

SEC Emergency Orders Re Short Sales

September 30, 2008

Client Advisory

September 30, 2008 by Paul DeCaprio and Guy P. Lander

On September 17 and 18, 2008, the SEC adopted three emergency orders regarding short sales. The first order adds a temporary rule to Regulation SHO that shortens the mandatory buy-in period for short sales that have failed to deliver. This order took effect on September 18, 2008. The second order prohibits short selling in any publicly traded firm designated by the SEC. This order took effect on September 19, 2008. The third order requires institutional investment managers that are required to file a Form 13F for the calendar quarter ended June 30, 2008, to file on EDGAR a new report, Form SH, on the first business day of every calendar week immediately following a week in which it effected short sales. This order took effect on September 22, 2008.

Regulation SHO

Under new Rule 204T, the threshold security^[1] concept is discontinued for short sale transactions involving market makers, clearing agents, and broker-dealers using a clearing agent to clear and settle trades. Rule 204T also shortens the buy-in period currently required in Regulation SHO Rule 203(b)(3) from the day after the 13th consecutive business day after the trade date to the business day after the usual settlement date for most transactions, which is the trade date plus three business days (T+3).^[2] Under Rule 204T, a broker-dealer or its clearing agent is still required to affirmatively locate or pre-borrow securities sold short, and market makers engaging in bona fide market making activities will still have an exception from having to locate securities sold short, unless those securities have failed to deliver in the new time frame. If any of the securities have not been delivered within T+3, then the market maker must borrow the securities before making any short sales. Any market maker, clearing firm, or broker-dealer for whom the clearing firm clears and settles trades that has a fail to deliver position in any equity security is prohibited from accepting or effecting a short sale order in the equity security without first borrowing the security, or entering into a bona fide arrangement to borrow the security until the fail to deliver position is closed out.

The emergency order also amends Regulation SHO Rule 203(b)(3)(iii) to eliminate the exception for options market makers from having to close-out a fail to deliver position in a threshold security. Options market makers must now immediately close out any fail position in a threshold security within 35 consecutive business days from September 18, 2008. Finally, the emergency order amends Regulation SHO Rule 203(b)(3)(v) by requiring options market makers to pre-borrow securities if the options market maker has a fail to deliver position in a threshold security for more than 35 consecutive business days, until the fail position is closed out. All other provisions of Regulation SHO remain in effect. Even though this is an emergency order, the SEC will seek comments for 30 days on all aspects of Regulation SHO.

Short Selling Ban

The second emergency order banning the short selling of publicly traded securities of certain financial firms began on September 19, 2008, at 11:59 pm EDT. The ban covers equity securities of 799 financial firms selected by the SEC^[3] as in the public interest and for the protection of investors to maintain or restore fair and orderly securities markets. The ban is effective until 11:59 pm EDT on October 2, 2008.

The short selling ban contains the following exceptions:

1. registered market makers, block positioners, and other market makers obligated to quote in the over the counter market if done as part of a bona fide market making activity; and
2. short sales that are the result of automatic exercise or assignment of an equity option held before 11:59 pm EDT on September 19, 2008, i.e., the effective date of the short sale ban.

Amendments. On September 21, 2008, the SEC issued technical amendments to the short selling ban. The technical amendments addressed technical and operational concerns as a result of the short sale ban, expanded the list of financial institutions whose equity securities are covered by the ban, and authorized the listing markets to select the individual financial institutions that should be included on the list.^[4] The amendment provides for each national securities exchange to publish the list of included companies that trade on that exchange on its Web site. An issuer can choose not to be covered by the short sale ban and the issuer will be excluded from the list.

The amendments provides additional exceptions to the short sale ban including:

1. short sales that result from the expiration of futures contracts held before the effective date of the short sale ban;
2. assignments to call writers that are the result of an exercise of an option; and
3. market makers that effect a short sale as part of a bona fide market making or hedging strategy as long as the market maker does not know that the transaction will result in the customer or counterparty establishing or increasing an economic short position of a financial institution on the list of financial institutions.

Finally, the amendment clarified that the order does not apply to sales of equity securities of covered firms made under Rule 144.

Short Position Reporting

The emergency order for short sale reporting (the "Reporting Order") requires each institutional investment manager that was required to file a Form 13F for the calendar quarter ended June 30, 2008 to electronically file a Form SH^[5] through the SEC's EDGAR filing system. Form SH would then be publicly available on EDGAR. The emergency order was effective at 12:01 a.m. EDT on September 22, 2008 and the first filing of Form SH will be on September 29, 2008. The Reporting Order ends at 11:59 p.m. on October 2, 2008, unless further extended by the SEC.

Form SH requires an institutional investment manager to disclose the number and value of securities sold short for each Section 13(f) security (except options)^[6], and the opening short position, closing short position, largest intraday short position, and the time of the largest intraday short position, for that security during each calendar day of the prior week.^[7] An institutional investment manager is not required to file a Form SH if there were no short sales of a Section 13(f) security effected after the previous filing of a Form SH. Institutional investment managers are only required to disclose their short sale positions for transactions effected after September 22, 2008.^[8]

However, an institutional investment manager need not report those short positions on Form SH that:

1. constitute less than one quarter of one per cent of the class of the issuer's Section 13(f) securities issued and outstanding as reported on the issuer's most recent annual or quarterly report, and any later current report, unless the institutional investment manager knows or has reason to believe the information contained in the issuer's report is inaccurate; and
2. have a fair market value of less than \$1,000,000.

On September 25, 2008, the SEC published guidance in the form of questions and answers relating to the disclosure of certain short sale transactions. The guidance can be found here <http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm>.

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Endnotes

[1] Threshold securities are those securities that have aggregate fails to deliver at National Securities Clearing Corporation of 10,000 shares or more where the level of fails to deliver in its principal trading market is equal to at least 0.5% of the issuer's total shares outstanding of that security. If, for five consecutive days after the trade date, a security meets these criteria, then that security is a threshold security. Each Self Regulatory Organization (e.g., FINRA) compiles a daily list of threshold securities.

[2] Rule 204T applies only to fails to deliver resulting from trades that occur after September 18, 2008. Rule 203(b)(3) of Regulation SHO continues to apply to fails to deliver that occurred prior to September 18. For example, if a broker-dealer or its clearing firm has a fail to deliver position in a threshold security prior to September 18, 2008 that has persisted after the trade date for six consecutive days and the fail continues to persist until the thirteenth day after the trade date, the broker-dealer or its clearing firm must still close out its position pursuant to Rule 203(b)(3).

[3] This list can be found at <http://www.sec.gov/rules/other/2008/34-58592.pdf>

[4] Expanded lists can be found at http://www.nyse.com/attachment/NYSE_SS_ORDERUPDATED.xls; http://www.nasdaqtrader.com/Micro.aspx?id=options_sec_shortsalelist; http://www.nasdaqtrader.com/content/newsalerts/2008/regulatoryalerts/sec_ss_092208.xls; and <http://www.amex.com/amextrader/tdrInfo/data/axNotices/2008/reg08044.ShortSaleBanList.xls>.

[5] Form SH <http://www.sec.gov/about/forms/formsh.pdf>. Instructions http://www.sec.gov/about/forms/formsh_instructions.pdf

[6] Section 13(f) securities are equity securities registered under Section 12 of the Securities Exchange Act of 1934, equity securities of insurance companies exempt from registration, equity securities of a closed-end investment company that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. A list of these securities is published by the SEC.

[7] Institutional investment managers should be aware of transaction where they have a net short position in a section 13(f) security and then sell a long position in this same security. Under Regulation SHO, effecting a transaction when the institutional investment manager is net short the security will result in the transaction being marked as a short sale. This short sale will be reportable on Form SH unless it meets the exception.

[8] Short positions in a section 13(f) security acquired prior to September 22, 2008 are not considered when determining whether such security needs to be reported on Form SH. For example, if, prior to September 22, 2008, an institutional investment manager has a short position in a section 13(f) security of 10,000 shares, and then shorts an additional 200 shares of the same security on September 22, 2008, only the 200 shares should be considered to determine if a reporting needs to be made.

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