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Title: ARE 'SLAM DUNKS' ON TROUBLED STOCKS A FOUL?
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Abstract: Wall Street traders have a new weapon to 'raid' bad-news stocks, an options-related strategy known as the 'slam dunk.' Stock-market regulators are scrutinizing these trades for signs of market manipulation. Traders say the biggest users are hedge funds that both buy stocks and sell them short.

Article Text:

NEW YORK -- Wall Street traders have a new weapon to 'raid' bad-news stocks: an options-related strategy known as the 'slam dunk.'

Stock-market regulators are scrutinizing these trades for signs of market manipulation.

Chase Manhattan Corp. stock was a raid target on various days as it slid from around $18 a share last August to $11.875 yesterday, traders say. First Interstate Bancorp, Security Pacific Corp., Wells Fargo & Co., USX Corp., Phelps Dodge Corp., McDonnell Douglas Corp. and Midway Airlines Inc. all have been bear raid targets, traders say. Texas Instruments Inc. fell 8% on volume of 2.1 million shares last Friday. Raiders may have been at work there.

'Take any stock that's been battered; airline and banking stocks are a good menu' of issues targeted for raids, says Richard Cooper, president of Cooper Neff Inc., a Philadelphia options firm.

One market regulator, who declined to be identified, said his staff is reviewing several trades for signs of stock manipulation. 'We are looking at movements in options and at large [options] transactions, and we are doing the same in stocks,' the regulator said, adding: 'We are watching; [the strategy] can lend itself to abuse.'

Bear raiding is an old game among stock-market manipulators, with roots as far back as the 1800s, when financier Jay Gould raided stocks. Later, in the early 1900s, the game was played by investment pool operators. The object is to gang up on a stock with aggressive sales, or rumors, to benefit from bets placed on the share's decline.

So vicious were the raids of old that the Securities and Exchange Commission in 1935 passed the 'short-sale rule,' also known as the 'uptick rule.' Still a potent law in the market today, the rule says bets on stock declines (known as short sales) can be placed only after the stock trades at a higher price than the previous trade. The rule was aimed at preventing sellers from ganging up on stocks, typical of the old raids. In effect, old-time bear raiding was shut down.

But now speculators using options-related strategies have found a way to sell into a market decline and get around the constraints of the short-sale rule, some securities lawyers say. Traders say the biggest slam-dunk artists are certain hedge funds, aggressive money managers that both buy stocks and sell them short.

Options-related bear raids explain why some stocks recently declined in conflagrations of enormous, seemingly inexplicable selling. It's not uncommon to see a stock drop 5% to 10% on disappointing earnings these days. But with the raiders working in the markets, ordinary markdowns can turn into breathtaking stock dives.

'I don't think these things are good for our market,' says Dudley Eppel, head of stock trading at Donaldson, Lufkin & Jenrette Securities Corp. Says one options trader: 'This is definitely increasing volatility.'

The formal name for the strategy used in raids is the 'married put,' which describes a legitimate hedging trade. The 'slam dunk' describes the potentially illegal way traders unwind the transaction in order to have an enormous impact on a stock.

Here's how the 'slam dunk' works. In a single transaction, the raider will buy a few thousand shares of the target stock, and several dozen 'deep in the money' put options. A put option gives the owner the right, but not the obligation, to sell 100 shares of stock at a specified price by a specified date. Deep-in-the-money puts are options where the 'strike price,' or price at which the holder can sell the stock, is well above the current market price of the shares. These options are desired by raiders because they respond more sharply to a stock's decline than near-the-money puts.

Then the raider quietly sells shares to lighten up his stock position. Timing is key. If the stock moves up at this point, the raider may sustain losses. But the raider waits for bad news or rumors about a company to build up. Then, when the stock looks vulnerable, the raider moves in for the kill -- ordering floor brokers to walk into the crowd on the stock exchange floor and bark out aggressive sell orders to get everybody's notice.

'Normally, someone who owns something is sensitive to price,' says Robert Fagenson, a specialist, or market-maker, and a floor governor at the New York Stock Exchange. 'When you see a lack of sensitivity, you begin to wonder what's on the seller's mind.'

At the same time, the raider may also be sending sell orders through the Big Board's electronic order system, known as 'SuperDot.' The raider's 'Dot' orders are cleared through as many as three different securities firms to give the impression that many people are selling and are aware of some pending negative news about the company.

The raider begins to flush out other sellers, perhaps knowing that the stock is held by risk-averse money managers. As the selling mounts, the raider smacks the market by selling the remaining bit of stock he still owns in a final coup de grace. Since the raider is not 'shorting' in his stock sales, he can pound the stock lower even as the stock is falling, unconstrained by the short-sale rule. (A short seller sells borrowed stock in hopes of replacing them later with shares purchased at a lower price.)

While the raider may lose money on his stock sales, the price of the put options can increase enormously as the company's stock tumbles, giving the raider a handsome profit.

'I think [the slam dunk] is a circumvention of the uptick [or short sale] rule, and something should be done about it,' says Jeffrey Miller, partner at securities firm Miller Tabak Hirsch & Co.

Ideally, the bear raider likes to work in thinly traded stocks where there is bad news. Bankers Trust Co. presented raiders with an opportunity recently. The big New York bank's earnings were 23% below what analysts expected for the fourth quarter, according to a survey by Zacks Investment Research. That's a sizable disappointment, and the stock fell $4.125 a share last Thursday to $41; Friday, another 75 cents was knocked off the stock.

Normally, Bankers Trust trades an average of 288,000 shares a day, the kind of relatively low volume bear raiders love. Last Thursday and Friday, the stock traded at more than four times normal volume, as the bear raiders' desired selling vortex got under way.

In some cases, the simultaneous purchase of a put option and the underlying stock can be a legitimate hedging technique -- 'the married put.' It is often used by stock-exchange specialists, and regulators say floor brokers and securities firms that do this are simply fulfilling their role as professional market-makers.

Harrison Roth, senior options strategist at Cowen & Co.,. says the traditional married put trade -- where a near-the-money put is purchased along with the stock -- 'affords unique hedging protection, limiting losses to a small percentage of total money invested.' He says the 'slam dunk' is 'an abuse of a legitimate options strategy.'

As in many aspects of securities regulation, illegal use of this options strategy is defined by the intent of the trader to manipulate a stock.

Morgan Stanley & Co., the big investment bank, is one of the largest dealers in married puts, traders say, selling both the stocks and puts to clients. But market-makers such as Morgan Stanley 'are not doing anything illegal that we know of,' says one regulator. 'My take is that they are providing more liquidity in the options market.'

A Morgan Stanley spokesman says the married-puts strategy 'represents a small portion of the many option hedge strategies the firm provides to accommodate customers' risk management requirements.' Morgan Stanley is known for its sophisticated skills in futures, options and other 'derivative' products.

Other securities firms are occasional dealers in married puts. But some, including Merrill Lynch & Co., have shunned the strategy entirely.

A Merrill spokesman says: 'After considering legal and firm policy implications, Merrill concluded that we would not engage in the business.' He said that Merrill officials were concerned that if the firm sold married puts to clients, it could be indirectly involved if a client used the strategy to violate the short-sale rule.

A Securities and Exchange Commission official says the commission is aware of the slam dunk strategy, but won't say whether a formal investigation is under way. A spokesman for the Big Board says: 'We always monitor the market closely for compliance with our rules and federal securities law, but we cannot comment on specific situations.'

How to Stage a Bear Raid on a Stock

STEP 1

BUY: 100,000 shares of XYZ Corp.
@ $76.75 each= $7,675,000
BUY: 1,000 Feb. 90 put options
@ $13.25= $1,325,000
($1,325 per option)
TOTAL COST: $9,000,000

STEP 2

AS EXPECTATIONS OF BAD NEWS BUILD: Lighten the stock position, gradually increasing volume and visibility of sales to flush out additional sellers.

Risk-averse investors begin dumping shares and selling spree begins. Prices of put options climb.

STEP 3

As XYZ falls, raiders sells all shares
@ $72.25, losing $150,000
(average)
Sells put options
@ $16.25, gaining 300,000
($1,625 per option)
NET PROFIT
ON THE RAID $150,000

BOTTOM LINE: Profit of $150,000 on capital of $9 million yields 1.7%. But the time for a raid is roughly 10 days. If 25 equally successful raids were conducted in a year, total return would be 42.5%.