

SHORT SELLING AND NAKED SHORTS IN THE REGULATION SHO ENVIRONMENT

The SEC Adopted Regulation SHO in 2004 to Address Naked Short Selling and Persistent Failures to Deliver, but Did Not Make Such Failures Per Se Violations of the Rules. The Authors Review the Regulation and Argue that Recent State Court Litigation Threatens to Upset the Commission's Balancing of Market Needs for Liquidity and Protection from Abusive Short Sales.

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This article originally appeared in the November 21, 2007 edition of *The Review of Securities & Commodities Regulation*. Posted with permission.

The Securities and Exchange Commission's regulation of short sales has changed significantly in recent years. A sale of a security is a "short sale" when the seller does not own the security or settles the sale by delivery of a security borrowed for that purpose. The Commission has regulated short selling since 1938,¹ but with the adoption of Regulation SHO in 2004,² the Commission changed the focus of this regulation from one prompted by concerns regarding short selling in a declining market, to one animated by concerns about naked short selling and persistent fails to deliver that sometimes accompany naked short selling. Naked short selling generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.³

Complaints about naked short selling are frequently made by smaller issuers who attribute it to the cause of poor market performance of their stock. While the Commission has at times expressed doubt about such assertions, it has also recognized that naked short selling can be manipulative.⁴ Frustrated by their perception that the Commission has been insufficiently vigilant, private plaintiffs have filed several lawsuits alleging harm as a result of naked short selling. These cases, which we discuss below, could increase legal uncertainty, while reducing liquidity in the markets and hampering price discovery.⁵

THE EVOLUTION OF SHORT SALE REGULATION

The SEC's adoption of Regulation SHO in 2004 was the first significant change to the rules governing short sales since their implementation in 1938. Before 1938, the national securities exchanges had regulated short sales, but the SEC determined that such rules were ineffective and adopted its own regulations.⁶ A key component of the short sale rules adopted in 1938 was Rule 10a-1, which imposed a "tick test." With certain exceptions, Rule 10a-1(a)(1) permitted a listed security to be sold short only: (1) at a price above the price at which the immediately preceding sale was effected (plus tick), or (2) at the last sale price if it was higher than the last different price (zero-plus tick). The purpose of the tick test was to: (1) allow relatively unrestricted short selling in an advancing market; (2) prohibit short selling at successively lower prices, thus eliminating short selling as a tool for depressing the market; and

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(3) inhibit short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.⁷ While the regulation of short sales evolved over the years through elaboration by staff in a series of no-action letters, the core provisions of Rule 10a-1 remained largely unchanged until the adoption of Regulation SHO in 2004.

The SEC, however, periodically reviewed its approach to regulating short sales. In 1963, the Commission issued a special study of short selling concluded that the short sale rules failed to avert market manipulation and recommended improvements in short sale data collection. In 1976, the SEC published for comment proposed temporary rules aimed at collecting short sale data. The proposed rules would have suspended, to varying degrees, the operation of the tick test and enabled the Commission and its staff to study, over a reasonable period, the effects of unrestricted short selling. The Commission reasoned that the study would allow it to determine the effectiveness of the price test. The proposed temporary rules were withdrawn in 1980 without further action because “commentators generally indicated that the ‘tick’ test provisions of that rule continue[d] to be appropriate for the protection of investors and should not be modified.”⁸

Concurrently, with the proposal to suspend the tick test, the Commission proposed Rule 10b-11, which would have established explicit borrowing requirements in connection with short sales. The Commission withdrew this proposal after adoption by the New York Stock Exchange, Inc. and NASD, Inc. of interpretations “specifying that members should not accept or enter a short sale order unless prior arrangements to borrow the stock have been made, or other acceptable assurances that delivery can be made on settlement date have been obtained.”⁹ The Commission reasoned that the self-regulatory organization (“SRO”) rules, combined with the antifraud provisions of the securities laws, were sufficient to prevent manipulative conduct.

In October 1999, the Commission issued a concept release that set forth eight proposals for regulating short sales: (1) suspending the tick test when the security or market is above a threshold price; (2) providing an exception from short sale regulation for actively traded securities; (3) focusing short sale restrictions on certain market events and trading strategies; (4) excepting hedging transactions from short sale regulation; (5) revising the tick test in response to certain market developments; (6) revising the definition of “short sale”; (7) extending the tick test to non-exchange listed securities; and (8) eliminating Rule 10a-1. The Commission received 2,778 comment letters in response to the concept release and several years later proposed Regulation SHO.

REGULATION SHO

On October 28, 2003, the SEC proposed Regulation SHO.¹⁰ The Commission expressed its belief that uniform short sale regulation was needed because the SRO rules intended to address naked short selling did not fully deal with the problems of naked short selling and resulting failures to deliver.

On July 28, 2004, the Commission adopted Regulation SHO and amendments to certain existing rules.¹¹ The Commission most directly addressed naked short selling by adopting Rule 203(b), which created a uniform requirement that broker-dealers “locate” equity securities

available for borrowing before effecting short sales in such securities.¹² The Commission aimed to reduce persistent failures to deliver by adopting the requirement to close out certain fails in “threshold securities.”

The “Locate” Requirement

Rule 203(b) prohibits a broker-dealer from accepting a short sale order in an equity security from another person, or effecting a short sale order for the broker-dealer’s own account, unless the broker-dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered at settlement. In all instances, the broker-dealer must document the locate prior to effecting the short sale. In the adopting release, the Commission stated that broker-dealers could rely on “easy to borrow” lists that are less than 24 hours old as “reasonable grounds” that the security is available for borrowing. The Commission cautioned, however, that if there are repeated failures to deliver in securities contained on the “easy to borrow” list, a broker-dealer’s reliance on such a list would no longer be considered reasonable.¹³ A broker-dealer may also rely on a customer’s assurance of delivery, but must be able to demonstrate that there are reasonable grounds for relying on a customer’s assurances of delivery. For example, a firm could document that previous borrowings arranged by the customer resulted in timely deliveries.¹⁴ In any event, the broker-dealer effecting the short sale is ultimately responsible for performing the locate.

Rule 203(b)(2) sets forth limited exceptions, including exceptions for: (1) broker-dealers accepting orders from another broker-dealer that is obligated to comply with the locate requirement; (2) bona-fide market making activities; and (3) situations where, through no fault of the broker-dealer or customer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date.

Threshold Securities

Persistent failures to deliver in a particular equity security may result in it being designated a “threshold security.” A threshold security is an equity security for which there is an aggregate failure-to-deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more and that is equal to at least 0.5% of the issuer’s total shares outstanding.¹⁵ To be removed from the threshold securities list, a security must not exceed the specified level of fails for a period of five consecutive settlement days. When a broker-dealer that is a participant of a clearing agency has a failure-to-deliver position in threshold securities that persists for ten consecutive days after settlement (*i.e.*, 13 consecutive settlement days), Rule 203(b)(3) requires the participant to take action to close out the position by purchasing securities of like kind and quantity.

Until the position is closed out, the participant, and any broker-dealer for which it clears transactions, may not effect further short sales in the particular threshold security without borrowing or entering into a bona fide arrangement to borrow the security. Clearing agency participants may allocate the responsibility to close out open failure-to-deliver positions to the particular account(s) responsible for the fail, and the requirement to borrow or enter into a bona fide arrangement to borrow the security would apply only to the responsible account.¹⁶

Exceptions to Close-out

As initially adopted, Regulation SHO provided “grandfather” and “options market maker” exceptions to the close-out requirements of Rule 203(b)(3). A position was “grandfathered” if it was established before the security became a threshold security. The Commission adopted the grandfather exception because of concerns that requiring the mandatory close-out of already established positions might contribute to short squeezes, increasing volatility.

The “options market maker” exception excluded from mandatory close-out any fail-to-deliver position in a threshold security that is attributed to short sales effected by a registered options market maker to establish or maintain a hedge on an options position created before the security became a threshold security. The Commission initially proposed to limit the duration of the options market maker exception, but, as adopted, the rule did not establish a fixed time frame for closing such fails.¹⁷ Registered options market makers can maintain open fail positions in securities used to hedge options positions, including adjusting such hedges, if the fail positions were created before the underlying security became a threshold security. Once the specific options position expires or is liquidated, any related fails with respect to threshold securities would be subject to mandatory close-out.

RECENT AND PROPOSED AMENDMENTS TO REGULATION SHO

Elimination of the Tick Test

Effective July 3, 2007, the Commission eliminated the short sale price test set forth in Rule 10a-1, permitting shorts to be effected without regard to the tick test.¹⁸ The Commission also prohibited SROs from adopting any sort of price test by adding Rule 201 of Regulation SHO. This amendment reflects the findings from a temporary suspension of short sale price restrictions for a sample of securities (referred to as the “Pilot”) that was conducted pursuant to Rule 202T.¹⁹ The Commission’s Office of Economic Analysis and others analyzed the Pilot data and found little empirical justification for maintaining price test restrictions.

Removal of the Grandfather Exception

The Commission has also eliminated the grandfather exception, effective October 15, 2007.²⁰ After the effective date, failure-to-deliver positions in threshold securities will have to be closed out within 13 consecutive settlement days, even if they arose before the security became a threshold security. The Commission reasoned that no failure-to-deliver position should be left open indefinitely. In response to comments expressing concern that the amendment might lead to increased volatility, reduced liquidity, and short squeezes, the Commission expressed confidence that such effects will be minimal and that the benefits of disallowing failures to deliver to continue indefinitely justify any potential negative effects of eliminating the exception.²¹

Proposed Removal of the Options Market Maker Exception

The Commission has also proposed eliminating the options market maker exception.²² An earlier proposal that only would have further limited the exception was rejected due to

concerns about persistent failures to deliver in certain equity securities. The Commission expressed concern that the potential negative impact on the market for certain threshold securities that have a history of large and persistent failures to deliver warranted eliminating the options market maker exception.

CURRENT SHORT SALE CIVIL LITIGATION

Dissatisfied that the Commission has not been more aggressive in investigating assertions of naked short selling, several civil cases have recently been filed against prominent broker-dealers in which plaintiffs are claiming harm due to an alleged pattern of short sales involving intentional failures to deliver. Although the initial cases were based on alleged violations of federal law, plaintiffs are increasingly seeking relief based on alleged violations of state law.²³

Avenius v. Banc of America Securities LLC

On November 22, 2006, dozens of current and former owners of Novastar Financial, Inc. (“NFI”) common stock filed a complaint in California Superior Court based on alleged state law violations, naming as defendants the same 11 Prime Brokers named in the ETG complaint. Plaintiffs allege that the defendant firms entered into naked short sales of NFI stock, intentionally failed to deliver the NFI stock, and that these failures depressed the price of NFI’s stock “because of the oversupply caused by failing to settle transactions with shares issued by NFI.”²⁴ Plaintiffs argue that this conduct gives rise to claims for (i) market manipulation in violation of California Corporations Code Sections 25400, *et seq.* and (ii) unfair business practices in violation of California Business and Professions Code Sections 17200, *et seq.* and 17500, *et seq.* Central to plaintiffs’ argument is that a naked short sale of stock creates “phantom stock” and artificially enlarges the issuer’s float.²⁵

Overstock.com v. Morgan Stanley & Co., Inc.

On February 2, 2007, Overstock.com, Inc. and several of its current or former shareholders filed a complaint in California Superior Court against 10 of the 11 Prime Brokers identified in the *Avenius* complaint.²⁶ Similar to the allegation in *Avenius*, the *Overstock* plaintiffs allege that the defendants intentionally failed to deliver the company’s stock to settle short positions, which in turn created phantom stock that greatly increased the supply of the firm’s stock and ultimately caused Overstock’s share price to drop. The *Overstock* complaint is substantively the same as that in the *Avenius* case. The *Overstock* plaintiffs also argue that these actions constitute market manipulation in violation of California Corporate Code Sections 25400 *et seq.* and unfair business practices under California Business and Professions Code Sections 17200 *et seq.* and Sections 17500 *et seq.*

In addition, the *Overstock* plaintiffs allege three causes of action based on common law theories of conversion, trespass to chattels, and intentional interference with prospective economic advantage. Conversion and trespass to chattels are both torts relating to physical “possession” of or “harm” to personal property. Under California common law, the key element for an intentional interference with prospective economic advantage claim is proving that the defendant not only knowingly interfered with the plaintiff’s expectancy, but engaged in the conduct that was wrongful by some legal measure other than the fact of interference itself.

Defendants' Arguments

Defendants filed a demurrer in the *Avenius* case in February 2007, and in the *Overstock* case in April 2007. Both demurrers were based on three principal arguments. First, defendants argued that pursuant to the Supremacy Clause of the U.S. Constitution, plaintiffs' claims are preempted by federal law because they stand as obstacles to the accomplishment of the full purpose and objectives of the Commission's short selling regulations. Second, defendants argued that plaintiffs failed to plead facts that would state a claim under California law. Specifically, in response to plaintiffs' claims that the defendants engaged in unfair business practices, defendants argued that such claims are contrary to case law that holds that the state law provisions underlying plaintiffs' claims do not apply to securities transactions. Defendants also argued that plaintiffs' manipulation claims under California Corporate Code Sections 25400 *et. seq.* fail because they did not plead facts that would constitute market manipulation under California law. Finally, defendants argued that plaintiffs' attempt to apply California law to conduct occurring entirely outside the state violates the Commerce Clause of the U.S. Constitution.

In *Overstock*, the defendants argued that plaintiffs' conversion and trespass to chattels claims were insufficient because they lacked the essential elements of control or interference with plaintiffs' right of possession of personal property, and plaintiffs' sole allegation was that defendants' conduct caused the value of plaintiffs' holdings in *Overstock* to decline. Defendants further argued that a successful claim for interference with prospective economic advantage requires "wrongful" conduct on the part of defendants and that wrongful conduct must disrupt the relationship the plaintiff has with third parties. Defendants argued this cause of action failed because *Overstock* did not allege that defendants engaged in any "wrongful" conduct nor did they allege that defendants' actions disrupted a relationship with any specific third party.

Recent Developments in the Avenius and Overstock Cases

Judge John E. Munter of the California Superior Court for the City and County of San Francisco presides over both the *Avenius* and *Overstock* cases. On July 17, 2007, Judge Munter, in an oral decision, substantially overruled defendants' demurrers in each case. He reasoned that plaintiffs' state law claims were not preempted by federal law because their successful assertion would not stand as an obstacle to the accomplishment of the objectives and purposes of federal law, which does not permit the alleged manipulative conduct.

With respect to plaintiffs' state law claims of market manipulation, Judge Munter ruled, without explanation, that the complaints were sufficient. With respect to plaintiffs' claim of unfair business practices, he ruled that the case law upon which the defendants relied does not preclude such claims in all cases relating to securities transactions, and further that the California Supreme Court has confirmed that the unfair competition laws should be broadly construed. Finally, defendants' commerce clause argument was rejected because plaintiffs alleged that defendants' market manipulation occurred in California.

Judge Munter also overruled defendants' demurrer regarding *Overstock's* causes of action based on conversion and trespass to chattels, but sustained with leave to amend defendants' demurrer with respect to *Overstock's* cause of action for intentional interference

with prospective economic advantage. The court stated that plaintiffs need to be more particular in pleading the existence of the relationships with which defendants allegedly interfered, defendants' knowledge of the relationships, and defendants' conduct that interfered with those relationships.

In light of Judge Munter's oral decisions, plaintiffs in both *Avenius* and *Overstock* filed amended complaints on September 14, 2007. Both amended complaints include a new claim that defendants profited from naked short selling in their proprietary accounts and that this practice further motivated defendants to intentionally fail to deliver stock. *Overstock* also eliminated its cause of action for intentional interference with prospective economic advantage, and *Avenius* added causes of action for conversion and trespass to chattels, which mirror the claims initially brought by *Overstock*.

Consequences of State Litigation

If the *Avenius* and *Overstock* litigations are successful, the ultimate result may be increased legal uncertainty and costs, and decreased market efficiency that will negatively impact the securities markets and market participants. The California litigation, and any potential copycat litigation in another state, will increase legal uncertainty for firms about whether activity that is lawful under the federal regulatory scheme may nevertheless be questioned in state court. This increased uncertainty may cause firms to impose restrictions on customer short sale activity and limit proprietary short sale activity. If such reductions in activity are significant, they will reduce liquidity and ultimately harm the markets by making price discovery less efficient.

This outcome would run directly contrary the SEC's own statements regarding the benefits of short sales. In proposing Regulation SHO, the SEC stated that "[s]hort selling provides the market with at least two important benefits: market liquidity and pricing efficiency."²⁷ The SEC staff has also indicated that short sale activity provides liquidity in circumstances of unexpected buyer demand and stated that naked short selling "is not necessarily a violation of the federal securities laws or the Commission's rules" and that in some circumstances it even "contributes to market liquidity."²⁸

The SEC is in the best position to weigh all of the interrelated concerns and determine how best to regulate the securities markets, and in particular short selling. As previously discussed, the Commission has been regulating short selling since the 1930s and has taken a measured and reasoned approach to modernizing its regulation of short sales that attempts to balance the need for fair and open markets that allow for efficient price discovery with the need to stand vigilant against potentially abusive behavior. The SEC has addressed certain persistent failures to deliver through the adoption of Regulation SHO and through the recent amendments that have eliminated the grandfather exemption from the close-out requirement with respect to threshold securities. The SEC has also proposed to eliminate the options market maker exception. In taking these actions, the Commission has assessed the potential negative impact eliminating these exceptions may have on the market by reducing liquidity. This careful and reasoned approach to regulating the securities markets is important to their continued viability. State actions like *Avenius* and *Overstock* threaten to frustrate the SEC's carefully constructed regulatory scheme and harm both the market and market participants.

¹ See Exchange Act Rel. No. 1548 (Jan. 24, 1938).

² See Exchange Act Rel. No. 50, 103, 69 Fed. Reg. 48,008 (Aug. 6, 2004).

³ See Exchange Act Rel. No. 54,154, 71 Fed. Reg. 41,710 (July 21, 2006).

⁴ In *SEC v. Rhino Advisors, Inc. and Thomas Badian*, Lit. Rel. No. 18,003 (Feb. 27, 2003) the Commission charged that short sales were an integral part of an effort to manipulate the conversion ratio of a convertible security.

⁵ The authors are associated with O'Melveny & Myers LLP, which has appeared in certain of such actions on behalf of a defendant.

⁶ See *supra* note 1.

⁷ See Exchange Act Rel. No. 42,037, 64 Fed. Reg. 57,996 (Oct. 28, 1999).

⁸ See Exchange Act Rel. No. 17,347, 45 Fed. Reg. 80,834 (Dec. 8, 1980) (stating that the proposals received relatively limited comment, and those that did comment indicated that the "tick" test provisions of Rule 10a-1 worked well and should not be modified).

⁹ See Exchange Act Rel. No. 26,182, 53 Fed. Reg. 41,206 (Oct. 20, 1988).

¹⁰ See Exchange Act Rel. No. 48,709, 69 Fed. Reg. 62,972 (Nov. 6, 2003).

¹¹ See *supra* note 3. In adopting Regulation SHO, the Commission established Exchange Act Rules 200, 202T and 203, and simultaneously amended Rules 105 of Regulation M and Rule 10a-1 under the Exchange Act.

¹² Rule 203 replaced Rule 10a-2 and incorporated the existing SRO "locate" rules into a uniform Commission rule.

¹³ See *supra* note 11.

¹⁴ See Exchange Act Rel. No. 50,103, 69 Fed. Reg. 48,008, 48,014 n.58.

¹⁵ Pursuant to Rule 203(c)(6)(ii), each SRO is responsible for publishing a daily list of the threshold securities that are listed on its market, or for which the SRO bears the primary surveillance responsibility.

¹⁶ See 17 C.F.R. 242.203(b)(3)(iv).

¹⁷ See Exchange Act Rel. No. 54,154, 71 Fed. Reg. 41,710 (July 21, 2006).

¹⁸ See Exchange Act Rel. No. 55,970, 72 Fed. Reg. 36,348 (July 3, 2007).

¹⁹ Regulation SHO included a temporary rule which authorized suspending short sale price restrictions for certain specified securities to enable the SEC and the public to study the impact of unrestricted short selling over a specified period of time.

²⁰ See Exchange Act Rel. No. 56,212, 72 Fed. Reg. 45,544 (Aug. 14, 2007).

²¹ In the same release, the SEC extended the close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144.

²² See Exchange Act Rel. No. 56,213, 72 Fed. Reg. 45,558 (Aug. 14, 2007). In the same release, the SEC proposed to amend the long sale marking provision of Regulation SHO to require broker-dealers to document the present location of securities sold long.

²³ In April 2006, Electronic Trading Group ("ETG") filed a lawsuit in the U.S. District Court for the Southern District of New York against 11 of Wall Street's largest prime-brokerage operations ("Prime Brokers") alleging federal antitrust violations. Plaintiffs argued that the defendants engaged in a well-orchestrated conspiracy that included: (1) fixing the cost to borrow securities by setting a minimum threshold borrowing rate well above rates that would normally be charged and arbitrarily designating securities as hard-to-borrow; (2) conspiring to create a system in which they would not force firms on the other side of a short sale to deliver the designated hard-to-borrow securities; and (3) conspiring to charge the plaintiffs improper "finders" or "locate" fees in connection with short sale transactions when such fees are not based upon the performance of any legitimate business function. Defendants filed a motion to dismiss on March 15, 2007 and plaintiffs filed their opposition brief on June 15, 2007. As of the date this article was submitted for publication, the court had yet to rule on the motion to dismiss. See

Class Action Complaint, *Electronic Trading Group, L.L.C. v. Banc of America Securities LLC*, (S.D.N.Y. 2006) (No. 06 Civ. 2859); Amended Class Action Complaint, *Electronic Trading Group, L.L.C. v. Banc of America Securities LLC*, (S.D.N.Y. 2006) (No. 06 Civ. 2859VM). *See also* Class Action Complaint, *Quark Fund LLC v. Banc of America Securities LLC*, (S.D.N.Y. 2006) (No. 06 Civ. 2933) (making nearly identical claims as those set forth in the ETG complaint; however, the Quark complaint was later withdrawn).

²⁴ *See* Complaint for Violations of California Corp. Code Sections 25400 *et seq.*, *Avenius v. Banc of America Securities LLC* (Cal. Super. Ct. 2006) (No. CGC-06-453422).

²⁵ The SEC staff has rejected the notion that naked short selling creates “phantom stock,” stating that “[n]aked short selling has no effect on an issuer’s total shares outstanding.” *See* Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, July 6, 2007, www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

²⁶ *See* Complaint for Violations of Conversion, *Overstock.com v. Morgan Stanley & Co., Inc.* (Cal. Sup. Ct. 2007) (No. CGC-07-460147).

²⁷ *See* Exchange Act Rel. No. 48,709, 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003).

²⁸ *See* Division of Market Regulation: Key Points about Regulation SHO, April 11, 2005, www.sec.gov/spotlight/keyregshoissues.htm (giving the example of market makers in thinly traded stocks).