SEC Adopts New Disclosure Rule Aimed at Increasing Short-Selling Transparency

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When hedge funds or other investors “short” a stock, they speculate that the stock’s share price will decline. To establish a short position, an investor will borrow shares of the stock, typically from its prime broker, and immediately sell them for cash. If the share price later declines, the investor may close out its position by purchasing an equivalent number of shares on the open market at the lower price, returning them to the lender, and pocketing the difference. If the share price increases, however, the lender may call its loan and the short seller will be required to purchase the shares at a higher price to close out its position, resulting in a loss. The danger of “shorting” stocks is the potential loss is theoretically unlimited.

In January 2021, we witnessed the rise of the “meme” stock craze and its attendant volatile effect on the broader market. During that time retail investors drove up the prices of shares in companies like GameStop and AMC, coordinating their purchasing frenzies on the Reddit forum r/WallStreetBets. Because many hedge fund managers held short positions in these securities, the retail purchasing frenzy resulted in a “short squeeze” requiring the hedge funds to repurchase shares at astronomical prices to close out their short positions. These repurchases caused the price of the securities to go even higher, creating even more volatility.

New Rule 13f-2 and Form SHO

The Securities and Exchange Commission (the “SEC”) recently adopted Rule 13f-2 and new Form SHO. Beginning in 2025, Rule 13f-2 will require certain investment managers to use Form SHO to report details about their short positions to the SEC for each short position that exceeds one of the reporting thresholds described below as of the end of any month. Form SHO must be filed within 14 calendar days after the end of the month in question, with the first filings due by February 14, 2025. The SEC believes this data will assist it and other regulators in assessing systemic risk and in reconstructing unusual market events, including instances of extreme volatility. A high-level summary of the Rule 13f-2 reporting requirements is outlined below.

Scope of Covered Persons

Rule 13f-2 applies to “institutional investment managers,” which include any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person. Practically speaking, this applies to broker-dealers, investment advisers, banks, insurance companies, pension funds, and other institutional investors.

Reporting Thresholds

A manager is required to file a Form SHO if its short position in an equity security exceeds one of three thresholds, as measured at the end of each calendar month. The applicable threshold depends on whether the short position relates to securities of a "Reporting Issuer" or those of a "Nonreporting Issuer." A Reporting Issuer is basically a publicly traded company that files periodic reports with the SEC. A Nonreporting Issuer is any other company, including private companies with securities that trade in the over-the-counter market.

A manager must report short positions in equity securities of a Reporting Issuer if the manager holds (1) an average daily gross short position with a value of $10 million or more for the month, or (2) an average daily gross short position equal to 2.5% or more of the outstanding class of securities for the month. These thresholds are designed to ensure that large short positions in both small and large capitalization securities are reported.

Managers must report gross short positions in equity securities of Nonreporting Issuers with a value that meets or exceeds $500,000 at the close of regular trading hours on any settlement date during the calendar month.

Reporting Requirements

Among other things, a Form SHO filing must include the size of the manager's gross short positions at the end of the month and the manager's "net" activity in the relevant security for each settlement date during the calendar month. Form SHO filings are confidential; however, the SEC will aggregate the data reported by all managers on Form SHO and publicly report the aggregate short positions in each security. According to the SEC, Rule 13f-2 is designed to provide greater transparency to investors, regulators, and other market participants through the publication of short sale-related data.

What To Do Now

Managers should prepare to develop and implement reporting systems to monitor whether a Form SHO reporting threshold is met or exceeded and policies and procedures for making Form SHO filings when required. This will require the manager to monitor short positions on a daily basis. Managers may want to employ a third party such as a fund administrator to assist with the short position monitoring. In short (no pun intended), this will increase the cost of shorting.

Unintended Consequences

Short selling is important to the healthy functioning of securities markets, including by providing market liquidity and by rewarding those that discover companies with potential unreported liabilities or even fraud. The new reporting requirements will likely increase the cost of shorting for institutional managers. There may also be increased risks from short squeezes as other investors may be able to identify stocks with concentrated short positions, particularly thinly traded stocks. While not the intent of the new rule, the increased costs and risks are likely to discourage short selling, which may have the unintended consequences of reducing liquidity of individual securities and increasing the volatility of the stock market as a whole.

Related Services

1. Securities and Directors & Officers