Commentary

Protection For All

Roel Campos, 07.31.08, 5:25 PM ET

Naked short-selling is a major contributor to market turmoil.

After years of arguing to the contrary, the Securities and Exchange Commission has finally acknowledged that the practice of short-selling without pre-borrowing or locating shares can be harmful to large public companies. It is time that it acknowledges the harm it does to small ones as well.

The SEC's July 15 emergency order, now extended through Aug. 12, aims to halt the naked shorting of mortgage giants Fannie Mae, Freddie Mac and 17 of the largest Wall Street and global financial institutions.

In the broadest sense, this is commendable. The move gives the perception that the SEC is the cop on the beat. It has instilled a renewed vigor that is providing world markets with much-needed confidence.

Still, by extending the emergency order of protection to only the largest and most powerful banks, the SEC is left in an awkward position.

Chairman Cox has hinted several times that the SEC may propose new rules very soon to extend protections against naked short-selling to all companies. This move cannot happen soon enough. Small "Main Street" companies have complained for years to the SEC that they too are often the victims of naked short-trading aimed at driving their share prices down.

In the current market environment, the failure of many small companies on America's Main Streets can just as easily threaten the U.S. economy as the fall of one or two large companies on Wall Street.

It is widely agreed that legal short-trading provides liquidity and price discovery to the market. The debate lies in how Regulation SHO, the three-year old set of rules regulating the shares of companies whose stock already have high levels of settlement failures, should work.

Legal short-trading will not be and should not be abolished. Public companies simply want a version of Regulation SHO that works. In the fast electronic environment, traders argue that they cannot pre-borrow shares in advance of unpredictable short trades for hedging.

After intense lobbying, the SEC granted an exception to the emergency rule and exempted registered exchange market makers from pre-borrowing shares.

Presumably, the SEC still favors eliminating a large and abused exception from the current Regulation SHO for option market makers. The regulation, as written, is unenforceable and requires a degree of mind reading to determine whether traders are shorting with intent to manipulate share prices.

Hundreds of public companies are on exchanges' so-called threshold lists for months at a time, indicating that a significant percent of shares from short trades have failed to be delivered, also known as FTDs. This situation creates "phantom shares" that leverage the downward pressure on share price.

As proposed, the SEC's new emergency order contains the two necessary elements for fixing Regulation SHO and eliminating naked shorting and settlement failures once and for all.

The first fix addresses the pre-borrowing of shares before shorting; the second, the need for "hard" delivery of shares traded short within the three-day settlement period. Both are essential to eliminating FTDs. Enforcement will be straight-forward. Either the shares are borrowed and delivered or there is a violation.

Existing exceptions to Regulation SHO have helped make the rule inoperable. In the future, when the SEC determines that a trader requires an exception, making it narrow with a hard delivery of shorted shares, will provide an adequate solution.

It is critical that the SEC go forward with extending the protections of the emergency order to all public companies. It is imperative that Regulation SHO become an enforceable rule that eliminates both naked shorting and FTDs. It is also imperative that it benefits all public companies, not simply a favored few.

Mr. Campos is the partner in charge of Cooley Godward Kronish's Washington, D.C. office and is a former SEC Commissioner.