

**SEC Staff Provides Guidance on Short Sale Emergency Orders:
Supplement to FYIs of September 21 and 22, 2008**

September 25, 2008

As the securities industry continues to wrestle with the emergency orders issued last week by the Securities and Exchange Commission (SEC), a number of interpretive questions have been raised. The SEC staff has provided guidance on two of those orders through FAQs and informal conversations with industry participants. The recent guidance relates to the following: (1) the order imposing temporary close-out requirements on short sales, and (2) the order imposing temporary short sale reporting requirements on institutional money managers.

The SEC staff guidance is incorporated into the Q&As below; added or affected Q&As are marked "NEW" or "REVISED" as applicable. The SEC staff has indicated that it will continue to monitor the situation and provide additional guidance as appropriate. Accordingly, our discussion here is subject to further guidance from the SEC and the SEC staff.

SEC Order Imposing Temporary Close-Out Requirements on Short Sales

The SEC's interim rules on close outs require that clearing brokers must deliver securities to settle long and short sale transactions on the scheduled settlement date for the security (generally Trade Date (T) +3) (Settlement Date). The rules also require that the clearing broker close out any fails to deliver at the beginning of the first trading date following the Settlement Day (generally T+4). Clearing brokers that do not close out fails become subject to a "borrowing penalty." Once a broker-dealer is subject to the borrowing penalty, the broker-dealer may not effect short sales without (i) pre-borrowing the security or (ii) entering into a *bona fide* pre-borrow arrangement, in both cases, until it purchases securities to close out the fail-to-deliver position and the purchase clears and settles at a registered clearing agency.

These rules affect not only the clearing brokers themselves, which are subject to the rules, but also those brokers clearing through them, such as introducing brokers and executing brokers (e.g., in prime brokerage arrangements) and the ultimate customers of both.

Reminder: Unless extended, the close-out requirements will expire at 11:59 p.m. on October 1, 2008. The SEC has authority to extend the order but not beyond 30 calendar days in total.

1. *When does a clearing broker become subject to the borrowing penalty? How long does the penalty last?*

Under the interim rules, a clearing broker with a fail position on Settlement Date does not become subject to the borrowing penalty as long as it **purchases or borrows** to close out the fail at the beginning of trading on the trading date immediately following the Settlement Date. A clearing broker that becomes subject to the borrowing penalty remains subject to the penalty until the covering purchase clears and settles. For example, if the clearing broker waits until T+5 to close out the fail, the firm remains penalized until T+8.

2. *What constitutes purchasing or borrowing "at the beginning of trading"?* (NEW)

Purchasing. The SEC staff has indicated that a purchase made on T+4 to satisfy the close-out requirement must be submitted in time for the market open (on T+4) and not be subject to limits on the time or price of the execution. A "market on open" order would satisfy the requirement. The SEC staff indicated that as long as the order is submitted on time, it does not have to be executed immediately at the open of trading on the market. At this point, the SEC staff has indicated that a "market on close" order or a volume weighted average price (VWAP) order will not satisfy the close-out requirements, although the SEC staff apparently is still considering the question of VWAP orders. In addition, the SEC staff has indicated that staggered executions (created, for example, to avoid driving up the price on a thinly traded security) would not satisfy the close-out requirement; however, the SEC staff also indicated that it may consider adjusting the terms of the order to address this issue.

Borrowing. The SEC staff has indicated that if a borrow request has been entered by a clearing broker no later than the beginning of trading on T+4, then the borrowing penalty would not attach to the clearing broker even if the shares are not delivered on time to settle the trade, so long as the failure to deliver was not the fault of the clearing broker. The SEC staff noted, however, that the determination of whether the borrowing penalty should apply ultimately would be based on the particular facts and circumstances and each clearing broker must be able to document the steps it took to effect the borrow.

3. *Does the borrowing penalty extend to the clearing broker's customers and introducing firms? (REVISED)*

Under the terms of the temporary rules, if a clearing broker becomes subject to the borrowing penalty, the penalty applies to short sales of all of the clearing broker's customers and correspondent firms, regardless of whether they were responsible for the fail. As a result, investors may find that their clearing broker or executing brokers will act quickly to buy them in and may not provide advance notice, as has been customary in the past, in an effort by the brokers to avoid becoming subject to the borrowing penalty.

- The SEC staff's FAQ #1 regarding the Close-Out Order indicates that a clearing broker may allocate responsibility for the close-out requirement to another broker-dealer that is responsible for the fail position (e.g., an introducing broker or an executing broker, including a market maker). According to the FAQ, the clearing broker may thereby avoid application of the borrowing penalty to the clearing broker itself and to other broker-dealers clearing it. The safe harbor is conditioned on a determination that the allocation by the clearing broker be "reasonable." Presumably an allocation would be "reasonable" so long as the responsible broker-dealer has execution capabilities and systems sufficient to effect the close-out. The ability to allocate responsibility for compliance allows flexibility among the parties to utilize the execution capabilities of the broker-dealers best positioned to handle the close-out.
- FAQ #1 regarding the Close-Out Order indicates that a broker-dealer to which responsibility for the close-out requirement is allocated will become subject to the borrowing penalty if it does not close out the trade by the beginning of regular trading hours on the close-out date, either by purchasing or borrowing the securities or through a Pre-Fail Credit (described below). The broker-dealer must notify the clearing broker immediately when it becomes subject to a borrowing penalty.
- The SEC staff's FAQ #3 regarding the Close-Out Order states that, even if a clearing broker becomes subject to the borrowing penalty, a broker-dealer that timely certifies to the clearing broker that it has not incurred a fail to deliver in the security on Settlement Date does not become subject to the borrowing penalty if it is in compliance with the requirements for a Pre-Fail Credit (described below).

4. *May a broker-dealer effect an "early close out" to avoid the borrowing penalty? (NEW)*

The SEC staff's FAQ #2 relating to the Close-Out Order permits early close outs through a purchase prior to the beginning of regular trading hours on T+4, i.e., the first trading day following the Settlement Date (Close-out Date). A broker-dealer may receive credit for purchasing securities prior to the beginning of regular trading hours on the Close-out Date. These purchase transactions, referred to as Pre-Fail Credits, must be *bona fide*, or sufficient in quantity to cover the open short position, and conducted on T, T+1, T+2, or T+3. In addition, for the Pre-Fail Credit to be effective, the broker-dealer must demonstrate that it has a net long position or net flat

position on its books and records on the scheduled Settlement Date (for the short sale).

For a purchase to be *bona fide*, the purchase may not be entered into with a seller that the broker-dealer carrying out the purchase knows or has reason to know will not deliver securities in settlement of the transactions.¹ In addition, the broker-dealer must intend to use the purchased securities to settle its short position and not enter into the purchase simply as a means to manufacture a net long or net flat position.

If the broker-dealer to which responsibility was allocated does not properly carry out purchases in a manner that satisfies the Pre-Fail Credit requirements, or otherwise purchases or borrow securities to close out its entire fail-to-deliver position by no later than the beginning of regular trading hours on the Close-out Date, the broker-dealer will become subject to the borrowing penalty.

5. *May a broker-dealer to which responsibility for close-out is allocated use a Pre-Fail Credit to avoid being subject to a borrowing penalty if its clearing broker is subject to such a penalty? (NEW)*

Yes, provided the broker-dealer timely certifies to the clearing broker that it has satisfied all requirements for the Pre-Fail Credit.

6. *How does the close-out requirement affect market makers? (NEW)*

The SEC staff's FAQ #4 provides guidance with respect to registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market (Market Makers).

FAQ #4 provides two additional days to effect close outs for Market Makers. (The relief does not apply to block positioners.) Specifically, the close-out requirement is extended for fails to deliver attributable to *bona fide* market-making activities by Market Makers to the beginning of regular trading hours on the morning of the third settlement day after Settlement Date (i.e., T+6) rather than the usual Close-out Date (i.e., T+4).

In addition, the SEC staff indicated that any Market Maker to which a fail-to-deliver position at a registered clearing agency is attributable must submit a written attestation that the fail-to-deliver position at issue was established solely for the purpose of meeting its *bona fide* market-making obligations. In general, this would preclude, among other things, activity related to speculative trading strategies or investment purposes of the broker-dealer.²

The written attestation must also describe the steps the Market Maker has taken in an effort to deliver securities to its registered clearing agency.

In order to allow Market Makers the necessary flexibility to facilitate customer orders in fast-moving markets, the SEC staff also exempted Market Makers from the borrowing penalty upon a failure to close out in accordance with the Close-Out Order so long as the Market Maker can demonstrate that it does not have an open fail-to-deliver position at the time of any subsequent short sales.

7. *What is the procedure for a Market Maker to make the written attestation that a fail-to-deliver position was established solely for the purpose of meeting its bona fide market-making obligations? (NEW)*

FINRA and Nasdaq have provided guidance relating to their affected Market Makers.

FINRA has stated that Alternative Display Facility (ADF) Market Makers or Market Makers in OTC equity securities (e.g., OTC Bulletin Board and Pink Sheet securities) that intend to avail themselves of the extension must submit to FINRA their written attestation in the form provided in Attachment A to its

1. The requirement that the purchase be "*bona fide*" is likely to be interpreted in a similar manner as that in Regulation SHO relating to close out requirements for threshold securities. Rule 203(b)(3)(vii) provides that where a participant of a registered clearing agency enters into an arrangement with another person to purchase securities to close out an open fail to deliver position in a threshold security, it would not be a *bona fide* purchase if the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase.

2. Securities Exchange Act Release No. 50103 (July 28, 2004) at p. 13. (Regulation SHO Adopting Release).

Regulatory Notice (08-50). The completed attestations must be faxed to FINRA Operations at (301) 978-8511 by the close of business on the settlement day following the original settlement date of the transaction(s).

FINRA's Regulatory Notice is available at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117089.pdf>

Nasdaq has stated that Nasdaq Market Makers must fax a form of written attestation to Nasdaq MarketWatch at (301) 978-8511. Presumably, the attestations are also due to Nasdaq by the close of business on the settlement day following the original settlement date of the transaction(s). Nasdaq's form of written attestation is available at:

http://www.nasdaqtrader.com/content/administrationsupport/agreementsTrading/req_for_relief_eq.pdf

8. *May a clearing broker count securities delivered on the morning of T+4 to reduce a fail position in effect as of T+3? (NEW)*

The SEC staff has indicated that a clearing broker may reduce its fail position by the amount of securities that are delivered on the morning of T+4 provided that it is able to document the later delivery on its books and records. For example, if the clearing broker's fail position is 1,000 shares on T+3, and it receives 500 shares on the morning of T+4, the clearing broker's close-out requirement would be reduced to 500 shares.

9. *How do the interim rules affect prime brokerage arrangements? (REVISED)*

Because the borrowing penalty applies at the clearing broker level, prime brokers may impose additional requirements on executing brokers to ensure that short sales effected by the executing brokers do not fail. The SEC staff has indicated that it is still considering how the close-out requirement applies where the prime broker is subject to the borrowing penalty but the customer executes away and the executing broker submits the trade to the penalized clearing broker for clearance and settlement.

10. *What is the close-out requirement for long sales? (REVISED)*

If a clearing broker can demonstrate on its books and records that a fail-to-deliver position resulted from a long sale, the broker has until the third settlement day following Settlement Date (T+6) to close out the fail without becoming subject to the borrowing penalty. Under these circumstances, the clearing broker must **purchase** the securities in question to close out the fail. The SEC staff has indicated that if a clearing broker takes advantage of the T+6 close-out requirement, it may borrow or otherwise make delivery of the securities before T+6 if it completes delivery prior to that date, but it is required to close out through a purchase if it waits until the beginning of trading on T+6 to make delivery.

11. *May a broker-dealer reasonably rely on representations from its customer that it has satisfied the "borrow or arrangement to borrow" requirement under the borrowing penalty if the broker-dealer is subject to a borrowing penalty? (NEW)*

Probably not. We understand that the SEC staff is considering this issue; however, informal indications from the SEC staff suggest that they are not likely to endorse this approach.

12. *What is the close-out requirement for Rule 144 securities? Does it apply to privately placed securities?*

If a clearing broker has a fail-to-deliver position for 35 consecutive settlement days after the settlement date of a sale in an equity security sold pursuant to Rule 144 under the Securities Act of 1933 (1933 Act), the broker has until the 36th consecutive settlement day following Settlement Date to close out the fail without becoming subject to the borrowing penalty. However, this extended period does not apply to privately placed securities, including those sold pursuant to Rule 144A under the 1933 Act and Private Investment in Public Equity securities (PIPEs). The clearing broker must close out the fail by **purchasing** the securities in question.

13. *How will the interim rules affect securities lending practices?*

The interim rules do not prohibit the use of locates in connection with short sales, as long as the clearing broker is not subject to the borrowing penalty. However, it is possible that clearing firms may insist on receiving pre-borrow on all short sales if traditional stock lenders withdraw from the market. Stock lending agents and clearing brokers that rely on borrowings from those lenders may want to discuss the mechanics around borrowings in light of the new rules to ensure that there will be available borrowing to satisfy trade orders. In addition, securities lending firms may want to take steps to lock up the locates or pre-borrows they have given so that they are able to fulfill all of their commitments to lend. The SEC, FINRA, and NYSE Regulation staffs jointly provided guidance on avoiding fails, including earmarking pre-borrowed shares, maintaining an inventory of securities in which the firm frequently executes short sales, and obtaining affirmations for DVP trades.

14. How does the close-out requirement apply to exercises and assignments of options? (NEW)

The SEC staff has indicated that the close-out requirement applies to exercises of options but not to assignments.

15. Does the close-out requirement apply to syndicate short sales? (NEW)

The SEC staff has indicated that the close-out requirement does not apply to syndicate shorts sales.

SEC Order Requiring Institutional Money Managers to Report New Short Sales

The SEC order mandated that every institutional investment manager (i) that exercises investment discretion over accounts holding Section 13(f) securities and (ii) that has filed or was required to file a Form 13F for the calendar quarter ended June 30, 2008, file a Form SH report with the SEC commencing September 29, 2008, disclosing specified information about securities sold short during the preceding week.³ Managers subject to the reporting requirement include both SEC-registered and unregistered managers that exercise investment discretion over \$100 million or more of the broad group of equity securities described in Section 13(f) of the Exchange Act.

The SEC modified its order on Sunday, September 21, 2008 to allow investment managers to file Forms SH on a nonpublic basis. Under the modified order, two weeks after the due date for the Forms SH, the SEC will make the forms available to the public. In establishing the two-week “confidentiality period,” the SEC noted that it believed that this time was sufficient to protect against misuse of proprietary information contained in the report. The SEC also made certain changes to the instructions for Form SH. On September 24, 2008, the SEC published FAQs relating to Form SH and the filing requirements (Form SH FAQs).

Unless extended, the reporting requirement will expire at 11:59 p.m. on October 2, 2008.

16. What securities must be reported on Form SH? (REVISED)

Investment managers must report short positions in “13(f) securities” as defined in Rule 13f-1(c)—meaning equity securities traded on an exchange or quoted on an automated quotation system. (See Release 58591 at n.4.) The Form SH FAQs noted that short options positions or synthetic short positions held through options, even if of a class on the Official List of Section 13(f) securities, do not need to be reported on Form SH.

17. What is the triggering event for Form SH? (REVISED)

The triggering event is when an investment manager enters into a new short position on Monday, September 22, 2008 or afterwards. The Form SH FAQs clarify that a “short position” is a position resulting from a “short sale,” as defined in Regulation SHO. Rule 200(a) of Regulation SHO defines “short sale” as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”

Closing a short position that was open on Monday, September 22, 2008 or earlier is not reportable, because

³. Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 (Exchange Act) Taking Temporary Action to Respond to Market Developments, Securities Exchange Act of 1934 Release No. 58591 (September 18, 2008) (Release 58591).

the portfolio position is deemed to be zero on Monday, September 22.

18. An investment manager has a short position at the opening on Monday, September 22, 2008 and the investment manager does not add to it, reduce it, or close it out during the week of September 22 (Monday to Sunday). What does the investment manager report on Monday, September 29? (REVISED)

Under these circumstances, the investment manager would not report a short position for the week of September 22, 2008, because its short position on Monday, September 22 is deemed to be zero and the investment manager has not changed the position. Instruction 10(a)(iii). If this is the investment manager's only short position, the investment manager would not file a Form SH. Transactions entered into after September 22 to close out pre-existing short positions do not need to be reported.

The order is currently scheduled to terminate at 11:59 p.m. on Thursday, October 2, 2008. If the order is extended, investment managers would be required to report new short sales through the end date of the extension. The SEC staff indicated that they expect that, upon an extension, Form SH filings would be required to reflect the manager's short position as of the end of the prior calendar week. The Form SH FAQs indicated that, upon an extension, no filing would be required unless the manager effected short sales of a Section 13(f) security since the previous Form SH filing.

19. An investment manager has a \$10 million short position at the opening on Monday, September 22, 2008 and it reduces the position on Wednesday, September 24 to \$5 million. What does the investment manager report on Monday, September 29?

The investment manager does not file a Form SH for this position because the investment manager closed out a previously unreported short position.

20. An investment manager has a \$10 million short position at the opening on Monday, September 22, 2008 and the investment manager adds to the position on Wednesday, September 24, causing the investment manager to be \$15 million short. What does the investment manager report on Monday September 29?

The investment manager reports Monday's and Tuesday's positions as zero. On Wednesday, in columns 4, 5, and 7, the investment manager reports \$5 million (because it entered into a new \$5 million short position). The investment manager reports \$5 million in columns 6 (end-of-day position) and 7 (largest intraday position), rather than \$15 million. The manager is not required to report the preexisting \$10 million position.

21. An investment manager is long \$10 million and short \$5 million at the opening on Monday, September 22, 2008. The investment manager closes out its short position on Monday, September 22. What does the investment manager report on Monday, September 29?

The investment manager does not file a Form SH for this position because it closed out a previously unreported short position.

22. Is there a materiality level for reporting short positions, as there is for reporting long positions on Form 13F? (REVISED)

Yes, there is a materiality level for reporting short positions referred to as the "*de minimis* exclusion." Short positions that both (i) are less than one-quarter of one percent of that class of the issuer's section 13(f) securities issued and outstanding (as reported on the issuer's SEC filings under the Exchange Act) and (ii) have a fair value of less than \$1,000,000, are excluded from the reporting requirement under the *de minimis* exclusion. The Form SH FAQs clarify that short positions established prior to September 22, 2008 are not considered in determining whether the threshold is exceeded; only short positions resulting from short sales on and after September 22 need to be considered in determining whether the threshold is exceeded.

The *de minimis* exclusion should be analyzed on a day-by-day basis and according to the particular column being completed on the Form SH. An amount may be *de minimis* for purposes of calculating the total for one column but not for another. If a manager excludes information in reliance on the *de minimis* exclusion, it

should enter "N/A" in the appropriate column.

23. Must an investment manager report short exposure through options or other derivatives? (REVISED)

No, but the investment manager will be required to report exercises and assignments if the investment manager borrows the covered securities to effect settlement. Similarly, if a manager exercises an option and is net short as a result, the exercise will be considered to be a short sale for purposes of the reporting requirements. Finally, if a manager effects a short sale as a result of an assignment to it as the writer of a call option, the resulting transaction is considered to be a "short sale" and must be reported. Short sales resulting from option exercises must be reported as of the date of exercise. Short swaps do not need to be reported.

24. If an investment manager manages two separate accounts, for purposes of determining whether a short sale has occurred, must the two accounts be netted? (REVISED)

No. For purposes of determining whether a short sale has occurred, the manager must examine the holdings on an account-by-account basis.

25. If an investment manager manages two separate accounts, for purposes of reporting a short position do the two accounts have to be aggregated/netted, even if one account did not effect a short sale? (REVISED)

The Form SH FAQs clarify that long positions should not be netted against short sales either across client accounts or within a client account. The manager must determine the total open short positions, aggregated across all accounts managed by the investment manager.

26. Once a report is required, must all short positions be listed even if there is no change from the prior week?

No, the order requires reporting of only those short positions in 13(f) securities in which there is a change in the size of the position as compared to that held during the prior week.

27. How should an investment manager calculate the "value" of a short position? (NEW)

The investment manager should use "fair market value" and not execution prices to value the securities. The NYSE market closing price must be used to determine the price for all reported securities regardless of the U.S. market on which the securities trade. If securities were sold short on a nonbusiness day, the manager must use the market price of the securities as of the NYSE close on the most recent business day.

28. Does a broker-dealer that executes customer orders on a "riskless principal" basis have to file a short sale report? (NEW)

A broker-dealer handling customer orders on a riskless principal basis is not required to file a report on Form SH.

29. For each security for which there is a new short sale or closing of a short position, does a report get filed for each day of the week or just the day that the change occurred?

A report must be filed for each day of the week even if there are days on which no change in the size of the short position occurs.

30. Will Form SH be publicly available? Will confidential treatment be available?

The SEC responded to industry concerns about the possible misuse by competitors of proprietary information by modifying the order on Sunday, September 21, 2008. Although the original order had contemplated that filings would be public immediately, under the modified order Form SH will not be made publicly available until two weeks after the report is submitted. The SEC previously indicated that it would not consider confidential treatment requests (see Release 58591 at n.6). Filings will continue to be made using the EDGAR system, although the Forms SH may be filed on a nonpublic basis (and kept nonpublic for two weeks). The revised

instructions to Form SH state that investment managers must "label their Forms SH with the phrase 'NONPUBLIC' in bold and all-caps on the top and bottom of each page of the form."

31. When will we be able to access the Form SH template? (NEW)

The SEC staff has indicated that the Form SH template for reporting on EDGAR (via Edgarlink) will be available at 6:00 a.m. EST on Monday, September 29, 2008. A Word version is available on the SEC's website. Form SH may be submitted in ASCII or HTML.

32. How do I complete columns 6 (short position at end of day), 7 (largest intraday short position), and 8 (time of day of largest intraday short position)? (NEW)

The SEC staff has indicated the following:

- Column 6: Use the number of shares sold short minus any covering positions.
- Column 7: If a manager enters into a 2,000 share short position on Thursday, September 25, enters into another 2,000 share short position, then covers 500 shares, and finally shorts 500 shares, the largest intraday position is 4,000 shares.
- Column 8: The time of day to use is the time the broker advises the manager that it has filled the manager's order and not the time of the broker's execution.

If you have any questions concerning these important legal developments or would like copies of the FAQs, please contact any of the following Morgan Lewis attorneys:

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