



Client Alert

SEC And FSA Take Action Against Abusive Short Selling

In reaction to recent market turmoil, the Securities and Exchange Commission ("SEC"), took several significant steps to combat perceived abusive short selling, particularly as to securities issued by financial institutions. In addition, the SEC and the UK Financial Services Authority ("FSA"), acting in concert, each issued orders prohibiting short sales in the securities of designated financial institutions.

Actions Regarding Short Sales of Financial Institution Stocks

SEC Action

The SEC issued a temporary emergency order (the "Emergency Order")¹ prohibiting short selling in the securities of nearly 800 financial companies to protect the integrity and quality of the securities market and strengthen investor confidence. The SEC's Emergency Order, issued pursuant to its authority under Section 12(k)(2) of the Securities Exchange Act of 1934 (the "Exchange Act"), is effective immediately and will terminate at 11:59 p.m. ET on October 2, 2008. The SEC may extend the Emergency Order beyond 10 business days if it deems an extension necessary in the public interest and for the protection of investors, but will not extend for more than 30 calendar days in total duration.

FSA Action

The FSA adopted rules, effective September 19, 2008, prohibiting short sales in the securities of 32 banks and insurance companies.² Under the new FSA rules, any person holding a pre-existing short position in excess of 0.25 percent of the issued share capital of such a company at market close is required to disclose the net amount of that short position on a daily basis for as long as it continues to be held. The new rules also prohibit persons from taking new net short positions in these UK financial sector companies and restrict those who hold such pre-existing short positions from actively increasing them. These rules build on the FSA's June 2008 rules³ requiring disclosure of short positions in the securities of a company that is conducting a rights offering.

The SEC and FSA are consulting on an ongoing basis with regard to short selling matters and will continue to cooperate in carrying out regulatory actions.

The White & Case LLP Securities Alert provides a brief overview of some of the latest legislative, regulatory and judicial actions, policy statements and decisions that affect public and private companies.

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1. See <http://www.sec.gov/rules/other/2008/34-58592.pdf> for the Emergency Order and the list of the companies which are the subject of the Emergency Order.

2. Available at http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf. See http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf for a list of the 32 financial companies which are the subject of the new FSA rules.

3. Available at http://www.fsa.gov.uk/pubs/press/PN0572008_instrument.pdf.

Other SEC Actions Concerning Short Sales

Interim Final Rule Imposing New Borrow and Delivery Requirements For All Public Securities

The SEC had taken several prior actions restricting “naked” short sales. In an ordinary short sale, the short seller borrows stock and sells it with an agreement to repay the loan by buying the stock in the market place at a later date. A naked short occurs where the short seller does not actually borrow stock and then fails to make delivery of the stock on the settlement date. It is believed that such activity lends itself to abusive practices, including market manipulation, which add to the downward pressure on the price of the stock. Under a prior emergency order,⁴ which expired on August 12, 2008, the SEC required sellers to borrow or arrange to borrow shares before a short sale, but this order applied only to the securities of financial institutions with access to the Federal Reserve’s Primary Dealer Credit Facility.

On September 17, 2008, the SEC issued new short selling rules,⁵ citing continuing concerns with respect to all public securities about artificial price movements resulting from naked short sales, as well as additional concerns that some sellers may exploit current market conditions to engage in harmful short sale transactions. These new rules, which became effective on September 18, 2008, apply to all public securities. They expire at 11:59 p.m. EDT on October 1, 2008, although they are likely to be extended because the SEC has provided a 30-day comment period, and stated that it intends to engage in further rulemaking.

As part of the new rules, the SEC adopted, on an interim final basis, Rule 204T under Regulation SHO, which imposes more stringent delivery requirements. The rule establishes a hard close-out requirement for short sellers and broker-dealers by requiring delivery of securities by the settlement date (T+3). A violation of the rule by a broker-dealer acting for a short seller will result in a prohibition from making further short sales in the same securities for any customer, unless the securities are not only located, but also borrowed beforehand.

Enhanced Short Sale Reporting Obligations

The SEC adopted a temporary rule requiring that institutional money managers having discretionary authority over assets having more than \$100 million in value report their new short sales in certain publicly traded securities, in addition to their current requirement to report their long positions in these securities under Section 13(f) of the Exchange Act.⁶ This temporary order becomes effective at 12:01 a.m. EDT on September 22, 2008 and will require the filing of new Form SH⁷ on the first Monday of each week after a week when short sales are effected by such managers. The order will terminate at 11:59 p.m. EDT on October 2, 2008 unless further extended.

Repeal of Options Market Maker Exception From Reg SHO

The SEC also amended Rule 203(b)(3) of Regulation SHO to repeal an exception from the rule’s close-out requirement for options market makers, who will now be subject to the same close-out requirements as other market participants.

⁴ A discussion of this order can be found at http://www.whitecase.com/alert_securities_072108/.

⁵ Available at <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

⁶ <http://www.sec.gov/rules/other/2008/34-58591.pdf>

⁷ <http://www.sec.gov/about/forms/formsh.pdf>

Short Sale Antifraud Rule

Also adopted was Rule 10b-21, a naked short selling antifraud rule, which provides that deceiving a broker, dealer or a purchaser about one's intention or ability to deliver securities on the settlement date and failing to make such delivery constitutes a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Exchange Act.

SEC Action Concerning Repurchases of Securities

The SEC has temporarily eased restrictions on the ability of securities issuers to re-purchase their securities by lifting the time and price conditions under the safe harbor of Rule 10b-18 under the Exchange Act. This change will give issuers more flexibility to buy back their securities, and help restore liquidity during this period of unusual and extraordinary market volatility.⁸

Other Developments

The last few days have seen significant and aggressive regulatory action by the SEC and FSA. There are many

market commentators and some public officials who support the reinstatement of the uptick rule as a further check on inappropriate short selling, although the SEC has given no indication that it intends to propose such an action. Under the uptick rule, which had been in effect for over 75 years but was eliminated in July 2007, short selling was limited by a requirement that public securities be sold short only at a price above their last different sale price.

The SEC stated that it is continuing to investigate suspected market manipulation through its general antifraud authority. The New York Attorney General also announced the commencement of an investigation into possible abusive short selling.

We will keep you advised on further developments in this area.

⁸ <http://www.sec.gov/rules/other/2008/34-58588.pdf>

White & Case

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We would be pleased to discuss any questions you may have arising from this update. Please contact the lawyer at White & Case with whom you regularly discuss securities matters or any of the lawyers identified on the cover page of this update.

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