ADOW FINANCIAL REGULATORY COMMITTEE

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Statement of the Shadow Financial Regulatory Committee

On

The SEC's Concern with Short Selling

February 24, 2003

The Securities and Exchange Commission (SEC) has recently expressed concern with alleged market manipulation by some market participants who are said to sell short illiquid securities, driving down their price, and then to buy back the securities to profit from the subsequent rise in price when the short selling ends. This strategy would be costly if the short seller had to borrow stock to make deliveries. Presumably to avoid this cost these short sellers fail to deliver the stock to the Depository Trust and Clearing Corporation (DTCC) for some period of time, in violation of its rules. The SEC is reportedly considering whether to prevent the clearing house from allowing this practice.

The Committee believes there is great value to short selling, since it tends to correct overvaluation. We are concerned that the SEC, which has had a long–standing antipathy to short selling, may try to further discourage short sales. Prior actions by the SEC that have limited short selling include its acceptance of the NYSE uptick rule (under which a stock may be sold short only after its last sale has gone up in price) and more stringent capital requirements on the short as compared with the long positions of securities firms.

There are three ways the current problem could be handled that would not impair traditional short selling. First, if there were stock market manipulation, the SEC should prosecute it as such. Second, if the SEC believes that proof of manipulation is unduly difficult, it could require the clearing house to disclose, on a daily basis, the aggregate "fail" volume of individual stocks. This would allow investors to understand that the downward movement of stock prices might be the result of the practice of deferred-delivery selling and not negative information about the security. Third, the SEC could require the DTCC to enforce its current rules. If the DTCC wants to continue to permit deferred delivery, it should change its rules and charge the users or require collateral in compensation for the additional settlement risk.