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Market Crisis Focus on Short Selling: SEC Adopts Rules to Curb Abusive Practices

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Introduction

In efforts to protect investors and assure fair and orderly securities markets, the SEC this week adopted a package of extraordinary emergency measures. These include an order strengthening investor protections against naked short selling, including rules requiring a hard T+3 close-out, eliminating the options market maker exception of Regulation SHO, and targeting fraud in short selling transactions. The SEC also announced emergency plans for a rule to ensure public disclosure of short selling positions of hedge funds and other institutional money managers. The U.K. Financial Services Authority, acting in concert with the SEC, adopted rules requiring both the disclosure of short positions on a daily basis in respect of financial institutions and prohibiting any active increase in a net short position in a financial stock by whatever instrument.

In another emergency order, the SEC eased restrictions on the ability of securities issuers to repurchase their securities in order to give them flexibility to buy back their securities and restore liquidity to the markets. Importantly, building on an earlier emergency order enhancing protections against short selling in the securities of primary dealers, the Commission prohibited short selling in the securities of 799 financial companies, effectively calling a time-out to aggressive short selling in financial institution stocks because of the essential link between their stock price and confidence in the institution.

Naked Short Selling

Against the backdrop of roiling markets, the SEC adopted rules to curb abusive naked short selling that go beyond its previously issued emergency order, which was limited to the securities of financial firms with access to the Federal Reserve's Primary Dealer Credit Facility. The new rules, which take effect September 18, apply to the securities of all public companies, including all companies in the financial sector. See Release 34-

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58572 (9-17-08). They signal the SEC's zero tolerance for abusive naked short selling, said Chairman Christopher Cox.

As part of its order, the Commission adopted, on an interim final basis, a new rule requiring that short sellers and their brokers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposing penalties for failure to do so.

If a short sale violates this close-out requirement, then any broker-dealer acting on the short seller's behalf will be prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. The prohibition on the broker's activity applies not only to short sales for the particular naked short seller, but to all short sales for any customer.

The SEC noted that Rule 204T applies only to fails to deliver resulting from trades that occur after the order becomes effective. Rule 203(b)(3) of Regulation SHO, as amended, continues to apply to fails to deliver that occurred prior to the order becoming effective. For example, if a participant has a fail-to-deliver position in a threshold security that has persisted for six consecutive settlement days prior to the order's effective date and the fail persists until the thirteenth settlement day, the participant must still close out its position pursuant to Rule 203(b)(3).

Although the rule will be effective immediately, there will be a 30-day comment period on all aspects of the rule. The Commission expects to follow further rulemaking procedures at the expiration of the comment period.

Also, effective on September 18, the SEC adopted Rule 10b-21, which is a naked short selling antifraud rule that expressly targets fraudulent short selling transactions. The new rule covers short sellers who deceive broker-dealers or any other market participants. Specifically, the new rule makes clear that those who lie about their intention or ability to deliver securities in time for settlement are violating the law when they fail to deliver. The intent of the enhanced delivery requirements and the antifraud rule is to impose powerful disincentives to those who might otherwise exacerbate artificial price movements through naked short selling.

Finally, the SEC approved a final rule eliminating the options market maker exception from the close-out requirement of Rule 203(b)(3) in Regulation SHO. This rule change also becomes effective on Sept. 18, 2008. As a result of the rule, options market makers will be treated in the same way as all other market participants, and must abide by the hard T+3 closeout requirements that effectively ban naked short selling. Regulation SHO was adopted to update short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938.

Investors must settle their security transactions in three business days. This settlement cycle is known as T+3; shorthand for trade date plus three days.

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This rule means that when someone buys securities, the brokerage firm must receive payment no later than three business days after the trade is executed. When someone sells a security, they must deliver to the brokerage firm the securities certificate no later than three business days after the sale. The first day of the three-day settlement cycle starts on the business day following the day the security was purchased or sold.

These rules were adopted to preserve fair and orderly markets pursuant to the SEC's powers under Exchange Act Section 12(k)(2). The Commission explained that its finding of an emergency is solely for purposes of Section 12(k)(2) and is not intended to have any other effect or meaning or to confer any right or impose any obligation other than set forth in the order. Under Section 12(k)(2), in appropriate circumstances the Commission may issue summarily an order to alter, supplement, suspend, or impose requirements or restrictions with respect to matters or actions subject to regulation by the Commission.

As explained in Release No. 34-58572, the SEC acted out of a concern that there is a substantial threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets that could threaten fair and orderly markets. There is the possibility of unnecessary or artificial price movements based on unfounded rumors regarding the stability of financial institutions and other issuers exacerbated by naked short selling. The Commission's concerns have gone beyond that limited amount of financial institutions that were the subject of its earlier emergency order.

There is also concern that some persons may take advantage of issuers that have become temporarily weakened by current market conditions, by engaging in inappropriate short selling of the issuer's stock. Moreover, sudden and unexplained declines in the prices of securities have raised questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis. In turn, this crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences.

"Short sale"

A short sale is the sale of a stock that the seller does not own or that the seller will borrow for delivery. Short sellers believe the stock's price will fall, or are seeking to hedge against potential price volatility in securities that they own. If the stock price drops, short sellers buy the stock at the lower price and turn a profit. If the price rises, short sellers will incur a loss.

Short selling is used for many purposes, including to profit from an expected downward price movement, to provide liquidity in response to unanticipated buyer demand, or to hedge the risk of a long position in the same security or a related security. The vast majority of short sales are legal.

However, abusive short sale practices are illegal. For example, it is prohibited for any person to engage in a series of transactions in order to create actual or apparent active

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trading in a security or to depress a security's price security for the purpose of inducing others to purchase or sell the stock. Thus, short sales effected to manipulate the price of a stock are prohibited.

"Naked short sale"

In a naked short sale, the seller does not borrow or arrange securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due, which is known as a failure to deliver or fail.

Failures to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. A fail may also result from naked short selling. For example, market makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

Naked short selling does not necessarily violate the federal securities laws or SEC rules. Indeed, in certain circumstances, naked short selling contributes to market liquidity. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers.

Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. This is especially true for market makers in thinly traded, illiquid stocks such as securities quoted on the OTC Bulletin Board as there may be few shares available to purchase or borrow at a given time.

Naked short selling, however, can have negative effects on the market. Fraudsters may use naked short selling as a tool to manipulate the market. Market manipulation is illegal. The SEC has toughened its rules and is vigilant about taking actions against wrongdoers.

Fails to deliver that persist for an extended period of time may result in a significantly large unfulfilled delivery obligation at the clearing agency where trades are settled. The SEC's Regulation SHO is intended to address these effects by reducing the number of potential failures to deliver, and by limiting the time in which a broker can permit a fail to deliver to persist. Regulation SHO requires brokers and dealers to close-out the open fail-to-deliver positions in threshold securities, for example, securities that have experienced

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a substantial number of extended delivery failures, which have persisted for 13 consecutive settlement days.

When considering naked short selling, it is important to know which activity is the focus of discussion.

- *Selling stock short without having located stock for delivery at settlement.* This activity would violate Regulation SHO, except for short sales by market makers engaged in bona fide market making.
- *Selling stock short and failing to deliver shares at the time of settlement.* This activity doesn't necessarily violate any rules. There are legitimate reasons why a seller may fail to deliver on the scheduled settlement date.
- *Selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the security's price.* This manipulative activity, in general, would violate various securities laws, including Exchange Act Rule 10b-5. Regulation SHO does not address this issue.

Prior emergency order

Earlier in the summer, in an effort to end naked short selling contributing to the disruption in the securities markets, the SEC issued an emergency order requiring all persons to borrow or arrange to borrow the securities identified in certain issuers prior to effecting an order for a short sale of those securities.

In testimony before the Senate Banking Committee, SEC Chair Christopher Cox said that the emergency order was designed to enhance protections against naked short selling in the securities of primary dealers, Fannie Mae, and Freddie Mac. The emergency order provided that all short sales in the securities of primary dealers, Fannie, and Freddie are subject to a pre-borrow requirement. In addition to this emergency order, said the chair, the SEC will undertake a rulemaking to address these same issues across the entire market.

The Commission acted because there now exists a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets. The SEC invoked the emergency powers granted it by Exchange Act Section 12(k)(2).

Noting that false rumors can lead to a loss of confidence in the markets, the SEC said that such loss of confidence can also lead to panic selling, which, in turn, may be further exacerbated by naked short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, reasoned the Commission, this chain of events can threaten market disruption.

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The SEC pointed to the events preceding the sale of The Bear Stearns Companies Inc. as amply illustrative of the market impact of rumors. During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns' stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms. In light of the potentially systemic consequences of a failure of Bear Stearns, the Federal Reserve took emergency action.

Congress and the uptick rule

In the wake of the SEC's emergency short sale order, there was growing congressional sentiment for the SEC to reinstate the uptick rule, which was rescinded in 2007. The uptick rule, Rule 10a-1, required all short sale stock transactions to be conducted at a price that was higher than the price of the previous trade. The SEC claims that they fully researched the regulation before it was repealed, but some commenters have noted that the research took place during one of the biggest bull markets in history.

The most demonstrative signal of congressional intent is a bill introduced by Rep. Gary Ackerman that would order the SEC to reinstate the uptick rule within 90 days. See H.R. 6517. Following the uptick rule's elimination, noted Mr. Ackerman, many volatile stocks that the regulation was designed to protect have been driven down as a result of manipulative short sale practices. He believes that the rule's reinstatement would help curb these abuses and ensure greater stability and confidence in the market. Under a reinstated uptick rule, he continued, fewer companies would fail, fewer investors would be driven out of the market, and more capital would remain in the stock markets.

In a short sale, an investor borrows shares of a stock from a broker, sells it to others, and then hopes to buy it back at a lower price before returning it to the lender. The difference, if any, is kept as a profit. The uptick rule was designed to prevent short sellers from being the only investors to cause a stock price to decline. Under the rule, a short sale could only be entered after a trade that caused the last price to increase. The uptick rule had been in place since 1938, and Rep. Ackerman saw no reason for the SEC to rescind it.

The core provisions of Rule 10a-1 had remained virtually unchanged since its adoption 70 years ago. Over the years, however, in response to changes in the securities markets, including changes in trading strategies and systems used in the marketplace, the SEC had added exceptions to Rule 10a-1 and granted numerous requests for relief from the rule's restrictions In addition, in rescinding the rule, the SEC noted that decimal pricing increments had substantially reduced the difficulty of short selling on an uptick.

In another signal of Congress' concern, Rep. Mike Castle sent a letter to Chairman Cox noting that, since the rescission of the uptick rule, there has been a dramatic increase in short selling and substantial market volatility. He suggested that the volatility might, in some measure, be attributable to the uptick rule's withdrawal. This rule had been in place

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since 1938, he said, and was responsible for limiting short selling in the securities markets.

Rep. Castle emphasized that it has been a longstanding goal of the SEC to maintain an orderly market process that offers reasonable risks and rewards for those willing to invest in it. Although speculation is an integral part of a vibrant market, he observed, today's market differs vastly from the market of 70 years ago and given that current market conditions are more volatile than those that previously prevailed, it is important that regulators monitor closely any impact of unrestricted short selling.

Short Sales of Financial Institution Stock

On top of its actions earlier this week to curb abusive naked short selling, the SEC has temporarily prohibited short selling in financial companies to protect the integrity and quality of the securities market and strengthen investor confidence. The Commission acted in concert with the U.K. Financial Services Authority, which took similar action.

The Commission’s action, which is effective immediately, applies to the securities of 799 financial companies. The action effectively calls a time-out to aggressive short selling in financial institution stocks because of the essential link between their stock price and confidence in the institution. See Release No. 34-58592 (9-18-08). The emergency order will terminate at 11:59 p.m. ET on October 2, 2008; but the SEC may extend it beyond 10 days if it deems an extension necessary in the public interest and for the protection of investors, but will not extend the order for more than 30 calendar days in total duration.

The Commission also will temporarily require that institutional money managers report their new short sales of certain publicly traded securities. These money managers are already required to report their long positions in these securities. Separately, the SEC also temporarily eased restrictions on the ability of securities issuers to repurchase their securities. This change will give issuers more flexibility to buy back their securities, and help restore liquidity during this period of unusual and extraordinary market volatility.

The SEC banned short selling in the stocks of almost 800 financial institutions out of a concern that short selling in the securities of a wider range of financial institutions may be causing sudden and excessive fluctuations of the prices of those securities in such a manner as to threaten fair and orderly markets. The Commission exercised its powers under Exchange Act Section 12(k)(2). The SEC believes that this emergency action will prevent short selling from being used to drive down the share prices of issuers even where there is no fundamental basis for a price decline other than general market conditions.

In later technical amendments (see Release No. 34-58611 (9-21-08)), the SEC retained the exception in the original order for short selling related directly to bona fide market making in derivatives in the securities of any included financial firm. However, this exception now requires that, for new positions, a market maker may not sell short if the market maker knows a customer or counterparty is increasing an economic net short

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position in the shares of the included financial firm. The technical amendments thus incorporate concepts included in the limitations on increasing net short positions imposed by the U.K. Financial Services Authority in its response to short selling. The provisions are not identical because, unlike the FSA, the Commission does not have statutory authority over swap contracts and other non-security over-the-counter derivatives. The technical amendments also provide criteria by which the listing exchanges will select the individual financial institutions with securities covered by the order, including banks, broker-dealers, and investment advisers. Issuers can opt out by notifying the exchange to exclude their securities from the list.

Hedge Fund Short Positions

The SEC also issued a new disclosure rule requiring hedge funds and other large investors to disclose their short positions. See Release No. 34-58591 (9-18-08). Prepared by the staffs of the Divisions of Investment Management and Corporation Finance, the new rule is designed to ensure transparency in short selling. Hedge fund managers with more than $100 million invested in securities must promptly begin public reporting of their daily short positions. The managers currently report their long positions to the SEC. The emergency order will terminate at 11:59 p.m. on October 2, 2008 unless further extended by the Commission.

Form SH

Specifically, under the order, institutional investment managers required to file a Form 13F for the calendar quarter ended June 30, 2008 must file a report on new Form SH with the SEC on the first business day of every calendar week immediately following a week in which it effected short sales. Form SH must be filed electronically on EDGAR, but will not be publicly available for two weeks pursuant to an amended order, Release No. 34-58591A (9-21-08). The Commission decided that Form SH should be initially filed on a non-public basis. It reasoned that non-public submission of Form SH may help prevent artificial volatility in securities as well as further downward swings that are caused by short selling, while at the same time providing the SEC with useful information to combat market manipulation that threatens investors and capital markets. Two weeks after the due date for the Forms SH, the Commission will make the Forms available to the public. The SEC believes that by two weeks after the due date the reasons to maintain the information as non-public will have diminished.

New Form SH requires disclosure of the number and value of securities sold short for each Section 13(f) security, except for short sales in options, and the opening short position, closing short position, largest intraday short position, and the time of the largest intra-day short position, for that security during each calendar day of the prior week.

No filing, however, will be required when no short sales of a Section 13(f) security have been effected since the previous filing of a Form SH. In addition, this disclosure requirement will only apply to short sales effected after the order's effective date. Moreover, the money managers need not report short positions otherwise reportable if the

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short position in the Section 13(f) securities constitutes less than one quarter of one per cent of the class of the issuer's outstanding Section 13(f) securities and the fair market value of the short position in the Section 13(f) securities is less than $1,000,000.

U.K. Financial Services Authority

Acting in concert with the SEC, the United Kingdom's Financial Services Authority adopted a rule requiring both the disclosure of short positions on a daily basis in respect of financial institutions; and a prohibition in any active increase in a net short position in a financial stock by whatever instrument. There will be an exception for market makers to enable them to meet client demand. The prohibition will remain in force until January 16, 2009, during which time the FSA will review both its effectiveness and the general policy the authority wishes to adopt in respect of short selling. Also, The FSA stands ready to extend this approach to other sectors if it judges it to be necessary.

According to FSA Chair Callum McCarthy, the FSA acted out of a concern over the volatility and incoherence in the trading of equities, particularly for financial institutions. There is a danger in a trading system which allows financial institutions to be targeted and subject to extreme short selling pressures, said the chair, because movements in equity prices can be translated into uncertainty in the minds of those who place deposits with those institutions with consequent financial stability issues.

Earlier this year in a significant move, the FSA adopted rules requiring the disclosure of significant short positions in stocks admitted to trading on markets that are undertaking rights issues. For this purpose, the authority defined a significant short position as 0.25% of the issued shares achieved via short selling or by any instruments giving rise to an equivalent economic interest. The obligation will be to disclose positions exceeding this threshold to the market by means of a Regulatory Information Service by 3.30 p.m. the following business day. The new rules took effect on June 20, 2008.

The FSA still views short selling as a legitimate technique that assists liquidity and is not in itself abusive. But it is also the case that the rights issue process provides greater scope for what might amount to market abuse, particularly in current conditions. The FSA believes that improving transparency of significant short selling in these shares would help prevent the potential for abuse. In these circumstances, non-disclosure of significant short positions gives the market a false and misleading impression of supply and demand in the securities concerned.

Issuer Repurchases

In another emergency order, the SEC temporarily eased restrictions on the ability of securities issuers to repurchase their securities based on its determination that issuer repurchases can represent an important source of liquidity during times of market volatility. This emergency order will also terminate at 11:59 p.m. on October 2, 2008 unless further extended by the Commission. See Release No. 34-58588 (9-18-08).

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Exchange Act Rule 10b-18 provides issuers with a safe harbor to effect repurchases within certain conditions. Historically, issuers have been reluctant to undertake repurchases without the certainty that their repurchases come within the safe harbor.

In the SEC's view, temporarily altering the timing and volume conditions in the safe harbor will provide additional flexibility and certainty to issuers considering the execution of repurchases during the current market conditions. In these unusual and extraordinary circumstances, the SEC believes that altering the timing and volume conditions in Exchange Act Rule 10b-18 is necessary in the public interest and for the protection of investors to maintain fair and orderly securities markets and to prevent substantial disruption in the securities markets.

Global Regulators Respond

Following the lead of the SEC and the U.K. Financial Services Authority, and in an effort to prevent regulatory arbitrage, securities regulators around the world have acted to ban forms of short selling as the crisis in the financial markets spreads globally. Countries that have now followed in banning or limiting short selling are Australia, France, Germany, Switzerland, Ireland and Canada (Ontario), and other regulators are assessing their responses.

The Australian Securities and Investments Commission has banned naked short selling and covered short selling subject to a limited authorized market-maker exemption. ASIC said it would reassess and advise the market in 30 days whether or not it will at that time, or at a later date, reopen covered short sales for non-financial stocks. Because of the relatively small size and the structure of the Australian market, the Commission believed that it was necessary to extend the prohibition to all stocks. To limit the prohibition to financial stocks, as has been done in the U.K., could subject other stocks to unwarranted attack given the unknown amount of global money that may be looking for short-sell plays.

Although emphasizing that it sees a legitimate place for short selling in markets, ASIC believed that in the current climate and, in light of the actions taken by other regulators, the market needed a circuit breaker to assist in maintaining and restoring confidence. These measures will operate for a limited time and in the case of non-financial stocks, will be reviewed in 30 days. In the case of financial stocks, the review will be in line with the time limits imposed by other international regulators such as the SEC and the FSA.

The Netherlands Financial Markets Authority took measures concerning the naked short selling of shares issued by financial companies. The measures concern shares issued by financial companies traded on the Euronext Amsterdam stock exchange; these shares concern transactions performed on own account or on behalf of third parties, with the exception of transactions performed by intermediaries acting as cash market maker or counterparty in block trade transactions. All selling orders resulting in postponed

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settlement/delivery concerning one of the shares involved must be covered for 100% by the financial instruments that are the subject of the selling orders.

Thus, the AFM's prohibition only applies to uncovered short positions as a result of selling orders in shares issued by financial companies. It does not apply to covered short positions resulting from selling orders in shares issued by financial companies. Market makers on the derivatives market and liquidity providers on the cash market, as defined by the Rulebook of Euronext, are exempt, as well as block trade counterparties. Market makers and liquidity providers designated by Euronext are only exempt in this capacity with regard to the relevant financial institutions.

The German Federal Financial Supervisory Authority (BaFin) prohibited short selling of the shares of a number of financial institutions, including Deutsche Bank, Commerzbank, and Allianz SE. The ban expires at the end of the year, but BaFin vowed to review it on an ongoing basis. BaFin justified this move by the recent developments in the global capital markets. The legal basis for its decision was section 4 of the Securities Trading Act. Based on this, the regulator had to counteract undesirable developments that might result in serious disadvantages for the financial markets. The statute provides that BaFin may issue orders that are appropriate and necessary to eliminate or to prevent such undesirable developments.

Noting SEC and FSA prohibitions on short sales, the BaFin said that, given the close interdependence of the financial markets, it is likely that without this order there would be serious adverse effects for the conduct of orderly trading on German markets. Particularly given the current state of the capital markets, an influencing of the market prices of shares of certain credit institutions, stock exchange operators, insurance companies and other companies from the financial sector is resulting in excessive price movements that could jeopardize the stability of the financial system.

The Ontario Securities Commission issued a temporary order prohibiting short selling of securities of certain financial sector issuers that are listed on the Toronto Stock Exchange and are also interlisted in the United States. This order was issued as a precautionary matter with respect to short selling of the securities of financial sector issuers subject to the SEC short selling order and to ensure that Canadian markets are not used for purposes of regulatory arbitrage The Commission vowed to monitor trading in securities of other Canadian financial issuers and take action if necessary. ❐

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