

July 16, 2008

SEC Bars Naked Short Sales of Major Financial Firms; More is Needed

Yesterday evening, the Securities and Exchange Commission issued an emergency rule barring naked short sales of the stock of Fannie Mae, Freddy Mac and seventeen primary dealers such as Lehman, Goldman Sachs, Merrill Lynch and Morgan Stanley. The rule, which takes force July 21 and will be in effect for thirty days, comes on the heels of a week in which Fannie Mae and Freddie Mac stocks were battered by unsubstantiated rumors. While the Commission's effort to respond, in what it called "unusual and extraordinary circumstances," to "disruption in the functioning of the securities markets that could threaten fair and orderly markets" is commendable, immediate stronger SEC action is necessary.

Under the emergency rule, no person may effect a short sale in the securities of any of nineteen major financial firms, including Fannie Mae and Freddy Mac, unless it (1) has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting the sale, and (2) delivers the security on the settlement date. The rule thus somewhat tightens current regulations, which also permit short sales where an investor has "reasonable grounds" to believe the securities can be borrowed in time to be delivered on the settlement date.

The SEC's emergency action late yesterday represents a step in the right direction; however, additional prompt measures are necessary to remedy what Chairman Cox called a "witch's brew" of short selling and manipulative behavior. The SEC needs to expand the temporary action beyond its initial thirty-day period and extend its coverage to all publicly traded securities. We have previously urged the SEC to heed market participants' calls to immediately reimpose the "Uptick" Rule to temper heightened market volatility, and continue to believe that is the correct course, especially given that current market conditions differ substantially from the low volatility and rising security prices that existed when the SEC conducted its pilot study.

Moreover, while the Commission's attempts to reign in the "substantial threat of sudden and excessive fluctuations of securities prices" are critical, they alone are not enough; the Commission must promptly complete ongoing investigations and bring enforcement actions against those who engage in abusive and manipulative short selling. It is uncontroverted that there are false rumors in the marketplace. The key question is who is creating and spreading the rumors and for what purpose. There needs to be a public report by the SEC to provide clarity on the extent to which abusive and manipulative short-selling and spreading of false rumors is taking place (see our memos of July 1 and July 14).

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