SEC Securities Lending and Short Sale Roundtable

September 20, 2009

Panel 2

Making Short Sale Disclosure More Meaningful: Public versus Non-Public Reporting; Consolidated Tape Disclosure; Timeliness of Information

Opening Thoughts

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Disclosure is costly. It imposes a tax on those who are forced to gather and disclose information. It also breeches the financial privacy and seizes the intellectual property of those forced to disclose. There needs to be an overwhelming public interest to justify this type of intervention. We as a society create property rights in intellectual as well as real property because doing so makes our economy run more efficiently. Yet we also limit those property rights for the public good with restrictions such as zoning restrictions.

We force a variety of disclosure in our public markets because it makes the markets work better. Investors cannot make good investment decisions without adequate information. Because we depend on our financial markets to direct investment and share risk, it is appropriate to require the disclosure of enough information so that investors can make good decisions. We require issuers to disclose information about the firm so that investors can make informed investment decisions. We require pre-trade transparency from exchanges in the form of the best bids and offers and we require post-trade transparency in the form of execution prices and quantities. This information reduces trading costs for investors and creates a fair marketplace. We require insiders to report their holdings and their trading, which sends useful signals to investors. We require large institutions periodically to report their holdings.

We also have some disclosure related to short selling as well. The exchanges release daily volume summaries with the total short volume on a stock by stock basis. Overnight short interest is released twice a month. And information about settlement failures is released with a lag. Do we need more disclosure, and if so, what kind?

Public disclosure not only helps investors make informed decisions, it also makes it easier for regulators to do their job. For example, public scrutiny of option grant information brought the option backdating scandal to light.

The question is: what kind of disclosure is appropriate with respect to stock lending and short selling? Short selling has been a controversial practice since modern equity trading started in Amsterdam in the 1600s. Whenever share prices go down, the short sellers are suspected of doing evil things. Yet short selling is a vital part of our capital markets as it permits market makers to add liquidity and it helps arbitrageurs keep the prices of related financial instruments (such as ETFs and their constituent stocks) in the proper alignment. Short selling also permits better price formation by making it easier to incorporate all information, good and bad, into stock prices. As short selling is associated with over one fourth of total trading volume, it is very important to make sure that any changes in short sale regulation do not inadvertently mess up our current markets.

Let's look at the problems sometimes associated with short selling.

Insufficient short selling.

When there are barriers to short selling, prices become less efficient measures of value. The case of Motors Liquidation Company (PINK: MTLQQ) is a current example. Motors Liquidation is the corpse of the old General Motors that is still twitching in Chapter 11. Due to the huge nature of the debts against what is left of the bankrupt estate in Motors Liquidation, it is unlikely that the common shareholders will get anything. The company has a large statement to this effect on its website.[1] Yet the stock stubbornly trades at about 75 cents. However, it is almost impossible to find the shares to short. This indicates that there are serious inefficiencies in the stock lending market that need to be addressed. The fragmented and opaque nature of the stock lending market makes it very costly to search for shares. These inefficiencies reduce the revenue that institutional investors such as pension and mutual funds (who invest on behalf of many small investors) can earn from stock lending, and it also drives up the cost to the short sellers.

The Commission should search for ways to make the stock lending market more efficient, and transparency is one of those ways.[2] Regulation has been needed to get adequate transparency in cash equities and corporate bonds. Laissez faire has not brought about an efficient and transparent stock lending market. It is not clear that new technological entrants into the field will do so either.

[1] The company states: " Management continues to remind investors of its strong belief that there will be no value for the common stockholders in the bankruptcy liquidation process, even under the most optimistic of scenarios." http://www.motorsliquidation.com/

[2] Another artificial barrier to stock lending comes from the well meaning but overly restrictive provisions of Rule 15c3-3 which make it prohibitively costly for brokers to lend out fully paid shares. This rule can be modernized to make it easier to lend shares while still protecting the safety of customer shares.

Regulation overcomes what I call The Prisoners' Dilemma of Trading.[3] For example, traders usually want to know what everyone else is doing without showing their own hand. After all, showing their desire to trade may make the price move against them. Even though all market participants may be better off in a regime with high transparency, it is in each participant's interest to withhold their own information. By requiring all players to disclose some information, the entire market is better off.

However, it is not at all obvious what type of transparency regime makes sense. Forcing collectivization into another Consolidated Tape Association-style entity with its cumbersome decision making and arcane revenue sharing rules would be a mistake. Technology has changed and greatly reduced the cost of aggregating information, reducing the need for a centralized data feed.

As a first step, I recommend experimenting with a lighter regulatory touch. **Each stock lending market participant would be required to make certain data available on a nondiscriminatory basis to anyone willing to pay for it. This data would include the price, quantity, and term of stock loan transactions, as well as bids and offers for stock lending. However, each participant would be free to negotiate their own terms and conditions.** If a market participant did not want to sell the data, it could post the data on its web site. This should be tried for a few years to see if adequate market performance prevails. If not, then different approaches will be needed.

Settlement failures

The Commission has driven a stake in the heart of naked short selling with Rule 204T.[4] Consequently, the protracted settlement failures that were a major embarrassment to our market have been reduced substantially. Yet, as anyone who has watched a horror movie knows, sometimes the stake gets pulled out of the vampire's heart and the vampire returns. Perhaps someone will find a loophole that permits excessive settlement failures. Whenever there is a big move in a stock, there will be suspicions of foul play. Prompt release of the fail-to-deliver data allows investors to see for themselves whether or not there are problems with settlement failures. **The Commission should continue to disclose daily fail-to-deliver data, and it should do so with a lag of no more than one week.** There is no good reason why the data should be kept secret for a longer period.

Data on who is actually failing to deliver should be readily available to regulators, but not necessarily to the general public.

Excess volatility and other market disturbances

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[3] For a nice description of The Prisoner's Dilemma, see http://en.wikipedia.org/wiki/Prisoner's_dilemma.

[4] However, there are still way too many ETFs on the Reg SHO Threshold list and the Commission should investigate why this is happening and what, if anything, to do about it.

Short sellers are often blamed for a variety of bad outcomes in the market, including share declines and excess volatility. Whether short selling is really to blame in such situations can only be answered by looking at the data.

As part of the Regulation SHO process, the Commission established a well designed Pilot Experiment to examine the impact of the proposed elimination of the uptick rule. The exchanges released (in rather muddy and hard to deal with form) information identifying which trades were actually short. This was a very useful and informative dataset. Alas, the SEC blundered by not making this data dissemination permanent when it eliminated the uptick rule. When market volatility exploded as a result of the subprime mess, short sellers were blamed for disruptions and there was no way to tell for sure what role, if any, short selling had in these disturbances.

Exchanges should disclose tick-by-tick data on which trades are short. As the exchanges already track this data internally, the cost should be minimal. A field indicating a short trade can be made part of the standard industry data feeds. If existing condition code fields can be used, it would not require any additional bandwidth. This would make it possible for investors to see for themselves whether short selling is a problem.

Short and distort

Short sellers are often accused of spreading false and misleading information about their targets. It is often not clear who these short sellers are. Unfortunately, Form 13F only requires institutions to report "holdings" and it is not clear whether short positions are required to be reported. The same public policy arguments that led to Form 13F apply to short positions and derivative positions as well as long positions. **The SEC should update form 13F to explicitly include short positions and derivative positions in reportable securities.** Investors who believe that this information would reveal their trading strategies should be able to request that the SEC not disclose the information publicly, although the judgment about whether the information is to be made public should be left to the SEC staff.

Similarly, it is very useful to know when short interest in a stock is climbing, as it may provide and early warning that some type of manipulation may be happening. The recent switch from monthly to bimonthly reporting of short interest has been very useful. Even more frequent reporting may be useful. **The Commission should require weekly dissemination of the short interest data and should explore the feasibility of daily dissemination, after an appropriate lag.**

Empty voting

A manipulator can easily buy votes in a corporate election by purchasing shares in a cash account, and then hedging the stock position by either shorting shares or using some derivative product. **Shareholders, especially officers and directors, who have hedged their shares should be required to publicly report this hedging when they vote.**