



Reg SHO and the New Short Squeeze

Josh Galper
Managing Principal
January 11, 2007

“The SEC has proposed several changes to Regulation SHO, including eliminating a major market maker exception to existing short sale rules. If these amendments are adopted, the SEC will create the opportunity for a new type of short squeeze, affecting a stock’s price, its securities lending rate, or both. Vodia Group’s analysis presents several strategies for managing trading and risk in this market.”

Market makers in equities and options enjoy a privileged position in the US markets. Besides being able to post two-side quotes with generally lower costs than their competitors, they may legally short some stocks without having to borrow the underlying security. This situation, called naked shorting, is permitted when market makers are conducting *bona fide* market making. Naked shorts are trades that fail to deliver, which the SEC has accepted in exchange for maintaining an orderly market.

Recently however, the SEC has proposed changes that aim to curtail naked shorting even when done in the legitimate best interests of a client. With the new rules, market makers would need to cover their shorts in securities that become hard to borrow after the trade, thereby changing the volatility and securities lending rates in an identifiable portion of the market. A range of actors will be affected by these changes: market makers will be forced to assume a new degree of financing risk while abusers of the market maker exceptions will be somewhat curtailed. Some market participants may attempt to squeeze the price or rebate rate of the affected securities. For lenders, forecasting which securities are about to be affected will become increasingly important to their own revenue streams.

Reg SHO, Threshold Lists and the Grandfather Clause

In 2004, The SEC adopted Regulation SHO (Reg SHO), which among other things mandated that broker-dealers obtain a locate whenever a stock was sold short by themselves or their clients. This means if any trading group (internal or external) wanted to short a stock, they must first locate the long position and borrow that stock into their account. Hedge funds rely primarily on their Prime Brokers to meet this need, and non-self clearing market makers rely on their correspondent clearing agents. Self-clearing market makers must cover themselves from inventory or borrow from a custodian¹.

One of the main points of Reg SHO was to eliminate fails to deliver in the market. If a trade is made and the stock can not be delivered, then the trade fails. This creates phantom stock in the marketplace, creates pricing distortions and allows for multiple parties to vote on shareholder matters. Few parties in the market disagree that unchecked naked short selling is harmful to an orderly marketplace.

For market makers engaging in *bona fide* market making activities, Reg SHO section 203(b)(2)(iii) gave them an exception to parts of the locate rule. The SEC reasoned that because equity market makers were often serving customers in fast moving markets, complying with the locate rule would be an undue burden for easy to borrow securities. Options market makers were also exempted so long as the short was used to cover a hedged position. The rule does not apply for proprietary trading (called “speculative selling strategies” by the SEC) or one-sided market making. Importantly, there is also no exception for securities that already have excessive fails to deliver.

In practice, the only securities that matter for the exemption are those that are about to be the hardest to borrow. These are securities that within the course of a trade go onto the Threshold Lists published daily by every stock exchange that has listings. When a market participant wants to short these securities, there is a genuinely open question whether

¹ For more information on the structure of the securities lending market, visit Vodia Group’s website at www.vodiagroup.com for our free papers and presentations.

they will be able to do so as the inventory may not be available. If one of these stocks is shorted before it goes on the Threshold List, the market maker exception continues to apply while other market participants must close out their positions.

Over the last two years critics have attacked the SEC for allowing the market maker exemption at all, as well as a related grandfather clause for many outstanding fails to deliver. The critics argue that the market maker exemption protects market makers from the same terms as everyone else, and that the difference between market making and proprietary trading is too slim to be noticed. Recently the NASD has gone so far as to send notices to members reminding them that the Reg SHO exception is strictly for *bona fide* market making activity, which supports the claim that the exceptions may be being abused.

In response, the SEC has released proposed changes to Reg SHO. The SEC now proposes that if a market maker is short a security that goes onto to the Threshold List during the trade, the market maker has 13 days to close out the position or cover the short. For options market makers, they would have to close out a position after 13 days once a *bona fide* hedge was removed. In addition, the proposed elimination of the general grandfather clause would force all market participants to close out fails to deliver within 35 days of the regulation going into effect, creating huge short-term volatility in the affected names.

Introducing Financing Risk in Market Making

By mandating that all Threshold List securities must be covered or closed out, regardless of the stock's status when the trade was made, the SEC would introduce a new financing risk to market makers. Market makers rarely factor any major financing risk into their trading activities as it is not usually relevant to their activities. When acting as a true market maker and not a proprietary trading desk, the desire of a market maker is to manage spreads and risk, not to be short stock. With the SEC's proposed rules, market makers may be faced with having to cover their positions by regulatory mandate, not when best in terms of market prices.

Financing risk may become a problem for market makers in the following case:

- 1) There is a run-up in an easy to borrow stock's price.
- 2) Market makers short securities in sales to the public.
- 3) Outside players such as hedge funds are also shorting the stock.
- 4) As demand for available inventory outstrips supply, trades will fail to deliver.
- 5) If the stock holds steady at the higher price, the market maker will be holding a meaningful amount of short inventory that is costly to unload.
- 6) Under the proposed SEC amendments, all market makers would have 13 days to cover their shorts, leading to either increased buying or borrowing of the underlying security by many players at the same time.

As an example with less financing risk, a stock may enter the Threshold List around the same time as a fierce decline in the stock price. In these situations the market maker is buying inventory from clients wanting to sell short, and may be short itself from buying back other short seller's positions and hedging to the street. Short seller demand may have outstripped supply in this case, but our scenario indicates that as the market price stabilizes, market makers can sell their inventory with little trouble to themselves or the market.

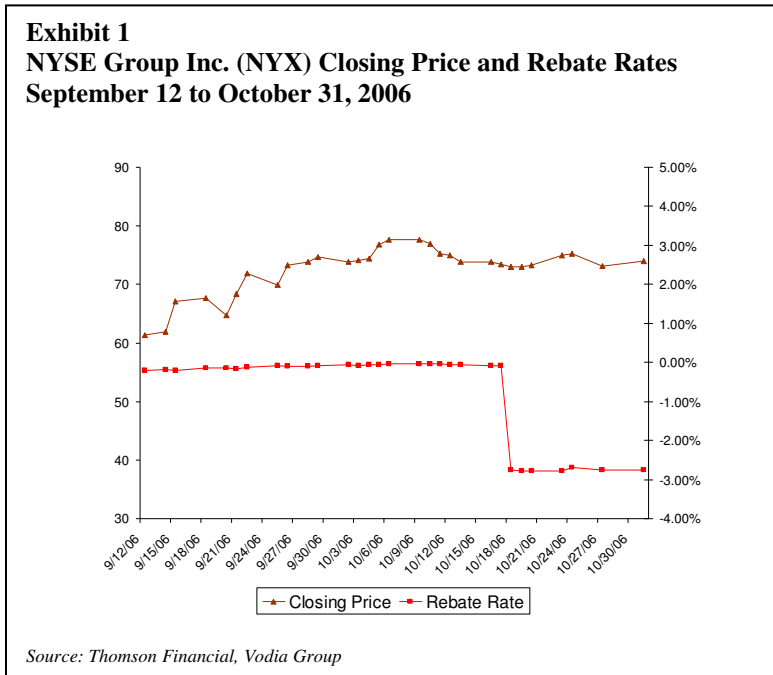
Two Case Studies: NYSE Group Inc. (NYX) and Telik Inc (TELK)

NYX: Market Makers Sell Short to Cover Buyer Demand

Recent trading in the New York Stock Exchange Group (NYX) presents a good history of market makers holding a net short position that would have been unprofitable to close out or cover. NYX has been a Threshold List security since September 22, 2006. The day before its entry to the list, NYX closed at \$68.30. On November 22, 2006, NYX closed at \$108.96, a run-up of 63%.

The day before NYX went onto the Threshold List it was an easy to borrow. Under both current and proposed regulations, if a security is not on the Threshold List there is no mandate to locate the short; it is assumed that the position can be covered as needed.

As fate would have it, the price of NYX went up from September 22nd. All along, its rebate rate continued to be negative, meaning that although buyers liked the stock, short sellers were convinced it was due to fall. On October 18th the rebate rate of NYX made a sharp jump negative, going from close to 0% to negative 2.75% (see Exhibit 1). For a specialist or market maker that was shorting the security to meet demand, under



current regulations their positions were grandfathered; there was no need to close out or borrow stock in case of a failure to deliver. In exchange for keeping an orderly market, market makers who were short got a free ride on their financing fees.

Under the proposed SEC regulations, the market maker would have been forced to borrow the stock after 13 days or be bought in. Since the stock price was rising, it would have been in the best interest of the market maker to not sell at a loss. If the market maker believed that the price of the stock would soon fall, they would want to cover the position with a stock borrow, thereby incurring financing fees between 0% and 2.75% annually. Without a crystal ball predicting the one month future of the stock, the market maker would not have known which way the price was heading.

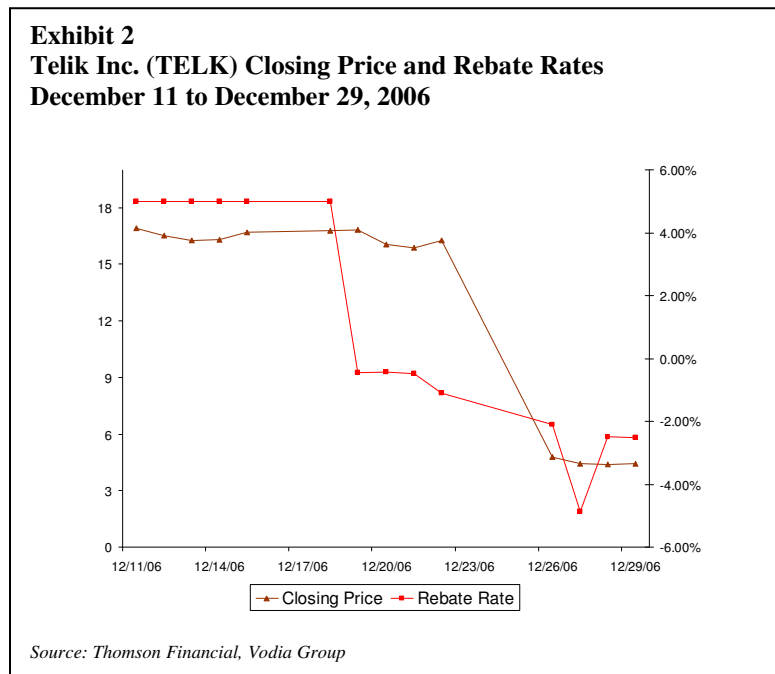
Once the stock hit the Threshold List, other market participants could see the market maker's actions coming. They would either push up the price of NYX to sell when the

market makers would, and/or lenders would raise their lending rates. The major reason why a security is on the Threshold List today is because the market maker exception allows this group not to close out their positions. If a close or cover is forced, a new type of short squeeze would be advertised to the market. Looking at comparable hard to borrow securities, we believe that a rebate of negative 8 for NYX would be reasonable in this short squeeze situation.

Not to be outdone, we expect the market makers to work as proactively as they can to avoid being squeezed. They may deliberately settle all the positions they can in order to get a security off of the Threshold List. They may work to lower the price of the security to an economic point where they can buy back at a profit. Or, they may simply price this new financing risk into the initial quotes they offer to the market, thereby widening spreads but also giving themselves a greater financial cushion. Whatever happens, a new calculus of risk will have entered the market.

TELK: The Smart Money Covers Its Shorts

Telik Inc. is, according to their website, “a biopharmaceutical company dedicated to discovering, developing and commercializing novel small molecule drugs to treat cancer and other serious diseases.” It is also a firm that announced the trial failure of its most promising cancer drug on December 26, 2006, when its share price plunged from \$16.26 the prior day to \$4.77. News of the trial



failure had reached the short selling community days before the stock price drop. On December 19, TELK’s rebate rate dropped from General Collateral (the easiest to borrow

rate) to negative 0.4% (see Exhibit 2). On December 22 the stock hit the NASDAQ's Threshold List, and by December 29th its rebate rate was negative 2.5%.

In the TELK scenario, it is possible that market makers were on the receiving end of trades made to cover outstanding short sale positions. The smart money got into TELK prior to December 18th, before its rebate rate dropped into negative territory; those positions earned \$11.49 per share. Market makers were forced to sell short inventory they did not own to cover these positions. Some of the market maker shorts were likely covered by disheartened investors who were themselves selling out. However, TELK's continuing appearances on the NASDAQ's Threshold Lists means that either directional money had re-entered the security on the belief that its price will go to \$0, or market makers who sold short on or prior to December 26th were using their exceptions and holding on to the stock.

A look at the primary market makers for TELK gives some additional information to the story. According to NASDAQ data, Lehman Brothers was the leading market maker in TELK for November, trading 17% of total volume (see Exhibit 3)². Keeping ratios constant, on December 26, Lehman would have traded 5.7MM shares. As TELK has 52.36MM shares outstanding, this means Lehman would have traded in one day 10% of the float.

Exhibit 3
Top Market Makers for Telik Inc. (TELK)
November 2006

Market Participant	MPID	Volume	Percent
Lehman Brothers Inc.	LEHM	3,274,464	17%
Morgan Stanley	MSCO	2,272,659	12%
UBS Securities	UBSS	2,183,654	11%
Merrill Lynch	MLCO	1,576,721	8%
Credit Suisse Securities (USA)	FBCO	1,373,008	7%
Citadel Derivatives Group	CDRG	1,153,259	6%
Goldman, Sachs & Co.	GSCO	1,094,304	6%
Nasdaq Execution Services, .	NSDQ	911,853	5%
Citigroup Global Markets Inc.	SBSH	649,739	3%
Deutsche Bank Securities Inc.	DBAB	627,708	3%
Knight Equity Markets	NITE	579,916	3%
Automated Trading Desk	AUTO	473,081	2%
National Financial Services	NFSC	372,711	2%
Banc of America Securities	BOFA	350,678	2%
J.P. Morgan Securities Inc.	JPMS	349,149	2%
Total Volume of all Participants		19,474,717	

Source: NASDAQ

² Lehman Brothers was also the leading market maker in TELK in September and October.

Publicly available data also tell us that for December 2006, 130.17% of TELK's ownership was outstanding. The 130.17% figure is not a typo; rather, it indicates that a large proportion of shares have failed to deliver, hence creating at least 30.17% of TELK's float as phantom shares. In a similar situation, Overstock.com shows 108.77% ownership outstanding. While the market maker exception is not to blame for this situation, it also does not help close out the naked short positions.

On the presumption that Lehman was net short at the end of the trading day of December 22nd, it would have been able to use its market maker exception to not cover its short position if it didn't want to. It obviously would not want to since that would incur financing charges. If the SEC's proposed amendments were law, Lehman would have either had 13 days to buy-in its net short position or pay 2.5% a year in financing charges. We can see that a small demand may have existed in the market maker community for long TELK shares either as market purchases or borrows to cover short positions.

Some Good, Some Bad

Under the SEC's proposed Reg SHO amendments, we expect that fails to deliver will decrease. However, we also expect a rise in market volatility for newly-minted Threshold List securities, as market makers work to avoid a short squeeze while others work to catch them in it. We will see this volatility expressed not just from the stock's price but also in its securities lending rate. We also expect spreads to widen in securities that are nearing the Threshold List as market makers account for financing risk.

Securities that will experience short squeeze trading conditions have common characteristics. These securities see high demand on the short side coupled with a rising stock price, leading to market maker accumulation of short positions prior to their inclusion on the Threshold Lists. We believe that TELK rather than NYX follows the more typical Threshold List pattern which should minimize the overall disturbance to the market. If the SEC's amendments are passed however, the NYX example will become one to watch out for.

About the Author

Josh Galper is Managing Principal of Vodia Group LLC. He has an expertise in the securities lending market and runs Vodia Group's securities lending practice area. He is a regular speaker at industry conferences, has been quoted in *The Wall Street Journal*, *New York Times*, *Forbes*, and appears occasionally on Bloomberg TV. He holds an MBA from the MIT Sloan School of Management. He can be reached at jgalper@vodiagroup.com.

About Vodia Group LLC

Vodia Group is a consulting firm focused on financial services and financial technology. The firm has a major practice area in securities lending and financing. For more information, please visit our website at www.vodiagroup.com.