

The SEC's Two-Pronged Attack Against Naked Short Selling

Perrie Weiner, Nicolas Morgan, and Joshua Briones, DLA Piper

Two options traders and their broker-dealers charged by the Securities and Exchange Commission (SEC) with violating the locate and closeout requirements of Regulation SHO have arrived at a settlement with the SEC. In settling these actions, the SEC enforced rules designed to prevent so-called abusive "naked" short selling. The SEC did so less than two weeks after making permanent a temporary rule put in place last fall to help settle the turbulent capital markets.

Short Selling v. Naked Short Selling

Short selling typically involves locating and borrowing a company's shares, selling them, buying them back at a later date (and, hopefully, a lower price) and returning them to the lender to close out the short position. A short seller, if the stock price falls, realizes a profit from the difference between the sale and purchase prices in a declining market. Short selling has a long history and is a legitimate and lawful trading strategy.

In a naked short sale, however, a seller (through its broker) does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period, and the seller fails to deliver the securities to the buyer when delivery is due. The SEC and various commentators have asserted that naked short selling can be used to manipulate the price of securities by artificially driving their prices down.¹

Rules Governing Naked Short Selling

Rule 203(b)(1), which lies at the core of Regulation SHO and has been in force since Regulation SHO was first adopted in 2004 and became fully effective in January 2005, states:

A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) Documented compliance with this paragraph (b)(1).

In the fall of 2008, at the height of the financial crisis, the SEC took a huge step toward prohibiting the practice by promulgating interim final temporary rule 204T (Rule 204T)² and amending Rule 203(b)(3)³ to govern naked short selling.

New Rule 204

The SEC permanently adopted Rule 204T as Rule 204 of Regulation SHO on July 27, 2009.⁴ In essence, Rule 204 tightens the mandatory delivery period for "fails to deliver" by requiring that participants of registered clearing agencies as well as market makers may close out a "fail to deliver" position by borrowing, in addition to purchasing, securities, and that "fails to deliver" from long sales may be closed out by purchasing or borrowing securities. In addition, broker-dealers may close out these positions by purchasing or borrowing securities sufficient to cover the entire amount of the failure to deliver position.

Rule 203(b)(3)

The SEC amended Rule 203(b)(3) to, among other things, eliminate the options market-maker exception to the closeout requirement. Rule 203(b)(3) now provides, in part, that:

[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity.

The Rule 203(b)(3) amendments became permanent in October 2008.⁵

SEC Settles with New York and Chicago Based Firms

In related actions based on previous rules,⁶ the SEC charged (1) New York City-based Hazan Capital Management LLC and its principal trader and majority owner, Steven M. Hazan; and (2) Chicago-based TJM Proprietary Trading LLC, one of its traders, Michael R. Benson, and Benson's supervisor, John T. Burke, with unlawful naked short selling.

The SEC alleged that Hazan improperly claimed the market maker exception to avoid locating shares before effecting short sale transactions in violation of Rule 203(b)(1).⁷ The SEC also alleged that Hazan violated Rule 203(b)(3) by engaging in a series of allegedly sham reset transactions that employed short-term, paired stock and option positions to circumvent close out obligations.⁸ Because Hazan failed to borrow or arrange to borrow securities to make delivery when delivery was due, the SEC deemed the sales to be "naked" short sales.⁹

In a separate proceeding, the SEC charged TJM with similar violations, but went one step further by including charges against Burke, TJM's chief operating officer, for

failing to reasonably supervise Benson with a view to preventing him from willfully aiding and abetting and causing TJM's violations of Rules 203(b)(1) and 203(b)(3).¹⁰

Less than two weeks after making Rule 204 permanent, the SEC settled these two cases and publicized the terms. In both cases, the parties settled without admitting or denying wrongdoing. In the Hazan proceeding, the parties agreed to pay disgorgement of \$3 million, and Hazan was barred from being associated with any broker-dealer for five years.¹¹ In the TJM case, the parties agreed to pay back the \$541,000 and pay a \$250,000 penalty. Benson was suspended from associating with a broker-dealer for three months, and Burke was suspended from acting in a supervisory capacity at a broker-dealer for nine months.¹²

Implications of SEC's Actions

Over the years, some issuers as well as their shareholders have made the contested claim that short sellers were abusing the rules while the SEC looked the other way. That claim can no longer be made. Since the collapse of Bear Stearns and Lehman Brothers and other related events, the SEC has come under intense pressure to identify and prosecute those found to have engaged in naked short selling.

With the two recent settlements and the finalization of related rules, the SEC has signaled a strong response to congressional calls to address naked shorting. Some wonder whether these latest developments are a prelude to even more stringent restrictions on short selling that may indicate an attempt by the U.S. government to protect public companies (and specifically major financial firms) from the discipline of the financial markets.

While short sellers are often treated with suspicion by their peers and viewed as purveyors of negative information or, worse yet, "market manipulators," they are important because short sellers sometimes help temper overheating markets and bring a dose of reality and effective price discovery to what some view as overly optimistic corporate projections or fraudulent financial statements. Enron, exposed by short sellers, is a good reminder of how vital short sellers can be to revealing fraud in the marketplace. And the restrictions on *naked* short selling may unduly chill a useful contrarian voice in the marketplace.

Perrie Weiner, the International Co-Chair of DLA Piper's securities litigation practice, is a managing partner of the Century City office and a member of the Executive and Policy Committees. He has a national practice, with litigation victories, pending cases and publications widely reported in Time, Business Week, Forbes, The Wall Street Journal, New York Law Journal, Los Angeles Daily Journal, Los Angeles Times, Los Angeles, Money Management Executive, PIPEs Report, HedgeWorld and The Economist, among others. Mr. Weiner also represents private and public companies in a variety of industries, in both national and international business disputes.

Nicolas Morgan practices complex securities litigation in state and federal courts with special emphasis in representing issuers, officers and directors, investment funds, analysts, and brokers in connection with SEC and Financial Industry Regulatory Authority investigations, litigation, and arbitration. Mr. Morgan also advises clients in non-litigation settings, such as counseling public companies, funds and broker-dealer firms in securities compliance and corporate governance issues, conducting internal investigations and assisting in regulatory examinations by the SEC's Division of Corporation Finance and Office of Compliance Inspections and Examinations.

Joshua Briones concentrates on litigating complex business disputes and consumer class actions, securities cases, and regularly counsels clients on issues relating to records retention. Mr. Briones also has international litigation experience. He represents foreign companies doing business in the United States in commercial and regulatory disputes. Mr. Briones is on the Hiring Committee for the Los Angeles office. He is also a member of DLA Piper's Los Angeles Diversity Committee.

¹ Daniel Kadlec, *Watch Out, They Bite!*, Time Magazine (Nov. 9, 2005).

² See SEC Release No. 34-58773 (Oct. 14, 2008); File No. S7-30-08.

³ See SEC Release No. 34-58775 (Oct. 14, 2008); File No. S7-19-07.

⁴ See SEC Release No. 34-60388 (July 27, 2009); File No. S7-19-07.

⁵ See SEC Release No. 34-58775 (Oct. 14, 2008); File No. S7-19-07.

⁶ See SEC Release No. 34-50103 (July 28, 2004); File No. S7-23-03.

⁷ *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, SEC Release No. 34-60441; Administrative Proceeding File No. 3-13570 (Aug. 5, 2009).

⁸ *Id.*

⁹ *Id.*

¹⁰ *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, SEC Release No. 34-60440; Administrative Proceeding File No. 3-13569 (Aug. 5, 2009).

¹¹ *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, SEC Release No. 34-60441; Administrative Proceeding File No. 3-13570 (Aug. 5, 2009).

¹² *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, SEC Release No. 34-60440; Administrative Proceeding File No. 3-13569 (Aug. 5, 2009).