
Under SEC Spotlight: Hedge Funds and Short Sale Activity

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I. Introduction

On October 10, 2007, the Securities and Exchange Commission (SEC or Commission) announced a settled enforcement action against an unregistered hedge fund manager, Sandell Asset Management Corporation (Sandell), its chief executive officer, senior managing director and head trader for engaging in improper short sales, imposing more than \$8 million in monetary sanctions against Sandell and \$190,000 in civil penalties against the individuals.^[i] The action against Sandell, one of the largest monetary sanctions to date, reflects the heightened regulatory scrutiny to which hedge fund managers are subject relating to short sale activities.

Historically, such enforcement actions largely have involved short sales relating to new offerings; an area of law recently addressed with revisions to Rule 105 of Regulation M under the Securities Exchange Act of 1934, as amended (Exchange Act).^[ii] In addition, however, order marking and locate requirements pursuant to Regulation SHO under the Exchange Act--at issue in the Sandell enforcement action--also have been areas of interest and may be more so in the future. ^[iii] Further, there appears to be an increased focus by the Commission on the development and implementation of policies and procedures and controls surrounding short sale activities in general.^[iv]

Hedge funds that engage in short sale activities should review carefully their current policies and procedures in light of the Commission's increased scrutiny in this area. We have included a list of focus areas below.

II. Enforcement Action against Sandell Asset Management Corporation

According to the SEC Release, Sandell engaged in unlawful short selling on behalf of its client Castlerigg Master Investment, Ltd. (Castlerigg). Specifically, on behalf of Castlerigg, Sandell purchased approximately nine million shares of Hibernia Corporation (Hibernia), a financial holding company headquartered in New Orleans, Louisiana, during the first half of 2005 in response to an announcement that Hibernia would be combining with Capital One Financial Corporation (Capital One). After purchasing the Hibernia securities on the open market, Sandell sold the shares to certain third parties and entered into swap transactions with the purchasers. Pursuant to the terms of the swap agreements, Castlerigg retained the risks of ownership, but the counterparties paid the

fund for, and held legal title to, the shares. Accordingly, the fund no longer owned shares of Hibernia, but it bore the risk of loss if the share price declined.

After Hurricane Katrina struck New Orleans on August 29, 2005, and the city and its residents suffered enormous losses as a result of the storm and the eventual break of the levees, Sandell believed that Capital One would reduce its offering price for Hibernia shares, leading to significant losses in Castlerigg's portfolio. To offset the anticipated losses, Sandell decided to hedge Castlerigg's position by selling short over nine million shares of Hibernia stock. Such short selling activity would have triggered the so-called "locate" requirement and trading restrictions under the "tick test."^[v] At that time, those requirements would have been quite burdensome to comply with given the extremely low availability of Hibernia stock for borrowing. Accordingly, Sandell reportedly sold over 3.5 million shares of Hibernia by mismarking the sales as "long." Of the shares sold, a little over two million were executed on a down tick or a zero-minus tick in violation of the tick test.

Subsequently, after learning from legal counsel that Sandell mismarked the sales of the Hibernia stock as "long" and that the merger between Hibernia and Capital One would be postponed, the CEO of Sandell further directed Sandell's traders to continue short selling the Hibernia shares, marking the sales as "short" and locating shares to borrow to cover the short sales. On September 2, 2005, however, after locating one million shares to borrow, the firm's traders were unable to locate any further shares, at which point they stopped short sale trading activities and told the CEO that they were unable to locate additional shares to borrow. The CEO challenged their conclusions and, ultimately, instructed them to keep selling short and to keep searching for shares to borrow despite the apparent unavailability of shares in the market. The CEO did not take steps to ensure that the traders understood that the selling should not occur without locating shares to borrow and did not inquire into their activities in an effort to ensure that the firm was locating shares to borrow to cover the short sales. In effect, Sandell's traders continued to execute the short sales by misrepresenting to the broker-dealers that executed the trades that they had located stock to borrow when, in fact, they had not. With these activities, the firm was able to avoid over \$6.5 million in losses.

In relevant part, the CEO, the senior manager and head trader of Sandell were charged with willfully aiding and abetting violations of Section 10(a) of the Exchange Act and Exchange Act Rule 10a-1. Further, pursuant to the settlement agreement, Sandell has agreed to employ an independent consultant to review its current policies and procedures relating to short sale activities and to make recommendations for the development and implementation of internal controls as well as policies and procedures to prevent future violations.

IV. Suggested Policies and Procedures and Internal Controls

Hedge fund managers that actively engage in short selling activity may consider adopting the following internal controls and procedures to ensure compliance with applicable regulations:

- Procedures to prevent firm personnel from entering sell orders marked long unless there is an affirmative indication that the firm owns the securities or that the security has been borrowed and the source of the borrow is indicated and confirmed. If practicable, such

procedures could include system-based controls that automatically prevent the entering of inappropriate orders. In the alternative, rigorous monitoring and testing procedures may be appropriate.

- Centralized databases for any locates done by the firm away from the executing broker-dealer or prime broker that maintain records of the symbols and quantity of the located securities, the source of the located securities (lending entity), the person with whom the locate was arranged, the person at the firm requesting the locate and the length of time the locate will be in place.
- Daily review of locates when (a) trading in securities with respect to which a material market event has occurred that may affect the demand for the securities (e.g., breaking news, surprise earnings announcement or a sudden large price change); (b) convertible bonds when the convertible bonds are illiquid; (c) thinly traded securities; and (d) "when issued" securities.
- Periodic surveillance of trader activities with respect to short sale marking and locate activities to monitor for compliance with the firm's short sale policies and procedures.

[i] In re Sandell Asset Management Corp., Administrative Proceeding File No. 3-12865, Securities Act Release No. 8857 (Oct. 10, 2007), available at <http://www.sec.gov/litigation/admin/2007/33-8857.pdf> (SEC Release).

[ii] Short Selling in Connection with a Public Offering, Exchange Act Release No. 56,206 (Aug. 6, 2007), 72 Fed. Reg. 45,094, n. 18 (Aug. 10, 2007), available at <http://www.sec.gov/rules/final/2007/34-56206fr.pdf> (referencing numerous recent enforcement actions for non-compliance with Rule 105 under Regulation M); see also SEC v. Colonial Investment Management LLC, Litigation Release No. 20332 (Oct. 15, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20332.htm>.

[iii] See Amendments to Regulation SHO, Exchange Act Release No. 56213, 72 Fed. Reg. 45558 (Aug. 14, 2007) (proposing an amendment to the long sale marking provisions of Regulation SHO that would require that brokers-dealers marking a sale as long document the present location of the securities being sold); James A. Brigagliano, US Securities and Exchange Commission, Speech by SEC Staff: Short Sale Regulation: A Targeted Approach for Efficient Markets, at <http://www.sec.gov/news/speech/2007/spch032207jab.htm> (Mar. 22, 2007) (discussing the attention of the SEC Division of Market Regulation to short sale activities under Regulation SHO, Regulation M and the short sale price tests).

[iv] Many of the enforcement actions, including that brought against Sandell, include the requirement to adopt, implement and maintain written policies and procedures and controls designed to prevent violations of the Exchange Act short sale provisions going forward.

[v] It is reasonable to assume that when executing a short sale, Regulation SHO requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security. This locate must be made before effecting the short sale. 17 C.F.R. §242.203(b). Further, the tick test under former Rule 10a-1 of the Exchange Act—which was eliminated by the SEC effective July 3,

2007, but was in effect at the time of the activities described in the SEC Release--provided, in relevant part, that a listed security can be sold short only at a price above the immediately preceding sale price (plus tick) or at a last sale price if it is higher than the last different price (zero-plus tick).