

The efficacy of Regulation SHO in resolving naked shorts 🛒

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Purpose

On January 3, 2005, Regulation SHO was implemented by the Securities and Exchange Commission, with the express purpose of updating short sale regulation by seeking to limit an abusive short selling practice known as naked short selling. The purpose of this paper is to examine the efficacy and impact of Regulation SHO in achieving this goal of reducing naked shorting.

Design/methodology/approach

Time series analysis using fixed effects regression, Fama-French-Carhart model, various parametric and non-parametric tests. The paper tests a number of hypotheses regarding the effectiveness of Regulation SHO in controlling naked shorts/fails-to-deliver in the American stock markets.

Findings

Utilizing several models, the authors find strong evidence in the first 30 to 60 days after being identified by Regulation SHO as having excessive naked short positions, those securities on average experienced further significant negative abnormal returns, indicating the regulation was at best ineffective. This result is robust for a number of parametric and non-parametric tests. Models also show a security identified by Regulation SHO as having an excessive short position may actually suggest a profitable trading strategy of continuing to short those stocks. The regulation was largely ineffective/insignificant in reducing naked shorting. In addition, results revealed that a profitable investment could be made by shorting stocks as they were identified by Regulation SHO as already having excessive outstanding failure positions.

Originality/value

This is the first paper, to the authors' knowledge, that considers whether SHO was effective and offers intuition as to reasons why it was not.

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