

## Client Advisory

November 2003

# SEC Issues Married Put Interpretation

The Securities and Exchange Commission has issued its long-awaited Interpretive Release regarding short sales and “married put transactions” (the “Interpretation”).<sup>1</sup> According to the SEC, while married puts can be part of a legitimate hedging strategy (a use they do not wish to discourage), they are “calling attention to abusive married put transactions that . . . are used in a scheme to create sham long positions in order to evade Commission rules.”

As we indicated earlier this month in our Client Advisory “SEC Proposes New Short Sale Rules,”<sup>2</sup> the SEC has been preparing interpretive guidance regarding the calculation of a seller’s “net long” position, as defined in Rule 3b-3 under the Securities Exchange Act of 1934, as amended,<sup>3</sup> when the seller engages in married put transactions as a part of certain trading strategies. The SEC notes that it has in the past expressed concern regarding married put transactions designed to avoid the short sale rules, pointing out that the 1999 Short Sale Concept Release stated that such strategies “may present a heightened potential for manipulation.”<sup>4</sup>

In determining whether a seller is long or short for purposes of various short sale restrictions, including SEC Rule 10a-1 (the “tick rule”), NASD Rule 3350 (the “bid test”), SEC Rule 105 (which prohibits covering certain short sales with securities obtained from an underwriter or dealer in a registered offering), and various self-regulatory organization requirements to affirmatively determine the availability of stock when executing short sales (collectively, the “short sale rules”), Rule 3b-3 provides that the seller is long only to the extent that the seller has a “net long” position, after aggregating all of its positions in that security. If, after such aggregation, the seller is “flat” or “net short,” the sale must be treated as a “short” sale.

Married puts involve the contemporaneous purchase of stock and a put option on that stock. Used as a hedge of the long stock position, the married put provides downside protection to the stockholder. If the stock price falls below the strike price of the put, the put can be exercised at the strike price. The SEC is not concerned with such transactions. However, the SEC is concerned about abusive married put strategies (sometimes referred to as “bullets,” “ghost bullets,” and “slam dunks”) that are designed to evade the short sale rules, noting that such strategies have been used to avoid the tick rule or bid test, and to drive down the market price of stocks in order to profit by purchasing at the lowered prices. The SEC also notes the recent emergence of strategies in which traders purchase married puts during the Rule 105 restricted period, aggressively sell the stock “long,” exercise the puts, and then use securities obtained at the (now depressed)

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<sup>1</sup> Securities Exchange Act Release No. 48795 (November 18, 2003) (<http://www.sec.gov/rules/interp/34-48795.htm>).

<sup>2</sup> On October 29, 2003, the SEC proposed new Regulation SHO, which, among other things, calls for a uniform price rule, based on the consolidated best bid, for short sales in all exchange-listed and Nasdaq National Market System securities, wherever traded. The Interpretation will apply regardless of whether Regulation SHO is adopted.

<sup>3</sup> Rule 3b-3 defines the term “short sale” as any sale of a security that the seller does not own, or any sale that is consummated by the delivery of borrowed securities.

<sup>4</sup> Securities Exchange Act Release No. 42037, 64 Fed. Reg. 57996 (October 28, 1999).

offering price to cover their short positions. The SEC sees this as harmful to the market and to issuers and their shareholders that receive reduced offering proceeds.

The SEC, finding that these strategies facilitate the abuse that the short sale rules are designed to prevent, has decided that “it is necessary to provide notice to traders that, under certain circumstances, the securities underlying married puts will not provide ownership (i.e., a ‘long’ position) under Rule 3b-3.” According to the SEC, the transactions used to create artificial long positions usually have some or all of the following characteristics (or variations thereof):

- purchase of an at- or in-the-money non-standardized put option with a short (one- to five-day) expiration period;
- contemporaneous purchase of an equivalent number of shares of the stock underlying the put option;
- contemporaneous sale of the stock, divorcing the stock position from the put option (and eliminating any argument that the put option was acquired to hedge the stock position);
- repeated use of a “facilitator” that provides both the put and the stock (often by selling the stock short to the married put purchaser);
- “netting out” of the transaction between the facilitator and the married put purchaser (often at the end of the same day the married put was purchased); and
- payment of a standardized fee by the married put purchaser to the facilitator, which is not calculated according to standard options pricing models.

The SEC states that such transactions present little or no economic risk to either party, and reiterates its past declarations that transactions with no market risk, and with no purpose other than to permit indirectly what is prohibited directly, may violate federal securities laws. The strategies that concern the SEC include:

- contemporaneously with or shortly after the purchase of a married put, selling the stock without regard to the tick rule or bid test as part of a day trading strategy dependent on trading without price rule execution delays;
- contemporaneously with or shortly after the purchase of a married put, aggressively and rapidly selling the stock on successive minus or zero-minus ticks as part of a short-term momentum play, where the strategy is aligned with a downward movement of the stock’s price; or
- contemporaneously with or shortly after the purchase of a married put, aggressively selling the stock during the five-day period prior to the pricing of a secondary offering, where the strategy is aligned with a downward movement of the stock’s price in an effort to profit from the difference between the sale prices and the offering price.

The SEC concludes that “it is important to disabuse traders of any notion that the use of married puts, as described above, complies with Commission rules,” calling them “sham transactions that do not give rise to security ownership under Rule 3b-3.” As a result, sellers relying on these strategies may violate the short sale rules and, if using married puts “as part of a fraudulent or manipulative scheme, the conduct may also violate the Commission’s anti-fraud and anti-manipulation provisions, including, but not limited to, Sections 9(a) and 10(b) of the Exchange Act.”<sup>5</sup>

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<sup>5</sup> According to the Interpretation, even viewed in the most favorable light, these transactions “appear to be nothing more than temporary stock lending agreements designed to give the appearance of a ‘long’ position in order to effect sales of stock in a manner that would otherwise be prohibited.” However, the SEC advises that borrowed stock does not confer ownership under Rule 3b-3 and must be sold in accordance with applicable short sale rules.

## **We Can Help**

Katten Muchin Zavis Rosenman will be happy to discuss further with you the implications of the Interpretation. Please contact one of the following KMZ Rosenman attorneys:

|                     | <b>Direct Dial</b> | <b>Email</b>               |
|---------------------|--------------------|----------------------------|
| Henry Bregstein     | 212.940.6615       | henry.bregstein@kmzr.com   |
| Daren R. Domina     | 212.940.6517       | daren.domina@kmzr.com      |
| Arthur W. Hahn      | 312.902.5241       | arthur.hahn@kmzr.com       |
| Edward J. Johnsen   | 212.940.8894       | edward.johnsen@kmzr.com    |
| Michael J. Metzger  | 202.625.3696       | michael.metzger@kmzr.com   |
| William Natbony     | 212.940.8930       | william.natbony@kmzr.com   |
| Michael M. Philipp  | 312.902.5367       | michael.philipp@kmzr.com   |
| Howard Schneider    | 212.940.8787       | howard.schneider@kmzr.com  |
| Marybeth Sorady     | 202.625.3727       | marybeth.sorady@kmzr.com   |
| James Van De Graaff | 312.902.5227       | james.vandegraaff@kmzr.com |

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**KMZ Rosenman**  
**KATTEN MUCHIN ZAVIS ROSENMAN**

[www.kmzr.com](http://www.kmzr.com)

525 West Monroe Street  
Suite 1600  
Chicago, IL 60661-3693  
Tel 312.902.5200  
Fax 312.902.1061

575 Madison Avenue  
New York, NY 10022-2585  
Tel 212.940.8800  
Fax 212.940.8776

2029 Century Park East  
Suite 2600  
Los Angeles, CA 90067-3012  
Tel 310.788.4400  
Fax 310.788.4471

1025 Thomas Jefferson St., N.W.  
East Lobby, Suite 700  
Washington, DC 20007-5201  
Tel 202.625.3500  
Fax 202.298.7570

401 South Tryon Street  
Suite 2600  
Charlotte, NC 28202-1935  
Tel 704.444.2000  
Fax 704.444.2050

260 Sheridan Avenue  
Suite 450  
Palo Alto, CA 94306-2047  
Tel 650.330.3652  
Fax 650.321.4746

One Gateway Center  
Suite 2600  
Newark, NJ 07102-5397  
Tel 973.645.0572  
Fax 973.645.0573