



# SEC Takes Emergency Action on Shorting; South Dakota Short Selling Ballot Initiative

In July, 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 stock of 17 financial institutions, including Fannie Mae, Freddie Mac, Lehman Brothers, Morgan Stanley, Goldman Sachs and Merrill Lynch. The order expired on August 12, 2008, and the SEC indicated that it was considering permanent rulemaking. On September 17, 2008, following the government rescue of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, sale of Merrill Lynch and bail-out of AIG, the SEC took emergency action and adopted three rules to prohibit naked short selling.

## Background

Short selling refers to a sale of a security that the seller does not own and that is consummated by the delivery of a security borrowed by or on behalf of the seller. Short selling has important positive influences in the market, but it may also be used to improperly manipulate markets. Short sellers profit from a security's price decline – if the seller is able 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 it is available to be borrowed, before selling it short. 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 2004, the SEC adopted Regulation SHO (Reg SHO) to regulate short sales. Reg SHO was intended 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. The SEC has been focused on problematic short selling activities for some time. Since adopting Reg SHO, the SEC has initiated a slew of regulatory and enforcement actions, including several amendments to Reg SHO. Prior to the SEC's recent action, if a clearing broker had a fail-to-deliver position in a threshold security for 13 consecutive settlement days, the broker was required to close out the position by buying securities to cover the fail.<sup>1</sup> Until the position was closed out, the clearing broker and any other broker-dealers for which it clears transactions were prohibited from making further short sales in the security.

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<sup>1</sup> Rule 203(b)(3) of Reg SHO.

## SEC Action

The first action under the SEC's three-pronged approach is to adopt a temporary rule under Reg SHO, Rule 204T. The new rule dramatically reduces the amount of time a broker has to close out a short position. The rule imposes a penalty on any participant of a registered clearing agency, and any broker-dealer from which it receives trades for clearance and settlement, for having a fail to deliver position — it 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 close-out 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 not only are 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. Although the temporary rule is effective as of September 18, 2008, the SEC has sought comment on the rule for a period of 30 days and expects to follow with further rulemaking after the expiration of the comment period.

In August 2007, the SEC introduced amendments to Reg SHO that eliminated certain exceptions to the closeout requirement in an effort to reduce the occurrence of persistent fails-to-deliver. In July 2008, the SEC re-opened the comment period on an additional proposed amendment to eliminate another exception, the "options market maker exception," to the closeout requirement of Rule 203(b)(3) in Regulation SHO. The options market maker exception was originally intended to address concerns regarding liquidity and option pricing. It 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. The SEC's second action is to adopt the amendments to Reg SHO to eliminate the options market maker exception. As a result, options market makers will be treated in the same way as all other market participants, and are required to abide by the new hard T+3 closeout requirements.

The third prong of the SEC's approach is to adopt Rule 10b-21 under the Exchange Act. The SEC previously proposed Rule 10b-21 on March 17, 2008 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 account, 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, Rule 10b-21 is intended to highlight the specific liability of persons that engage in this deceptive practice. The new rule makes clear that those who lie about their intention or ability to deliver securities in time for settlement are violating the law when they fail to deliver.

## Measure 9

Some contend that the SEC's actions are too little, too late. This November, voters in South Dakota will consider a ballot initiative called Measure 9 that could impact short selling across the United States. Promoted by American Entrepreneurs for Securities Reform, or ESR, a non-profit organization backed by small businesses, Measure 9 would amend sections of the South Dakota Uniform Securities Act of 2002. The initiative is cast by ESR as a consumer protection measure that will protect South Dakota's small investors by curbing naked short selling. Opponents of Measure 9 argue that the initiative is unnecessary, impractical, poorly drafted and unconstitutional, with the potential to halt all legitimate short selling activity in the U.S.

Several commentators oppose Measure 9 on the grounds that, as written, the ballot measure would effectively ban short selling altogether. The proposed law would permit the state to take action against a seller of stock in a publicly traded company if that seller engaged in a pattern of commercially unreasonable delay in the delivery of

securities sold, or “has sold securities that the person did not own or have a bona fide contract to purchase.”<sup>2</sup> This language tracks the definition of a short sale in Regulation SHO. The law would apply to any brokerage registered in South Dakota even if does not have an office there. If interpreted to ban short sales altogether, a broker that transacts short sales with investors in South Dakota would violate the law, regardless of where the transaction takes place or whether the transaction complies with federal law. Because a broker-dealer’s South Dakota registration is all that would be required to trigger liability under the law, some have predicted that Measure 9 would result in broker-dealers leaving the state or, alternatively, ceasing all short selling activities.

ESR and its supporters contend that the SEC’s efforts to restrict naked shorting have been ineffective and support additional regulation at the state level. From their perspective, the purpose of Measure 9 is to ban naked short selling by permitting South Dakota regulators to take action against broker-dealers engaged in a pattern of fails-to-deliver. Opponents of Measure 9 argue that the trading of securities occurs on a national market and accordingly, should be regulated solely by federal law to preserve consistency, making additional state regulation both unnecessary and impractical. They predict that the introduction of additional legislation in various states will result in a confusing patchwork of inconsistent and contradictory rules, choking the very markets they are designed to protect. Additionally, they contend that proposed law would be preempted by the National Securities Markets Improvement Act (and thus would be unconstitutional). These opponents point out that litigation over the law after it has been adopted (on preemption grounds) would be costly and time-consuming for the parties opposing it, as well as for South Dakota taxpayers.

## Conclusion

Measure 9 is not the first proposal of its kind. Measures seeking to limit shorting have popped up in other states such as Virginia and Arizona, where legislation was introduced and quickly withdrawn, and Utah, where such a measure was overturned. Despite setbacks for these similar proposals, ESR plans to lobby for similar legislation in 19 additional states. Opponents of Measure 9 are concerned that the initiative, which addresses relatively sophisticated matters of securities law, will pass due to a lack of voter understanding, leading to unintended consequences in the national markets. Even if Measure 9 is not approved by South Dakota voters or is subsequently overturned, it, and similar proposals, as well as continuing market pressures, will place additional pressure on the SEC to demonstrate that it is proactive in its efforts to curb abusive short-selling practices. The impact of the SEC’s newest regulations on shorting activities, legitimate or otherwise, and whether the results will satisfy activist groups like ESR remains to be seen.

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<sup>2</sup> The full text of Measure 9 is available at a Web site operated by ESR, <http://www.voteyes9.com/measure9.php>.