Regulatory Panic – The SEC Issues Emergency Orders Regulating Short Sales

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Last week, the SEC issued four emergency orders dealing with short sales, which were then modified by two more orders issued over the weekend. I do not believe the SEC has issued four emergency orders involving market regulation in the last four decades. Maybe never.

Emergency orders represent the extraordinary exercise of power by any governmental agency. But, the SEC's primary objective is to protect the national interest in maintaining fair and orderly markets. The emergency orders issued last week reflect an unsteady hand at the helm, which is inconsistent with the SEC's primary objective.

To understand the significance of last week's emergency orders, a bit of background is required.

A person sells a stock short by selling stock that he doesn't own. The idea is to profit when the stock declines in value by buying it back at a lower price.

Issuers generally despise short sales because they imagine that short sellers effectively drive the price down. There is in fact a form of market manipulation known as the "bear raid" that is intended to drive a stock price down. Generally, however, issuers dislike the way markets punish diminished expectations by beating down stock prices. Lower market prices for the stocks of Bear Stearns, Lehman, Goldman, Merrill and Morgan Stanley represented an entirely rational response to the difficulties these firms experienced dealing with their liabilities. These firms were, and some still are, in trouble, and the correct response was to mark their stock prices down.

Other than bear raids, a relatively rare form of manipulation, short sellers are important to the proper functioning of markets because they reflect the expectations of some market participants that a company's prospects are diminished. Short sellers, as compared to long sellers, are buyers of the stock, since the seller's profit is derived from a subsequent purchase. The activities of short sellers therefore enable markets to adjust smoothly to these expectations, rather than experience free falls, the result when many investors decide at the same time to sell long.

Beginning in the 1930s, the SEC regulated short sales by requiring them to occur on an "uptick" or when the price of a stock had risen in the previous trade. This was based on the unproven theory that bear raids worked by engaging in rapidly repeated, successive short sales. The idea was to break the chain of short sales by intervening increases in stock prices.

The uptick rule did not prove to be a successful way to regulate short sales. It did not prevent bear raids and was easily circumvented by professional traders using derivative instruments. The rule's only benefit was political – it made issuers happy.

In 2004, the SEC abandoned the uptick rule, and promulgated Reg SHO. This regulation seeks to prevent bear raids by requiring short sellers to deliver stock that has been shorted. To do this, the short seller must borrow the stock, which effectively limits the amount of stock that can be shorted to the amount that can be borrowed. This is an effective rule that makes bear raids very difficult to accomplish.

Reg SHO created the concept of "threshold securities," representing securities that have substantial failures to deliver. A "fail" occurs when a security is not delivered to the purchaser on settlement date. While there can be many causes for fails, including back office snafus, fails are most often caused when a short seller does not borrow stock and therefore fails to deliver it for settlement. Reg SHO sought to eliminate this practice, called "naked shorting," by prohibiting it and then requiring clearing firms to close-out fails in threshold securities by buying the stock in the market after fourteen days and sending the bill to the offending short seller. The rule takes the profit out of naked shorting and deprives manipulators of an economic incentive to conduct bear raids.

The first edition of Reg SHO contained a number of exceptions. Most important, the rule did not require clearing firms to close out market makers that established short positions before a stock became a threshold security. Over time, these exceptions have been whittled away.

The most recent proposed rule, issued in October 2007 and followed up with a re-proposal in May 2008, would have eliminated the options market maker exception from the close-out rule for threshold securities. Market markers would still be permitted to sell short without borrowing because they would otherwise be unable to fill customer orders. But, they would have to cover immediately to avoid being bought in. The SEC also proposed to make it a fraudulent practice for a short seller to tell a broker falsely that securities are being borrowed for timely delivery. The short seller who failed to deliver would therefore be exposed to potential civil and criminal penalties, as well as suffering the financial loss of being "bought in."

That brings us to last week's emergency orders.

The first order made final some of the proposed rules. The options market maker exception from the close-out rule was eliminated. It is now a fraudulent practice for a short seller to make the false claim that she is arranging for a borrow in a security.

Then came the big surprises. The threshold security concept was eliminated. Now, the close-out rule applies to all securities. Instead of a 14-day close-out period, clearing firms are required to buy in fails on the day after settlement (T+4). None of this was part of the original proposal.

The SEC's second emergency order requires large institutional investment managers to file weekly reports of their daily short positions on a new Form SH. Again, the agency has never suggested that this was in the works.

The third order broadened the safe harbor that permits issuers to repurchase their own stock. Issuer repurchases provide a tempting opportunity for issuers to manipulate the market for their stock on the upside. Think of it as a "bull raid." The order therefore enables an issuer to support the price of its stock, even when the fundamentals argue otherwise, and even engage in these support tactics at the open and close, when the market is most susceptible to up-side manipulation.

The zeal for emergency orders unquenched, the SEC finished up by prohibiting for at least two weeks any short sales in the stocks issued by 799 financial institutions, mostly consisting of banks.

The ink was scarcely dry on the page when modifications to these emergency orders were announced. Working over the weekend, the SEC decided that making short positions of investment managers public would encourage "short squeezes," another form of market manipulation. To reduce this nasty incentive, the SEC will not make the short reports public for two weeks after filing. This also means that some SEC staffers will have access to non-public information that will be extremely valuable to certain hedge funds and professional traders. The SEC will need to institute procedures to keep this information out of the wrong hands.

The SEC also modified its prohibition on short sales for financial institutions to allow writers of call option to short a stock upon exercise and permit market makers to short stock in order to fulfill their market making obligations. These functions generally cannot exist without the capacity to short stocks temporarily.

The exchanges have been empowered to lengthen the list of issuers of stock that cannot be shorted. Issuers are the primary customers for an exchange. Since issuers hate short sellers, the exchanges were only too happy to indulge this prejudice by broadening the list of financial institutions whose stock cannot be shorted. The stock of General Electric and General Motors now cannot be shorted. You may have thought that General Electric was a manufacturer of appliances and General Motors made cars. But no, they have been classified as financial institutions. This is simply a case of the exchanges pandering to issuer fantasies.

My guess is that more tune-ups will follow.

It is ridiculous to imagine that short sellers of the stock of financial institutions have caused, or even contributed to, the current financial crisis. We are undergoing a credit crisis, caused by loan defaults and exotic securities, such as credit default swaps. Short sellers may drive the stock of Morgan Stanley to zero. It will still stand firm as a financial institution. When its creditors descend because it cannot pay off on its swaps, the game is over. Yet, so far no one has banned credit default swaps or prohibited lending to flaky creditors.

The SEC is a regulator in panic, powerless to do much of anything about the current crisis in the markets, but receiving plenty of heat. Prominent politicians, including one Presidential candidate, have called for the head of Christopher Cox, the Chairman of the SEC, on a platter. Oddly enough, Mr. Cox served in Congress as a member of the same political party that now wants him drawn and quartered. Acknowledging that there is little he or anyone else at the SEC can do about the crisis at the moment, his hypocritical detractors have suggested that Mr. Cox should have called for more regulation two years ago, before all of this started. This is a trap for fools set by knaves. The former Chairman of the SEC, William Donaldson, was ridden out of town on a rail for suggesting that more regulation was required, which is how Mr. Cox got this job.

I am no fan of Christopher Cox. The fact remains that the political reaction to the current financial crisis is nothing more than a witch hunt. Burning witches could not stop plagues, and replacing Mr. Cox will do little to stem the current financial crisis. Witches confronted with fiery stakes nonetheless peer deep into their cauldrons in hope that some magic might be summoned. Hence, emergency orders and short sales prohibitions.

Emergency orders are not the way a Constitutional democracy functions. The "due process" clause of the US Constitution requires notice and public comment before rules are enacted. This principle is inscribed in the Administrative Procedures Act. Issuing rules by emergency order is government by fiat and runs counter to our democratic and constitutional principles.

It is true, as Justice Robert H. Jackson famously declared, the "Constitution is not a suicide pact." There will be times when due process protections must be set aside to confront an emergency that threatens the public peace and order. But, the occasions that demand a suspension of due process are rare events.

The reason for this is not because the US Constitution is a sacred text, which it most assuredly is not. The reason we should be so reluctant to impose emergency orders is that they are most often a mistake, representing actions taken in haste at great cost with undesirable, adverse consequences.

These most recent emergency orders are a case in point. It is not the SEC's job to promote bull markets or stem bear markets, but to maintain fair and orderly markets. Governmental attempts to influence market prices are, in an event, an exercise in futility. Instead, the SEC is charged with the task of making sure that markets work properly, free of fraud and manipulation. Issuers should not be encouraged to manipulate the price of their stock. The emergency orders represent a misguided attempt to "do something, even if it's wrong."

So far, the equity markets have responded to the current crisis with some modicum of calm and good order. It would truly be a calamity if the equity markets were to become as dysfunctional as the credit markets. We can only hope that our equity markets, having endured so much stress, can also survive regulatory panic.

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