Today's Guest
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The Edge

Scott Rothbort, founder and partner of LakeView Asset Management, LLC, is filling in for Doug Kass today. Email Rothbort at scott.rothbort@thestreet.com. Doug Kass will return on Tuesday.

Slam Dunking and Short-Selling on the Downtick
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QuickTake

Update SMH RTH

> - Broker/dealers and financial institutions are being pimped by the hedge funds, and they don't even see it.

Married puts is the simultaneous purchase of puts and stocks to create a hedge position. This is typically facilitated by upstairs options desks for the benefit of hedge funds or other institutional clients. Recognizing that sham married puts can be used as part of a fraudulent or manipulative scheme, the **SEC** issued an interpretive release on November 21, 2003, seeking to curb this illicit behavior while at the same time ensuring the proper use of married puts.

The SEC's concern was that a married put position would be established and then the long stock leg would be sold out in a rapid fashion to drive the stock down. Then, the put would be sold at a hefty profit. This process is called Slam Dunking.

However, the SEC's release, while long on intention, was otherwise short-sighted because smart hedge funds integrated the use of ETFs and swaps into the slam-dunking playbook. By doing so, they were outside of the parameters of the SEC's interpretive release. Here is how it now works:

- **Swaps.** The hedge fund arranges to put on a total rate of return swap with a financial institution. Remember that I helped to pioneer this business, so I understand it quite well. The hedge fund will buy stock from the dealer and take the short side of the swap against the same dealer. The dealer will then be short stock and long the swap. All parties are hedged. It looks like a financing position. Now, if this is a legitimate financing transaction, then there should be no issue and we can stop right here. When the hedge fund later blows out the stock and creates a selling frenzy, however, it is a manipulative transaction. Later, the hedge fund steps in and buys back stock. This can be done over and over again until the swap matures. What makes the swap more appealing is that it can be done offshore, is not delta dependent, is not subject to position limits and could be done with a lower margin requirement than a married put.

- **ETFs.** Sector specific ETFs have grown in popularity, availability and differentiation since the SEC's pronouncement on married puts. A sector ETF may have 20 to 30 stocks in the trust supporting the security, and typically, there are one or two stocks that have much higher weighting within that ETF portfolio. The manipulators will go ahead and buy puts on the top one or two stocks underlying the ETF vs. a broker/dealer. Now, thanks to not having to sell stock short on an uptick, the hedge fund will start to slam the ETF, forcing buyers of the ETF to hedge by selling the underlying basket of stocks. The underlying stocks go down, and the puts increase in value. The hedge fund buys the ETFs at the bottom while also selling out the puts. In addition, this can be done in a mirror-image way. The hedge fund will buy puts on the ETF and then raid the individual stocks in a similar manner to which I described.

I always hear from upstairs traders that puts are transacted on a fully delta-hedged basis. The same also occurs in the swap scenarios. That's what the hedge fund wants. They are merely loading up with ammunition for when the time is right. The broker/dealer or financial institutions are being pimped and used by the hedge funds, and the former doesn't even see it. They are happy earning commissions and interest spreads and, in all honesty, are not a willing or knowing participant in the slam dunking.

The SEC made these practices much easier by not bringing their interpretive release to its logical conclusion, failing to extend the prohibition to all derivative instruments and ETFs. Furthermore, the SEC exacerbated the situation by first making ETFs exempt from the uptick rule and then, a few years later, removing the uptick rule from stocks in general. Lastly, as I described earlier, the **NYSE** move to a hybrid system allows the machines to bypass human intervention and create waves of slam dunk selling.

When you put this all together, it creates opportunity for manipulative transactions linked to derivatives in downward markets. I hear arguments over and over again that the same can be true on the upside. The answer is that panics occur in downside markets, not in rising markets. In up markets, the only people who get burned are the short sellers who get squeezed and the over leveraged buyer (more on that later) who buys too high. Finally, remember that shareholder, not short seller or arbitrageur, rights are paramount.

So what does the SEC need to do to restore investor confidence, prevent manipulative practices and protect the rights of shareholders? Again I have some suggestions:

- The practice of slam dunking and trading of married puts to stocks embedded in sector ETFs and swaps must also be prohibited and strictly enforced.

- Improve stock market surveillance techniques to update techniques and/or begin to monitor uptick, circuit breaker, derivative and other violations.
- Reinstitute the uptick rule for short sellers of stock and extend it to ETFs that are not broad-based, such as the **Semiconductor HOLDRs** (SMH), **Retail HOLDRs** (RTH), etc., and permit downtick selling on broad-based ETFs, with some limitations.

Position: *No positions*