The GameStop Mess Exposes the Naked Short Selling Scam

A decade ago, a Biden confidant tried to stop it. Now there's another chance.

BY LUCY KOMISAR FEBRUARY 25, 2021

134 Shares

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The Securities and Exchange Commission could create a system to identify and enable punishment of illegal trading activities, including naked short selling.

At the House Financial Services Committee hearing last week on the GameStop debacle, there was an elephant in the room: naked short selling.

Short selling, effectively betting that a stock will go down, involves a trader selling shares he does not own, hoping to buy them back at a lower price to make money on the spread. The trader is supposed to locate (or have a "reasonable belief" he can locate) or borrow the shares in brokerage accounts, and then transfer them to the buyer within two days. This accounts for as much as 50 percent of daily trading.

Naked short selling is when the trader does not find those shares to deliver. It's costly to big hedge funds to locate hard-to-borrow shares. So prime brokers, who carry inventory of stocks for high-volume short sellers, simply lie about the borrows, to assist their favorite clients.

It's a scam central to the stock trading system, enabled by the Securities and Exchange Commission (SEC), the market regulator, and the Depository Trust and Clearing Corp. (DTCC), the stock clearinghouse, to benefit the big players. The SEC has long been run by revolving-door officials who move between it and Wall Street trading houses and law firms. DTCC is owned by the prime brokers, such as Goldman Sachs, JPMorgan, and Citi, and run in their interests.

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At the House hearing, Rep. Nydia Velazquez (D-NY) asked about the dangers of short selling. “GME [GameStop] sold short 140 percent. Why isn’t that manipulation?” She meant that short sellers sold 40 percent more shares in GameStop than existed. They were phantom shares that didn’t exist but that were posted in buyers’ accounts as “entitlements.” The buyers have no idea they don’t have real shares. They can sell and even loan those digital entitlements.

In other words, large numbers of “locates” or “borrows” were fake, making the shorts “naked.” Why does it matter? Because naked short selling causes the number of shares in the market to increase, which normally makes their value drop; more shares equals less value. And it can massively disrupt the market, as GameStop showed.

Rep. Andy Barr (R-KY) backed up Velazquez. “We are interested in naked shorting. How do you make sure you are first locating to borrow?” Rep. Ed Perlmutter (D-CO) asked if sellers were in a naked position.

In fact, more than one million GameStop shares were deemed “failed-to-deliver,” meaning buyers never got the shares they ordered, according to a Bloomberg report. Business Insider reported that “$359 million in stock was in limbo, with buyers lacking cash or sellers not having the shares to settle trades, according to data from the Securities and Exchange Commission.”

Kenneth Griffin, CEO of Citadel Securities, which handled GameStop trades for the internet company Robinhood, downplayed the problem. “Hedge funds have to borrow shares to short sales,” Griffin said. “The practice of naked shorting largely was curtailed by SEC mandate years ago.”

That is not true. Griffin noted, “Institutional investors earn substantial returns from lending out shares, 25 or 30 percent.” He didn’t point out that a gain for those investors is a loss for the borrowers, often big hedge funds. So their brokers commonly wink and do a “locate,” not a borrow, effectively saying, “Yes, I know where the share is and can buy it when the time comes to deliver.” Except it doesn’t work quite that way.

The problem is worsened by off-exchange trading, including secret internal trading systems called “dark pools,” and ex-clearing trades inside or between cooperating brokers that evade DTCC clearing. Dark pools handle more than half of all trading, with most dark pools owned by the big prime brokers.

Keith Gill, the independent investor whose social media posts started the GameStop frenzy, made the most important comment of the hearing. He pointed out that the same share can be "located" dozens of times, even for multiple clients. And options market makers like Citadel are exempt from the rules that they must locate the stock.

Gill said, "The ability for the same share to be shorted infinite times is a pathology. We don't have the ability to track what shares are shorted and how many times."

Robinhood CEO Vlad Tenev echoed that: "Yes, someone could have no shares when the music stops. How would claims on shares be solved?" That's another result of the phantom shares created by digital entitlements.

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Citadel, as a market maker that has to accept all buys and sells, gets a pass on many naked short selling rules. Even then, Rep. Vicente Gonzalez (D-TX) pointed out that in 2020, Citadel violated the Security Commission's Reg SHO, the rule regulating short sales. On November 13, 2020, FINRA, the traders' self-regulator, fined Citadel Securities $180,000 for failing to mark 6.5 million equity trades as short sales between September 14, 2015, and July 21, 2016. Citadel did not admit or deny the allegations but paid the fine.

The problem is not new. The SEC and New York Stock Exchange fined Goldman Sachs an infinitesimal $2 million in 2007 for allowing customers for more than two years to use its automated direct market access system and automatically mark short orders as long.

Beyond that, the SEC rule itself is so weak, traders can roll over naked shorts and stay naked indefinitely. Larry Tabb of Bloomberg told me in a tweet during the hearing that "failed trades roll over to the next day—ie you can buy them back and they will net out day to day. So, you could continually buy back your sell fails and re-short, extending your fail. If you don't, after 10 days, brokers are forced to buy them back."

Of course, there's no enforcement. Even when crooked traders and dealers are caught red-handed, all they pay is a small fine—the cost of doing business.

A LITTLE-KNOWN BACKSTORY involving Ted Kaufman, who ran President Joe Biden's transition, shows how big stock market players and the institutions they control have blocked attempts to deal with naked short selling. Kaufman was Biden's longtime chief of staff, and was named to the Delaware Senate seat vacated by his boss when Biden became Barack Obama's vice president.

After the market meltdown that included abusive naked short selling, Kaufman, a Democrat, and former Georgia senator Johnny Isakson, a Republican, had introduced legislation that directed the SEC to write regulations to end the practice. They determined that the SEC's current regulations were unenforceable. Hedge funds could spread rumors, do massive shorts without locating stocks, and deliver after the prices dropped.

Jeff Connaughton, then Kaufman's chief of staff, told me what happened next. He got an email from a lobbyist and former staffer to Senate Banking Committee chair Christopher Dodd (D-CT). The ex-staffer now represented a hedge fund known for short selling. "She warned me that it would be bad for my career if Ted and I went after short selling," Connaughton told me. But that didn't stop Kaufman.

In July 2009, Sen. Kaufman and six colleagues from both parties wrote to the SEC, proposing a "hard locate" plan that would ban all short sales unless the executing broker first obtained a unique identification number for the shares, perhaps through an automated centralized system implemented by the DTCC. This would prevent multiple short sales on the basis of a single share.

According to Connaughton's 2012 book *The Payoff*, months before the letter, "the DTCC had gone to the SEC with a proposed solution to naked short selling" that looked similar to Kaufman's solution, with the DTCC creating "a centralized database [that] would prevent the same shares from being used for multiple short sales."

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Connaughton recalled, "Shortly after that, the SEC announced a roundtable for September. At that point I thought, 'Great, we're going to change the way stocks are traded.'" However, the event was dominated by the big trader banks, which made huge sums lending stocks for short sales, and had been lobbying against any restrictions on it. Connaughton wrote, “During the meeting, the DTCC representative sat mute and didn’t even mention the DTCC’s proposed solution for naked short selling.” He asked DTCC officials what happened. “They admitted, ‘We got pulled back.’ They meant: by their board, by the Wall Street powers-that-be.”

As Connaughton later explained to me, “That’s when the light bulb went on. Industry finds it unacceptable, because we’re now trading in a microsecond environment. So there will never be a hard locate.”

Kaufman continued to try to fight naked short selling in the Dodd-Frank debate. But the SEC was dodging the issue, and Dodd’s Senate Banking Committee largely ignored it.

AFTER THE “FLASH CRASH” IN MAY 2010, where stocks sharply dropped in a matter of minutes, the SEC said it would create a consolidated audit trail (CAT) on trading in stocks and options. The order and trade execution information it collected would identify and enable punishment of illegal trading activities, including naked short selling. More than a decade later, CAT doesn’t exist.

But maybe Ted Kaufman is now in the CATbird seat. Kaufman was a co-chair of the Biden-Harris transition team and is a trusted Biden friend and adviser. (He was also against the repeal of Glass-Steagall, which enabled banker-broker corruption.) Now would be the time to get Biden to move on reforming the corrupt trading system, beginning with naked short selling, if he is willing to threaten the interests of his Wall Street funders.

House Financial Services Committee chair Maxine Waters (D-CA) said future hearings would include witnesses from the SEC and DTCC. They should be asked why they haven’t implemented CAT, insisted on hard locates, and ended naked short selling. It’s the most significant challenge Democrats could make to Wall Street.

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