

SEC Emergency Orders: Implications for Buyside and Sellside Firms

UPDATED as of 12:00 p.m., September 22, 2008

This FYI is an update of the FYI circulated by Morgan Lewis on Sunday, September 21, to reflect changes announced overnight by U.S. and foreign regulators. To ensure that our clients have the latest developments, we have described these changes in Q&As 1, 2, 4, 6, 7, 14, and 20 and below and have added two new Questions and Answers in 29 and 30. We have also described some of the changes under the amendments to the “SEC Order Banning Short Selling in Financial Stocks” and to the “SEC Order Requiring Institutional Money Managers to Report New Short Sales.”

In the face of the current extraordinary market conditions, the Securities and Exchange Commission (SEC) has announced that it is exercising regulatory powers through the following temporary orders: (1) prohibiting short selling in the common stocks of publicly traded financial services companies, (2) requiring that registered and unregistered institutional money managers report initiation of short sales of certain publicly traded common equity securities, (3) instituting temporary borrowing and delivery requirements on short sales of all publicly traded equity securities, (4) adopting an antifraud rule addressing “naked short selling,” and (5) easing restrictions on issuers’ repurchases of their shares. The orders were compiled quickly in the face of rapidly changing market conditions, and thus have raised interpretive questions and some uncertainty regarding their implementation.

The SEC also announced, on Friday, September 19, 2008, that it was expanding its existing investigation into possible market manipulation in the securities of certain financial institutions. According to the SEC’s press release, the SEC will require market participants, including hedge fund managers, broker-dealers, and institutional investors having significant trading activity in securities of financial issuers or positions in credit default swaps, to disclose those positions to the SEC under oath and provide additional information about their trading activity to the SEC. Investigators from NYSE Regulation and the Financial Industry Regulatory Authority (FINRA) will be conducting a separate parallel inquiry by making onsite visits to broker-dealers specifically related to recent short-selling activity.

In light of these SEC actions, there is expected to be heightened regulatory focus on short selling in general over the coming days, particularly in respect to stocks of financial services companies. As a result, both investors and financial services firms should exercise care in evaluating their trading ideas and ensure that they comply with the new temporary rules, as well as stay attuned to the regulatory concerns and policies underlying the rules.

In this FYI, we discuss the implications of the SEC’s temporary orders. The discussion below includes guidance presented in question-and-answer form to make the information more accessible and is based on discussions with members of the SEC staff and industry participants.

The SEC staff has been proactive about addressing these questions, but there remain some open questions. **On Sunday, September 21, 2008, the SEC amended its orders regarding the short sale prohibition and the reporting of short positions by institutional money managers.** As the market reacts to and absorbs these changes, we expect that there may be additional changes over the coming days. The SEC staff has indicated that it will continue to monitor the situation and provide additional guidance as appropriate. Accordingly, our discussion here (even with the amendments of September 21) is subject to further SEC staff and commission guidance.

Through our foreign offices, we will also continue to monitor developments in trading regulations affecting foreign markets, where regulators have also taken steps to address the recent market volatility.

SEC Order Banning Short Selling in Financial Stocks

The SEC has temporarily banned all short selling in common stock of financial services companies. The ban on short selling is subject to three limited exceptions: (i) short sales conducted by registered market makers, block positioners, and other market makers in connection with bona fide market-making activity in the security, (ii) short sales conducted by options market makers (both listed and over-the-counter) and market makers in other derivatives (both listed and over the counter) relating to the designated stocks in connection with bona fide market-making activity in the derivatives, and (iii) exception related to auto exercises or assignments of equity options and settlement of futures contracts, in both cases, due to expiration, provided the options or futures were held prior to September 19, 2008.

The exception provided to options market makers was originally due to expire at 11:59 p.m. on September 19, 2008. However, the SEC has modified the order to allow, for the life of the order, any person that is a market maker, including an over-the-counter market maker, that effects a short sale as part of bona fide market-making and hedging activity related directly to bona fide market making in (a) derivative securities based on the affected securities, or (b) exchange traded funds (ETFs) and exchange traded notes (ETNs) of which the affected securities are a component. The SEC described the purpose of the modification as aimed at permitting "market makers to continue to provide liquidity to the markets."

The exception is limited so that if a customer or counterparty position in a derivative security based on an affected security is established after 12:01 a.m. Eastern Time on September 22, 2008, a market maker may not effect a short sale in the affected security if the market maker knows that the customer's or counterparty's transaction will result in the customer's or counterparty's establishing or increasing an economic net short position (i.e., through actual positions, derivatives, or otherwise) in the affected security. Firms should note that the modified order requires every firm relying on the exception, as soon as operationally practicable, to publish a notice on its website warning all customers and counterparties that it may not knowingly effect a short sale that would violate this limit.

The SEC's amendment to the order does not expressly define which derivative instruments are included. However, our expectation is that, because the exception is not limited by definition, it should include a broad range of derivative instruments.

Unless extended, the ban on short selling will expire at 11:59 p.m. on October 2, 2008.

Scope of SEC Order

1. *What specific ticker symbols does the SEC order cover?*

The SEC's initial order covered a list of specific ticker symbols listed in Appendix A of the order. However, a number of financial companies, including several major buy-side firms were not on the initial list.

The SEC's amended order directs the exchanges listing the securities of the affected companies to determine the specific securities to be subject to the order. The SEC directed each national securities exchange listing securities issued by financial institutions to immediately publish a list, on its website, of individual listed companies with common equity that will be covered by the order's prohibition on short sales (Affected Securities). In addition, the SEC stated that it expects these lists to cover banks, savings associations, broker-dealers, investment advisers, and insurance companies, whether domestic or foreign, and the owners of any of these entities.

The SEC also stated that, if an issuer chooses not to be covered by the prohibition on short sales, the applicable exchange is authorized to exclude that issuer from its list of covered financial firms.

2. *Does the ban cover other instruments or trading strategies that provide short exposure to the affected firms?*

The SEC order does not cover short sales of instruments other than those whose symbols are listed on

Appendix A. The order also does not address trading strategies that provide short exposure other than by directly selling short the common stock, including short exposure provided through derivatives, both listed and over the counter. The SEC staff clarified that ETFs on financial indices are not within the scope of the order, although the SEC did include ETFs and ETNs in the modified order published September 21 relating to market making. As a result, a market maker may not facilitate a customer order in the instrument through a short sale in one or more of the underlying stocks if they are Affected Securities, to the extent that the market maker knows that the customer or counterparty is establishing or increasing an economic net short position in one or more of the Affected Securities.

3. Does the ban cover syndicate shorting or short selling in connection with index arbitrage or convertible arbitrage activities?

The SEC staff has indicated that syndicate shorting is not covered by the order. In addition, the SEC staff has indicated that it is considering whether the order applies to short selling in connection with index arbitrage or convertible arbitrage activities.

Market-Making Exception

4. What market-making activity will be covered by the market-making exception?

The SEC order includes an exception for short selling by both market makers (whether or not registered as such) and block positioners from the ban imposed by the order.

In addition, the SEC has amended the order to allow any person that is a market maker, including an over-the-counter market maker, that effects a short sale as part of bona fide market making and hedging activity related directly to bona fide market making in (a) derivative securities based on the affected securities, or (b) ETFs and ETNs of which the affected securities are a component. The exception is limited so that if a customer or counterparty position in a derivative security based on an Affected Security is established after 12:01 a.m. Eastern Time on September 22, 2008, a market maker may not effect a short sale in the Affected Security if the market maker knows that the customer's or counterparty's transaction will result in the customer or counterparty establishing or increasing an economic net short position (i.e., through actual positions, derivatives, or otherwise) in the issued share capital of a firm covered by the order. Additionally, every market maker relying on the exception to the limitation on short selling must, as soon as operationally practicable, publish a notice on its website that it may not knowingly effect a short sale that would violate this limit.

5. What kinds of block positioning will be covered by the exception?

With respect to block positioners, the SEC staff has preliminarily indicated that the current regulatory definition will apply.¹ However, it appears this exception applies only to firms that have acted as a block positioner on an ongoing basis and will not allow a firm to commence activity as a block positioner in order to take advantage of the exception.

We understand that the SEC staff is considering the question of whether a block positioner in an ETF may sell short Affected Securities as part of a hedging strategy.

6. How will the market-making exceptions be applied in the case of ETFs?

The SEC staff also has indicated that a registered ETF market maker may sell short a component security

¹ Rule 3b-8 under the Securities Exchange Act of 1934 (Exchange Act) states that a firm must satisfy the following conditions to be considered a block positioner: (1) be a registered broker-dealer, (2) be subject to and in compliance with the SEC's net capital rule, (3) have and maintain minimum net capital of \$1 million, and (4) except when such activity is unlawful, meet all of the following additional conditions: (i) engage in the activity of purchasing long or selling short, from time to time, from or to a customer (other than a partner, or a joint venture, or other entity in which a partner, the dealer, or a person associated with such dealer participates) a block of stock with a current market value of \$200,000 or more in a single transaction, or in several transactions at approximately the same time, from a single source to facilitate a sale or purchase by such customer, (ii) have determined in the exercise of reasonable diligence that the block could not be sold to or purchased from others on equivalent or better terms, and (iii) sell the shares composing the block as rapidly as possible commensurate with the circumstances.

that is an Affected Security as part of hedging its ETF position, but only to the extent that the order that the market maker is facilitating will not, to the knowledge of the market maker, result in the customer's or counterparty's establishing or increasing an economic net short position in one or more of the Affected Securities. We understand the SEC staff is considering the question of whether a block positioner in an ETF may sell short component securities that are Affected Securities as part of a hedging strategy.

Exercise and Assignment of Options and Settlement of Futures on the Affected Securities

7. How does the order affect automatic exercises or assignments, due to expiration, of equity options held before September 19?

The SEC order includes an exception for short sales that occur as a result of automatic exercise of or assignment of equity options and settlement of futures contracts, in both cases due to expiration, to the extent that the instruments were held prior to September 19, 2008. The SEC staff has indicated that, for options positions in the Affected Securities created on or after September 19, 2008, an exercise that results in the sale of an Affected Security will be considered a short sale subject to the ban if the option holder was not long the underlying security prior to the exercise, subject to the order's exceptions for market making and block positioning.

Additionally, the SEC's amendment to the order includes an exception to allow for creation of long call options. Specifically, the order does not apply to the writer of a call option that carries out a short sale in an Affected Security as a result of assignment following exercise by the holder of the call.

SEC Order Requiring Institutional Money Managers to Report New Short Sales

The SEC order mandated that every institutional investment manager that exercises investment discretion over accounts holding Section 13(f) securities and 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.² 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 Securities Exchange Act of 1934. **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 "confidential period," the SEC noted that it believed that this time was sufficient to protect against misuse of proprietary information contained in the report.**

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

8. What securities must be reported on Form SH?

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, n.4.)

9. What are the triggering events for Form SH?

The triggering events are:

- An investment manager enters into a new short position; or
- An investment manager closes part or all of any short position that it entered into on Monday, September 22, 2008 or afterwards.

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

² 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.

- 10. 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?**

The investment manager does not report a short position for the week of September 22, 2008 for this issuer, because its short position on Monday, September 22, is deemed to be zero and the investment manager has not changed it. Instruction 10(a)(iii). If this is the investment manager's only short position, the investment manager does not file a Form SH.

- 11. An investment manager has a \$10 million short position at the opening of Monday, September 22, 2008 and it reduces the position on Wednesday, September 24, 2008 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.

- 12. 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, 2008, 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—it never has to report the preexisting \$10 million position.

- 13. 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 have to 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.

- 14. Is there a materiality level for reporting short positions, as there is for reporting long positions on Form 13F (fewer than 10,000 shares of an issuer and aggregate fair market value of holdings in that same issuer is less than \$200,000)?**

Yes, there is a materiality level for reporting short positions. We understand that the SEC staff has indicated to individual managers that short positions established prior to September 22, 2008 should not be included in the calculation of whether the threshold is exceeded and they should only count short positions resulting from short sales on and after that date. We have not, however, seen any public confirmation of this from the SEC or the staff.

- 15. Must an investment manager report short exposure through options or other derivatives?**

No, but the investment manager will be required to report exercises and assignments if the investment manager borrows the covered securities to cover settlement.

- 16. If an investment manager manages two separate accounts, for purposes of determining whether a short sale has occurred, must the two accounts be netted?**

No. Rule 200 of Regulation SHO does not require netting across separate accounts for determining the existence of a short sale.

- 17. 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?**

Although there is no guidance from the SEC or its staff, it may be reasonable to aggregate only those accounts that have a short position for Form SH reporting purposes. This approach appears to be consistent with the SEC staff's advice that only short positions resulting from short sales be reported. Netting with accounts that are not short could result in an underreporting of short positions.

18. 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 only of 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.

19. 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 no change in the size of the short position occurs on the other days.

20. 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. 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 submission of the report. 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 "NON-PUBLIC" in bold and all-caps on the top and bottom of each page of the form.

SEC Order Imposing Temporary Close-Out Requirements on Short Sales

The SEC's interim rules on close outs require that clearing brokers generally must deliver all securities for long and short sale transactions on settlement date, and must close out any fails-to-deliver at the beginning of trading on the next settlement day. Clearing brokers that do not close out fails become subject to a borrowing penalty, and may not effect short sales without first borrowing the security or entering into a bona fide pre-borrow arrangement. These rules affect not only the clearing brokers expressly subject to the rule but also the introducing brokers and institutional money managers transacting business with them.

Unless extended, the close-out requirements will expire at 11:59 p.m. on October 1, 2008.

21. 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 T+3 does not become subject to the borrowing penalty so long as it **purchases or borrows** to close out the fail at the beginning of trading on T+4. However, a clearing broker that becomes subject to the penalty must **purchase** securities to close out the fail and remains subject to the penalty until that 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.

22. Does the borrowing penalty extend to the clearing broker's customers and introducing firms?

When a clearing broker becomes subject to the borrowing penalty, the penalty applies to short sales of all the clearing broker's customers and correspondent firms, regardless of whether they are responsible for the fail. As a result, investors may find that their 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 penalty.

23. How do the interim rules affect prime broker arrangements?

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.

24. What is the close-out requirement for long sales?

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 to close out the fail without becoming subject to the borrowing penalty.

25. 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 PIPEs.

Note: In both of these cases (long sales and Rule 144 securities) the clearing broker must close out the fail by **purchasing** the securities in question.

26. How will the interim rule affect securities lending practices?

The interim rules do not prohibit the use of locates in connection with short sales, so 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 who 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.

SEC Interim Antifraud Rule Relating to “Naked” Short Selling

27. What is the scope of the SEC’s interim antifraud rule?

Rule 10b-21 under the Exchange Act makes it an offense for a person to deceive a broker-dealer, participant of a registered clearing agency, or purchaser about its intention or ability to deliver the equity security before settlement date and actually fail to deliver such security on settlement date. The rule supplements and does not replace the more general antifraud provisions under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Rule 10b-21 will provide additional flexibility to the SEC to bring actions against market participants that the SEC determines are engaging in abusive short-selling practices.

Unless extended, Rule 10b-21 will expire at 11:59 p.m. on October 1, 2008.

SEC Order Easing Restrictions on Issuer Repurchases

The SEC also eased restrictions on issuers repurchasing their securities by temporarily amending Rule 10b-18 under the Exchange Act, a safe harbor imposing certain conditions on issuers.

Unless extended, the eased restrictions on issuer repurchases will expire at 11:59 p.m. on October 2, 2008.

28. How does the SEC order change the restrictions on issuer repurchases?

The SEC’s interim rules eased restrictions regarding the timing, pricing, and volume of issuer repurchases. In this regard, the SEC temporarily removed the timing restriction in Rule 10b-18, thereby permitting issuer

repurchases at any time during the trading day. In addition, the SEC increased the volume limit on issuer repurchases to permit purchases up to 100% of the security's average daily trading volume.

The other conditions of Rule 10b-18 regarding the pricing of repurchases and the use of a single broker remain unchanged.

Other Clarifications to the Ban on Short Selling of Affected Securities

29. What further clarifications have been provided by the SEC?

On Sunday, September 21, 2008, the SEC clarified that sales of Affected Securities under Rule 144 would not be subject to the ban on short sales of Affected Securities.

Parallel Actions by Other Regulators

30. What actions have regulators in other countries taken to address the current market crisis?

Regulators in the United Kingdom, Germany, Switzerland, Australia, Taiwan, and the Netherlands have all adopted bans on short selling. The regulations vary and, in some cases, such as Australia, appear to cover more than just financial stocks. Other regulators, such as the Japanese Financial Services Agency, appear to be monitoring the situation and are likely to announce their own regulations covering short selling over the coming days.

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

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