

News from our Public Securities Group

## SEC Announces Rulemaking Initiative Aimed at Naked Short Selling

### Overview

On July 29, 2008, the SEC announced that it would undertake a rulemaking initiative aimed at protecting the broader market from naked short selling. Rulemaking is scheduled to begin “immediately” following the expiration on August 12, 2008 of the SEC’s July 15, 2008 emergency order designed to protect a select group of financial institutions from these types of transactions, which the SEC considers abusive. Assuming the SEC moves forward as planned, this rulemaking represents an unexpected opportunity for the SEC to put in place new rules that could effectively end naked short selling. However, since naked short selling has become such a heated topic of public debate—involving all levels of market participants—the SEC will likely seek significant public commentary before determining its next step. Representatives of trading interests have generally come out against a wholesale expansion of the emergency rule to cover all public companies, while representatives of public companies, such as the American Bankers Association, generally appear to favor a broader ban.<sup>1</sup>

The following memorandum provides a brief overview of naked short selling and the impact it can have on the capital markets, the events that gave rise to the SEC’s emergency order, the SEC’s past efforts to control it and the elements of an approach we believe the SEC is likely to consider as it undertakes a new round of rulemaking in this critical area.

### What is naked short selling?

A short sale involves the sale of stock not owned by the person selling it. In a typical short sale, the seller “borrows” the stock from a third-party holder (agreeing to return the stock, with interest, in a certain period of time), and then sells the stock on the open market to a third-party buyer. The stock sold to the third-party buyer must generally be delivered within three days of the short sale, a settlement date known as T+3. Later, the short seller will close out his or her position by purchasing an equivalent number of shares in the market and returning these shares, plus interest, to the stockholder from whom the short seller originally borrowed the shares.

Put simply, the short seller is betting on the trading price of the issuer’s stock to fall. If it does, the short seller profits by purchasing the stock to close out the short position at a lower price. If the trading price of the stock increases, the short seller loses money by purchasing the stock to close out the short position at a higher price. Short selling is perfectly legal. Moreover, market participants generally agree that short selling represents an efficient mechanism for price discovery.

“Naked” short selling involves the sale of stock without an agreement in place to borrow such shares from a third-party holder (or even before the short seller has “located” such shares to borrow). As a result, the naked short seller often does *not* deliver the stock sold to the third-party buyer within the T+3 settlement period (a

condition known as a “failure to deliver,” “fail” or “FTD”). This type of naked short sell is illegal as an abusive practice and, under a proposed new SEC rule, Rule 10b-21, would be expressly actionable as market manipulation.

### Why is the SEC concerned about naked short selling?

Allowing investors to sell short without arranging to borrow shares can take away a short seller’s incentive to close out his or her short position when the price of the stock rises because the short seller is not paying anything for the use of the borrowed stock. This has several consequences that undermine the SEC’s mission of protecting investors and ensuring fair, orderly and efficient capital markets:

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▶ First, with no incentive to cover the short position, the naked short seller can efficiently maintain a short position for an extended period of time in the hope that the price will fall. As a result, a naked short seller's FTDs often go unremedied well past the required T+3 settlement date. Indeed, a short seller can go for weeks, months or even years without delivering shares, since he is not paying for the use of such shares. If enough short sellers behave in this manner, a company's stock price can be subject to significant downward pressure, with no corresponding uplift, even on the announcement of positive news. Accordingly, a company's fundamentals and its share price may become increasingly disconnected.

▶ Second, the persistent FTDs that result from naked shorting can lead to the creation of so-called "phantom" shares. In the case of companies with significant short interests, these "phantom" shares can sometimes result in "over-voting," a process whereby stockholders seek to vote more shares than the company has outstanding. This can undermine corporate governance processes and distort the results of stockholder voting.

In its Proposing Release for Rule 10b-21, the SEC recognized these core short-selling concerns. The SEC expressed concern that the perception of manipulative conduct in an equity also may undermine the confidence of investors and that, if abusive naked short selling is allowed to proceed unchecked, investors may be reluctant to commit capital to particular issuers.

### Is Regulation SHO effective?

The primary mechanism that the SEC uses to regulate short selling is contained in Regulation SHO, which became fully effective on January 3, 2005. The regulation requires that a broker/dealer take action to close-out FTDs in securities in which there are a relatively substantial number of extended

FTDs (known as "threshold securities") if the FTDs have persisted for 13 consecutive settlement days. Until the position is closed out, the broker/dealer may not effect further short sales in that security without borrowing or entering into a bona fide arrangement to borrow the security. Early on, there were predictions that a hard settlement limit for FTDs would effectively eliminate naked short selling in threshold securities after 13 days. However, this has not come to pass, as many companies have been on the exchanges' "threshold" lists for much longer than 13 days. Many commentators believe that this is evidence that Regulation SHO, in its current form, is not working.

### The emergency order

On July 15, 2008, in the wake of the massive sell-off in Bear Stearns, the SEC issued an emergency order designed to curtail naked short selling in the stocks of 19 financial institutions. In view of the perceived "systemic" threat posed by the failure of any of the nation's 17 largest banks, or Fannie Mae or Freddie Mac, the SEC approved a series of emergency measures, including:

- ▶ prohibiting any "person" from effecting a short sale unless such person has, prior to the time of sale, borrowed or arranged to borrow the security or has the security available to borrow in its inventory (this is known as the "pre-borrow" requirement);
- ▶ requiring broker/dealers to actually deliver securities sold short on the normal settlement date, T+3; and
- ▶ extending the prohibition on naked short selling to short sales effected as a result of put options.

There is some evidence that the emergency order has deterred naked short selling in the stocks of the covered institutions. In the days following the order, short sales of the 19 firms protected by the order declined significantly.<sup>2</sup>

The emergency order, which was originally scheduled to expire on June 29, 2008, was extended through midnight, August 12, 2008, and will not be further renewed. In extending the order, the SEC also announced its intention to immediately begin a rulemaking initiative aimed at curtailing abusive short selling following the expiration of the emergency order.

### How should Regulation SHO be revised?

Although the SEC has announced that it will initiate rulemaking in the area of naked short selling, it has not indicated the approach it intends to take. In light of the success of the emergency order in deterring naked short selling, it is clear that expanding the order to protect all public companies and revising Regulation SHO to enhance disclosure and enforcement would be an efficient and effective way to achieve the SEC's objectives. Accordingly, rulemaking in this area should address each of the following:

- ▶ extending the key protections of the emergency order to *all* public companies, as opposed to a select group of financial institutions. Many public companies outside of the financial services sector have expressed interest in seeing broader market protection;
- ▶ strengthening the current "locate" requirement by prohibiting all market participants from effecting short sales unless they have, prior to the time of such sales, borrowed or arranged to borrow the security or have the security available to borrow in inventory;
- ▶ eliminating certain exceptions to the locate requirement, such as for securities on the so-called "Easy to Borrow" list;
- ▶ requiring broker/dealers to actually deliver the security within the normal T+3 settlement cycle. The SEC has stated its concern about "large and persistent fails to deliver [that] can deprive

shareholders of the benefits of ownership, such as voting and lending,” and finding ways to ensure settlement should be a top priority in the SEC’s new rulemaking initiative; and

- ▶ imposing additional reporting obligations (and instituting penalties) for broker/dealers and other market participants for non-compliance. Currently, due to confidentiality concerns, neither the SEC nor the exchanges will identify traders with significant FTDs, on the grounds that such information may reflect a firm’s proprietary trading strategy.

### Tick test

Some commentators have recently urged that the SEC restore the “tick test” under Rule 10a-1 of the Exchange Act. The tick test essentially provided that securities could only be sold short in an “up” market. It was eliminated by the SEC after the results of a pilot study demonstrated that the tick test was ineffective in reducing naked short selling after the exchanges went to decimals and the tick was reduced to a penny.<sup>3</sup> Accordingly, it is unlikely that the SEC would seek to reintroduce the old tick test as a part of its broader rulemaking effort in this area (although it is reportedly reviewing other pricing tests based on wider margins, such as a nickel or dime).

### Conclusion

As the events involving Bear Stearns have demonstrated, naked short selling among financial services firms can pose a systemic threat to the capital markets. However, many large companies outside of the financial services sector and many smaller public companies have long been targeted by naked short selling in their securities. The SEC has determined that the issue must be addressed quickly and decisively. However, the rulemaking process will not proceed without significant public comment and input.

Cooley Godward Kronish has been involved in an active dialogue with the SEC on these topics and intends to continue to do so. We welcome and encourage the input of our clients on these and other current topics.

If you have questions, please contact one of the attorneys listed above. ■

### Notes

<sup>1</sup> *Pensions & Investments*, August 8, 2008, “Shorting Ban Won’t Hurt Too Much, Say Money Managers.”

<sup>2</sup> *MarketWatch*, July 23, 2008, “SEC Emergency Order Leads to Dramatic Drop in Short-Selling of Fannie Mae and Freddie Mac Securities; Business Intelligence Firm Reports 90 Percent Reduction.”

<sup>3</sup> *DowJones Newswires*, July 25, 2008, “SEC to Extend Short Selling Restrictions.”