

ZERO TOLERANCE FOR 'ABUSIVE' NAKED SHORTING

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With what began in July as a temporary ban on “naked short selling” on the shares of 19 financial institutions, it appears that the Securities and Exchange Commission has launched a full-blown attack designed to thwart what it has characterized as “abusive” forms of short selling. The SEC has taken a series of extraordinary actions in an attempt to control the volatility of stock prices amidst ongoing market turmoil. In September and October, the SEC exercised its emergency powers and issued new temporary rules and orders in its effort to combat artificial market fluctuations caused by naked shorting transactions.

Analysts often cite aggressive shorting tactics as a significant cause for falling stocks prices. In ordinary short sales, an investor borrows an issuer’s stock from a third party, and then sells the borrowed stock into the market, betting that the price will go down. To close the short position, the investor must buy back the stock in the open market to return it to the lender. In abusive “naked” short transactions, the investor does not actually borrow or own the stock, and instead misrepresents to its broker or dealer that it has either borrowed the stock or that it owns the stock (i.e., holds a long position). The naked short seller then fails to deliver the stock sold by the broker-dealer to the buyer. The potential effect of this naked short sale is to allow more sales in the stock than there are shares outstanding, thereby putting undue negative pressure on the issuer’s stock price. The SEC has stated that “such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis.”

On July 15, the SEC took its first overt step against short sales by issuing an unprecedented emergency order temporarily halting short selling of securities of 19 financial services companies (including issuers such as **Fannie Mae, Freddie Mac, Merrill Lynch and Lehman Brothers**). After the emergency ban was instituted, pressures to sell were alleviated and the stock prices of the 19 companies began to stabilize. However, as the deterioration of the financial markets continued, and the bans expired, naked shorting returned and the stock prices of these companies again began to deteriorate.

On Sept. 17 and 18, the SEC exercised its emergency powers to issue temporary orders and adopt new temporary anti-shorting rules in an effort to stabilize the market. These rules were originally set to expire on Oct. 1 and 2. The SEC, mired in typical confusion, announced on Oct. 1 the extension of these emergency orders until 11:59 P.M. on Oct. 17. The SEC’s press release announcing these extensions addressed all of the previous Sept. 17 and 18 actions, but, in actuality, the SEC only issued orders extending two of the five previous actions. The next day, Oct. 2, the SEC published the rest of the extension orders without further explanation, thereby completing the extension. The SEC also adopted the guidance previously issued by the staff of the Division of Trading and Markets, which provided details on the technical and operational implementation of these rules and orders.

The new anti-fraud rule, 10b-21, the institutional manager’s reporting requirements and the hard T+3 delivery requirements are intended to remain in effect beyond the Oct. 17 expiry as interim final rules.

The complete prohibition on short sell-

ing securities of financial institutions was to expire on the third day after the “bailout legislation” is signed into law. (Oct. 8.)

The repeal of the market maker exception was final and will not be reinstated on Oct. 17.

New SEC Rules Adopted Sept. 17

The new rules adopted on Sept. 17 specify mandatory delivery requirements and impose strict penalties for failure to comply with those requirements. As a result, short sellers and their broker-dealers must now deliver the securities that are sold short within three trading days of the sale transaction date (T+3) or face stiff consequences.

Failure to deliver on the T+3 settlement date carries the following consequences. The broker-dealer is required to go into the market and cover (i.e., buy shares at the then prevailing market price to cure the delivery failure) or borrow shares to cure the delivery failure. The broker-dealer also is prohibited from effecting any further short sales in that issuer’s equity security, not only for the customer who failed to deliver, but also for all of that broker-dealer’s customers, unless its other short selling customers have first actually borrowed or pre-borrowed the securities. These prohibitions remain in place until the delivery failure is covered.

There are two exceptions to these prohibitions. If the broker-dealer can demonstrate that the delivery failure is due to a long sale, then the rules allow an additional three trading days to cure the failure. Also, if the delivery failure relates to equity securities sold pursuant to SEC Rule 144, and the failure continues for 35 consecutive trading days after T+3, then the delivery failure must be cured (i.e., covered) by the

36th consecutive trading day after T+3.

As a companion provision to these trading requirements, the SEC adopted Rule 10b-21 which makes it a “manipulative and deceptive device or contrivance” under Section 10(b) of the Securities Exchange Act – the insider trading law, and therefore potentially subject to criminal penalties – to submit an order to sell an equity security if the seller deceives the broker-dealer, clearing agency or the purchaser, about “its intention or ability to deliver the security on or before the settlement date” and such person fails to so deliver. While the SEC has previously stated that such selling tactics “as part of a manipulative scheme” are already prohibited under the general anti-fraud provisions of Rule 10b-5, it distinguished the new rule as a means to “highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares.”

The new rules also permanently eliminate the options market maker exception from Regulation SHO relating to naked shorts. Market makers are now required to abide by the T+3 settlement date, thereby treating them the same as all other market participants. Although designed to “impose powerful disincentives to those who might otherwise exacerbate artificial price movements through ‘naked’ short selling,” these new rules greatly impact the substantive requirements on broker-dealers which were forced to immediately modify their current practices.

Emergency Orders Issued Sept. 18

On Sept. 18, the SEC issued an emergency order prohibiting the shorting of any publicly traded securities of 799 of the nation’s banks, insurance companies, securities firms and other finan-

cial institutions. This order, however, provides for narrow exceptions for bona fide market makers, block positioners and automatic exercise or assignment of an equity option held prior to the effective date of the order (Sept. 19). In addition, the order only prohibits entering into short sales in the named financial institutions after the effective date of the order and does not require the unwinding of any pre-existing short positions with the named financial institutions. The order refers to Rule 200(a) of Regulation SHO with respect to the definition of “short sale.” On Sept. 21, the SEC issued amendments to the order to address technical and operational concerns which provide as follows:

- The list of included financial institutions covered by the order will be amended and no longer be determined by the SEC. Instead, each national securities exchange will be responsible for determining and publishing on its website the financial institutions covered by the order on that exchange. The listing exchanges, upon an issuer’s request, can exclude that issuer’s securities from the list.
- Certain short sales in covered financial institutions’ securities (i) resulting from the expiration of futures contracts held before the original order’s effective date or (ii) resulting from an assignment to call writers upon exercise will be permitted.
- The narrow exception contained in the original order for bona fide market makers will not apply if the market maker knows that the transaction will result in an increased net short position in securities of a covered financial institution.
- Persons effecting sales pursuant to Rule 144 of the Securities Act of 1933, as amended, in a covered financial institution’s securities will be exempted from the original order.

On Sept. 18, the SEC also issued two other emergency orders. The first of which requires that institutional investment managers report information concerning daily short sales of certain publicly traded securities on the newly created Form SH. The second of these orders temporarily reduced restrictions on corporate stock buy-backs, in an attempt to provide companies greater flexibility to repurchase their securities and help restore liquidity. The order modifies the issuer stock buy-back safe harbor under Rule 10b-18 by suspending the time of purchases condition and modifying the volume of purchases condition under the Rule so that purchases of up to 100% of the average daily trading volume for the security are now permitted, and trades may now occur at the open and close of the trading day.

Overall, these emergency actions have many supporters and many opponents. The opponents feel the SEC has undermined the efficiency of the capital markets by eliminating shorting as a result of the conduct of a minority of naked short sellers. These opponents argue that the SEC should carry out its mandate and enforce its rules by prosecuting naked short sellers, rather than artificially manipulating the free flow of the capital markets and punishing otherwise compliant market participants. The opponents’ voice is, however, quashed by the hue and cry of hedge fund detractors, who blame funds for the undue volatility in the capital markets. Hopefully the recent adoption of the Emergency Economic Stabilization Act will obviate the need for further emergency action by the SEC and both the opponents and supporters can get back to trading as usual. ■

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