

The Bear “Naked” Truth: Short Sales and Rumors

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After watching Bear Stearns and Lehman Brothers collapse amidst a frenzy of rumors and innuendo, corporate executives and many others are convinced that, contrary to the age-old adage, words can indeed break more “bones” than sticks and stones. On the morning of Monday, March 10, 2008, Bear Stearns had \$18 billion in cash reserves; less than a week later, its board of directors approved a merger with J. P. Morgan, effectively selling the bank for a mere \$236 million—a fraction of the value of its Madison Avenue headquarters. Just six months later, rumors swirled as Lehman Brothers plunged into bankruptcy.

Many observers viewed these collapses as, at best, a case of speculation creating its own reality or, at worst, a financial assassination committed by malicious short-sellers who infected the marketplace with disinformation to reap a murderous profit.¹ Not surprisingly, securities regulators have focused on the intentional spreading of rumors and abusive “naked” short sales as targets for heightened scrutiny.

The SEC Office of Compliance Inspections and Examinations (OCIE) confirmed this focus at the 2009 SIFMA Compliance and Legal Conference on March 24, 2009. Chief Counsel John Walsh laid out OCIE's top 13 inspection priorities for the coming year, including a focus on both firms' (a) controls on the intentional spreading of rumors and (b) compliance with short selling rules.

This article provides a snapshot of the current and proposed legal and regulatory framework aimed at combating the impact of rumors and abusive short sales in the securities markets.

I. The Intentional Spreading of Rumors

A. Statutory Framework

As a general matter, any effort to manipulate the securities markets using fraudulent devices and misinformation is prohibited by Section 17(a) of the Securities Act of 1933 (the “Securities Act”) and Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 thereunder. In the words of Rule 10b-5, “[i]t shall be unlawful for any person . . . to make untrue statements of material

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fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading . . . in connection with the purchase or sale of any security.” This prohibition is reinforced by Section 9(a)(4) of the Exchange Act, which makes it unlawful for a person to make a statement that he or she has reasonable grounds to believe is false or misleading with respect to any material fact in order to induce the purchase or sale of an exchange-listed security.

Recently, the SEC has shown that it will not shy away from enforcing these rules. On April 24, 2008, the Commission charged Wall Street trader Paul S. Berliner with fraud and market manipulation under Section 17(a) of the Securities Act and Sections 10(b) and 9(a)(4) of the Exchange Act for instant messages he sent to 31 securities professionals, including traders at brokerage firms and hedge funds, containing a fabricated rumor that a pending, high-profile merger was being renegotiated on substantially different terms. The rumor spread quickly, and in the ensuing flood of trading, Berliner profited handsomely from short positions taken in the target company’s stock just minutes before he sent the instant messages.² As part of an agreement settling the charges, Berliner consented to pay back the ill-gotten funds, as well as a large fine, and he is barred from future association with any broker or dealer.

B. FINRA

FINRA Rule 6140(e) states that, “No member shall make any statement or circulate and disseminate any information concerning any designated security³ which such member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of such security.” This general prohibition, however, is in the process of being supplemented by a more robust and targeted regulation addressing the dissemination of rumors.⁴

On July 16, 2009, the comment period expired for proposed FINRA Rule 2030, addressing the “Origination and Circulation of Rumors.” FINRA’s second attempt at such regulation in as many years,⁵ Rule 2030 would lay out a broad prohibition on any member originating or circulating, in any manner, a rumor related to any security that the member has reasonable grounds to believe is false or misleading and is likely to affect the market price of such security. Further, the Rule would impose a reporting requirement, mandating that members alert FINRA

if they learn of a rumor that they know, or have reasonable grounds to believe, was originated or circulated for the purpose of improperly influencing the market price of a security.

In the Supplementary Material to Rule 2030, FINRA proposes to define a “rumor” as a statement that is false, misleading, or without a reasonable basis—a definition intended to exclude statements that clearly express an individual’s or firm’s opinion, such as an analyst’s view of a company’s prospects. The Supplementary Material also contains three limited exceptions to the general prohibition on the spreading of rumors. First, a “rumor” is not proscribed by proposed Rule 2030 if it has been widely circulated by the public media and its unsubstantiated nature is disclosed. Second, the Rule “does not prohibit the discussion of rumors among market participants when necessary to explain market or trading conditions,” if such discussion is not an attempt to influence a security’s price, but merely an attempt to present a member’s (or associated person’s) view of the validity of such information in a responsible way. Third, internal communications undertaken for the sole purpose of inquiring into the truthfulness or accuracy of a rumor would not be prohibited.

In light of these exceptions, the Supplemental Material goes on to clarify that any knowing circulation of false or misleading information with the intent to impact the price of a security is unlawful under the FINRA rules, as well as provisions of the federal securities laws mentioned above and the rules of the SEC.

Despite the valiant efforts of FINRA to rein in false rumors, the exceptions largely limit the rules’ reach. Furthermore, the right of Americans to speak ignorantly—even foolishly—is protected by no less than the First Amendment. However, the rule contains a supervisory requirement that has the potential to produce some substantial effect. The Supplemental Material mandates that members must maintain “adequate written policies and supervisory procedures reasonably designed to identify and address the circulation of rumors.” In addition, members must develop appropriate training programs and clearly designate the parties responsible for dealing with rumors and reporting obligations. These procedural provisions, and the compliance monitoring that will follow, may have some success in tamping down reckless rumor-mongering on the trading desk.

II. Short Sales

"Abusive Short Selling" ranks with "False Rumors" on the popular Most Wanted List of financial market regulation. In response to widespread concerns that the SEC left the markets unguarded with the 2007 repeal of Rule 10a-1's Short Sale Price Test, the SEC leapt into action with a flurry of short sale orders and rules in September and October of last year.

Of lasting importance, the SEC adopted temporary Rule 204T to curtail fails to deliver and address the potentially abusive "naked" short selling of securities. Citing concerns about the sudden and unexplained declines in prices of equity securities, as well as the potential for fundamentally baseless crises of confidence, the Commission strove to provide a powerful disincentive to those who might destructively exploit the turbulent economic conditions.⁶

In a nutshell, temporary Rule 204T provided for an accelerated close-out requirement for fail to deliver positions, a borrowing requirement for those who failed to meet their close-out obligations, pre-fail credit for broker-dealers who acted to mitigate their fails in certain ways, and allocations and certifications of fails to deliver to other sellers in certain situations. According to the Commission's Office of Economic Analysis, the temporary rule had its intended effect. The average daily number of fails to deliver for all equity securities declined by 56.6%--from 1.1 billion to 478 million.⁷ Based on these numbers and the ongoing concern with abusive "naked" short sales, the major provisions of temporary Rule 204T, slightly modified, were made permanent with the adoption of Rule 204 on July 27, 2009.

In addition to Rule 204T/Rule 204, on April 10, 2009, the Commission released a set of proposals that would further restrict short sales and reverse its 2007 elimination of prior short sale restrictions, such as the Uptick Rule.⁸ The release offered five possible restrictions.

Two of the candidates are "price test proposals," restraining the price at which short sales may be effected. One is a reincarnation of the traditional 10a-1 Uptick Rule,⁹ except that the new rule would reference the consolidated prices from all markets rather than permitting each market to reference its own last sale price. The other is the Modified Uptick Rule, which would use the national best bid, instead of the last sale price, as the reference point for short sale restrictions.¹⁰ The Modified Uptick Rule em-

plies a procedural approach in lieu of an outright ban, requiring trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order at a prohibited price.

The remaining three candidates are "circuit breaker proposals." The Circuit Breaker Halt rule would impose a temporary halt on the short selling of a particular security—and only that security—if its price declines by 10% or more from its prior day's clos-

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ing. The Circuit Breaker Uptick rule would operate similarly, except that instead of imposing a "halt" on the shorting of a particular security, the 10% decline would trigger the Uptick Rule, applicable only to that security. Finally, the Circuit Breaker Modified Uptick Rule would simply impose the Modified Uptick Rule as a result of the 10% decline.

On August 17, 2009, the Commission issued an additional release, proposing for the public's comment yet another possibility, the "alternative uptick rule". This proposed rule would be similar to the modified uptick rule, except that it would not allow short selling at the current national best bid (it would only allow short selling at an increment above the current national best bid). The issuance of this additional proposal, without rule text, illustrates that adoption of a price test restriction is a subject that requires serious consideration by all relevant parties, and that industry professionals, regulators, and commenters to the proposals have not yet arrived at a consensus view as to the preferred outcome.

These proposals contain various exceptions to the regulation's requirements, largely drawn from the historical Rule 10a-1 and SEC no-action letters.¹¹

Stung by the charges of the SEC Inspector General that the SEC had failed to enforce existing short sale rules, the SEC has increased its examination efforts to assure that firms implement Rule 204T/Rule 204 and comply with the continuing provisions of Regulation SHO. Given the complexity of compliance with these provisions in active trading markets, the SEC's examination

efforts, combined with those of FINRA, should be expected to generate a series of deficiency letters and even enforcement referrals of broker-dealers whose procedures were not up to the challenge.

In light of this dynamic, it is important that compliance professionals become well acquainted with the requirements of Rule 204, which are described below, as well as any future price test/circuit breaker regulation.

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Rule 204(a): Close-out Requirement

Participants of registered clearing agencies must deliver equity securities to the clearing agency for a long or short sale by the settlement date. Rule 204's close-out requirement mandates that if the participant fails to deliver the securities of any equity position, the participant must immediately purchase or borrow shares to close out that position by the beginning of normal trading hours on the first settlement day after the settlement date. Fails to deliver resulting from long sales or bona fide market making activity have two additional settlement days before they must be closed out. If the fail to deliver relates to securities that the seller is "deemed to own," such as Rule 144 securities or securities not yet received after the exercise of an option or warrant, the seller is entitled to an extended close-out period that runs to the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date.

Note that a participant must take *affirmative action* to close out a fail to deliver position by purchasing or borrowing securities. A participant *may not* "offset the amount of its fail to deliver position with shares that the participant simply receives or will receive during the applicable close-out date."¹²

Rule 204(b): Borrowing Requirement

If a participant of a registered clearing agency fails to close out an open fail to deliver position in accordance with the rules described above, that participant, along with any broker or dealer from which that participant receives trades, is subject to the borrowing requirement of Rule 204(b). Until the participant closes out the open fail to deliver position by purchasing the necessary kind and quantity of securities, Rule 204(b) disallows the participant, or any broker or dealer from which that participant receives trades, to accept additional short sale orders for that security or effect additional short sales of that security for its own accounts without first borrowing, or entering into a bona fide arrangement to borrow, the securities in question. However, if a broker or dealer can prove to the clearing agency that it was in no way responsible for the clearing agency incurring the fail to deliver position, the Rule provides an exception from the borrowing requirement for such brokers or dealers.

Rule 204(c): Notification Requirement

As a result of the borrowing requirement's impact on other broker-dealers, 204(c) imposes a notification requirement on participants with an open fail to deliver position. Rule 204(c) requires that a participant notify all broker-dealers for which they receive trades (1) when they have a fail to deliver position that has not been closed out according to the close-out requirement and (2) when they clear and settle the purchase to close out the fail to deliver position.

Rule 204(d): Allocation

Participants of a registered clearing agency may reasonably (e.g., timely) allocate their responsibility to close out a fail to deliver position to another broker or dealer from whom they have received trades and who can be identified as responsible for the fail to deliver position. When such an allocation occurs, the broker-dealer to whom responsibility is allocated must be able to show, on the close-out date, that it has purchased or borrowed securities in the full quantity to cover the open position and that it has a net flat or net long position for that security on its books. Further, under 204(d), the broker-dealer assumes a responsibility to immediately notify the participant of the registered clearing agency that they have become subject to the borrowing requirements of Rule 204(b).

Rule 204(e): Pre-Fail Credit

A broker-dealer can avoid the close-out and borrowing requirements of Rule 204 by purchasing or borrowing enough shares to cover its entire fail to deliver position under certain conditions. The purchase or borrow must be executed after the trade date, but no later than the end of regular trading hours on the settlement date. In addition, the broker-dealer must be able to demonstrate that, on the day of purchase, it has a net flat or long position on its books for the security in question.

Rule 204(f): Sham Close-Outs

When purchasing or borrowing securities to close out a fail to deliver position, a participant cannot fulfill Rule 204's requirements if the participant knows,

or has reason to know, that the party from whom it agrees to purchase the securities will fail to deliver the securities. Rule 204(f) pre-empts attempts to circumvent the Rule's provisions using sham close-outs.

III. Conclusion

In light of the OCIE's announcement that during the coming year it will focus on controls on the intentional spreading of rumors and compliance with short selling rules, and in light of the recent regulatory changes in these areas, compliance professionals should be familiar with the rules described in this article, and should revisit their respective firm's compliance systems to ensure awareness of, and compliance with, the new rules.

ENDNOTES

¹ See, e.g., Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR, August 2008, available at http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808.

² The case revolved around The Blackstone Group's acquisition of Alliance Data Systems Corp. On May 17, 2007, Blackstone announced that it had entered into a definitive agreement to acquire all outstanding common stock of ADS at a price of \$81.75 per share. According to the Complaint, on November 29, 2007, Berliner wrote and disseminated to 31 traders via instant message a false rumor alleging that the ADS board was meeting to consider a revised Blackstone proposal at \$70 per share. As the rumor spread quickly through Wall Street, ADS' stock, which had been trading around \$77 per share, plummeted to \$63.65 before the New York Stock Exchange suspended its trading. Minutes before spreading the rumor, Berliner sold short 10,000 shares of ADS, turning a \$25,000 profit on the market's panic.

³ Rule 600(b)(46) of SEC Regulation NMS defines these securities as "any security or class of

securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options."

⁴ The FINRA manual also incorporates select NYSE rules for NYSE members. One such rule is NYSE Rule 435(5) prohibiting the circulation of false or misleading rumors "of a sensational character which might reasonably be expected to affect market conditions."

⁵ Comment on a prior version of Rule 2030 was solicited with Regulatory Notice 08-68 in November of 2008.

⁶ See Rule 204T Adoptive Release, 73 FR at 61707, Exchange Act Release No. 34-58773 (Oct. 14, 2008).

⁷ See Rule 204 Adoptive Release, Exchange Act Release No. 34-60388 (July 27, 2009).

⁸ For nearly seventy years—from 1938 to 2007—Rule 10a-1 under the Exchange Act generally prohibited short sales on listed stocks unless they occurred in a rising market (i.e., on an "uptick").

⁹ The Uptick Rule precluded all persons from executing short sales below the last sale price, and also precluded them from selling short at the last sale price, unless that last sale was on an uptick or a zero-plus tick.

¹⁰ The proposal restricts the display or execution of short sale orders at a down-bid price, defined as a price that is less than the current national best bid or, if the differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid.

¹¹ However, exceptions to the Circuit Breaker Halt Rule are markedly different, largely modeled on the exceptions to the short sale ban implemented in September and October of 2008.

¹² Per the Rule 204T Adoptive Release, "a participant must be able to demonstrate on its books and records that, on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position and, therefore, that the participant has as net flat or net long position."

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