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SEC Refocuses on Short Selling

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In response to the current state of the markets and its debilitating effects on investor confidence, the Securities and Exchange Commission recently adopted several rules targeting "short sales." A "short sale" is a sale of stock that the seller does not own or that the seller may borrow for delivery. A "naked" short sale occurs when the seller does not borrow or arrange to borrow the securities in time to make the delivery to the buyer within the standard three-day settlement period. Consequently, the seller is unable to deliver the securities to the buyer when delivery is due. This is known as a "fail to deliver." While "fails to deliver" may sometimes be justifiable, they can be potentially abusive.

In 2004, the SEC adopted Regulation SHO to govern short sales and address abusive practices related to "naked" short sales. Regulation SHO imposes delivery requirements on securities with substantial and persistent amounts of "fails to deliver." For example, it requires broker-dealers to "locate" securities that they reasonably believe can be delivered within the standard three day settlement period. Additionally, it imposes a "close-out" requirement on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency ("threshold securities").

Following a series of emergency actions which temporarily banned short selling for certain stocks in September, 2008, the SEC ultimately decided to amend Regulation SHO by:

- eliminating the exception to the "close-out" requirement,
- strengthening its delivery requirements,
- adopting an antifraud rule specific to "naked" short selling practices, and
- adopting a rule requiring disclosure by institutional investment managers about their short sales and positions of Section 13(f) securities.

These new rules were designed to promote investor confidence during this volatile time. SEC Chairman Christopher Cox stated that these rules were needed to "ensure that hidden manipulation, illegal naked short selling or illegitimate trading tactics do not drive market behavior and undermine confidence." It remains to be seen how effective these new rules will be in restoring investor confidence but for now, it is important for investors to know that they exist.

Elimination Of The Options Market-Maker Exception

In October 2008, the SEC eliminated the "options market-maker" exception to the "close-out" requirement. This exception had exempted any fail to deliver in a threshold security resulting from short sales effected by a registered options market-maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security. The SEC decided to eliminate this exception because the SEC believed that large and persistent fails to deliver were not being closed out under the existing requirements and were having a negative impact on the market for those securities.

Stronger Delivery Requirements

The SEC strengthened its delivery requirements by adopting Rule 204T, which took effect on Oct. 17, 2008 and will expire on July 31, 2009 unless the SEC decides to extend it. This rule requires that securities of like kind and quantity be purchased or borrowed to close out any fail to deliver position in an equity security no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver occurred. The rule operates to avoid fails to deliver by requiring a participant to take

affirmative action to either purchase or borrow securities by the settlement date.

'Naked' Short Selling Anti-Fraud Rule

The SEC adopted new Rule 10b-21, an anti-fraud rule specifically aimed at short-sellers. In the adopting release, the SEC stated that "although 'naked' short selling as a part of a manipulative scheme is always illegal under the general antifraud provisions of the federal securities laws, including Rule 10b-5 ... Rule 10b-21 will further evidence the liability of persons that deceive others about their intention or ability to deliver securities in time for settlement." The SEC's concern was that some short sellers may have been deliberately misrepresenting to broker-dealers that they have obtained a legitimate source for the necessary shares. Rule 10b-21, which became effective on October 17, 2008, requires the mental state of scienter. Furthermore, violation of the rule only occurs if a fail to deliver results from the relevant transaction.

Disclosure And Form SH

Finally, the SEC adopted Rule 10a-3T as a new disclosure rule relating to short sales. Rule 10a-3T requires institutional investment managers that exercise investment discretion with respect to accounts holding Section 13(f' securities to file with the SEC a non-public Form SH on a weekly basis if they have effected short sales with respect to a 13(f) security during the reporting period preceding the due date of the filing. Form SH will provide the SEC with useful information for evaluating whether their current rules are working as intended.

The rule requires the filing of Form SH by those institutional investment managers that (1) as of the end of the most recent calendar quarter, file or were required to file, a Form 13F for the calendar quarter and (2) during a Sunday to Saturday calendar week effected a short sale in a Section 13(f) security other than options. The manager is required to file a Form SH with the SEC on the last business day of the following calendar week. The rule became effective on October 18, 2008 and will expire on July 31, 2009, unless the SEC decides to extend it.

Form SH requires disclosure of the following items: date, CIK of manager, name of issuer, CUSIP number, short position at the start of day, number of securities sold short and short position at the end of day. There is a de minimis exception to the disclosure requirements, which exempts certain Form SH filers from reporting short sales or short positions if the securities sold short during the day and the end of day short position are below certain thresholds.

Historical Perspective

Short selling has been criticized as contributing to declining stock prices during market downturns. Short selling was a hotly debated topic during the legislative hearings leading to the enactment of the Exchange Act. Consequently, Congress passed Section 10(a) under the Exchange Act which gave the SEC authority to regulate short sales of securities registered on a national securities exchange. Utilizing this grant of power, the SEC adopted Rule 10a-1, known as the "uptick rule," in 1938.

The uptick rule prohibited short selling in a falling market. Subject to various exceptions, the rule provided that a security may be sold short only at a price above the price at which the immediately preceding sale was effected. The rule sought to prevent short sellers from accelerating the downward movement of prices in a declining market.

While the uptick rule remained unchanged for almost seventy years, the SEC believed that the increased demand for exemptions from the rule and the sometimes disparate application of the rule created an "unlevel playing field." Moreover, the SEC noted that changes in the securities markets warranted taking a second look at the rule. The SEC's doubts about whether the rule still continued to serve a purpose led the SEC, in 2005, to adopt a one-year pilot program, which temporarily suspended the tick test in a list of designated companies. After a review of the pilot program, the SEC decided in 2007 to eliminate the uptick rule.

Conclusion

During times of financial distress, people often criticize various market practices claiming them to be the source of the problem. Changes are then made to "correct" the perceived problems and abuses. It was thought that short selling could be used in manipulative ways and that abusive "naked" short selling could drive down the prices of stock. To provide a check against this perceived abuse, the SEC created the uptick rule, in reaction to the 1929 stock market crash.

However, over time as the markets began to revive from the crash, people became more comfortable with such potentially abusive practices.

The perceived threat such practices pose is somewhat diminished during economic good times. In fact, in eliminating the uptick rule, the SEC noted that “today’s markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of abusive or manipulative short selling going undetected.”

In response to the current financial crisis, the SEC has refocused its attention on short selling and its potential abuses. It is too early to tell whether these new rules will produce their intended effect. The SEC is monitoring the impact of the rules and will consider the comment letters in response to the interim rules to determine whether further actions are needed. Given the criticism of short selling practices, the debate on short sales and the possible reinstatement of the uptick rule is likely to continue.

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[1] FN1 13(f) securities are equity securities of a class described in Section 13(d)(1) of the Exchange Act and require the filing of a Form 13F. Each quarter the SEC publishes an official list of Section 13(f) securities.