

August 14, 2008

SEC Allows Emergency Order that Constrained Abusive Short Sales to Lapse;  
Prompt Action is Needed

On July 15, the Securities and Exchange Commission issued an Emergency Order effective July 21, barring naked short sales in the securities of nineteen substantial financial firms in response to what it called a “substantial threat of sudden and excessive fluctuations of securities prices” caused by potential manipulative and abusive trading. On July 29, the Commission extended the Emergency Order until August 12. On that date, the SEC allowed the Emergency Order to lapse, without putting in place an alternative means to address heightened market volatility and illegal short selling practices. We think this was a mistake. The SEC should move quickly to propose and adopt a market-wide rule to address abusive short selling and should re-impose the “Uptick Rule.”

Under the Emergency Order, traders were not able to short a security without borrowing shares, or entering into “bona fide” agreements to borrow them, prior to effecting the sale. The Order thus tightened existing regulations, which 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. While the Order was not a panacea for the markets’ troubles, it made abusive short selling more difficult and dampened market volatility.

The Commission has announced that it intends to propose permanent, market-wide rules that will mimic the effect of the Emergency Order. However, those rules won’t be proposed until at least mid-September, and could take months to finalize. We urge the Commission to take immediate steps in the interim. As an initial matter, the SEC should request broker-dealers to voluntarily continue to adhere to the lapsed Emergency Order. Moreover, as we previously advocated, the SEC should heed market participants’ call to immediately re-impose the “Uptick Rule” on a temporary basis in order to maintain investor confidence in the fairness and orderliness of the markets.

There has been substantial speculation and debate about the effectiveness of the Emergency Order and whether there is manipulative and illegal short selling or other abusive trading activities occurring, including the spreading of false rumors. The SEC should promptly issue a public report to provide clarity on the extent to which abusive and manipulative short selling and rumor-mongering are taking place (see our memos of July 1 and July 14) and to provide information about the effectiveness of the Emergency Order.

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