FAILING TO DELIVER FOR DUMMIES – Stock Borrow Flow

The NSCC intermediates the fail transaction with the stock borrow program. The Naked Seller fails to deliver, and issues an IOU along with cash to over-collateralize the share that the NSCC borrows from the DTC's lending member's account. The DTC issues a share of stock to the NSCC that is given to the Buyer, who pays his money to the NSCC, where it also collateralizes the borrowed share. The IOU from the Naked Seller sits on the NSCC's "C" account as a receivable, offset by the cash from the Buyer and the Naked Seller in the NSCC "D" account. The "Fail" is the Naked Seller's IOU to the NSCC/DTC lending participant's account. Until the Naked Seller delivers a share he buys in the market or borrows from another broker, there is a fail on the books. As the price of the shares goes down, a portion of the $ collateralizing the borrow is freed up and returned to the Naked Seller – hence there is an economic driver to never cover, but rather continue to sell and drive the price down. If the company is de-listed or trades at a nominal level (.01) the Naked Seller never has to cover, as there is no tax consequence and he has use of virtually all or the cash generated in the sales – the position is marked to market each evening, and any excess cash returned to the Naked Seller. One can easily see how just a few dollars of over-collateralization enables a Naked Seller to leverage and use the proceeds from the sale to control a decent amount of stock. In this example the Buyer's DTC account can lend the share out the day after settlement, taking the position of Lending Participant A. This is my best take on how I believe the process works.

Transaction Flow