Securities

Emergency Restrictions on Short Selling in the United States, Canada and the United Kingdom

The upheaval in the financial markets last week has prompted international securities regulators, led by the United States Securities and Exchange Commission (SEC), to adopt emergency restrictions on short-selling of certain financial stocks. The SEC also has banned "naked" short-selling. In support of the SEC's measures, and to avoid regulatory arbitrage, the United Kingdom's Financial Services Authority, and some Canadian regulators have also implemented restrictions on short-selling. In the coming days, other Canadian securities regulators may follow suit.

The restrictions not only affect short sellers, but also investment managers who rely on models and programs that assume short selling takes place. Those models and programs must be adjusted to address these changes. Furthermore, investment managers will be subject to additional disclosure requirements under U.S. law in connection with their short sales and short positions.

What is Short Selling?

Short selling is the practice of selling securities the seller does not own, with the intention of acquiring the securities (or "covering" the short position) at a lower price in the future. The short-seller traditionally borrows the securities from a dealer for a fee and makes a profit based on how far the price of the security declines before they must pay for the covered securities.

To those unfamiliar with it, short-selling has historically been seen as somewhat of a black art. More recently, it has been blamed for contributing to the recent crisis in financial stocks and institutions. For example, Morgan Stanley's John Mack complained that short sellers wrestled his company's stock to the ground. The second largest pension fund in the U.S. called short-sellers "piranhas" and refused to lend stock to them. New York's Attorney General Andrew Cuomo likened short-sellers to, "looters after a hurricane."

Temporary Ban of Short Selling of Certain Financial Stocks

On September 19, 2008 the SEC took temporary emergency action to prohibit short selling in 799 identified financial companies. According to the SEC, it did this, "to protect the integrity and quality of the securities market and strengthen investor confidence." The SEC acknowledged that, "Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets." However, the agency went on to explain, "At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation."

The SEC's emergency order was immediately effective and will terminate at 11:59 p.m. ET on October 2, 2008, unless the SEC extends that date. Some short-selling is exempted from the SEC's emergency order, including short sales by registered market makers as part of a bona fide market-making in derivatives in the securities of the covered financial companies, and under certain circumstances, short sales that occur due to automatic exercise or assignment of certain equity options.

The SEC's emergency order followed the U.K.'s Financial Services Authority's September 18, 2008 temporary ban against the short sale of securities of 29 financial companies, which does not expire until January 16, 2009.

On September 19, 2008, the Ontario Securities Commission restricted the short sale of 13 financial stocks that are also listed in the United States. The restriction, effective immediately, expires October 3, 2008.

SEC Action Against "Naked" Short Selling

On September 18, 2008, the SEC also adopted measures against so-called "naked" short-selling. In a naked short sale, the short seller does not formally borrow the security (i.e. obtain a positive confirmation that the dealer is in a position to lend the shorted securities) before shorting. Furthermore, the short-seller does not meet the standard requirement for settlement by delivery of shares within three days of the trade ("T+3 Settlement").

The fact that the naked short seller does not borrow the security puts downward price pressure on the security through what is in effect an artificial increase in the supply of that security. In a naked short sale, the short seller is at immediate risk of a buy-in if delivery of the shares is insisted upon by the buyer of the securities sold short. For this reason, naked short selling is often done with a very short-term outlook where price declines are in progress.

To avoid exacerbating price declines in securities, the SEC's new rules effectively prevent naked short selling by requiring a T+3 Settlement. The ban applies to naked short selling in all stocks, not just financial ones. Under these rules, short sellers and their broker-dealers must deliver shorted securities for clearance and settlement by the close of business within three days of the date of the short sale. A broker-dealer who fails to comply with this rule may not accept further short sales in that stock unless the shares are located and pre-borrowed. Although this rule was immediately effective, it was adopted on an interim basis, so the SEC will seek public comment before adopting a final rule.

The SEC also adopted a final rule that makes options market makers subject to the T+3 Settlement requirement.

As part of these efforts, the SEC has also adopted a new anti-fraud rule under Section 10(b) of the *Exchange Act* to address deceptive short selling practices. New Rule 10b-21, effective immediately, provides that short sellers that make misrepresentations about their intent and ability to deliver securities in compliance with the T+3 Settlement requirements are in violation of the law when they fail to deliver the securities as represented. This rule is intended to flush out the situation where the short seller does not advise the broker that the shares are being sold short, but rather directs the broker to sell shares which are not in the account on the basis of an implied promise by the seller to lodge the shares before settlement is required, or buy them back and cover at that time.

New SEC Disclosure Requirements

Another SEC emergency order approved September 19, 2008 requires institutional money managers to report certain information every week about the prior week's short sales and short positions with respect to section 13(f) securities. Most equity securities admitted to trading on a national securities exchange or quoted on an automatic quotation system of a registered securities association are considered 13(f) securities. In determining if a security is a 13(f) security, an institutional investment manager may rely on the most recent list of such securities published by the SEC.

The new reports require information about the daily number and value of shorted securities, the opening and closing short position, and the amount and time of the largest intraday short position.

More Canadian Restrictions to Come?

The SEC coordinated some of its recent activity with the United Kingdom's Financial Services Authority, which passed some similar measures. Canada's financial sector has not been rocked as severely by sub-prime loan related market turmoil and the imperatives for action have not appeared as compelling as they have in the U.S. and perhaps the U.K. Additionally, Canadian short selling rules require that the short sale may occur only on an "up-tick" trade (that is, one that is higher than the previous trade), which inhibits short selling in a falling market. The SEC did away with its up-tick rule last year, which likely has exacerbated the current problem with short-selling in the U.S.

Despite these differences, the risk of regulatory arbitrage appears sufficiently real that other Canadian regulators may adopt similar measures in the days to come.

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