

Securities Lawyer 101

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# Short Sales Q & A



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## Short Sales Q & A

Short selling can be a legitimate trading strategy. It is often endorsed for its beneficial effects on the securities markets, which include increasing liquidity. Short selling is also criticized. Short sellers profit by identifying companies that are weak or overvalued, and companies whose shares have been manipulated to rise to artificially high share prices. The most widely misunderstood aspect of short selling is under what circumstances it becomes illegal. We created this Securities Lawyer 101 Series to address the most common questions we receive about [Short Sales](#).

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### Q. What is a Short Sale?

A. A short sale is the sale of a security that the seller does not own but has borrowed for delivery to the purchaser of the security. In a short sale, the short seller speculates that the price of a particular company's shares will decrease.

The Short Seller borrows shares to sell in the open market at the stock's then trading price. The loan of shares is arranged by his brokerage firm. The stock may come from the firm's own inventory, the accounts of other clients on margin, or from another lender. Eventually, the Short Seller will repay the borrowed shares by purchasing the shares in the open market. If the stock price decreases as the Short Seller expected, he or she can buy to cover at a lower price, and keep the difference as profit. If the price increases, the Short Seller must pay the difference and so will take a loss.

### Q. What is a Naked Short Sale?

A. A [naked short sale](#) occurs when the short seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer, within the standard three-day settlement period. As a result, the short seller fails to deliver securities when delivery is

due. This is known as a "[failure to deliver](#)".

### Q. Did Regulation SHO make naked short selling illegal?

A. In January 2005, the Securities and Exchange Commission ("SEC") launched [Regulation SHO](#), which was intended to reduce persistent failures to deliver. Failures to deliver are sometimes, though not always, associated with short selling. The new rules have been largely successful.

### Q. What is the Alternative Uptick Rule?

A. In February of 2010, the SEC adopted Rule 201 under Regulation SHO; it is also known as the Alternative Uptick Rule. The Alternative Uptick Rule restricts short selling when the price of a security drops at least 10% in the course of one session. At that point, short selling is permitted only if the price of the security is above the current highest bid price. The rule remains in effect for that security for the rest of the session, and for the following day. The Alternative Uptick Rule also requires that brokers establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale. Short selling is not illegal in these circumstances; it is merely regulated.

**Q. A broker-dealer shorted my company's stock and failed to cover. Is this legal?**

A: Broker-dealers who make a market in a security must be ready to buy and sell the security on a regular and continuous basis at the publicly quoted price, even if there are no other buyers or sellers. This results in market makers selling the security to a buyer even when no stock is available. Because it may take the market maker considerable time to purchase or arrange to borrow the security, he may need to sell the security short without having the immediate ability to borrow shares. This is most common for market makers in thinly traded, illiquid stocks such as securities quoted on the [OTC Markets](#). This activity is legal.

**Q. What is T + 3?**

A. Rule 204T requires that the short seller's broker-dealer, as opposed to the short seller, locate an entity that the broker reasonably believes can deliver the shares within three days after the trade ("T+3"). If reasonable, the broker-dealer may rely on the short seller's assurance that he or she has located a lender who can deliver the security in time for settlement. Rule 204T made it a violation of Regulation SHO if a clearing firm fails to purchase or borrow shares to close out a failure to deliver that results from a short sale in any equity security by no later than the beginning of trading on the day after the fail first occurs (T+4). Beyond that point, penalties will be imposed.

**Q. I think a broker shorted my Company's stock and failed to cover. Is this illegal?**

A. If a broker accepts a short sale for a large

percentage of an issuer's float without having the ability to cover, it may have an extremely difficult time demonstrating it acted reasonably. Selling stock short and failing to deliver shares at the time of settlement doesn't necessarily violate any rules unless it was done for the purpose of driving down the security's price. The latter is considered to be manipulative activity and violates the securities laws, including [Rule 10b-5](#) under the Securities Exchange Act of 1934.

**Q. What is a manipulative short sale?**

A. Market manipulation is intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of a security. Market manipulation can cause a stock's price to increase or, in a short sale, can cause it to decrease.

**Q. Can short sellers release information about my company to drive the stock price down?**

A. Short sellers engage in manipulative conduct when they attempt to drive down a stock's trading price by spreading false and/or misleading information. This practice is manipulative if short seller's trade in collusion, because as the group's sell orders hit the market, the stock price declines while the short sellers profit. The more precipitous the drop, the more profit the short sellers make, and the more devastating it is to the security.

**Q. What are some examples of manipulative short selling?**

A. One example of a manipulative practice would include announcements of negative information concerning an issuer, such as

false statements about SEC investigations and/or trading suspensions or [DTC chills](#). Other examples include false or misleading statements indicating a company has engaged in fraudulent activity when it has not. A common example that has come up recently involves an alleged fraudster who files frivolous litigation accusing public companies of spam or other illegal activity while at the same time his cohorts engage in short sales of the same company. This is clearly illegal.

Another form of manipulation can occur when the Short Seller shorts a large percentage of the public float of the security he or she is trading. Under these circumstances, it may be difficult for the Short Seller to establish that he or she intended to cover. His or her broker may also have

difficulty showing that he or she acted reasonably in accepting the Short Seller's order.

### **Q. Where do I report illegal short sales?**

A. If you believe your company has been the victim of illegal short selling then you should report the activity to:

FINRA – Regulatory Tips  
1735 K Street, NW  
Washington, DC 20006-1500  
Fax: (866) 397-3290

Office of the Whistleblower  
Securities & Exchange Commission  
100 F Street, NE, Mail Stop 5971  
Washington, DC 20549  
Fax (703) 813-9322

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For further information about [Short Sales](#), please contact [Brenda Hamilton](#), Securities Attorney at 101 Plaza Real South, Suite 202 North, Boca Raton, Florida, (561) 416-8956, or by email at [info@securitieslawyer101.com](mailto:info@securitieslawyer101.com). This securities law Q&A is provided as a general informational service to clients and friends of [Hamilton & Associates Law Group, P.A.](#) and should not be construed as, and does not constitute legal advice on any specific matter, nor does this create an attorney-client relationship. Please note that the prior results discussed herein do not guarantee similar results.

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