

Financial Services and Products ADVISORY

September 23, 2008

SEC Revises Short Selling Restrictions

Over the past several days, the SEC has issued a flurry of emergency orders in an attempt to calm the financial markets. On September 17, it issued an order imposing new temporary restrictions on all “naked” short selling.¹ The following day, it announced a temporary ban on short selling in a designated list of financial stocks² and imposed new short sale position reporting requirements on large hedge funds and other Form 13F filers.³ Since we first reported these developments,⁴ the SEC has twice revised its emergency orders to clarify the new rules and provide some limited relief from the most stringent restrictions.⁵ In this advisory, we summarize the current state of play under SEC’s emergency short sale restrictions and reporting requirements.

¹ See “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,” Exchange Act Rel. No. 34-58572, <http://www.sec.gov/rules/other/2008/34-58572.pdf> (Sept. 17, 2008).

² See “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,” Exchange Act Rel. No. 34-58591, <http://www.sec.gov/rules/other/2008/34-58592.pdf> (Sept. 18, 2008).

³ See “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,” Exchange Act Rel. No. 34-58591, <http://www.sec.gov/rules/other/2008/34-58591.pdf> (Sept. 18, 2008).

⁴ See Alston & Bird Advisory, “Federal Responses to the Financial Crisis During the Week of September 14,” http://www.alston.com/fisap_Fed_responses_financial_crisis (Sept. 19, 2008).

⁵ See “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,” Exchange Act Rel. No. 34-58591a, <http://www.sec.gov/rules/other/2008/34-58591a.pdf> (Sept. 21, 2008); and “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,” Exchange Act Rel. No. 34-58611, <http://www.sec.gov/rules/other/2008/34-58611.pdf> (Sept. 21, 2008).

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In addition to the SEC's actions, the U.K.'s Financial Services Authority (FSA)⁶ and securities regulators in a number of other countries⁷ have taken their own steps to ban or strengthen prohibitions against naked short selling, halt short selling of financial stocks and require the disclosure of short positions.

With All of the Amendments, Where Are We Now?

Naked Short Selling

The SEC's emergency rules to combat naked short selling apply to all public company securities, became effective at 12:01 a.m. on September 18, and will terminate at 11:59 p.m. on October 1, 2008, unless extended by the SEC. Those rules provide for the following new restrictions:

- **Hard T+3 Close-Out Requirement; Penalties for Violation Include Prohibition of Further Short Sales, Mandatory Pre-Borrow.**
 - The SEC adopted a new temporary rule (Rule 242.204T) requiring that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposing penalties for failure to do so.
 - If a short sale violates the new close-out requirement, then any broker-dealer acting on the short seller's behalf will be prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales for any customer.
- **Exception for Options Market Makers from Short Selling Close-Out Provisions in Regulation SHO Repealed.** The SEC eliminated the options market maker exception from the close-out requirement of Rule 203(b)(3) in Regulation SHO.
- **New Short Selling Anti-Fraud Rule.** The SEC also adopted Rule 10b-21, which prohibits any person from submitting "an order to sell an equity 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 or before the settlement date, and such person fails to deliver the security on or before the settlement date."

⁶ On September 18, the FSA announced that, effective beginning at midnight on September 18, it was prohibiting the "active creation or increase of net short positions" in a designated list of 29 U.K. financial services companies. The FSA also announced that, beginning on Tuesday, September 23, daily disclosure would be required of all net short positions in excess of 0.25 percent of outstanding shares. These provisions will remain in force until January 16, 2009. See "FSA Statement on Short Positions in Financial Stocks," <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml> (Sept. 18, 2008).

⁷ On Friday, the Australian Securities and Investments Commission followed suit by banning naked short selling and requiring the disclosure of covered short selling. The ASIC issued a clarification of their rules today and banned all covered short selling as well, except for hedging for existing positions, dual listed entities, all exchange-traded options entered into before the effective date, index arbitrage transactions, and market makers. <http://www.asic.gov.au/asic/asic.nsf>. It's been reported that on Sunday night, Taiwan's financial regulators took similar measures placing a ban on short selling 150 domestic companies <http://www.forbes.com/afxnews/limited/feeds/afx/2008/09/21/afx5451753.html>. Japanese regulators have implemented restrictions on short selling of financial firms, as well as other securities <http://www.fsa.go.jp/en/announce/state/20080922.html>. Also on Monday, the Netherlands issued their ban on naked short selling <http://www.afm.nl/corporate/default.ashx?DocumentID=11483>. Today, the Ontario Securities Commission announced restrictions similar to those of the FSA and SEC http://www.osc.gov.on.ca/Media/NewsReleases/2008/nr_20080922_osc-amend-temp-order.jsp. However, recent press reports indicate that the New Zealand stock exchange is unlikely to alter their rules to ban or require further reporting of short selling <http://www.nbr.co.nz/article/short-selling-unlikely-be-regulated-nz-35522>.

The SEC first proposed new Rule 10b-21 in March 2008,⁸ but had taken no further action on its adoption until issuing this order.

While the SEC expressed hope that these efforts would quell manipulative practices that could lead to further investor loss of confidence in the securities markets, the SEC chose not to revive the “uptick” rule, which had been the SEC’s historic measure for regulating against short sale manipulation. Although a number of commentators are clamoring for reinstatement of the uptick rule, there is no indication that Chairman Christopher Cox is willing to entertain the idea.⁹

Prohibitions Against Short Selling of Financial Stocks

The SEC’s September 18 emergency order prohibiting all short selling in the financial institutions remains in effect, but has been revised to provide greater clarity and some limited relief from its restrictions.¹⁰

- **Prohibition Against Short Selling in Financial Stocks.** Effective as of September 18, 2008, and until 11:59 p.m. on October 2, 2008, all short selling in the stocks of financial services companies is prohibited. While the SEC originally listed 799 companies to which the order applied, some issuers complained about being left off the list of specified issuers. The SEC, responding to these complaints, amended its order to require each national securities exchange or listing market to publish a list of individual financial firms that would be covered by the SEC’s emergency rules.¹¹
- **The SEC has provided a number of exemptions and exceptions for**
 - short sales effected by market makers, including over-the-counter market makers, as part of a bona fide market making and hedging activity related directly to bona fide market making in (a) derivative securities based on covered financial securities, or (b) exchange traded funds and exchange traded notes of which covered financial securities are a component;¹²

⁸ See Proposed Rule: “Naked” Short Selling Anti-Fraud Rule, Exchange Act Rel. No. 34-57511, <http://www.sec.gov/rules/proposed/2008/34-57511.pdf> (Mar. 17, 2008).

⁹ The uptick rule (former Rule 10a-1) was originally adopted by the SEC in 1938 after conducting an inquiry into the effects of concentrated short selling during the market break of 1937. The uptick rule provided that, subject to certain exceptions, at the time a listed security was sold short, it had to be sold either at a price above the price at which the immediately preceding sale was effected or at the last sale price, if the last sale price was higher than the last different price. The SEC eliminated the uptick rule in July 2007, after concluding that it did not appear necessary to prevent manipulation.

¹⁰ See “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,” Exchange Act Rel. No. 34-58611, <http://www.sec.gov/rules/other/2008/34-58611.pdf> (Sept. 21, 2008).

¹¹ The categories of covered issuers include banks, savings associations, broker-dealers, investment advisers and insurance companies, whether domestic or foreign, and the owners of any of these entities. Issuers can opt out by notifying the exchange to exclude their securities from the list. The NYSE’s published list is available at <http://www.nyse.com/about/listed/1222078675703.html>. The NASDAQ’s list is available at <http://www.nasdaqtrader.com/Trader.aspx?id=RegSho>.

¹² However, for positions established on or after September 22, a market maker may not sell short if it knows a customer or counterparty is establishing or increasing an economic net short position in the shares of a financial firm covered by the SEC’s order. Notice of this restriction must be published on market makers’ websites as soon as practicable.

- short sales resulting from automatic exercise or assignment of an equity option held prior to the effectiveness of the SEC’s order due to expiration of the option, and a one-day exemption for options market makers who sell short on September 19 as part of their bona fide market making and hedging activities related directly to market making in equity derivatives;
 - short sales that occur as a result of the expiration of futures contracts held prior to the effectiveness of the SEC’s order; and
 - short sales by the writer of a call option resulting from assignment following exercise of the option.
- **The SEC has also clarified that its order does not apply to persons that effect sales of covered financial services securities pursuant to Rule 144 of the Securities Act.**

SEC Disclosure of Short Positions

The SEC’s September 18 emergency order requiring the weekly disclosure of short positions of institutional money managers on Form SH also remains in effect, but has been revised to address some objections raised in the hedge fund community.

- **New Daily Short Sale Reporting Obligations.** Until October 2, 2008, unless extended by the SEC, any investment manager who filed a Form 13F¹³ for the calendar quarter ended June 30, 2008, will be required to file a new Form SH on September 29, 2008. Thereafter, a new Form SH must be filed before 5:30 p.m. on the first business day of every calendar week immediately following a week in which the institutional investment manager effected short sales.¹⁴ Form SH requires disclosure of the number and value of securities sold short for each Section 13(f) security (except for short sales in options), the opening short position, closing short position, and the amount and time of the largest intraday short position during each day of the prior week. The disclosure requirements will only apply to short sales effected after September 19, 2008, and no filing will be required if the short position constitutes less than 0.25 percent of the issuer’s outstanding shares and the fair market value of the short position is less than \$1 million.
- **Under the most recent amendments to these rules, Form SH filings initially will be non-public, but will become publicly available via the SEC’s EDGAR database two weeks after filing.** The SEC also noted that its confidential treatment procedures will not apply to the Form SH.

¹³ Form 13F is required to be filed by institutional investment managers that exercise investment discretion with respect to accounts holding Section 13(f) securities having an aggregate fair market value on the last trading day of any month of at least \$100,000,000. See Exchange Act Rule 13f-1.

¹⁴ See Form SH, <http://www.sec.gov/about/forms/formsh.pdf>, and Instructions to Form SH, http://www.sec.gov/about/forms/formsh_instructions.pdf.

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