SEC Imposes Additional Limits on Short Selling

2008-09-19

On September 19, 2008, the Securities and Exchange Commission ("SEC" or "Commission") took additional steps[1] to protect the integrity and quality of the securities markets and strengthen investor confidence. Specifically, the SEC issued emergency orders that ban short selling in financial companies, require certain institutional money managers to report short sales on new Form SH, and ease restrictions on the ability of issuers to repurchase their securities. These orders expire at 11:59 p.m. (EDT) on October 2, 2008, although the Commission has the authority to extend the orders so that they remain in effect for a total of 30 calendar days.

In the press release describing the emergency orders, the SEC noted that it is cooperating with the U.K. Financial Services Authority ("FSA"), which took similar actions on September 18, 2008. However, the regulatory impacts of the emergency actions by the SEC and FSA are not identical. The scope of the SEC's action is broader, in several respects, than the FSA's.

Ban on Short Sales of Financial Company Securities

The Commission imposed an immediate ban on all short sales, regardless of whether or not they are considered "naked," in the securities of over 700 financial firms identified by the SEC and enumerated here at Appendix A ("Included Financial Firms").[2] The ban is an attempt to restore equilibrium to the markets and stem the recent, sudden price declines in the securities of financial institutions that seemingly are unrelated to true price valuations. It applies to short selling activities by "all persons," subject to certain limited exceptions.

Scope of the Ban. Although the order on its face applies to "any publicly traded securities" of the Included Financial Firms, the SEC Staff has clarified that it applies only to those equity securities whose ticker symbols are listed in the order. Therefore, short sale transactions involving preferred stock, traditional corporate bonds, or convertible bonds should not be affected by the ban. Likewise, the order does not apply to transactions that initially create synthetic short positions, such as buying put options or selling call options. Note, however, that the ban will be applicable to short sales resulting from options exercises and assignments. Accordingly, the writer of a call option or the buyer of a put option on any Included Financial Firm should take appropriate precautions to cover the position. In addition, the short sale ban does not apply to sales of shares in various exchange-traded funds ("ETFs") that hold positions in the Included Financial Firms, unless the ETF itself is listed as an Included Financial Firm. Finally, the short sale ban does not apply to syndicate shorts or 144 sales.

Exceptions from the Ban. Short selling by certain entities and/or in connection with certain bona fide activities are excepted from the short sale prohibition:

- The short sale ban does not apply to registered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, to the extent they are selling short as part of bona fide market making in the relevant security. We understand that this exception allows ETF market makers, as a hedge, to short securities that are components of the ETF. Note, however, that it is not clear if a block positioner in ETFs is also excepted from the ban with respect to the component securities. The exact contours of this exception are likely to be further clarified by the SEC Staff.

- Short sales that occur as a result of automatic exercise or assignment of an equity option held prior to September 19, 2008, due to the expiration of the option are carved out from the order.

- Separately, the Commission provided a temporary exception, available until 11:59 p.m. on September 19, 2008, for options market makers and over-the-counter derivatives dealers selling short as part of bona fide market making and hedging activities related directly to bona fide market making in derivatives of the relevant security. The SEC Staff recommended that the exception be extended for the life of the order (*i.e.*, until 11:59 p.m. (EDT) on October 2, 2008), subject to Commission approval.

Please note that the order does not include a general hedge exemption, and it is still an open question whether short sales in connection with index arbitrage and convertible arbitrage would be considered exempt.

Form SH Reporting

The SEC will temporarily require that certain institutional money managers report on Form SH new short sales of certain publicly traded securities that are executed on or after 12:01 a.m. (EDT) on September 22, 2008. Institutional money managers are subject to the new disclosure requirement if they were required to file a Form 13F for the calendar quarter ended June 30, 2008.[3]

This reporting requirement is similar in some respects to an existing requirement pursuant to Rule 13f-1(a), which requires disclosure of certain long positions, but unlike the quarterly Form 13F reporting requirement, Form SH requires disclosure on a weekly basis of activity for the prior week. The first Form SH must be filed electronically with the SEC on Monday, September 29, 2008, and thereafter on the first business day of every calendar week immediately following any week in which the firm entered into any new short position in Section 13(f) securities that are not options, or closed all or part of any such position. Click here ;to view Form SH.

Short positions in individual securities that would otherwise be reportable need not be reported if they constitute less than 0.25% of the class of securities issued by the issuer and the fair market value of the short position is less than $1 million.

Issuer Repurchases

Effective immediately, the SEC gave issuers additional flexibility under Rule 10b-18 to buy back their securities. Specifically, the SEC suspended the timing conditions in Rule 10b-18(b)(2) and adjusted the volume conditions in Rule 10b-18(b)(4) to allow purchases not to exceed 100% of the average daily trading volume for the security. No other portions of Rule 10b-18 are affected by this order.

[1] This alert supplements the WilmerHale alert dated September 18, 2008, which described the short sale restrictions adopted by the Commission on September 17, 2008.

[2] The list of Included Financial Firms is more extensive than the list in connection with the SEC's emergency order from July 2008. If you believe that your firm has been inadvertently omitted from the list of Included Financial Firms, please contact David Liu of the SEC's Division of Trading and Markets. We understand that the SEC will update the list of Included Financial Firms as appropriate. Please note that until a financial services firm is included on the list of Included Financial Firms, the short sale ban technically does not apply to its securities.

[3] Firms are required to file a Form 13F if they exercise investment discretion with respect to accounts holding Section 13(f) securities (i.e., those securities listed here) that have an aggregate fair market value on the last trading day of any month of any calendar year of at least $100 million