

Asset Management/Financial Institutions Advisory/Litigation | September 22, 2008

Short Sale Update: Emergency actions by the SEC prohibit short selling on stocks of financial institutions; require notice of short sales by institutional investment managers; adopt amendments to Regulation SHO; and adopt new 'naked' short sale antifraud rule; New York Attorney-General announces criminal and civil probe into short selling activity

I. Introduction

On September 18, 2008, the U.S. Securities and Exchange Commission ("SEC") issued two emergency orders. The first prohibits short selling in a wide array of financial stocks.¹ The second requires institutional money managers over a certain size to report short sales to the SEC on a weekly basis.² Both the Short Sale Ban Order and the Form SH Order have subsequently been amended by the SEC.

On September 17, 2008, the SEC adopted a number of amendments to Regulation SHO. These amendments: (a) enact temporary Rule 204T, which imposes a penalty on broker-dealers for failing to timely deliver an equity security, and (b) eliminate the "options market maker" exception.³

Finally, on September 17, 2008, the SEC adopted new Rule 10b-21, an antifraud rule prohibiting any person from deceiving a broker-dealer or a purchaser regarding its intention or ability to deliver the security on the date delivery is due.

Concurrently, New York Attorney General Andrew Cuomo has a criminal and civil probe into short selling activity and related rumors regarding such activity.

Each of these actions is summarized below.

II. The Emergency Orders

2.1 Prohibition on short selling of financial institution stocks

To "prevent short selling⁴ from being used to drive down the share prices of issuers even where there is no fundamental basis for a price decline other than general market conditions," the SEC issued an emergency order prohibiting the short selling of the publicly traded securities of certain financial institutions. A complete listing of the covered financial institutions can be found in the Short Sale Ban Order.

¹ See SEC Release 34-58592, "Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments" (September 18, 2008) (the "Short Sale Ban Order"). A copy of the Short Sale Ban Order is available on the SEC's Internet website at <http://www.sec.gov/rules/other/2008/34-58592.pdf>.

² See SEC Release 34-58591, "Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments" (September 18, 2008) (the "Form SH Order"). A copy of the Form SH Order is available on the SEC's Internet website at <http://www.sec.gov/rules/other/2008/34-58591.pdf>.

³ See SEC Release 34-58572, "Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments" (September 17, 2008) (the "September 17 Order"). A copy of the September 17 Order is available on the SEC's Internet website at <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

⁴ A footnote in the Short Sale Ban Order reads: "The definition of 'short sale' shall be the same definition used in Rule 200(a) of Regulation SHO and the requirements for marking orders 'long' or 'short' shall be the same as provided in Regulations SHO."

The Short Sale Ban Order further provides three exceptions to this prohibition:

- Short sales by bona fide market makers;⁵
- Short sales that occur as a result of automatic exercise or assignment of an equity option (held prior to effectiveness of the Short Sale Ban Order) due to expiration of the option; and
- Short sales effected by options market makers when short selling as part of a bona fide market making and hedging activities related directly to bona fide market making in derivatives. This exception was initially available until 11:59 p.m. on September 19, 2008, but has since been extended. This extension is summarized at Section 2.2 below.

The Short Sale Ban Order will affect short sales in the named securities executed between September 18, 2008 and October 2, 2008, unless further extended by the SEC.

2.2 Amendments to the Short Sale Ban Order

The Short Sale Ban Order was amended by the SEC on September 21, 2008.⁶ This followed a recommended amendment by the Staff of the Division of Trading and Markets on September 19, 2008, which recommended amendment would expand the exclusion for market making to certain derivatives.⁷

⁵ According to the Short Sale Ban Order, a “bona fide market maker” includes “registered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, in each case that are selling short a publicly traded securities of [a named financial institution] as part of a bona fide market making in such security.”

⁶ See SEC Release 34-58611, “Amendment to Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action To Respond To Market Developments” (September 21, 2008) (the “Short Sale Ban Order Amendments”). A copy of the Short Sale Ban Order Amendments are available on the SEC’s Internet website at <http://www.sec.gov/rules/other/2008/34-58611.pdf>.

⁷ On September 19, 2008, the SEC Division of Trading and Markets issued a recommendation that these exclusions be expanded to exclude “hedging activities by exchange and over-the-counter market makers in derivatives on the securities covered by the order.” The Statement of the Division of Trading and Markets is available on the SEC’s Internet Website at <http://www.sec.gov/news/press/2008/2008-213.htm>.

The amendments to the Short Sale Ban Order are as follows:

- *Amendment to list of financial institutions covered by the Short Sale Ban Order.* The SEC has determined that its initial list of 799 financial institution stocks “led to the omission of financial institutions falling within [the enumerated list].”⁸ Consequently, the SEC has amended the Short Sale Ban Order to permit exchanges to select the individual financial institutions with securities covered by the Order, and “expects each national securities exchange listing financial institutions to immediately publish a list, on its internet Web site, of individual listed companies with common equity that will be covered by the Order’s prohibition on short sales.”⁹
- *Settlement of futures contracts.* The Short Sale Ban Order has been amended to allow short sales that occur as a result of the expiration of futures contracts held prior to effectiveness of the Order.
- *Assignment of options.* The Short Sale Ban Order has been amended to state that the prohibition on short sales will not apply to 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 that call option.
- *Market makers and derivative instruments.* Included in the Short Sale Ban Order was an exception for any market maker that effects a short sale as part of bona fide market making and hedging activity, which activity is related directly to bona fide market making in derivatives on the publicly traded securities of any included financial firm. As noted above, this exception initially applied until 11:59 p.m. on September 19, 2008. The SEC has amended the exception so that it now continues for the duration of the Order.

⁸ See the Short Sale Ban Order Amendments at page 1.

⁹ See the Short Sale Ban Order Amendments at page 2. Note that the SEC has authorized the exchanges to exclude an issuer’s securities from the Short Sale Ban Order “To the extent an issuer chooses not to be covered by the Order’s prohibition.”

Note, however, that the SEC has limited this exception: we are limiting the exception to state that if a customer or counterparty position in a derivative security based on a covered security is established after 12:01 a.m. E.D.T 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 a firm covered by the Short Sale Ban Order Amendments.

- *Rule 144 securities.* The SEC has clarified that the Short Sale Ban Order does not apply to persons that effect sales of covered securities pursuant to Rule 144 of the Securities Act.

2.3 Required reporting of short sale activity by institutional money managers

In response to recent market developments, the SEC issued an emergency order requiring institutional investment managers that exercise "investment discretion"¹⁰ with respect to accounts holding "section 13(f) securities"¹¹ having an aggregate fair market value on the last trading day of any month of any calendar year of at least \$100,000,000 to file a new form with the SEC. This new form, Form

SH,¹² must be filed electronically with the SEC on the first business day of every calendar week immediately following a week in which the manager effected short sales. Form SH will be filed on a non-public basis; two weeks after the due date for Form SH, the SEC will make the Forms publicly available.¹³ The Forms will not be subject to any confidential treatment requests.¹⁴

For each section 13(f) security sold short during the previous week, Form SH requires the following daily information:

- The number and value of securities sold short for each section 13(f) security, except for short sales in options;
- The opening short position;
- The closing short position;
- The largest intraday short position; and
- The time of the largest intraday short position.

The Form SH Order further provides the following exceptions from the filing requirement:

- No disclosure is required for any period during which no short sales have been effected since the previous filing of a Form SH;
- Short sales effected prior to the effective date of the Form SH Order are not required to be disclosed;
- Short positions that constitute less than one-quarter of one percent 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 current report subsequent thereto need not be disclosed, unless

¹⁰ A footnote in the Form SH Order reads: "The term 'investment discretion' has the same meaning as in Exchange Act Rule 13f-1(b)." That Rule generally refers back to Section 3(a)(35) of the Securities Exchange Act of 1934, which states that "A person exercises 'investment discretion' with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder."

¹¹ A footnote in the Form SH Order reads: "The term 'section 13(f) securities' has the same meaning as in Exchange Act Rule 13f-1(c)." That Rule states that Section 13(f) securities are "equity securities of a class described in section 13(d)(1) of the Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association".

¹² A copy of Form SH can be found at: <http://www.sec.gov/news/press/2008/2008-217.htm>.

¹³ See SEC Release 34-85891A, "Amendment to Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments" (September 21, 2008) (the "Amended Form SH Order"), available at the SEC's Internet website at: <http://www.sec.gov/rules/other/2008/34-58591a.pdf>.

¹⁴ In this regard, footnote 6 of the Form SH Order [footnote 9 of the Amended Form SH Order] states: "No Commission procedure for seeking confidential treatment of information filed with or transmitted to the Commission, [...] shall apply to the information that this Order requires to be filed."

the manger knows or has reason to believe the information contained therein is inaccurate; and

- No disclosure is required where the fair market value of the short position in the section 13(f) securities is less than \$1,000,000.

The Form SH Order goes into effect on September 22, 2008 and will terminate on October 3, 2008, unless further extended by the SEC. The first Form SH is required to be filed on September 29, 2008.

III. Amendments to Regulation SHO

To “significantly reduce any possibility that “naked” short selling may contribute to the disruption of markets in these securities,” the SEC adopted certain amendments to Regulation SHO. The September 17 Order states that the actions of the SEC are meant to “impose powerful disincentives to those who might otherwise exacerbate artificial price movements through “naked” short selling. The amendments: (a) impose penalties for failing to deliver an equity security and (b) eliminate the “options market maker” exception.

The September 17 Order effecting these amendments went into effect on September 18, 2008 and will terminate on October 2, 2008, unless further extended by the SEC.

3.1 Penalty for failing to deliver in an equity security

Rule 204T of Regulation SHO imposes a penalty on any “participant”¹⁵ of a “registered clearing agency”,¹⁶ and any broker-dealer from which it receives trades for clearance and settlement, for having a fail to deliver position at a registered clearing agency in any equity security. Specifically, any participant of a registered

clearing agency must, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.

Rule 204T further provides two exemptions to this requirement:

- Participants that can demonstrate on their books and records that such failed to deliver position resulted from a long sale must deliver securities of like kind and quality by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date; and
- Participants that have failed to deliver positions in Rule 144 securities must deliver securities of like kind and quality by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date.

Any participant and related broker-dealer who does not comply with the close-out rules discussed above (a) will be prohibited from accepting a short sale order in the equity security from another person, (b) will be prohibited from effecting a short sale in the equity security for its own account, without first borrowing the security or entering into a bona-fide arrangement to borrow the related security. Furthermore, any such participant must notify any broker or dealer from which it receives trades for clearance and settlement of the existence of a fail to deliver position that has not been closed out in accordance with the rule.

3.2 Elimination of the “options market maker” exception

Rule 203(b)(3) of Regulation SHO was amended to eliminate the options market maker exception from Regulation SHO’s close-out requirement. Under Regulation SHO as it existed prior to this amendment, the requirement under Regulation SHO to close out

¹⁵ A footnote in the September 17 Order reads: “The term “participant” has the same meaning as in section 3(a)(24) of the Exchange Act.”

¹⁶ A footnote in the emergency September 17 Order reads: “The term “registered clearing agency” means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act.”

failed positions in certain “threshold” securities¹⁷ did not apply to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on an options position that was created before the security became a threshold security. In 2007, the SEC proposed to eliminate this exception.¹⁸ On September 19, 2008, as part of its emergency orders, the Commission has eliminated the options market maker exception.

IV. Adoption of antifraud Rule 10b-21

Rule 10b-21 was initially proposed by the SEC in March 2008.¹⁹ Rule 10b-21 is an antifraud rule that prohibits any person from intentionally deceiving a broker-dealer, or a buyer, as to the intention or ability of that person to deliver shares on settlement date. The full text of Rule 10b-21 is as follows:

It shall constitute a “manipulative or deceptive device or contrivance” as used in section 10(b) of this Act for any person to submit an order to sell a security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.

This rule is not intended to limit or restrict the applicability of the general antifraud provisions of the federal securities laws. New Rule 10b-21 is notable in that it is an antifraud rule, and therefore requires an intent to deceive on the part of the person making the sale in order to establish a violation.

¹⁷ For more information regarding the “close out” requirements of Regulation SHO, or regarding Regulation SHO generally, please see “SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules” (March 2005), available at http://www.shearman.com/cm_0305/.

¹⁸ See SEC Release 34-56212, “Amendments to Regulation SHO” (August 7, 2007).

¹⁹ See SEC Release 34-57511, “Naked Short Selling Anti-Fraud Rule” (March 17, 2008), available on the SEC’s Internet website at <http://www.sec.gov/rules/proposed/2008/34-57511.pdf>.

V. Criminal and Civil Probe announced by New York Attorney-General

On September 19, 2008, it was announced that New York Attorney General Andrew Cuomo is investigating short sales of Lehman Brothers Holdings Inc., American International Group Inc., Morgan Stanley, Goldman Sachs Group Inc. and other financial firms to investigate the use of rumor to drive down stock prices.

The Attorney General has indicated that he will use the Martin Act to pursue criminal and civil actions for investors over illegal sales.²⁰ The Martin Act, which is also New York’s principal securities regulation statute, grants wide-ranging anti-fraud powers to the Attorney General.

VI. Conclusion

The Emergency Orders, the amendments to Regulation SHO, and the adoption of Rule 10b-21 in quick succession constitute extraordinary actions by the SEC. Many of the consequences of these actions have yet to fully unfold, and further amendments and interpretive guidance are expected to arise in the coming days regarding the application of the Emergency Orders, the new amendments to Regulation SHO, and regarding Rule 10b-21.

²⁰ Erik Larson and Allan Dodds Frank, “Cuomo Starts Criminal, Civil Probe of Short Sellers,” currently available at: http://www.bloomberg.com/apps/news?pid=email_en&refer=law&sid=aWx0b41WYUxc.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Erica J. Laudano
New York
+1.212.848.4933
erica.laudano@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Geoffrey Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

M. Holland West
New York
+1.212.848.4579
hwest@shearman.com

Steven Molo
New York
+1.212.848.7456
smolo@shearman.com

Adam S. Hakkı
New York
+1.212.848.4924
ahakkı@shearman.com

Stuart J. Baskin
New York
+1.212.848.4974
sbaskin@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM

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