SEC Issues Short-Selling Rules in Bid to Stop Manipulation

BY KARA SCANNELL

WASHINGTON—With stocks tumbling, the Securities and Exchange Commission launched an effort aimed at making it harder for traders to improperly drive down stock prices.

The three rules, which go into effect Thursday at 12:01 a.m., follow a weekend of tense negotiations with Wall Street firms, which have asked SEC Chairman Christopher Cox to stop a tide of short selling. Some hedge funds have been pointing a finger at other hedge-fund managers, claiming that short sellers share responsibility for the recent panic on Wall Street, which has been especially brutal for financial stocks.

Falling stock prices have made it harder for banks to raise money to shore up their funding, and manipulative trading may have contributed to the fall of Bear Stearns Cos. and Lehman Brothers Holdings Inc. In a short sale, a trader sells borrowed stock, hoping it will fall in price and can be repurchased later at a profit. The trader has to return the borrowed stock within three business days.

Corporations and others have complained that loopholes in the existing rules made it easier for traders to manipulate the market by shorting stock without actually borrowing the stock and then failing to deliver it within three days. The SEC has said that most traders who missed the deadline delivered shares within five to 10 business days and that the delays are often the result of clerical errors.

Christopher Dodd

Under the new provisions, the SEC will eliminate the wiggle room by penalizing a trader who doesn't deliver shares within three business days. For violating that rule, the SEC will bar the broker executing the trade from engaging in any short sale without actually borrowing the shares before selling them.

The SEC also is tightening requirements on market makers that trade options and making it illegal for a customer to mislead a broker about having located stocks and then failing to deliver them.

The new curbs apply to the entire market, not just the 19 financial firms covered by emergency short-selling rules that took effect earlier this summer but have since expired. Wednesday's move bypassed the usual public-comment process, reflecting the urgency with which the agency views the situation.

Edward Yingling, president of the American Bankers Association, said he was pleased with the rules, but added: "This needed to be done yesterday, frankly." He added, "We're in a very dangerous situation."

In a memo to clients, attorneys Edward Herlihy and Theodore Levine of law firm Wachtell, Lipton, Rosen & Katz called the SEC moves "too little too late" and said the SEC needs to take more-dramatic steps and to look at short sellers' related transactions "to determine whether these strategies are contributing to the severe dislocations taking place in the marketplace."

Christopher Cox

Other traders, while approving of the SEC's new short-sale rules, suggest that the rush to blame short sellers is misguided. "There's no reason loopholes should exist," said Rick Schottenfeld, who runs New York trading firm Schottenfeld Group, which buys and shorts stocks. "But...we're placing the blame in the wrong place. Short sellers are seeing how leveraged financial companies are and are reacting to that."

Some traders and lawyers and others were frustrated that the SEC didn't reinstate a Depression-era rule that put speed bumps in place to slow the pace of short sales. The so-called "uptick" rule, which the SEC repealed in July 2007, prohibited traders from selling short unless there was an uptick, or higher bid, in the stock. Traders say that tamped down volatility and applied the brakes during times of heavy selling.

Some fund managers say they hope to discuss with members of Congress ways to potentially curb short selling, perhaps by putting a limit on the ability of investors to target financial shares.

Wednesday, **Morgan Stanley** Chief Executive John Mack called Mr. Cox, Treasury Secretary Henry Paulson and **Goldman Sachs Group** Inc. CEO Lloyd Blankfein about how to stop short sellers betting on a decline in Goldman and Morgan Stanley shares, a person familiar with the matter said.

The previous short-selling crackdown for financial stocks helped limit the downside in those shares, many observers say.

—Gregory Zuckerman and Aaron Lucchetti contributed to this article.