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Society Cannot Afford Naked Short Selling Part 1)

By u/graycrayon02

Thought I'd share my account of what happened so far and an attempt to make sense of it. Added a bunch of posts and some of you may be mentioned. Let me know what you think.

Society Cannot Afford Naked Short Selling: Much Needed Regulatory Change

I. Introduction

In January, retail investors initiated a “short squeeze” made possible by excessive short-selling of GameStop shares.\[2\] Short-sellers borrow shares to sell to buyers, expecting that the price will go down, and later repurchase at a lower cost while pocketing the difference.\[3\] A short squeeze can drive the price of a stock up to record highs when increased demand meets a diminishing supply of shares as short sellers buy back shares to satisfy a margin call.\[4\] Much of the upsurge in demand stemmed from a positive change in GameStop’s outlook when the company announced that it added new board members, including Ryan Cohen, co-founder of Chewy.com.\[5\]

On January 26, the price of GameStop’s publicly traded stock soared from $88.56 at market open to $147.98 by the end of the day. The following day it opened at $354.83 and closed at $347.51.\[6\] In the span of only a few days, my portfolio skyrocketed to lunar heights and showed no signs of coming down.\[7\] That was until the morning of the 28th, when Robinhood and other brokers blocked retail investors from buying shares of GameStop, causing the price to crash from $500.00 premarket to $193.60 by day’s close.\[8\] News contributor Charles Payne offered Robinhood advice that morning and aptly highlighted the irony of our betrayal.\[9\] “Pro Tip. Don’t call yourself Robin Hood if you are going to turn your back on the folks in Sherwood Forest after one phone call from the Sherriff of Nottingham.”\[10\] January 28 marks the day retail investors collectively discovered that Robin Hood was nothing but a front for Prince John’s latest money-making scheme.\[11\]

“Payment for order flow,” a practice pioneered by the infamous Ponzi-schemer Bernie Madoff, enabled Robinhood to provide “commission-free trading” in its claimed goal to “democratize finance.”\[12\] In 2020, Robinhood received most of its revenue by selling customer orders to large institutions to execute or facilitate trades—among other purposes.\[13\] That same year, the Securities and Exchange Commission (“SEC”) fined Robinhood $65 million for failing its duty of best execution when Robinhood prioritized the income it received for order flow four times more than improving prices for its customers.\[14\] Market maker Citadel Securities is the largest purchaser of Robinhood’s order flow.\[15\] In 2017, Financial Industry Regulatory Authority (“FINRA”) fined Citadel Securities $22 million for failing to fill orders at the best price for over three years.\[16\] In 2020, FINRA fined Citadel Securities $700,000 for trading ahead of customer orders—a violation the market maker continued for more than two years.\[17\]

In the United States, Citadel Securities executes roughly 26% of equities volume, 47% of all retail volume, and 99% of traded options volume.\[18\] Its affiliated hedge fund, Citadel Advisors, manages accounts for a handful of clients worth an average of over $12.65 billion each.\[19\] Citadel’s founder, Ken Griffin, is worth $16 billion and owns $1 billion in real estate, including the most expensive home in the United States, priced around $238 million.\[20\] In January, hedge fund Melvin Capital Management lost 53% of its $12 billion assets due to a GameStop short position.\[21\] Soon after, Citadel Advisors invested $2.75 billion in Melvin Capital, giving Citadel Advisors majority ownership.\[22\]

When brokers blocked retail investors from buying GameStop and other heavily shorted “meme” stocks, it was clear that Wall Street only permitted retail investors to be there under the condition that we would continue to be on the losing side of the deal.\[23\] Many insiders continued to add insult to injury. Steven Cohen, a former mentor of Melvin Capital's Gabe Plotkin, stepped in on Twitter and mocked retail investor's collective loss.\[24\] "I'm not feeling the love on this site today. Trading is a tough game. Don't you think?"\[25\] Unsurprisingly, Plotkin's boss was fined $1.8 billion for insider trading in 2013.\[26\]

Robinhood later joined the gaslighting club by promoting a "debunking misinformation" advertisement on Reddit to "clarify" it "didn't limit or block the selling of $ GME or other stocks in response to the January market events" (emphasis added).\[27\] Robinhood also stated it "would never want to prevent customers from selling securities because it would limit their ability to manage market risk."\[28\] Not long after making the statement, Robinhood came under fire for stopping both the buying and selling of cryptocurrencies during another market surge.\[29\]

Wall Street historically found ways to collect wealth at the expense of Main Street.\[30\] Among Wall Street's various schemes, naked short selling was one of the easiest to carry out and contributed significantly to the Global Financial Crisis.\[31\] "Naked" short-selling occurs when a short seller does not borrow shares to deliver to the buyer before the trade settles.\[32\] When a short seller does not deliver shares to the buyer by trade settlement, it results in a "failure to deliver."\[33\] According to the SEC, large and persistent failures to deliver negatively affect the stock market and are a tool for naked short sellers to drive down the price of a stock.\[34\] Failures to deliver can also deprive shareholders of the benefits of ownership, such as voting at corporate meetings or lending shares.\[35\]

Unless used for "bona fide market making," the SEC prohibits naked short selling due to its observed contribution in the collapse of Bear Stearns, Lehman Brothers, and the near-collapse of Morgan Stanley.\[36\] Days before Bear Stearns collapsed, over 13 million shares failed to deliver, and shareholders traded around 128% of the company's float during market hours.\[37\] Lehman Brothers saw over 32 million shares fail to deliver days before suffering a similar fate.\[38\] In the case of GameStop, not only was over 140% of the company's float sold short, over two million shares worth approximately $359 million failed to deliver, and over 300% of the company's float traded in one day.\[39\] These abnormalities signaled that, once again, abusive naked short sellers sought to profit from a vulnerable company's collapse using the stock market.\[40\]

When Robinhood stopped retail investors from buying shares of GameStop, it effectively protected institutional investors and their wealthy clients from having to pay their fair share for a failed bet that GameStop's stock would tank.\[41\] In the days leading up to the day Wall Street closed its doors on us, mainstream media and Wall Street insiders continued to characterize retail investors as nothing more than "dumb money."\[42\] Many news outlets identified retail investors as the source of the market volatility, and debates centered on whether regulators needed to protect retail investors due to the potential risks.\[43\] One insider told retail investors we were playing a "loser's game" and "had no idea what we were doing."\[44\] As the billionaire hedge fund manager framed it, "the reason the market is doing what it's doing is people are sitting at home getting their checks from the government."\[45\] The billionaire later characterized the idea that the wealthy should have to pay a "fair share" as a "bullsh-t concept" that was just "a way of attacking wealthy people."\[46\] Such ideas were "inappropriate," and everyone instead needed to "work and pull together."\[47\]

In stark contrast to the billionaire's assertion, the average American family has progressively fallen behind a rising cost of living in what is known as "the middle-class squeeze."\[48\] Weak income growth for the bottom 90% of Americans fell behind inflation in consumer goods and the housing market, making the "middle-class lifestyle" unaffordable.\[49\] In the last four decades, the rising income of the top 10% squeezed roughly $47 trillion (or $142,000 per person) from American middle-class workers.\[50\] When measured against Gross Domestic Product, the bottom 90% product lost a sizeable share of economic power.\[51\] Meanwhile, the average wealth of billionaires in the United States increased over five times faster than the average household's wealth—an increase boosted considerably by the Global Financial Crisis.\[52\]

At the further expense of middle-class Americans, billionaire's wealth grew at record-setting numbers throughout the global pandemic.\[53\] While billionaire CEOs laid off and furloughed thousands of employees during the global pandemic, their collective wealth grew by $1.6 trillion.\[54\] Most CEOs refused to take a pay cut.\[55\] Before the pandemic, nearly 40% of Americans could not pay for an unexpected $400 expense.\[56\] By the height of the pandemic, unemployment rates surpassed those of the Great Recession deepening the wealth divide.\[57\] The wealth of under a thousand people grew to more than four times the wealth of approximately 165 million people—half of the entire United States population.\[58\] By the time brokers blocked retail investors from buying shares of GameStop, unemployment had shown no signs of returning to pre-pandemic numbers.\[59\]

As GameStop's share price soared in January, roughly a third of Americans saw an opportunity for growth and traded GameStop and other meme stocks.\[60\] Robinhood and other brokers prevented a considerable portion of middle-class Americans from much-needed capital gains.\[61\] Hedge funds, unaffected by the restriction, were still allowed to trade.\[62\] Many profited from the volatility.\[63\] When retail investors, squeezed for decades by income inequality and Wall Street's schemes, finally found a way to squeeze back Wall Street's front man swiftly pushed everyone out of the market and locked the door.\[64\]

This article reviews Regulation SHO, which the SEC developed to reduce abusive naked short sales. The following section includes a discussion of Regulation SHO and its amendments by the SEC in response to the Global Financial Crisis. The article then explores the psychological forces that drive irrational market swings and the moral philosophy of John Finnis' natural law. It then proposes further amendments to eliminate naked short selling and harmonize Regulation SHO with the natural law, including eliminating the "bona fide market maker" exception to the "locate" requirement. Next, the article discusses short squeezes and their potential to deter abusive naked short selling and redistribute wealth in ways that follow the natural law.

II. Review of Regulation SHO

The SEC adopted Regulation SHO in 2004, responding to issuer and investor concerns of abusive naked short selling.\[65\] Naked short selling is the opposite of a "covered" short sale.\[66\] A covered short sale occurs when a short seller borrows shares and agrees to pay a borrowing rate before selling them on the market.\[67\] In contrast, a naked short sale results from a short seller's failure to borrow shares before selling them on the market.\[68\] The SEC acknowledged that some naked short sellers deliberately failed to deliver a security as part of a scheme to manipulate its price or avoid short sale borrowing costs.\[69\] The SEC adopted Regulation SHO to promote market stability and boost investor confidence by reducing problematic failures to deliver.\[70\]

Regulation SHO provides basic rules to reduce manipulative practices by naked short sellers.\[71\] Rule 200 requires all sell orders for securities placed with broker-dealers to be marked "long," "short," or "short exempt."\[72\] Under securities law, the term "broker-dealer" refers to a brokerage firm's dual function as both a "broker" and a "dealer."\[73\] When executing an order for a client, it acts as a broker, whereas it acts as a dealer while trading for itself.\[74\]

Under Rule 203(b), also known as "the locate requirement," a broker-dealer must either (1) borrow the security, (2) enter an arrangement to borrow the security, or (3) have "reasonable grounds to believe" it can borrow shares to deliver on the due date.\[75\] "Reasonableness" relates to "facts and circumstances of a particular transaction."\[76\] An executing broker may, in some circumstances, reasonably rely on a customer's assurances that he or she can obtain shares from an identified source.\[77\] "Borrow lists" that mark a security based on the availability of shares may also provide grounds for reasonableness.\[78\] For example, a security placed on an "Easy to Borrow" list within the last 24 hours allows a broker-dealer to reasonably rely on the security's availability.\[79\] "Hard to Borrow" lists do not permit a broker-dealer to reasonably believe it could borrow a security.\[80\] A broker-dealer must record its compliance with the locate requirement.\[81\]

Market makers are exempt from the locate requirement if engaged in bona-fide market-making activities with respect to the short sale.\[82\] "Market makers" are dealers that hold themselves out as willing to buy and sell a security on a regular or continuous basis.\[83\] Under Regulation SHO, a market maker may use naked short sales to facilitate customer orders in a fast-moving market to provide "liquidity."\[84\] If shares are difficult to borrow, market makers instead use electronic "book-entry securities."\[85\] A market maker engaged in bona-fide market-making is a broker-dealer that frequently deals with other broker-dealers to actively buy and sell a security while regularly and continuously placing quotations in a quotation medium the bid and ask side of the market.\[86\]

“Bona-fide market-making” depends on the “facts and circumstances of the particular activity.”\[87\] Examples of bona-fide market-making include incurring economic or market risk for securities, a pattern of buying and selling comparable amounts to provide liquidity, and accessible, continuous quotations at or near the market on both sides.\[88\] Bona-fide market-making permits market makers to sell short in a declining market.\[89\]

When the aggregate number of fails to deliver meets or exceeds 10,000 shares and at least 0.5% of the issuer’s total shares outstanding for five days, a self-regulatory agency may place the security on its “threshold security” list under Rule 203(b)(3).\[90\] If a threshold security fails to deliver for thirteen consecutive settlement days (T+13), all participants of a registered clearing agency must (1) take steps to close out the fail to deliver position and (2) “pre-borrow” before engaging in a short sale.\[91\]

A “self-regulatory agency” includes any national securities exchange, registered securities association, or registered clearing agency.\[92\] A “clearing agency” typically refers to an intermediary who facilitates securities settlement without requiring physical delivery of paper certificates.\[93\] A “participant” of a clearing agency is any person (typically a broker-dealer) who uses a clearing agency to clear or settle transactions or transfer, pledge, lend, or hypothecate securities.\[94\] The participant can only accept a short sale if it either borrows shares, enters a bona-fide arrangement to borrow shares, or “closes out” all fail to deliver positions under by purchasing securities “of like kind and quantity.”\[95\] When failures to deliver fall below the qualifying number for five days, the security is no longer a threshold security.\[96\] Rules 200 and 203 required compliance by market participants as of January 3, 2005.\[97\]

Two days after Lehman Brothers filed for bankruptcy, the SEC released an emergency statement regarding “sudden and unexplained declines in the price of securities.”\[98\] The SEC was concerned that the volatility posed a threat to the order and fairness of the market.\[99\] Identifying naked short selling as the source, the SEC adopted temporary rule 204T—which later became permanent Rule 204.\[100\] In any sale of equity security, the participant must deliver them to the clearing agency for clearance and settlement by the settlement date.\[101\] Under Rule 204, known as the “close-out requirement,” broker-dealers that are participants of a registered clearing agency must take action to close out failures to deliver.\[102\] Under the current regulations, securities settle two days after the trade took place (T+2).\[103\] “Settlement date” is the business day on which participants must deliver securities and payments through the clearing agency.\[104\]

If the participant fails to deliver at the clearing agency for a short sale, it must close out its position by the beginning of the settlement day on the trading day after the settlement date (T+3).\[105\] The participant has until the third consecutive trading day following the settlement date for a long sale or bona fide market making (T+5). If the participant does not close the position, it must pre-borrow before engaging in a short sale until the position is closed and the purchase clears and settles.\[106\] To close out a failure to deliver, the participant must purchase or borrow shares of like kind and quantity.\[107\] Rule 204, as implemented under the emergency order, was effective as of September 18, 2008.\[108\]

Rule 201, also known as “the modified uptick rule,” requires trading centers to design and enforce rules to prevent manipulative short sales of a stock which declined 10% or more in price during trading hours and thus triggered a circuit breaker.\[109\] If the declining price triggers a circuit breaker, the short-selling restriction remains in place for the current and following day.\[110\] Rule 201 was effective as of February 28, 2011.\[111\]

Regulation SHO failed to reduce volatility or prevent large and persistent failures to deliver GameStop’s stock. From the beginning of September through the end of January, an average of 500,000 shares failed to deliver daily.\[112\] GameStop’s stock remains volatile three months after the January short squeeze.\[113\] Many retail investors and regulators make the obvious inference that Wall Street shut down the buying of meme stocks to protect naked short sellers.\[114\]

III. Naked Short Selling Steals from Society’s Prosperity.

Judge Posner wrote extensively about law and economics during and after nearly forty years on the bench.\[115\] His economic theory of law holds that investors are “rational maximizers” of their satisfactions, both pecuniary or nonpecuniary, in all of their activities based on the information available to them.\[116\] “Wealth maximization” is the sum of all tangible and intangible goods and services, weighted by offer and asking prices.\[117\] Social wealth derives from the satisfaction a buyer or seller gains through profitably trading in the bid-ask spread.\[118\] Social wealth is maximized when buyers and sellers are both satisfied with their interactions.\[119\]

In Posner’s economy, wealth redistribution is only permitted if it is cost-justified.\[120\] Natural rights are irrelevant because the “economic man,” driven purely by an incentive to maximize his wealth, operates with the same rationality as a pigeon or a rat.\[121\] To improve the economy, the economic man need only follow his natural incentive towards wealth because it will lead him to exchange his labor for income.\[122\] Income disparities under this approach are merely the product of genetic differences in intelligence, allowing people to be more productive and thus earn more.\[123\] Inequality is thus naturally occurring, and social and political efforts to correct it would be ineffective.\[124\] Posner believed markets are efficient and regulation is unnecessary because prices naturally reflect all available information and are always fair and accurate.\[125\]

Posner recognized that cost-justification in pursuit of maximizing wealth could lead to transactions where one party is harmed at the other’s expense.\[126\] In his view of the legal system, moral considerations stem from the overall goal of maximizing social wealth.\[127\] Legislatures, who cater to wealthy special-interest groups, achieve a balance with the rest of society through the judicial branch.\[128\] The judicial branch protects against the harms created by laws developed for wealthy special interest groups. \[129\] Therefore, the law is balanced between the competing wealth-maximizing interests of legislators and judges. \[130\]

Time revealed that the market is not efficient but is instead prone to wild and unnatural fluctuations. For example, an efficient market theory would find that GameStop’s price fluctuating from $17 to $347 to $40 in just over a month or from $269 to $172 to $348 in a single day was a fair and accurate valuation.\[131\] The market is instead driven by what John Maynard Keynes called “animal spirits.”\[132\] According to Keynes, non-economic motives drive people to act, and people are thus not always rational when pursuing economic interests.\[133\]

As the financial crisis revealed, capitalism does not self-police, and if regulators fail to watch over it and give it proper directions, it will seek the most profit-maximizing opportunities and follow such opportunities wherever they lead.\[134\] Regulators took the “invisible hand” concept—that a free market would naturally benefit the best interests of society—too seriously.\[135\] When it came to regulation, “\[i\]t can only be surmised that the regulators were asleep at the switch, dozing off in the confident but wrong-minded notion that capitalist markets would police themselves because people would watch out for their interest.”\[136\] Instead, financial institutions notoriously lent themselves to corruption, and it has become widely accepted that it is in their nature to do so.\[137\]

After the financial crisis, Posner took a different stance on regulating the market.\[138\] Market self-regulation, from which it followed that bubbles, risky lending, defaults, and other market perturbations would self-correct, is impractical.\[139\] It helps to analyze the idea as analogous to industrial pollution regulation.\[140\] If the government provided no remedies, then the rational profit-maximizing industry will engage in a self-centered cost justification analysis and disregard how polluting a river will affect people with whom they do not have a contractual relationship.\[141\] When the social cost of pollution exceeds the cost of governmental inaction—non-intervention should be considered “governmental failure.”\[142\]

“Rational choice theory” fails to explain why retail investors continued holding GameStop rather than selling at a profit.\[143\] Instead of aiming for wealth maximization, many retail investors sought to squeeze every last penny from the hedge funds poised to take down businesses weakened by the pandemic—even if it meant holding for a loss.\[144\] Many retail investors continued to squeeze hedge funds during GameStop’s large price swings and even bought and held at high prices.\[145\] Sociology explains why someone at the short end of a transaction will be angry—the impulse naturally drives behavior, which forces another to engage in a fair exchange.\[146\] A social psychological theory of exchanges, or “equity theory,” believes subjective evaluations of fairness go into the perceived valuation of the inputs or outputs of an exchange.\[147\]

Economists George Akerlof and Robert Shiller revisited “animal spirits” in the wake of the financial crisis to explain the market’s wild behavior.\[148\] Animal spirits are our (1) confidence, (2) fairness, (3) corrupt and antisocial behavior, (4) money illusion, and (5) stories—which drive the economy.\[149\] Under this view, regulatory policy “should dampen—even if it cannot prevent altogether—the financial market excesses caused by errant animal spirits.”\[150\] The proper role of the government is to engage in rulemaking in a way that heeds the advice from parenting books.\[151\] Like a good parent, the government should set the stage to allow creative freedom while limiting the child from overindulging in animal spirits.\[152\]

During the events surrounding GameStop, several animal spirits were overindulged. (1) Hedge funds became overconfident in their ability to short sell a company on the brink of bankruptcy into the ground.\[153\] (2) Retail investors held on to GameStop’s shares despite the dramatic rise and fall in price because they felt it was unfair to allow hedge funds to destroy household name companies weakened by the pandemic.\[154\] (3) Robinhood shut the doors on its customers because the CEO sought to minimize the dilution of his ownership of the company.\[155\] (5) Keith Gill’s success as a value investor who identified GameStop’s share dilution inspired many retail investors and began the GameStop saga.\[156\]