

CAPITAL MARKETS | BY [ANNA T. PINEDO](#) AND [JAMES R. TANENBAUM](#)

## The long shadow of the shorts

Short selling, or shorting, includes a variety of methodologies used by market participants to attempt to profit from a decline in the market price of a security. In most instances, the objectives are either speculation, hedging, or arbitrage. For a variety of reasons, short selling or and short sellers do not always get the most favourable press. They are routinely viewed as profiting from the misfortune of others and distorting the market. Yet, short selling continues to be a critical and growing component of the US capital markets. Against this backdrop and after a few years of studies, the SEC has undertaken regulatory reforms affecting shorting. In June 2007, the SEC voted to eliminate the 'tick test' and to amend restrictions on short selling contained in Regulation SHO. The SEC also approved amendments intended to strengthen Rule 105 of Regulation M, governing short selling prior to the pricing of a public offering. The release was published in August 2006. The effective date of amended Rule 105 was October 2007.

### Tick test

The tick test established price restrictions intended to prevent manipulative short selling. The rule prohibited short selling of a security in a 'down' market by providing that a security may be sold short only (i) at a price above the immediately preceding reported price (plus tick) or (ii) at the last sale price if higher than the last different reported

price (zero-plus tick). The SEC eliminated the tick test after reviewing the results of a pilot study that exempted a select group of securities from these price restrictions. The pilot study confirmed the rule was no longer necessary given changes in market dynamics.

### Regulation SHO

Regulation SHO was originally adopted in July 2004 to provide a framework for regulating short sales. The regulation was intended to prevent naked short selling by requiring the closeout of fails to deliver against short positions in certain securities, called threshold securities.

Through the recent amendments, the SEC eliminated the 'grandfather' exception to the mandatory closeout requirement for threshold securities. Previously, fails to deliver against open short positions that existed when a security was added to the threshold securities list were exempt, or 'grandfathered', from the closeout provisions. The rationale was to prevent disruptive buying pressure when a security was first designated a threshold security.

Threshold securities are equity securities with respect to which there is an aggregate fail-to-deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, that equals at least 0.5 percent of the issuer's outstanding shares, and is included on a list disseminated by an SRO. If a clearing broker has a fail-to-deliver position in a threshold security for 13 consecutive settlement days, the broker is required to close out the position by buying securities of like kind and amount to cover the fail. In addition, until the position is closed out, the clearing broker, as well as any other broker-dealers for which it clears transactions, is prohibited from engaging in further short sales in the security. Following elimination of the grandfather exception, all fail-to-deliver positions in threshold securities will have to be closed out within 13 consecutive settlement days.

### Rule 105 of Regulation M

Rule 105 is designed to prevent manipulative short selling that may affect pricing in a follow-on securities offering and to facilitate pricing based on the market. Currently, Rule 105 prohibits a person who sells short an equity security during the restricted period from covering the short sale by purchasing securities in a firm commitment offering from an underwriter, broker or dealer participating in the offering. Market participants who expect to receive shares in an offering may have an incentive to short the stock prior to pricing and to cover that short position with stock that they are allocated in the offering, at a reduced offering price. ▶▶

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Amended Rule 105 eliminates the concept of 'covering'. The amended rule makes it unlawful for a person who sells short an equity security during the restricted period to 'purchase' securities in the offering, even if the securities purchased in the offering are not used to cover the short sale. The restricted period generally consists of the shorter of the five business days preceding the pricing of the offering or the period commencing with the initial filing of the registration statement and ending with the pricing.

Rule 105 applies only to registered firm commitment offerings of equity securities. The rule does not apply to reference securities (security into which the 'subject security', or security that is the subject of the distribution, may be converted, exchanged or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security). In an offering of securities convertible into common equity, a person may still short the underlying common stock and purchase the convertible security in the offering without violating Rule 105. The rule retains the exception for best efforts offerings. Footnote 41 of the release provides that: "amended Rule 105 continues to retain the exception for best efforts offerings....By way of another example, PIPEs generally did not fit within the elements of former Rule 105. One reason for this is that PIPEs are typically not conducted on a firm commitment basis. PIPE offerings not conducted on a firm commitment basis continue to be exempted from Rule 105...." The rule also does not address options or derivatives trading.

The SEC believes that by establishing a bright-line test prohibiting a short seller from purchasing in the offering (in contrast to the current rule, which prohibits the seller from covering the short sale with offering securities), it will 'once and for all put an end to the progression of schemes that have been engineered to camouflage covering activity [in violation of the rule].'

As originally proposed by the SEC, this bright-line test did not contain any exceptions. However, as finally adopted, the amended rule includes a few exceptions. First, a person who sells short during the restricted period will not be prohibited from participating in the public offering if the person makes a 'bona fide' purchase of the same security no later than one business day prior to the pricing of the offering. The bona fide exception is intended to allow persons to participate in

an offering if they sold short before they became aware of the offering or if their shorting activity was part of their regular trading strategies. The amended rule sets forth a number of conditions for the covering transaction all of which are intended to minimize the market effect of the trading activity and to ensure transparency. Given the timing parameters of the rule, investors will not be able to avail themselves of the bona fide exception for bought or overnight deals. Prior to 2004, the rule included an exception for shelf offerings, which was subsequently eliminated.

Second, the rule contains an exception for registered investment companies. Third, the rule contains an exception for certain other entities that make separate trading and investment decisions. Amended Rule 105 will not prevent one account from selling short during the restricted period and a related account from purchasing in the offering so long as the accounts are not coordinating their trading or sharing profits. Examples of persons eligible for the separate account exception include individual investors with multiple accounts if the investor cannot coordinate trading between accounts or make investment decisions; an adviser that provides capital to two or more advisers or private investment funds if the funds are separate legal entities; a money manager that provides capital to separate advisers; an adviser that operates a black box using a trading algorithm; and multiple sub-advisers to a registered investment company that are subject to the supervision of a single, primary investment adviser.

In conclusion, the SEC found that the effectiveness or prior regulations of short selling had been eroded due to the changes in market dynamics. While artificial 'price restraints' like the tick test were no longer useful in light of decimalisation, automation of trading and other developments, regulation of shorting, especially in connection with underwritten offerings, was still an important matter. We will see whether these new regulations will alleviate shorting into offerings and how they will affect offering dynamics. ■

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