

Vodia Group Note

Short First, Ask Questions Later: An Analysis of SEC Fails to Deliver Data

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New SEC Fails to Deliver Data Suggest a “Short Now, Ask Questions Later” Mentality

The SEC has recently released data on equities that failed to deliver in August and September of 2007. While the SEC data are not comprehensive – they omit securities with fails totaling less than 10,000 shares – they do offer a public and consistent window of transparency into a historically opaque corner of the markets. Both camps of the “naked shorting” debate, the deniers of wrongdoing and the conspiracy theorists, can come out of the shadows and face certain facts.

We see a strong relationship between securities that fail to deliver and heavy negative market sentiment. While not every security on the fail list was hard to borrow in securities lending terms, most had put to call ratios that outweighed the market as a whole by a fair margin. This suggests that these fails were driven by short sales. Only a minority showed regular market sentiment suggesting a certain portion of fails due to missed paperwork or other clerical error.

We analyzed the two month data set and isolated August 15th as the day with the greatest number of securities that failed to deliver. August 15th also served to illustrate our major points:

- 1) Fails to deliver account for a very small percentage of market capitalization.**
 - Fails to deliver on August 15th accounted for \$8.9B of value. This was \$2B more in failed value than the average of the two month period. \$8.9B represented 0.05% of the market capitalization of the major equity markets on that day (and does not include failed positions of under 10,000 shares).
- 2) Reg SHO does not mean a fail, and a fail does not mean a Reg SHO security.**
 - Regulation SHO securities comprised 10% of the fail to deliver list and 22.9% of fails by dollar value. There were plenty of securities not on the SHO list that failed to deliver.
- 3) Failing to deliver does not mean hard to borrow.**
 - A total of 1,004, or 61%, of fails to deliver were general collateral for a securities loan. 3% of fails had rebate rates of -5% or worse, meaning that the stock was very hard to borrow and it is possible that a naked short could have occurred (see Exhibit 1).

4) Heavy shorting tends to accompany fails to deliver.

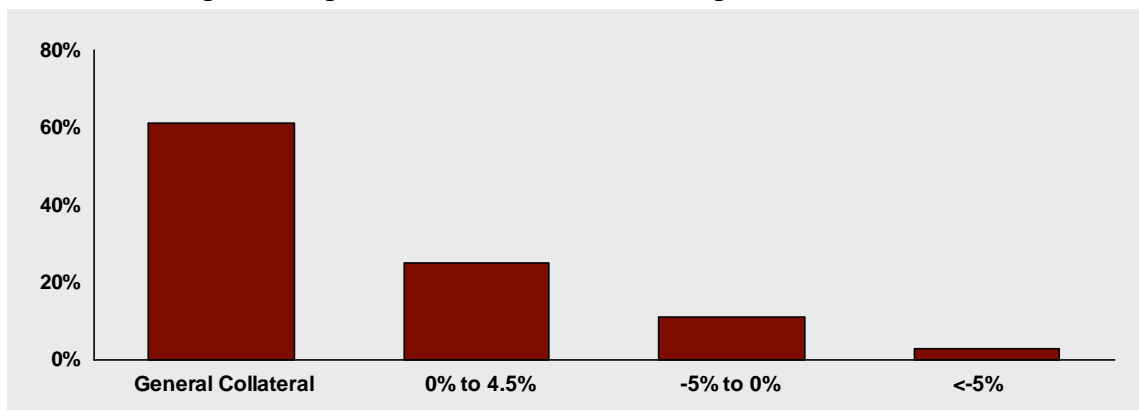
- The put to call ratio for the fail to deliver securities was 1.43 compared to 0.89 for the market as a whole. This means that fail to deliver securities had very heavy negative sentiment compared to the overall market.

5) Smaller cap names tend to fail more than large cap names.

- The largest 500 equities by market cap represented 28% of fails and 92% of the total market cap; the smallest 500 listings represent 41% of total fails and only 1% of total market cap.

Exhibit 1:

Securities Lending Rate Ranges of Fail to Deliver Securities, August 15th 2007



Source: Vodia Group, SEC

Fails to deliver data can be used to argue that no wrongdoing occurs in the market or that evil wrongdoers abound. The fact is that fails occur for a variety of reasons. We found that stocks with fails to deliver tend to have greater than average short selling, and since the trade failed to deliver, this suggests that short sellers are not adequately locating their securities before shorting. This is a “short first, ask questions later” mentality, at least as far as the operations are concerned. It does not mean however that fails to deliver represent a conspiracy.

We appreciate the SEC’s publication of the fail to deliver data and encourage it to continue with this disclosure.

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