

## SEC Emergency Orders: Implications for Buyside and Sellside Firms

September 21, 2008

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; (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 moving 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 generally on short selling 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 continue to 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. We expect that, over the coming days, the SEC staff will continue to provide additional guidance to address the scope and application of the orders. Accordingly, our discussion here is subject to further SEC staff guidance.

### 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 of options that are expiring provided the options 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. The SEC staff announced on Friday, September 19, 2008 that it had recommended that the SEC modify the order to allow, for the life of the order,

hedging activities by exchange and over-the-counter market makers in derivatives on the securities covered by the order. The SEC staff also stated that the exception is “consonant” with short position restrictions of the U.K. Financial Services Authority (FSA). While the modification recommended by the SEC staff has not been formally adopted by the SEC, the issuance of the recommendation in a press release may indicate an informal SEC blessing of the recommendation. And while the press release does not expressly define which derivative instruments would be included (other than options), our expectation is that, because it 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?***

According to the SEC staff, the short sale ban applies to the specific ticker symbols listed in Appendix A of the SEC order, not the broader universe of companies covered by the SIC codes specified in the order. However, a number of financial companies and SIC codes were omitted from the list, including several major buy-side firms, and we understand that the SEC staff is working with the NYSE and Nasdaq to compile an updated list. A handful of companies have filed Current Reports on Form 8-K stating that their securities are or should be covered by the order. The list of affected stocks is likely to be updated, perhaps before the beginning of trading on Monday, September 22, 2008.

### **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 exchange traded funds (ETFs) on financial indices are not within the scope of the order.

### **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.

The SEC order initially provided a narrow exception from the ban for options market makers. As announced in the original order, the exception would have expired at 11:59 p.m. on September 19, 2008. However, the SEC staff has recommended that the SEC modify the order to exempt hedging activities by exchange and over-the-counter market makers in derivatives on the securities covered by the order. The recommendation specifically referenced the short position restrictions of the FSA.

According to FAQs published by the FSA, the market making activity that is exempted from the FSA short selling ban is defined as activity conducted by a market maker “ordinarily as part of their business dealing as principal in equities, options, or derivatives (whether OTC or exchange-traded) to fulfill orders received from clients, to respond to a client’s requests to trade, or to hedge positions arising out of those dealings.” (See *FSA Short Selling (No. 2) Instrument 2008 – FAQs*, 19 September 2008, General, Q.6.)

The SEC staff has also indicated that a registered ETF market maker may sell short a component security that is on Appendix A as part of *bona fide* market making in the ETF.

**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.<sup>1</sup> 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 component securities listed in Appendix A 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 that is on Appendix A as part of hedging its ETF position. We understand the SEC staff is considering the question of whether a block positioner in an ETF may sell short component securities listed in Appendix A as part of a hedging strategy.

**Exercise and Assignment of Options 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 due to expiration for equity options (presumably, both listed and over-the-counter) 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.

**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.<sup>2</sup> 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.

**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 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, fn. 4.)

**9. What are the triggering events for Form SH?**

<sup>1</sup> 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 comprising the block as rapidly as possible commensurate with the circumstances.

<sup>2</sup> 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 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 the portfolio position is deemed to be zero on Monday, September 22, 2008.

**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, 2008 (Monday to Sunday). What does the investment manager report on Monday, September 29, 2008?**

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, 2008 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, 2008?**

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, 2008?**

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, 2008. What does the investment manager have to report on Monday, September 29, 2008?**

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. An investment manager need not report a short position if it is both (a) less than ¼ of 1% of the class of the issuer's 13(f) securities outstanding as of the most recent or annual quarterly report and any "current report" subsequent thereto—unless the investment manager knows or has reason to believe that that number is inaccurate; and (b) the fair market value of its short position in those 13(f) securities is less than \$1 million. (See Release 58591 at p.3.) Presumably, the pre-September 22, 2008 short position is included in the calculation of whether the threshold is exceeded, not just the short position resulting from short sales on or after that date, but the SEC staff has not yet confirmed this.

**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?**

Form SH will be publicly available through EDGAR. The SEC will not consider confidential treatment requests (see Release 58591 at fn. 6).

### **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 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 fails 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.

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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