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A Short Summary of Short Selling Regulations

On July 15, 2008, the SEC issued an emergency order barring naked short sales of the stock of Fannie Mae, Freddie Mac and 17 financial firms, including Lehman Brothers, Goldman Sachs, Merrill Lynch and Morgan Stanley. This action further intensified the media's focus on short selling. The emergency order, however, represents only the latest in a line of SEC regulatory and enforcement actions aimed at addressing problematic short selling activities.

A short sale occurs when a seller sells a security it does not own, requiring that it make delivery with a security borrowed by it or on its behalf. Whether executed as a hedge or for speculative purposes, the profitability of a short position depends on the seller's ability to buy in shares to cover its short position at a lower price than the price at which it effected the original short sale. Short selling has important positive market effects, but also may be manipulative. One form of manipulation is the "short and distort" scheme, the inverse of a "pump and dump" scheme, in which a company's stock is shorted and fraudulent negative information about that company is disseminated in order to drive down its stock price. Such schemes recently have received attention from the SEC's enforcement division, as have shorting activities of hedge fund investors in PIPE transactions. As recently as April 2008, the SEC charged a trader with securities fraud and market manipulation for intentionally disseminating a false rumor in connection with short selling activities. The SEC's longstanding concern with shorting activities is evidenced by its recent amendments and proposed amendments to short selling regulations. In light of the increased attention on shorting, additional changes are likely. In order to understand the direction of regulatory changes, a short summary of existing and proposed shorting regulations may be useful.

Regulation SHO

The most extensive changes to shorting regulations were the SEC's amendments to Regulation SHO, or Reg SHO. Reg SHO was originally adopted in July 2004 to regulate short sales and to prevent naked short selling by requiring the closeout of fails-to-deliver against short positions in certain securities, called threshold securities. Threshold securities are equity securities with respect to which there is an aggregate fail-to-deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, that equals at least 0.5% of the issuer's outstanding shares, and is included on a list disseminated by an SRO. Ordinarily, market participants must borrow a stock, or determine that borrow is available, before selling it short. This is known as the "locate" requirement. Naked shorting refers to the illegal practice of selling securities short that the seller does not borrow or arrange to borrow in time to make delivery to the buyer within the standard three-day settlement period. A "fail-to-deliver" occurs when a seller fails to deliver the security by the settlement date. If a clearing broker has a fail-to-deliver position in a threshold security for 13 consecutive settlement days, the broker is required to close out the position by buying securities to cover the fail.[1] Until the position is closed out, the clearing broker and any other broker-dealers for which it clears transactions are prohibited from engaging in further short sales in the security.

[1] Rule 203(b)(3) of Reg SHO.

Exceptions to the Closeout Requirement

Prior to the July 15th order, the SEC had implemented or proposed several amendments to Reg SHO intended to reduce the number of persistent fails-to-deliver in certain equity securities by eliminating exceptions to the closeout requirement. Prior to the amendments, fails-to-deliver against open short positions that existed when a security was first designated a threshold security were exempt, or "grandfathered," from the closeout requirement to prevent disruptive buying pressure. In August 2007, the SEC eliminated the exception, concerned that, although high fail levels exist only for a small percentage of stocks, large and persistent fails-to-deliver may have a negative effect on the market for those securities. As a result, all fail-to-deliver positions in threshold securities now must be closed out within 13 consecutive settlement days.

Also in August 2007, the SEC proposed to eliminate the "options market maker exception" to Reg SHO, originally intended to address concerns regarding liquidity and option pricing. The options market maker exception excepts from the closeout requirement any fail-to-deliver position in a threshold security attributable to short sales by a registered options market maker if, and to the extent that, the short sales are effected by the registered market maker to establish or maintain a hedge on options positions created before the security was designated a threshold security. In response to comments it received in 2007, the SEC postponed implementation of the proposed amendment. In July 2008, the SEC re-opened the comment period after gathering empirical data suggesting that a high number of fails-to-deliver were not closed out as a result of the options market maker exception.[2]

The proposed amendment would require that any previously excepted fail-to-deliver position in a threshold security, including any adjustments to that fail-to-deliver position, be closed out within 35 consecutive settlement days of the effective date of the amendment. The initial 35 consecutive settlement days would be a one-time phase-in period, after the expiration of which, any additional fails-to-deliver in the threshold security would be subject to the current mandatory 13 consecutive settlement day closeout requirement. If the fail-to-deliver position persists beyond the phase-in period, a participant and any broker-dealer for which it clears transactions, including market makers, would be prohibited from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona fide arrangement to borrow, the security until the participant closes out the entire fail-to-deliver position by purchasing securities of like kind and quantity. The SEC also offered two alternative proposals that would each allow a longer period for close outs of fail-to-deliver positions.

Tick Test

In June 2007, the SEC eliminated the short sale price test, or 'tick test', under Rule 10a-1 of the Exchange Act.[3] The tick test established price restrictions intended to prevent manipulative short selling. The rule prohibited short selling of a security in a "down" market by providing that a security may be sold short only (1) at a price above the immediately preceding reported price (plus tick) or (2) at the last sale price if higher than the last different reported price (zero-plus-tick). The effect of the tick test was that securities could be shorted only in an "up" market. The SEC eliminated the tick test after reviewing the results of a pilot study that exempted a select group of securities from these price restrictions. The pilot study confirmed that the restrictions were no longer necessary given changes in market dynamics. In connection with the July 15th emergency order, some commentators urged reinstatement of the tick test as a means of tempering heightened market volatility.

Regulation M

In August 2007, the SEC amended Rule 105 of Regulation M, which governs short selling in connection with public offerings. Generally, in a secondary or follow-on offering, stock is priced at a discount to its closing price on the pricing date. As a result, a person that expects to be allocated offered shares may attempt to "lock in" a

2 SEC Release No. 34-58107 (July 7, 2008).
3 SEC Release No. 34-55970 (June 28, 2007).

gain by aggressively short selling just prior to pricing and then covering those short sales with securities received in the offering, at the lower offering price. This shorting activity may exert downward pressure on the issuer's stock price, resulting in a lower offering price and, thereby, reducing the offering proceeds to the issuer.

To eliminate this "covering," the SEC amended Rule 105 of Regulation M to impose a bright-line test on short sales in connection with a public offering. The amended rule makes it unlawful for a person who sells short an equity security during the restricted period to "purchase" securities in the offering, even if the securities purchased in the offering are not used to cover the short position. The restricted period generally consists of the shorter of the five business days preceding the pricing of the offering or the period commencing with the initial filing of the registration statement and ending with the pricing. The rule applies only to registered firm commitment offerings of equity securities and does not apply to reference securities (securities into which the "subject security," or the security that is the subject of the distribution, may be converted, exchanged or exercised or which, under the terms of the subject security, may in whole or in significant part, determine the value of the subject security). In an offering of securities convertible into common equity, a person may still short the underlying common stock and purchase the convertible security in the offering without violating Rule 105. The rule also retains the exception for best efforts offerings. Therefore, PIPE transactions and registered direct offerings (agency best efforts deals) do not fall within the purview of the rule because they typically are conducted on best efforts basis. The rule also does not address options or derivatives trading.

As originally proposed, the rule did not contain any exceptions. However, as adopted, the rule exempts three activities from its scope: (1) bona fide purchases, (2) purchases by separate accounts and (3) purchases by investment companies. An investor who sells short during the restricted period will not be prohibited from participating in the offering if the investor makes a bona fide purchase of the same security at least one business day prior to pricing. This exception is intended to allow persons to participate in an offering if they sold short before they became aware of the offering or if their shorting activity was part of their regular trading activities. The exception for separate accounts allows a person to purchase the offered securities in an account even if there was a short sale in another account held by that person so long as decisions regarding securities transactions for each account are made separately and without coordination. The exception for investment companies allows an individual fund within a fund complex, or a series of a fund, to purchase an offered security if another fund within the same complex or a different series of the fund sold short during the restricted period.

By amending Rule 105, the SEC believed that it was establishing a "bright-line" test prohibiting a short seller from purchasing in an offering (in contrast to the prior rule, which prohibited the seller from covering the short sale with securities received in the offering) that would "once and for all put an end to the progression of schemes that have been engineered to camouflage covering activity [in violation of Rule 105]."

Proposed Rule 10b-21 Relating to Naked Short Selling

On March 21, 2008, the SEC proposed an anti-fraud rule, Rule 10b-21, under the Exchange Act, to address fails-to-deliver associated with naked short selling. Rule 10b-21 is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to make delivery by the settlement date. Broker-dealers are permitted to reasonably rely on customer assurances regarding identified borrow in the securities. The SEC is concerned that some short sellers have made deliberate misrepresentations to broker-dealers that they have obtained a legitimate source of shares, about their ownership of shares, or that their sales are long sales (when they are in fact short). Although abusive naked short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the securities laws, including Rule 10b-5, proposed Rule 10b-21 is intended to highlight the specific liability of persons that engage in this deception.

Naked Shorting Emergency Order

The SEC's recent emergency order was issued in response to a perception that naked shorting might trigger a market stampede away from the securities of the subject institutions. The order requires that anyone affecting a short sale of securities of these institutions have an actual agreement to borrow the securities, rather than simply a belief that such securities can be obtained. The order intended to promote investor confidence and reassure investors that the SEC is protecting companies and investors from manipulative short selling.[4] FINRA has issued a regulatory notice explaining that when using pre-borrowed shares to make delivery on a short sale of a security covered by the emergency order, the short seller must clearly document the link between the borrow, the short sale and the delivery. On July 18, the SEC amended the emergency order to exclude market makers selling the specified securities short as part of bona fide market making and hedging activities. On July 29, when the order was set to expire, the SEC announced that it would be extended through August 12.

Enforcement and Private Litigation

In conjunction with tightening restrictions on short selling, beginning in 2005, the SEC stepped up its enforcement efforts. The enforcement division has focused its efforts on problematic shorting practices of hedge funds that invested in PIPE transactions. In a number of cases, the SEC alleged that hedge funds had committed securities law violations by effecting short sales in the securities of an issuer consummating a PIPE transaction prior to the effective date of the resale registration statement covering the securities purchased by the hedge funds in the PIPE transaction. The hedge funds had covered their short positions using shares received in the transaction pursuant to the registration statement. Separately, the SEC also has alleged that hedge funds had engaged in insider trading violations by effecting their short sales while in possession of material non-public information about the issuers (i.e., that such issuers were conducting financing transactions). A number of courts have rejected the SEC's arguments that the hedge fund short sales constituted Section 5 violations;[5] however, the SEC has successfully pursued its insider trading allegations. Various hedge funds and their advisers have agreed to multimillion dollar settlements, as well as suspensions or bars from the securities industry.

In addition to increased enforcement actions, in nearly a dozen pending lawsuits, short sellers have found themselves defendants in private litigation brought by companies alleging that they are victims of fraudulent naked short selling. The most publicized case was filed in 2007 by Overstock.com, Inc. against a number of large Wall Street firms.[6] The cases are currently mired in the discovery phase and it remains to be seen how courts will address claims relating to naked shorting. The SEC has thus far declined significant involvement in these cases, perhaps recognizing that there often are other factors contributing to the degradation of shareholders' value. Many earlier complaints came from small, thinly traded companies, some of which had weak financials and were likely to attract legitimate short sellers trying to find overpriced stocks, and, indeed, several suits brought by companies alleging improper shorting have been promptly followed by countersuits alleging fraudulent reporting on the part of the plaintiff companies. However, given the SEC's aggressive stance on naked short selling and the fact that many companies now complaining about naked shorting are neither small nor thinly traded, it seems likely that a new round of cases may be on the horizon.

Conclusion

The SEC is actively monitoring short selling activities and is seeking to reduce abusive short selling practices through a combination of regulations, enforcement actions, and, most recently, the emergency actions. In particular, the SEC is focused on addressing the issue of naked shorting. The emergency order will expire on August 12 and the SEC has stated that it will "proceed immediately to consideration of rulemaking" which would expand the scope of the prohibitions to the "broader market." Further, the SEC has indicated that it may require disclosure of substantial short positions. The SEC found that its existing regulations on short selling are unable to address market abuses in light of changing market dynamics and is poised to make additional changes to address the perceived abuses.

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[4] SEC Chairman Christopher Cox has stated that the emergency order "is not a response to unbridled naked short selling—which so far has not occurred." Rather, it is intended as a preventative step to help restore market confidence. Cox, Christopher, "What the SEC Really Did on Short Selling," *The Wall Street Journal*, July 24, 2008.

[5] SEC v. Mangan, Civil Action No. 3:06-CV-531 (W.D.N.C. Dec. 28, 2006); SEC v. Lyon, Civil Action No. 06-CV 14338 (S.D.N.Y. Dec. 12, 2006); and SEC v. Berlacher, Civil Action No. 07-cv-3800 (E.D. Pa. Sept. 13, 2007).

[6] Quarterly Report on Form 10-Q of Overstock.com, Inc. for the period ended March 31, 2008, filed on May 9, 2008.

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