SEC Abolishes a Grandfather, Narrows a Harbor

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07/12/2006 5:46:40 PM ET

WASHINGTON (HedgeWorld.com)—The Securities and Exchange Commission unanimously approved two proposals from the staff of its division of market regulation Wednesday [July 12]: an interpretive release regarding soft money and a proposal to amend Regulation SHO, its effort to reduce the frequency of fails-to-deliver (FTDs) arising from naked short sales.

The second item on the SEC's agenda Wednesday morning was the one more likely to stir passions: It was what Chairman Christopher Cox referred to as "the serious problem of abusive naked short sales." The SEC adopted Reg. SHO in 2004. Among other provisions, it required short sellers and their brokers to have reasonable grounds to believe that they'll be able to borrow the stock certificates and deliver them at settlement.

In the words of Harvey Pitt, who chaired the SEC from 2001 to 2003 and who wrote an opinion piece about Reg. SHO for *Forbes* Tuesday, "Many prime brokers … satisfy the requirement of reasonable grounds by assuming that, if large long positions reside somewhere in-house, they can borrow from those long positions without bothering to check if the shares are actually available for borrowing and without ascertaining if those same shares have already provided reasonable grounds to permit another short sale of the same security." This practice leads to over-shorting.

SHO also requires the closing out of FTD positions in certain securities, known as the "threshold" securities. But it exempts from that closeout requirement FTDs that existed before a stock joined the "threshold list"—this is the "grandfather clause." Another controversial provision of SHO authorizes naked short-selling by market makers. The proposed amendments will change Reg. SHO both by eliminating the grandfather clause, and by limiting the range of the market maker exception.

Mr. Colby told the SEC, "We think that this will work, and if it doesn't, from the point of view of the option market makers, they're not shy and they will tell us."

Commissioner Annette L. Nazareth, in support of these changes, said that "with the adoption of Reg. SHO the commission made clear that it would monitor the results of this rule," and she praised the staff for its "countless hours studying the data. … I believe those efforts are evident in the results today."

She also said, "When the public reads this release they will be very pleased to see the number of really thoughtful questions" that it has posed.

David Patch, promoter of an anti-naked shorting petition and the founder of a web site on the subject, said in an email exchange that the SEC's apparent willingness to retreat from its grandfather clause only confirms what he and others have maintained in the year and a half since it was first adopted: that the clause was ill-conceived in the first place, putting the interests of financial institutions ahead of "the investing public and the companies they have invested in."

Mr. Patch criticized the SEC for its continuing concern "that the Broker Dealers and Options traders would not be happy with the changes" and said that the commissioners rarely discuss "the decades

of concerns the investing public has experienced."

Gary Weiss, author of *Wall Street Versus America*, a book that pillories the "pump and dump" crowd, has a very different take on the issue. He said Wednesday in a telephone interview that the SEC's action was both politically motivated and unhelpful for the investing public. "Regulation SHO in and of itself is just an utter waste of regulatory resources. If anything, the SEC should work to make it easier to short sell."

It has never been demonstrated to his satisfaction, Mr. Weiss said, that naked shorting is a significant problem.

Manuel Asensio, once a prominent and successful short seller himself, agreed with Mr. Weiss. "The SEC is a creaking machine, and the creaking has now at last gotten so loud it may finally inspire a popular reaction," he said.

Farewells and Soft Dollars

This was the final SEC meeting for one of the commissioners, Cynthia Glassman, who has been on board since January 2002, and who was the acting chair a year ago. The other commissioners each bid her farewell.

The sentiments of Roel C. Campos were representative in this respect. He said that Ms. Glassman "has challenged us all to rethink long-held assumptions" and that her presence [as an economist] has proven that "economists and lawyers can work together, and can sometimes agree."

Ms. Glassman also made light of her status as an economist amongst lawyers. She said, in connection with the "safe harbor rule" in the soft-money field, that its underlying purpose is to "protect money managers from liability for the violation of fiduciary obligations to their investors" when and if they pay higher brokerage commissions than they might have, given the market rate for execution services. After making that point, she paused and said, "I seem to be speaking in legalize. I must have drunken too much SEC water."

The new interpretation of the safe harbor, presented by the staff today after a period of comments on an older draft, limits the use of such paying-up arrangements. They may be used to pay for advice, analysis, and reports, whether from the brokerage in-house team or from a third party, and for other "reasonable" products and services. The guidance applies prospectively, beginning six months from the release, and where it conflicts with the prior guidance, issued in a 1986 release, the new release supersedes the old.

The fact that third-party research stands on a par with in-house research is one that both commissioners and the staff seemed eager to emphasize. "Do you sense that the industry is pretty clear that third-party research can definitely be provided for under soft dollars?" Mr. Campos asked Robert Colby. Mr. Colby, acting director, division of market regulation, replied, "Definitely."

Much of the discussion focused on the disclosure aspect of the softing issue. This release doesn't directly address disclosure, but both the SEC and its staff hopes that they'll soon be in a position to do so.

In a related development, Horizon Cash Management announced the results of a best-practices survey of 2,000 hedge fund managers July 12 **Previous HedgeWorld Story**, and the some of the survey's questions addressed softing. A quarter of the respondents reported some soft-dollar arrangements with the prime brokers and/or clearing firms. Most of those said they disclosed those practices to their investors, chiefly through the offering documents.

Half of the respondents said they have a soft-dollar policy in place.