



Client Alert

Financial Markets Developments

SEC Takes Further Action to Curtail Naked Short Selling

On October 14, 2008, the US Securities and Exchange Commission (the "SEC") issued three formal rulemaking orders including an Antifraud Rule Adopting Release¹ which adopted Rule 10b-21 under the Securities Exchange Act of 1934 (the "Exchange Act") (the "Antifraud Rule") and two releases finalizing amendments to Regulation SHO ("Reg SHO") (together the "Reg SHO Amendments")² (and collectively with the Antifraud Rule, the "October 14th Amendments"). These releases, represent the latest of a series of coordinated actions to limit or restrict "naked" short selling³ and substantially finalized a package of temporary "naked" short selling rules adopted by the SEC under an emergency order issued on September 17, 2008 (the "September Emergency Order").⁴ By formally adopting the October 14th Amendments, the SEC hopes to curtail perceived abusive short selling activity and persistent fails to deliver⁵ in certain equity securities. The October 14th Amendments included the Antifraud Rule, an interim final temporary rule to strengthen delivery requirements under Reg SHO⁶ and a rule eliminating Reg SHO's options market maker exception to the close-out requirement. The October 14th Amendments became effective on October 17, 2008. On October 15, 2008, the SEC issued another formal rulemaking order extending the requirement for Form SH disclosure of short sales and short positions by certain institutional investment managers.⁷

Recent History of SEC Regulatory Action Regarding Short Selling

As reported in previous White & Case client memos, in recent months the SEC has undertaken several initiatives restricting "naked" short sales. The SEC expressed particular concern that "naked" short selling, which is believed to cause deceptively low prices in targeted securities, may have contributed to the demise of financial institutions such as Bear Stearns and Lehman Brothers.⁸ Turbulent market conditions, including the rapid decline in the price of securities of certain financial institutions, led the SEC to issue an emergency order restricting the short selling of financial stocks

¹ See Exchange Act Rel. No. 58,774 (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58774.pdf>.

² See Exchange Act Rel. No. 58,775 (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58775.pdf>; See also Exchange Act Rel. No. 58,773 (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58773.pdf>.

³ A "naked" short sale is the practice of selling shares that a trader does not own and has neither borrowed nor arranged to borrow at the time of sale.

⁴ See Exchange Act Rel. No. 58,572 (September 17, 2008) available at <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

⁵ "Fails to deliver" refers to situations that arise when sellers do not obtain the shares within the required settlement period.

⁶ Reg SHO, which regulates short selling, has been effective since January 3, 2005. In fact, concerns about potential abusive "naked" short selling practices were an important reason for the adoption of Reg SHO.

⁷ See Exchange Act Rel. No. 58,785 (October 15, 2008) available at <http://www.sec.gov/rules/final/2008/34-58785.pdf>.

⁸ See http://www.whitecase.com/alert_securities_072108/



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in July 2008.⁹ The financial stock short sale ban was officially lifted as of midnight October 8, 2008. The SEC also issued new and more restrictive short selling rules on a temporary basis as part of the September Emergency Order. The SEC has expressed concern that existing regulation, including Reg SHO, had proven ineffective at preventing abusive “naked” short selling activity and that some sellers may exploit current market conditions to engage in harmful short sale transactions. The SEC, through the October 14 Amendments, has substantially finalized those temporary rules to enhance its ability to counter market abuses in this area.

This alert highlights the main provisions of the final rules and the most significant changes from the temporary short sale rules as they existed prior to the October 14 Amendments.

Short Sale Antifraud Rule

The SEC formally adopted Rule 10b-21, which provides that it constitutes a “manipulative or deceptive device or contrivance” as used under Section 10(b) of the Exchange Act, for any short sellers, including broker-dealers acting for their own accounts, to deceive others about their intention or ability to deliver short sale equity securities in time for settlement and to subsequently fail to deliver those securities by the settlement date. By adding a specific short sale Antifraud Rule, the SEC intends to spotlight and deter certain manipulative “naked” short selling schemes. The Antifraud Rule is intended to add to the general antifraud provisions of Rule 10b-5 by highlighting abusive short sales practices and providing greater certainty in the settlement of securities. The temporary version of Rule 10b-21 implemented under the Emergency Order lapsed on October 17, 2008, at which time the formal rule became effective. The SEC is not seeking comment on this rule because it was formally proposed prior to the Emergency Order.¹⁰

Amendments to Regulation SHO

The SHO Amendments consist of an interim final temporary close-out rule (the “Close-Out Rule”) and a rule eliminating the options market maker exception to Reg SHO’s close-out requirement (the “Options Market Maker Rule”). The SHO Amendments were adopted to address the SEC’s continued concerns about both the negative market impact caused by fails to deliver and the fact that threshold securities¹¹ with ongoing fail to deliver positions were not being closed out as provided for under existing delivery and settlement requirements.

The Close-Out Rule

Rule 204T(d) of Reg SHO, adopted on an interim final basis on October 14, 2008, strengthens the delivery requirements under Reg SHO for sales of all equity securities. The rule was adopted due to continuing concerns about the potential impact of “naked” short selling on the weakened financial markets. The Close-Out Rule requires short and long sellers and their broker-dealers to deliver equity securities by the settlement date (T+3, or three trading days after the settlement date). Fails to deliver are required to be closed out by the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred (the “Close-Out Date”). In the release for the Close-Out Rule, the SEC noted the detrimental impact that fails to deliver have on buyers and that sellers, unrestrained by a delivery rule, use the freedom to engage in manipulative trading practices that depress market prices to their benefit. The Close-Out Rule substantially tracks the temporary delivery requirements put in place September 17, 2008 with a few differences:

9 See http://www.whitecase.com/alert_securities_072108/; See also http://www.whitecase.com/alert_cmsecurities_shortsell_091908/, where White & Case advised our clients that similar action was taken by the UK Financial Services Authority, which issued orders prohibiting short sales in the securities of designated financial institutions.

10 See Exchange Act Rel. No. 57,511 (March 17, 2008) available at <http://www.sec.gov/rules/proposed/2008/34-57511.pdf>.

11 A “threshold security” is any equity security that has an aggregate fail to deliver position for (a) five consecutive days at a registered clearing agency, (b) totaling 10,000 shares or more and (c) equal to at least 0.5 percent of the issuer’s total shares outstanding. Threshold securities only include issuers registered or required to file reports with the SEC (“reporting companies”). See <http://www.sec.gov/answers/threshold.htm>.

Rule 204T(d):

- (a) Applies to fails to deliver in all equity securities (not limited to threshold securities)
- (b) Shortens the close-out period for fails to deliver from 13 days (ten days after settlement date) to the beginning of regular trading hours on the Close-Out Date
- (c) Imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's responsibilities.

The Borrowing Requirement

As a penalty for failure to deliver equity securities by the settlement date, Rule 204T requires participants to purchase or borrow shares, as applicable, to close-out a fail to deliver position. The rule requires that participants and broker-dealers from which they receive trades for clearance and settlement borrow or arrange to borrow securities prior to accepting or effecting short sales in the security that has a fail to deliver position that has not been closed out. Further, the participant must notify any broker or dealer from which it receives trades for clearance or settlement (a) that the participant has a fail to deliver position in an equity security and (b) when the purchase that the participant has made to close-out the fail to deliver position has cleared and settled.

The Close-Out Rule became effective October 17, 2008. The SEC is accepting comments on the rule and, absent further SEC action, the Rule is set to expire July 31, 2009.

Elimination of the Options Market Makers Exception to the Close-Out Requirement

The SEC also formally adopted amendments to Rule 203(b)(3) of Reg. SHO that eliminate the options market maker exception from the rule's close-out requirement. Options market makers have been subject to the same close-out requirements as other market participants since the SEC enacted temporary rules pursuant to the September Emergency Order.¹² The intent of these rules is to reduce fails to deliver in certain equity securities that result from hedging activities by options market makers. Because substantial levels of fails to deliver continue to persist in threshold securities and it appears that a significant number of these are due to the options market maker exception, this amendment makes permanent the September 17, 2008, temporary rule eliminating the options market maker exception. The final rule became effective October 17, 2008 and the SEC is not seeking comment on these amendments because they were formally proposed prior to the September Emergency Order.¹³

Removing the options market maker exception serves the dual purpose of providing buyers with the protections and benefits of the T+3 standard settlement period and imposing restrictions on sellers, thereby deterring trading activities designed to improperly depress the price of a security and the harmful market effects of fails to deliver. Registered options market makers will be required to close out fails to deliver in threshold securities that result from hedging activities in accordance with the close-out requirements of Reg SHO, including those resulting from short sales effected to establish or maintain a hedge on options positions established before the security became a threshold security.

¹² Amendments include a one-time 35 consecutive settlement day phase-in period in which any previously excepted fail to deliver position in a threshold security must be closed out (this settlement period is a continuation of the settlement period that began with the September Emergency Order depending on whether the security at issue was a threshold security pursuant to the September Emergency Order).

¹³ See Exchange Act Rel. No. 56,213 (August 7, 2007) available at <http://www.sec.gov/rules/proposed/2007/34-56213.pdf>.

Enhanced Short Sale Reporting Obligations

Finally, on October 15, 2008, the SEC adopted an interim final temporary Rule 10a-3T requiring certain institutional investment managers to file information on a nonpublic Form SH on a weekly basis concerning their short sales and positions of Section 13(f) securities, other than options, having an aggregate fair market value of at least US\$100 million. The interim final temporary rule is substantially similar to the reporting requirements established by the Emergency Order with the following modifications.

- **Extended filing deadline**—The filing deadline under the new rule is the last business day of the calendar week after a week when short sales are effected
- **Higher Threshold**—The threshold for reporting short sales or positions will be raised from a fair market value of US\$1 million to a fair market value of US\$10 million. During a two-week phase in period, filers required to file a Form SH on October 24, 2008 or October 31, 2008, will be given the option to choose to (a) exclude short sales effected before September 22, 2008 and take advantage of the higher threshold or (b) continue using the lower threshold. All Form SH filers will be required to report their short positions as specified in Rule 10a-3T beginning with the November 7, 2008, filing (the filing for the calendar week ending November 1, 2008)

- **Less Information Disclosure Required**—Filers will no longer be required to disclose the value of the securities sold short (former column 5 of Form SH), the largest intraday short position (former column 7), or the time of day of the largest intraday short (former column 8)
- Filers will be required to submit an XML tagged data file to the SEC providing the requested data.

The new rule became effective on October 18, 2008 and will expire, absent further SEC action, on August 1, 2009. The SEC is requesting public comments on interim final temporary Rule 10a-3T as it decides whether the interim final temporary rule or Form SH should be revised or whether a longer-term or permanent short sale reporting requirement should be promulgated upon its expiration.

Conclusion

The SEC will continue to explore various alternatives to eliminate abusive short selling practices as part of its overall efforts to restore investor confidence in the securities markets without impairing the legitimate purposes of short selling including the creation of liquidity. Market participants need to remain flexible in their operational and systems practices in connection with short selling activities in order to be prepared to adjust to a changing regulatory environment.

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