsters. Fiero didn't read financial

statements; instead, he relied on a network of shady characters that he trusted for good information.

Fiero's informants told him that the securities underwritten by Hanover were ripe for the plucking. So, Fiero went on a naked short selling spree. Fiero's information was good, and when Hanover tried to stand against the tide, it went up in flames.

If it had ended there, Fiero could have scooped his winnings off the table, rewarded his information sources and looked for the next easy pickings. But, Hanover was an introducing firm. Adler Coleman, Hanover's clearing firm, had to back Hanover and find securities to sell Fiero so he could cover. When this proved impossible, Adler Coleman slid below the waves. Adler cleared for about forty firms, and the resulting debacle set off alarms at FINRA and the SEC's Division of Trading and Markets.

Besides instituting proceedings to bar Fiero and his friends from the industry, the SEC began to work on some rule changes. First, it introduced Reg SHO. The main objective of Reg SHO is to require back offices to buy each other in within 14 days in certain threshold securities. No more gentlemanly conduct. Reg SHO has been tightened since its original adoption to include non-reporting over-the-counter securities. The grandfathering exemption, which applied to securities shorted before Reg SHO's adoption, has been eliminated. And, in threshold securities, market makers are not exempt from buy-ins, no matter how bona fide.

The text of the recent proposed rule prohibiting naked shorts has not been released yet. But, I am betting that it is aimed at the head of market makers who have been maybe a tad liberal in their interpretation of the bona fide market maker exemption.

I doubt we are done. I predict that the next rendition of Reg SHO will transform all equity securities into "threshold securities." If I am right about this, then no matter what, shorts will be bought in within 14 days.

There's a lot about the way John Fiero did business that was less than exemplary. But, in some ways, his activities, and those of others, including a few hedge funds that are still lurking about, served the purpose of identifying fraudulent issuers and driving them out of the markets. In doing away with this business, we have also made it easier to issue fraudulent securities and escape market discipline.

In the absence of the naked short seller, it will be the task of the regulators, and particularly their enforcement divisions, to protect the public from fraudulent issuers. Certainly, that would be a good use of our tax dollars. But, wait a minute. Protecting the public from fraudulent issuers has always been the regulator's job. If they were any good at it, Fiero would not have had a business. Will they improve? I certainly hope so.