Securities Law Alert: SEC Takes Action Against Abusive Short Sales

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On July 27, 2009, the Securities and Exchange Commission (the SEC or Commission) announced steps to curtail abusive short sales and increase market transparency relating to those sales, as part of its ongoing efforts to strike an appropriate balance between regulation of abusive practices and allowing market participants to engage in legitimate short sale activity.[1]

Rule 204 under Regulation SHO Becomes Permanent

First, the Commission made permanent what had been a temporary rule, Rule 204T (now Rule 204) of Regulation SHO under the Securities Exchange Act of 1934, as amended (the Exchange Act), which seeks to reduce abusive, naked short selling by requiring broker-dealers to promptly purchase or borrow securities to deliver on a short sale. The temporary rule, which had been in place since the fall of 2008, was set to expire on July 31, 2009.

In a short sale, an investor borrows shares of a stock from a broker, sells the shares, and then hopes to buy the shares back at a lower price before returning them to the broker and keeping the difference in price.[2]

Naked short selling is the practice of selling shares short without borrowing them first. Before effecting a short sale, Rule 204 requires broker-dealers to locate an entity the broker reasonably believes can deliver the shares within the required settlement time for the trade, or three days after the trade (T+3 settlement). As an alternative, a broker-dealer may instead rely on a short seller's assurance that the short seller has located his or her own source for the shares that can deliver the shares by the T+3 deadline. If neither the investor nor the broker-dealer *delivers* the shares by the T+3 settlement date, a "failure to deliver" occurs. Where the investor or the broker-dealer neither *locates nor delivers* shares, a naked short sale has occurred.

While a "failure to deliver" can occur for legitimate reasons, such as delays in processing paperwork, that are not attributable to naked short selling activities, a large number of fails in a particular security may be a sign that naked short selling is occurring, and such "fails to deliver" may create a misleading impression of the market for an issuer's securities.[3] As such, the SEC has a strong interest in curtailing "fails to deliver" to the greatest extent possible.

Rule 204 also requires firms that clear and settle trades to purchase shares to close out "fails to deliver" within 13 days of the initial trade. This close-out requirement only applies to equity securities with large and persistent "fails to deliver," known as threshold securities. The SEC has eliminated two major exceptions to the close-out requirement, called the "grandfather" and "options market maker" exceptions. Both exceptions provided that certain "fails to deliver" in threshold securities never had to be closed out. The Commission eliminated these exceptions in August 2007 and September 2008, respectively.

An analysis conducted by the SEC's Office of Economic Analysis, which followed the adoption of the close-out requirement and the elimination of the options market maker exception, showed that the number of "fails to deliver" appeared to have declined significantly as a result of these measures, confirming the effectiveness, in the SEC's view, of Rule 204.

Increased Reporting by SROs of Short Sale Activity

Second, the Commission is working with self-regulatory organizations (SROs) to make short sale volume and transaction data increasingly available through SRO websites. This will result in a substantial increase in the information presently required by temporary Rule10a-3T. That rule, which will expire on August 1, 2009, applies only to certain institutional money managers and does not require public disclosure of short sale information. Instead of renewing the rule, the Commission is working with the SROs to increase the public availability of short sale-related information through a series of actions, including (1) daily publication of short sale volume information, (2) disclosure of short sale transaction information, and (3) twice-monthly disclosure of "fails to deliver" data. The SEC expects this additional information to become available on SRO websites within the next several weeks.

SEC Roundtable to Discuss Securities Lending, Short Selling and Related Issues

Third, the Commission plans to hold a public roundtable on September 30, 2009 to discuss securities lending, pre-borrowing, and possible additional short sale disclosures. According to the SEC's press release regarding these developments, the roundtable panelists will consider (1) issues related to securities lending, such as compensation arrangements, disclosure practices, and methods of collateral and cash reinvestment; (2) whether it would be appropriate to impose a requirement on short sellers to "pre-borrow" shares that are to be the subject of a short sale, or other means of enhancing the requirement to "locate" shares to be used in a short sale transaction, potentially on a pilot basis; and (3) additional means to foster transparency regarding short sales, such as adding a short sale indicator to the tapes on which transactions are reported for exchange-listed securities, and requiring public disclosure of individual large short positions.

Proposals on Price Tests and Circuit Breaker Restrictions Under Consideration

Apart from these measures, the Commission continues to actively consider its rule proposals on short sale price tests and circuit breaker restrictions.[4] On April 8, 2009, the Commission unanimously voted to propose two new alternative approaches to short selling regulation. One approach would impose a permanent market-wide short sale price test. The second approach would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities, referred to as circuit breaker restrictions.[5]

With respect to the first approach, the SEC proposed two alternative short sale price tests: one based on a national best bid (the Modified Uptick Rule), which would require trading centers to have policies and procedures reasonably designed to prevent the execution or display of short sales at impermissible prices, and the second based on the last sale price (the Uptick Rule), which would prohibit any person from effecting short sales at impermissible prices. These alternative tests are as follows:

Price Tests, Adopting a *Market-Wide, Permanent* Approach

- ***Uptick Rule***: This rule would create a market-wide short sale price test based on the last price or tick that would limit short selling to (1) a price above the price at which the immediately preceding sale was effected, or (2) the last sale price if it is higher than the last different price.
- ***Modified Uptick Rule***: This rule would create a market-wide short sale price test based on the national best bid that would limit short selling to a price at or above the current bid when that bid is above the previous bid.

With respect to the circuit breaker approach, the SEC proposed the following alternatives. One circuit breaker rule would temporarily prohibit short selling in a particular security when there is a severe decline in the price of that security (a halt), which could operate in place of, or in addition to, a short sale price test rule. Another alternative is a circuit breaker rule that would trigger a short sale price test rule. The accompanying short sale price test would be based on the national best bid for any security for which there has been a severe decline, or be based on the last sale price for any security for which there has been a severe price decline.

Circuit Breakers, Adopting a *Security-Specific, Temporary* Approach

- ***Circuit Breaker Halt Rule***: This rule would create a circuit breaker that would ban short selling in a particular security for the remainder of the day upon a severe price decline in that security.
- ***Circuit Breaker Uptick Rule***: This rule would create a circuit breaker that would impose a short sale price test based on the last sale price in a particular security for the remainder of the day upon a severe price decline in that security.
- ***Circuit Breaker Modified Uptick Rule***: This rule would create a circuit breaker that would impose a short sale price test based on the national best bid in a particular security for the remainder of the day upon a severe price decline in that security.

We examine each of these alternatives in turn.

The Uptick Rule

The SEC's proposed Uptick Rule is a modified version of former Rule 10a-1 under the Securities Exchange Act of 1934, as amended (the Original Uptick Rule). The Original Uptick Rule mandated that every short sale transaction be entered into at a price that is higher than the price of the previous trade in the stock. Established in the wake of the Great Depression, the initial purpose of the Original Uptick Rule was to prevent short sellers from conducting so-called "bear raids" on companies whose stock prices were falling dramatically, which could result in the actions of short sellers being the primary cause of a stock price's rapid decline. The SEC abolished the Original Uptick Rule on July 3, 2007 after conducting studies on its effectiveness and considering market developments since its adoption.[6]

Unlike the Original Uptick Rule, the proposed Uptick Rule, as well as the proposed Modified Uptick Rule, would apply a uniform rule subjecting trades in the same securities in different markets, wherever traded, to one short sale price test.

Modified Uptick Rule

The Modified Uptick Rule would require trading centers to have policies and procedures in place to prevent them from executing or displaying any short sale order, absent an exception, at a price that is below the national best bid.

In the proposing release for these rules, the SEC states its belief that the proposed Modified Uptick Rule would be more suitable to today's markets and would have advantages over the proposed Uptick Rule. A significant advantage highlighted by the SEC is that bid prices are generally a more accurate reflection of current prices for a security than last sale prices, due to delays that can occur in the reporting of last sale price information. Last sale price information is published to the market in reporting sequence rather than in transaction sequence, which may result in untimely information.

Circuit Breaker Halt Rule

The proposed Circuit Breaker Halt Rule would halt short sales of a particular security for the remainder of the day upon a severe price decline in that security, subject to certain exceptions. The SEC has initially proposed a 10% market decline threshold, such that the circuit breaker would be triggered if the price of a security declines by at least 10% from the prior day's closing price for that security. The SEC states in its proposing release that a short selling halt for the remainder of a trading day may be necessary to help ensure that market participants have a reasonable opportunity to discover and react to a significant decline in a security's price.

To avoid market disruption, the proposed circuit breaker rules would not be triggered if the specified market decline threshold is reached within 30 minutes of the end of regular trading hours, and would contain other exceptions.[7]

Circuit Breaker Price Test Rules

The proposed Circuit Breaker Uptick Rule and Circuit Breaker Modified Uptick Rule would impose short sale price restrictions for a particular security upon a severe decline in the price of that security. The circuit breaker price test rules would be implemented in place of permanent, market-wide short sale price test restrictions. Similar to the Circuit Breaker Halt Rule, the SEC has initially proposed a 10% market decline threshold so that the circuit breaker price test rule would be triggered if the price of a security declines by at least 10% from the prior day's closing price for that security.

The Commission sought public comment on whether either the market-wide short sale price restrictions or the security-specific circuit breaker restrictions should be imposed, and whether such measures would help promote market stability and restore investor confidence. The Commission stated that it has proceeded with the knowledge that any short selling restrictions must balance the goal of helping to prevent abusive short selling with the view that legitimate short selling can provide tangible market benefits, such as improved liquidity and pricing efficiency.

The SEC hosted a roundtable on May 9, 2009 to discuss the effectiveness and impact of short sale price test regulations, as well as the proposed regulatory alternatives. Mary Schapiro, the Chairman of the SEC, said she made it a priority "to evaluate the issue of short selling regulation, and ensure that any future policies in this area are the result of a deliberate and thoughtful process."[8] The purpose of the roundtable was to consider the wisdom of making it harder to sell stocks short, either by allowing such sales only at prices higher than the last different one, or by barring such sales at all when either the stock in question or the entire market has fallen by a large amount. Three panels discussed (1) the necessity and effectiveness of short sale price tests and circuit breakers, (2) the proposed amendments to Regulation SHO and evaluation of the costs and benefits of the alternatives outlined in the release, and (3) the empirical data on short selling.[9]

Market participants have wide-ranging opinions on whether short sale regulation is appropriate. To some, short selling is an evil that has caused severe market disruption. Others believe short selling makes the market more efficient. Smaller companies have consistently argued that short sellers drive down stock prices and destroy investor confidence. The SEC has received thousands of comment letters on the proposed short selling measures. One comment letter calling for reinstatement of the Uptick Rule received tremendous support, with over 5,500 individuals submitting the same letter.

Comments on the rule proposals were due by June 19, 2009. The SEC stated in the release that whatever rule is adopted, it will not be effective until 90 days after adoption to allow time for affected parties to make the necessary programming and other changes in response.

Endnotes

[1] The press release, dated July 27, 2009, is available on the SEC website at http://sec.gov/news/press/2009/2009-172.htm.

[2] Short selling is typically used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security.

3 Floyd Norris, *Goodbye to Naked Shorting*, NY TIMES May 1, 2009.

4 *See* SEC Release No. 34-59748, File No. S7-08-09, April 10, 2009, available at http://www.sec.gov/rules/proposed/2009/34-59748.pdf.

5 The proposing release is available on the SEC's website at http://www.sec.gov/rules/proposed/2009/34-59748.pdf.

6 *See* SEC Release No. 34-55970, June 28, 2007, available at http://www.sec.gov/rules/final/2007/34-55970.pdf.

7 *See* SEC Release No. 34-58592, September 18, 2008, available at http://www.sec.gov/rules/other/2008/34-58592.pdf, as amended by SEC Release No. 34-58611, September 21, 2008, available at http://www.sec.gov/rules/other/2008/34-58611.pdf.

8 SEC Speech: Opening Statement at May 5, 2009, Roundtable to Examine Short Sale.

9 CCH SEC Today, *Short Sale Roundtable Panelists Disagree on Need for Rulemaking*, May 6, 2009.

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