

SECURITIES ALERT

SEC EMERGENCY ORDERS – WHERE WE ARE TODAY



The Securities and Exchange Commission (SEC) has taken several emergency actions over the last week in an effort to restore confidence in the financial markets. The emergency orders began on September 17, 2008, with the SEC taking action to curb naked short selling of securities.¹ The SEC took further action on September 18, 2008, with the issuance of three emergency orders relating to (1) a prohibition of short sales in certain financial stocks,² (2) a requirement to report, on a weekly basis, daily short sales by institutional investment managers who currently file reports on Form 13F³ and (3) changes to certain timing and volume conditions on issuer repurchases under Rule 10b-18 of the Securities Exchange Act of 1934 (the “Exchange Act”).⁴ The SEC subsequently issued certain technical amendments to the orders relating to 13F filers and the prohibition on short sales in financial stocks on September 21, 2008.⁵ In an effort to clarify this recent activity, we summarize below the current status of the SEC’s emergency actions.

NAKED SHORT SELLING ORDER

On September 17, 2008, the SEC took emergency action to curb naked shorting of securities by (1) adopting an interim final rule to require the closing out of “failures to deliver” securities (the “Close-Out Rule”), (2) adopting a previously proposed anti-fraud rule targeting deception of market participants about a seller’s ability to deliver securities at settlement (the “Anti-Fraud Rule”) and (3) amending Regulation SHO to eliminate the option market maker exemption from closing out fails to deliver in threshold securities (the “Naked Short Selling Order”).

The Close-Out Rule. The Close-Out Rule, or Rule 204T of Regulation SHO, requires all clearing brokers or other participants of a registered clearing agency (a “clearing firm”) to close out any sales of equity securities (including short sales and certain long sales that cannot be properly documented) for which the seller fails to deliver equity securities by the settlement date by borrowing or purchasing securities of like kind and quantity by the beginning of trading on the business day following the original settlement date. If the clearing firm fails to deliver

¹ SEC Release No. 34-58572 (September 17, 2008).

² SEC Release No. 34-58592 (September 18, 2008).

³ SEC Release No. 34-58591 (September 18, 2008).

⁴ SEC Release No. 34-58588 (September 18, 2008).

⁵ SEC Release No. 34-58611 (September 21, 2008); SEC Release No. 34-58591A (September 21, 2008).

securities and does not close out the failure to deliver by the next settlement day, the clearing firm with the failure to deliver will not be able to accept any short sale order in that equity security from any person, without first borrowing the security or arranging to borrow the security until such clearing firm closes out the original failure to deliver. Under current SEC rules, the settlement date for the sale of securities must be no later than the third business day after entering into the trade (T+3). The SEC staff has recently published guidance to assist in the understanding and application of the Naked Short Selling Order.⁶

The above requirements apply differently for certain long sales and for sales pursuant to Rule 144 under the Securities Act of 1933 (the "Securities Act"). Transactions that a clearing firm can demonstrate on its books and records resulted from a long sale are required to be closed out by the beginning of trading hours on the third consecutive settlement day following the original settlement day. Sales of equity securities pursuant to Rule 144 are required to be closed out by the 36th consecutive settlement day following the original settlement date.

The Anti-Fraud Rule. The Anti-Fraud Rule, or Rule 10b-21 under the Exchange Act, deems any person who deceives a broker, dealer, clearing firm or purchaser as to such person's ability or intention to deliver securities in connection with the sale of an equity security to be a "manipulative or deceptive device or contrivance" in violation of Rule 10(b) if such person fails to deliver the security. The deception may include a representation to the broker that the seller has arranged to borrow the securities or by marking the securities as a long sale when the seller does not own the securities or maintain a long position.

Elimination of the Option Market Maker Exception. Prior to amendment, Rule 203 of Regulation SHO required clearing firms to close positions in any security designated as a threshold security by a self-regulatory organization within 13 days after a failure to deliver, but Rule 203 did not apply to certain short sales by options market makers. The SEC has now amended Rule 203 to eliminate the exception for options market makers. Clearing firms will now be required to close out any open transactions in threshold securities for which an options market maker has failed to deliver securities by the 36th consecutive settlement date after the effectiveness of the amendment. If they fail to close out the transaction, they will be required to borrow the securities or arrange to borrow the security for all transactions in a manner similar to the Close-Out Rule.

Effective Date. The Naked Short Selling Order and the rules thereunder were effective as of 12:01 a.m. on September 18, 2008, and will expire at 11:59 p.m. on October 1, 2008, unless extended by the SEC. The Close-Out Rule will only apply to orders entered after the effectiveness of the rule.

SHORT SALE ORDER

On September 18, 2008, the SEC took further action by issuing an emergency order prohibiting all persons from selling short⁷ any publicly traded common equity securities of certain financial institutions (as amended, the "Short Sale Order"). On September 21, 2008, the SEC amended the Short Sale Order to expand the original list of financial institutions. The Short Sale Order now provides that each national securities exchange listing financial institutions will publish a list on its Internet Web site of individual listed companies with common equity that will be covered by the

⁶ See Division of Trading and Markets "Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors Against "Naked" Short Selling Abuses", located at <http://www.sec.gov/divisions/marketreg/204tfaq.htm>.

⁷ The term "short sale" means any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Terms referenced in the definition of "short sale" shall have the same meaning as set forth in Rule 200 of Regulation SHO. "Short positions" to be reported are those resulting from such short sales.

Short Sale Order (each a “Covered Security”). The SEC expects the lists to cover banks, savings associations, broker-dealers, investment advisers and insurance companies, whether domestic or foreign, and the owners of these entities. If an issuer chooses not to be covered by the Short Sale Order, the SEC has authorized the exchanges to exclude that issuer from its list of covered financial institutions.

The Short Sale Order includes some limited exceptions from the prohibition against short selling.

- **Market Makers.** Registered market makers, block positioners and other market makers required to quote in the over-the-counter market, are excepted from the short sale prohibition, so long as they are selling short a Covered Security as part of bona fide market making in such security.
- **Options and Futures Contract Expiration.** The prohibition against short selling a Covered Security does not apply to any person who sells short a Covered Security as a result of an automatic exercise or assignment of an equity option, or in connection with settlement of a futures contract, due to the expiration of that option or futures contract, provided the option or contract was held prior to effectiveness of the Short Sale Order.
- **Options Assignments.** To allow for creation of long call options, the SEC added an exception for the writer of a call option that effects a short sale in any Covered Security as a result of assignment following exercise by the holder of the call.
- **Market Making in Derivatives.** The Short Sale Order does not apply to market makers effecting short sales as part of bona fide market making and hedging activity related directly to bona fide market making in derivatives on Covered Securities. This exception applies to all market makers, including over-the-counter market makers. This exception also applies to bona fide market making and hedging activities related directly to bona fide market making in exchange traded funds and exchange traded notes, of which the Covered Securities are a component. The SEC has limited this exception, so that, if a customer or counterparty position in a derivative security based on a Covered Security is established after 12:01 a.m. EDT on September 22, 2008, a market maker may not effect a short sale in the Covered 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 the financial institution. All market makers relying on this exception are required, as soon as operationally practicable, to publish a notice on their Internet Web site that, pursuant to the order, the market maker may not knowingly effect a short sale in a manner prohibited by this exception.
- **Sales of Restricted Securities.** The Short Sale Order does not apply to sales of Covered Securities pursuant to Rule 144 of the Securities Act.

Effective Date. The Short Sale Order is immediately effective and will terminate at 11:59 p.m. EDT on October 2, 2008, unless further extended by the SEC.

SHORT SALE REPORTING ORDER

On September 18, 2008, the SEC also issued an emergency order requiring certain institutional investment managers to report information concerning daily short sales of securities (as amended, the “Short Sale Reporting Order”). The SEC is requiring every institutional investment manager that exercises investment discretion with respect to 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, to file a report on a new form—Form SH—with the SEC, to provide information relating to any short sales effected by such manager.⁸ The SEC amended this order on September 21, 2008, to provide that the Form SH must be filed electronically through EDGAR on a non-public basis.⁹ The SEC will subsequently make the filed Form SH available to the public two weeks after the due date. The Form SH filing must be made on the first business day of each week immediately following a week in which the institutional investment manager has effected any short sale with respect to any Section 13(f) security that is not an option. The Form SH filing must reflect the—

- number and value of securities sold short during the day (except for short sales in options)
- opening short position
- closing short position
- largest intraday short position
- time of the largest intraday short position

for the security on each calendar day of the prior week in which the institutional investment manager engaged in trading with respect to short sales. An institutional investment manager will not be required to make a Form SH filing if it has not effected any short sales of a Section 13(f) security since its previous Form SH filing.

Notwithstanding the above, an institutional investment manager need not report short positions if (1) the short position constitutes less than one quarter of one percent of the class of the issuer's Section 13(f) securities issued and outstanding and (2) the fair market value of the short position in the Section 13(f) securities is less than \$1 million. The SEC staff has recently published guidance to assist in the understanding and application of the Short Sale Reporting Order.¹⁰

Effective Date. The Short Sale Reporting Order only applies to short sales effected after 12:01 a.m. EDT on September 22, 2008, and will terminate at 11:59 p.m. on October 2, 2008, unless further extended by the SEC. Based on the effective date, the first Form SH will be required to be filed on September 29, 2008.

RULE 10B-18 ORDER

On September 18, 2008, the SEC issued a third emergency order suspending certain timing conditions and altering volume conditions relating to issuer share repurchases under Rule 10b-18 under the Exchange Act (the "Rule 10b-18 Order"). Rule 10b-18 provides a safe harbor from the anti-manipulation provisions of Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 thereunder for purchases by an issuer of its common stock if the purchases comply with certain timing, volume, price and manner-of-purchase conditions. Because the SEC has determined that issuer repurchases represent an important source of liquidity during times of market volatility, this emergency order temporarily alters the timing and volume conditions in Rule 10b-18 to provide issuers additional flexibility and certainty regarding repurchases under current market conditions.

Timing Conditions. Rule 10b-18(b)(2) sets forth certain conditions for the timing of purchases. Among other things, to remain within the safe harbor, purchases pursuant to Rule 10b-18 must not be (1) the opening (regular way) purchase reported in the consolidated transaction or quotation reporting system or (2) effected during either the 10 minutes or 30 minutes before the scheduled close of the market, depending on the security's average daily trading volume (ADTV) for

⁸ The form and related instructions are available on the SEC's Web site.

⁹ The instructions to Form SH require a manager to label the Form SH as non-public by adding the phrase **NON-PUBLIC** (in bold and capital letters) at the top and bottom of each page of the filing.

¹⁰ See Division of Corporation Finance, Division of Investment Management and Division of Trading and Markets "Guidance Regarding the Commission's Emergency Order Concerning Disclosure of Short Selling", located at <http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm>.

the previous four full calendar weeks and public float value. Pursuant to the SEC's order, these time of purchases conditions, as set forth in Rule 10b-18(b)(2)(i)-(iii), are temporarily suspended.

Volume Conditions. Rule 10b-18(b)(4) sets forth certain conditions for the volume of purchases, including that the total volume of Rule 10b-18 purchases effected by or for the issuer on any single day must not exceed 25 percent of the ADTV for the security. Pursuant to the SEC's order, this volume condition is temporarily modified, so that the amount of Rule 10b-18 purchases must not exceed 100 percent of the ADTV for the security.

Except as set forth above, an issuer must meet all other conditions in Rule 10b-18 to take advantage of the safe harbor with respect to share repurchases.

Effective Date. The Rule 10b-18 Order is effective beginning at 12:01 a.m. EDT on September 19, 2008, and will terminate at 11:59 p.m. on October 2, 2008, unless further extended by the SEC.

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