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The short story

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In short, here's our view of the story. Prior to the credit crisis, there was already widespread recognition that market dynamics had changed significantly in recent years, and that existing regulations might not address all of the implications associated with the increasing prevalence of synthetic ownership arrangements, like swaps, and potentially abusive shorting activities. In the US, the SEC had undertaken enforcement actions against hedge funds and other investors that engaged in manipulative trading practices, including naked short sales, in connection with PIPE transactions. The SEC also proposed amendments to Regulation SHO, originally adopted in July 2004, to regulate short sales and prevent naked short selling by requiring the closeout of fails-to-deliver against short positions in certain securities. In 2007, the SEC amended certain provisions of Regulation M, governing short selling in connection with public offerings in order to "put an end to the progression of schemes that have been engineered to camouflage covering activity [in violation of Regulation M]".

In recent months, proxy contests wherein stakeholders were revealed to have acquired indirect interests in the securities of the applicable issuers revealed that the one share/one vote ownership model was outmoded. Regulators in Europe, including the Financial Services Authority in the UK, turned their focus to the disclosure of derivative positions for companies undertaking certain rights issues. Despite these developments, it was not until the sale of Bear Stearns that public attention has focused on the effects of short selling. The recent regulatory actions discussed below have been an extraordinary reaction to the continued market volatility and credit crisis.

Effective 19 September 2008, the SEC prohibited short selling (as opposed to naked short selling) of the securities of an identified list of financial companies subject to limited exceptions.

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 shares to cover its short position at a lower price than the price at which it effected the original short sale. 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.

In July 2008, in response to concerns about the effects of naked short selling on the stocks of major financial institutions, the SEC issued an emergency order prohibiting the practice with respect to the stocks of 17 financial institutions, including Fannie Mae, Freddie Mac, Lehman Brothers, Morgan Stanley, Goldman Sachs and Merrill Lynch. The order expired on 12 August 2008. On 17 September, following the conservatorship of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, the sale of Merrill Lynch and the bailout of AIG, the SEC adopted three rules that permanently prohibit naked short selling. On 18 September 2008, the SEC issued two additional emergency orders that expire on 17 October 2008 (extended from the original 2 October expiration date). It would not be surprising if they were extended again.

Effective 19 September 2008, the SEC prohibited short selling (as opposed to naked short selling) of the securities of an identified list of financial companies subject to limited exceptions. As modified by a subsequent order, the exceptions are for: (i) short sales that occur as a result of the automatic exercise or assignment of an equity option, or the expiration of a futures contract, held prior to the effectiveness of the SEC's initial order; (ii) short sales that occur as a result of an assignment to a writer of a call option of an obligation to fulfil the call upon an in-kind exercise; and (iii) market makers who engage in short sales as part of bona fide market making activities provided that a market maker cannot engage in short sales in connection with transactions for a customer if the market maker knows the transaction will create or increase a net economic short position for that customer. The FSA also issued rules prohibiting the creation or increase of short positions in publicly traded financial companies; however, the FSA's approach differs from the SEC's approach as the FSA targets short positions. The FSA order, for example, permits the sale of borrowed shares provided there is no establishment of, or increase in, a net short position. Even following the amended order, the SEC short sale ban has resulted in market disruption and confusion, particularly in certain segments, such as the convertibles market. Moreover, because short sales frequently are effected in connection with more complex trading or hedging strategies, the short sale prohibition affects other aspects of the derivatives market.

On 18 September, the SEC issued an order temporarily requiring that certain institutional money managers report their new short sales of certain publicly traded securities under specified circumstances. The amended order requires electronic information reporting on Form SH. On 24 September, the SEC issued FAQs providing guidance regarding the preparation and filing of Form SH. These FAQs clarified that for reporting purposes, managers are required to aggregate gross short sales across all accounts, strategies and funds. Any manager subject to the order is required to provide the reports on the first business day of every calendar week beginning on 29 September 2008 immediately following a week in which it effected short sales.

The first action under the SEC's three-pronged approach of 17 September was to adopt a new rule, Rule 204T pursuant to Regulation SHO, dramatically reducing the amount of time a broker has to close out a short position. The rule requires that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposes penalties for a failure to do so.

If a short sale violates this closeout requirement, any broker-dealer acting on the short seller's behalf will be prohibited from making further short sales in the same security unless the shares are not only located but also are pre-borrowed. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales in that security for any customer. The SEC also eliminated the options market maker exception, which excepted 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 were effected by the registered market maker to establish or maintain a hedge on options positions created before the security was designated a threshold security. Now, options market makers will be treated in the same way as all other market participants, and are required to abide by the new closeout requirements.

Finally, the SEC adopted Rule 10b-21 under the Exchange Act to target fraudulent short selling transactions and 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). Rule 10b-21 highlights the specific liability of persons that engage in this deceptive practice.

The recent regulatory responses relating to shorting leaves free marketers a bit queasy. It is usually the case that measures adopted in haste to address an emergency may not serve us all that well once the emergency has passed. There is little doubt though that public outrage and the perceived political need to respond to these sentiments makes it more likely that emergency measures that should have a brief life will be allowed to live to a ripe old age. It is unreasonable to expect that the average American will develop an in-depth, sophisticated understanding of short selling. Yet, that is exactly what the SEC and Congress will have to do in order to provide us with regulation that will discourage inappropriate short selling and enable the resumption of a free market in securities. It is a balancing act and adjustments will be required for several years. We think of it as the never-ending short story. ■

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