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Securities Lending Alert

A report for clients and friends of the firm

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SEC Proposes New Rules for Short Sales

The SEC has just published for comment new rules with respect to short selling. While recognizing that short selling may serve useful market purposes by enhancing market liquidity and pricing efficiency, the SEC noted that short selling may be used to illegally manipulate stock prices. In particular, the SEC has focused on naked short selling where a short sale is effected without borrowing the necessary securities to make delivery, thereby potentially resulting in a fail-to-deliver. Where the fail-to-deliver persists over time, market efficiency is compromised and a significantly large unfilled delivery obligation may arise in the securities at the clearing agency that settles the trades. The SEC is concerned about naked short selling not only because the buyer's rights may be adversely affected (such as with respect to voting) but, more importantly, naked short sellers may reap greater leverage than if they were required to borrow securities and deliver within a reasonable time period, which could afford them additional opportunities to engage in selling activities that deliberately suppress stock prices. To counter naked short selling, some issuers have sought to withdraw issued securities on deposit at DTC or to make transfer of securities "custodial only." The SEC believes that such actions undermine the goal of a national clearance settlement system which seeks to reduce required physical movement of securities.

The SEC has two areas of particular concern. First is the "bear raid," where an equity security is sold short in order to drive down the price by creating an imbalance of sell-side interest. Another scheme is the so-called "death spiral" where a party arranges financing for a weak-credit public company. The party providing financing receives debentures that are convertible into stock, with the conversion ratio tied to the market price at the time of conversion. By engaging in extensive naked short selling, the financing party can lower the price of the issuer's stock and realize enhanced profits when the debentures are converted.

To address the foregoing, the SEC has proposed to establish a uniform standard specifying the procedures for all short sellers to locate securities for borrowing. Proposed Rule 203 would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale is executed, (i) borrowed the security or entered into an arrangement for the borrowing of the security or (ii) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the settlement date. (This is similar to proposals first advanced by the SEC in 1976.) Consistent with current SRO requirements, the proposed rule would require that the locate be made and annotated in writing *prior* to effecting any short sale, regardless of the fact that the seller's short position may be closed out by purchasing securities the same day. The SEC would except from these requirements short sales executed by specialists or market-makers in connection with bona fide market-making activities.

In addition, the SEC proposes a delivery requirement targeted at securities where there is evidence of significant settlement failures (*i.e.*, any security where there are fails-to-deliver at a registered clearing agency of 10,000 shares or more per security, which is equal to at least one-half of one percent of the issuer's total shares outstanding). The proposed rule would specify that for short sales of any security meeting this threshold, selling broker-dealers would have to deliver the securities no later than two days after the settlement date (currently, there is a ten-day requirement). If for any reason such security was not delivered within two days after the settlement date, the rule would restrict the broker-dealer, including market-makers, from executing future short sales in such security for the person for whose account the failure to deliver occurred, unless the broker-dealer or the person for whose account the short sale is executed borrowed the security, or entered into a bona fide arrangement to borrow the security, prior to executing such short sale and actually delivered on settlement date. This restriction would be in effect for a period of 90 calendar days. In addition, the rule would require the applicable clearing agency to notify the NASD of any such delivery failure by the broker-dealer. With respect to these additional delivery requirements, there would be no exception for short sales in connection with market making. Unlike existing SRO rules, these additional delivery requirements would apply to all registered equity securities (not just NASDAQ securities).

The SEC believes that these proposals will enhance the integrity of the markets and the clearance and settlement system and will protect buyers by substantially curtailing naked short selling. Comment is requested, among other things, as follows:

- What is the appropriate manner by which short sellers can comply with the requirement to have "reasonable grounds" to believe that securities sold short could be borrowed? Should short sellers be permitted to rely on blanket assurances that stock is available for borrowing, *i.e.*, "hard to borrow" or "easy to borrow" lists?
- Should short sales effected by a market maker in connection with bona fide market making be excepted from the proposed "locate" requirements?
- Should proposed additional delivery requirements be limited to securities in which there are significant failures to deliver? Is the proposed threshold adequate?

With respect to long sales, the SEC is proposing to replace and modify existing Rule 10(a)(2) to make it consistent with the new delivery requirements in the proposed short sale rule. Rule 10(a)(2) provides that if a broker-dealer knows or should know that a sale is marked long, it must make delivery when due and cannot lend securities to do so. If it does not have the securities on hand, it must effect a buy-in, unless it knows that the seller is in the process of forwarding the securities to the broker-dealer or will do so as soon as possible without undue inconvenience or expense. In addition, broker-dealers are excused from the buy-in requirement and may lend securities to settle (i) in connection with sales between broker-dealers or (ii) if, as a result of a good-faith mistake, the broker thought it was long when it was really short. The SEC is proposing to modify Rule 10(a)(2) to extend the delivery requirements to all securities, including those traded over the counter. The proposed rule would permit a broker-dealer to fail to deliver, or to deliver borrowed securities, if an exchange or national securities association found that the broker-dealer used due diligence in obtaining the seller's confirmation that the security would be in the broker-dealer's possession prior to settlement, and that either compelling a buy-in would result in undue hardship or that the mistake was made by the seller's broker-dealer and the sale was at a permissible price.

Proposed regulations would also institute a new uniform bid test allowing short sales to be effected at a price one cent above the consolidated best bid. A temporary rule would suspend the operation of the proposed bid test for specified liquid securities during a two-year pilot period. The temporary suspension would allow the Commission to study the effects of relatively unrestricted short selling on market volatility, price efficiency and liquidity.

The extent to which the SEC's proposed rules will affect the securities lending market by affecting the level of short selling remains to be seen.

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Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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