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Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation

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Abstract

The SEC recently adopted Regulation SHO to tighten restrictions on short selling and curb abusive short sales, including naked shorting masquerading as routine fails to deliver. This paper models market equilibrium when short selling is permitted and contrasts the equilibrium with and without manipulators among the short sellers. I explain how naked short selling can routinely occur within the securities clearing system in the United States and characterize its potentially severe market impact. I show how a recent securities innovation called floating-price convertible securities can resolve the unraveling problem and enable manipulative short selling to intensify.

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