

SEC ANNOUNCES EXTENSION OF EMERGENCY SHORT SELLING ORDERS

On October 1 and 2, 2008, the Securities and Exchange Commission (the “SEC”) extended until 11:59 p.m. on October 17, 2008 the emergency short selling orders that it previously issued. Specifically, the SEC extended:

1. The short sale ban: the prohibition on selling short the securities of specified companies. The ban will expire on the earlier of three business days after enactment of economic stability legislation or October 17, 2008.¹ The legislation was signed by President Bush on the afternoon of October 3, 2008, and the ban will terminate at 11:59 p.m. on Wednesday, October 8, 2008.² Although the SEC was urged to include an exception for hedging a variety of securities transactions, it made no changes to the scope of the ban.
2. Form SH: the requirement that institutional money managers report to the SEC on Form SH their short sales activity in certain publicly traded securities.³ All filings now will be non-public “to the extent permitted by law.” This indicates that the Freedom of Information Act applies to Form SH filings. The Instructions to the form continue to require each page to be marked “NON-PUBLIC.” We understand from SEC staff that the statement in the SEC’s order that a filer need not submit a “confidential treatment request” (“CTR”) with Form SH is based on a view that the statements in the SEC’s order coupled with the requirement that all Form SH pages be marked as non-public is equivalent to a request for confidential treatment under the SEC’s rules.⁴ While the SEC staff has said that it is not strictly necessary to submit a CTR, we believe that, at least for the filing due on October 6, 2008, filers should submit a CTR to the SEC to ensure that the filing will be subject to the SEC’s confidential treatment procedures and available exemptions from public disclosure.⁵ We note, moreover, that the SEC’s confidential treatment rules do not provide a basis to withhold information from Congress.⁶

Under the SEC’s order, Form SH filings are required on October 6 and 14, 2008 by managers with reportable activity. In announcing the extension of its emergency order,

¹ SEC Release No. 34-58723 (Oct. 2, 2008).

² SEC Press Release 2008-238 (Oct. 3, 2008).

³ SEC Release No. 34-58724 (Oct. 2, 2008).

⁴ See 17 C.F.R. 200.83.

⁵ We can assist clients in preparing a CTR.

⁶ See 5 U.S.C. 552(d).

the SEC noted that it intends to continue the Form SH filing requirement beyond October 17, 2008 through an interim final rule.⁷

3. Rule 204T: the “hard” T+3 close-out requirement for naked short selling under temporary Rule 204T.⁸ The order extending the close-out requirement incorporates and adopts SEC staff guidance on Rule 204T, including sales of loaned but recalled securities, discussed below. In announcing the extension of its emergency orders, the SEC noted that it intends to continue the close-out requirement beyond the October 17, 2008 expiration date of the emergency order through an interim final rule.
4. Repeal of the options market maker exception: the repeal of the exception for options market makers from the short selling close-out provisions in Regulation SHO.
5. Rule 10b-21: the new “naked” short selling anti-fraud rule, which covers short sellers who deceive broker-dealers or any other market participants about their intention or ability to deliver securities in time for settlement, and who fail to make timely settlement of their trades.
6. Rule 10b-18: the order easing restrictions on the ability of securities issuers to repurchase their common stock.⁹

Starting on September 17, 2008, the SEC issued a series of emergency orders with respect to short selling and manipulation. The SEC staff also issued subsequent guidance on those orders. This memorandum describes the current prohibitions and obligations under the orders and guidance.

Prohibition on Short Selling Certain Securities

On September 18, 2008, the SEC issued an emergency order prohibiting short sales in the publicly traded securities of 799 banks, insurance companies and securities firms (“Included Financial Firms”), the names and symbols of which were listed in Appendix A to the order.¹⁰ The order provided exemptions for, among other activities, bona fide market making by registered market makers.

On September 21, 2008, the SEC modified the emergency order to require the listing exchanges to designate Included Financial Firms.¹¹ The exchange-designated Included Financial Firms are

⁷ Statement of Securities and Exchange Commission Concerning Short Selling, <http://www.sec.gov/news/press/2008/2008-235.htm> (Oct. 1, 2008).

⁸ SEC Release No. 34-58711 (Oct. 1, 2008).

⁹ SEC Release No. 34-58703 (Oct. 1, 2008).

¹⁰ SEC Release No. 34-58592 (Sept. 18, 2008).

¹¹ SEC Release No. 34-58611 (Sept. 21, 2008).

supplemental to, not in lieu of, the 799 Included Financial Firms designated by the SEC. The exchanges have published their respective lists of Included Financial Firms on their websites. The ban applies only to the common equity securities with the ticker symbols on the combined SEC and exchange lists.

Limited Market Maker Exception

The SEC's September 18, 2008 order included an exception from the prohibition on selling short the securities of Included Financial Firms for market makers effecting short sales as part of bona fide market making and hedging activities. The SEC amended its order on September 21, 2008, however, to prohibit a market maker from relying on the hedging exception to short prohibited securities 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., actual positions, derivatives, or otherwise) in the issued share capital of a firm covered by this Order [*i.e.*, an Included Financial Firm]."¹² If, for example, a market maker purchases from a manager a call option on a security of an Included Financial Firm, and the market maker knows that the manager has a flat or an existing short position in that security, the market maker may not sell the security short to hedge its exposure to the call option because the call option transaction would increase the manager's net economic short exposure in the security of the Included Financial Firm. We understand that market makers are asking managers for a representation that a derivatives transaction by the manager will not result in increasing the manager's economic net short exposure to an underlying security of an Included Financial Firm. In addition, some market makers have posted notices on their websites to the effect that a client engaging in a derivative transaction with the market maker will be deemed to represent that the derivative transaction will not increase the client's net economic short position in the security of an Included Financial Firm.

Options Exercises and Assignments

Exercise of an option on the security of an Included Financial Firm that results in a short sale is prohibited. An exercise of an option that requires delivery of the underlying security is considered to be a sale of that security. If the person required to deliver has a short or flat position in the underlying security at the time of exercise, the sale is a short sale.

There is an exemption from the short selling ban for automatic exercises and assignments of exercises of an option (or a futures contract) that was held prior to September 19, 2008 due to the expiration of the option or futures contract.¹³ This exemption initially was added to permit the settlement of automatic options exercises and assignments in connection with the September 19, 2008 quarterly options expirations. In addition, the writer of a call option that is assigned an exercise that results in a short sale by the assignee is exempt from the prohibition of short sales

¹² Release No. 34-58611.

¹³ Release No. 34-58611.

of securities of Included Financial Firms.¹⁴ The call option need not have been written before September 19, 2008.

No exemptions are available for voluntary exercises of options, whether held before September 19, 2008 or acquired later. However, a manager could exercise a put option on the security of an Included Financial Firm if the manager had a net long position in the security in an amount at least equal to the delivery obligation, because the exercise of the option would not result in the manager having a net short position in the security.

Form SH

The SEC extended its emergency order requiring reporting of short sales and short positions for all asset managers required to file Form 13F under the Securities Exchange Act of 1934 (“Exchange Act”) for the quarter ended June 30, 2008.¹⁵ For each day that short sales were made during the reporting period, Form SH requires the manager to disclose certain information, including the name of the issuer, the CUSIP number of the security, and the number and value of securities sold short. The list of securities that must be reported on Form SH is contained in the official list of Exchange Act Section 13(f) securities published by the SEC.¹⁶

Short positions extant before 12:01 a.m. on September 22, 2008 are not required to be reported on Form SH. This means that only short sales and related short positions occurring on or after September 22 must be reported. The SEC clarified that no filing is required if “no short sales of a section 13(f) security have been effected since the previous filing of a Form SH,” if any.¹⁷ The next Form SH filing deadline is 5:30 p.m. on Monday, October 6, 2008.

On September 24, 2008, the SEC staff issued a series of questions and answers (“Q&As”) intended to clarify certain requirements with respect to filing Form SH.¹⁸ Among other things, the Q&As stated that short options positions and short swaps are not required to be reported on Form SH, although exercises of options that constitute short sales are subject to reporting. The Q&As also noted that if the aggregate value of short sales in a Section 13(f) security on a given day during the reporting period is below the de minimis level (*i.e.*, the fair market value of the short sales is below \$1 million and less than 0.25 percent of the issued and outstanding shares of the security), such short sales are not required to be reported on Form SH for that day. However, de minimis short sales must be taken into account in determining whether any short *position* in a security must be reported on Form SH for that day.

¹⁴ *Id.*

¹⁵ SEC Release No. 34-58591 (Sept. 18, 2008).

¹⁶ *See* General Instruction 4 to Form SH.

¹⁷ SEC Release No. 34-59591A (Sept. 21, 2008).

¹⁸ Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets Guidance Regarding the Commission’s Emergency Order Concerning Disclosure of Short Selling, <http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm> (Sept. 24, 2008).

“Boxed” Positions

Sales of a security in a “boxed” position are short sales within the meaning of Regulation SHO and subject to reporting on Form SH if they involve an Exchange Act Section 13(f) security. A “boxed” position exists if a manager holds a long position and a short position of equal size in a security. If the manager sells the long position, the sale would be a short sale because the manager does not have a *net long* position in the security, and the sale creates a net short position.¹⁹

Loaned But Recalled Securities

The SEC expressly adopted guidance issued by its staff on September 29, 2008²⁰ addressing the situation in which a person has loaned a security and subsequently sells the loaned security. If the person initiates a bona fide recall of the loaned securities within two business days after the trade date of the sale, the person is deemed to own the securities for purposes of Rules 200(g)(1) and 200(b) of Regulation SHO, and the sale of the securities would not be treated as a short sale for purposes of Form SH, short selling shares of securities of Included Financial Firms, or Rule 204T of Regulation SHO. The guidance confirms that such sales may be marked as long sales. We note that the guidance did not address the application of Rule 200(c) of Regulation SHO which provides that a person is deemed to own a security only to the extent that he has a net long position in the security.²¹ Pursuant to that provision, the recalled securities may be sold long only if the seller has a net long position in that amount, including the recalled securities, at the time of the sale.

Temporary Rule 204T

The SEC issued temporary Rule 204T to Regulation SHO under the Exchange Act²² on September 17, 2008, effective as of 12:01 a.m. on September 18, 2008, in an effort to battle perceived problems related to “naked short selling.”²³ The rule contains two obligations: (1) a participant must deliver securities to a registered clearing agency by settlement date (normally, three business days after the trade date, or T+3) on a long or short sale of an equity security; and (2) if a participant has a fail to deliver position at a clearing agency in an equity security, the participant “shall, by no later than the beginning of regular trading hours on the next settlement day immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.” The next settlement day for a:

¹⁹ See Rule 200(c) of Regulation SHO.

²⁰ See Division of Trading and Markets Guidance Regarding Sale of Loaned But Recalled Securities, <http://www.sec.gov/divisions/marketreg/loanedsecuritiesfaq.htm> (Sept. 28, 2008).

²¹ See Rule 200(c) of Regulation SHO.

²² Regulation SHO, 17 C.F.R. 242.200 et seq. (2008).

²³ SEC Release No. 34-58572 (Sept. 17, 2008).

- short sale is T+4,
- long sale is T+6, and
- sale of a restricted security pursuant to Rule 144 under the Securities Act of 1933 is T+39.

If a participant does not close out a fail to deliver position as required, the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker, may not accept a short sale order in the equity security from another person or effect a short sale for its own account (if the broker-dealer submits its short sales to the participant for clearance and settlement) without first borrowing the security, or entering into a bona fide arrangement to borrow the security (a “preborrow requirement”), until the participant has closed out the fail position and the purchase has cleared and settled at a clearing agency.

The SEC expressly adopted staff guidance issued on September 22, 2008.²⁴ The guidance notes, among other things, that a broker-dealer may allocate responsibility for Rule 204T’s close-out requirement to the broker-dealer that is responsible for the fail position and avoid application of the restrictions if such allocation is reasonable. Furthermore, the close-out requirement for fails to deliver attributable to bona fide market making activities by market makers (including options market makers) has been extended to T+6, but the market maker must attest in writing to the market on which it is registered that the failure to deliver was established solely to meet its bona fide market making obligations.

Repeal of the Options Market Maker Exception

The SEC’s order also extends the repeal of the exception for options market makers from the short selling close-out provisions in Regulation SHO. It appears that the SEC takes the position that it has adopted repeal of the options market maker exception as a final rule in its emergency order, although this adoption was not accompanied by the usual publication of a release in the Federal Register.

Rule 10b-21

The extended order also applies to Rule 10b-21 under the Exchange Act, which prohibits sellers from misrepresenting their intention or ability to deliver securities to make timely settlement of their trades and then failing to deliver. To avoid problems with this provision, the seller must have a reasonable basis to believe that it has the ability to deliver the securities. The rule does not limit or restrict the applicability of the general antifraud provisions of the securities laws, such as Rule 10b-5 under the Exchange Act. It appears that the SEC takes the position that it adopted Rule 10b-21 as a final rule in its emergency order, although this adoption was not accompanied by the usual publication of a release in the Federal Register.

²⁴ Release No. 34-58711. See Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against “Naked” Short Selling Abuses <http://www.sec.gov/divisions/marketreg/204tfaq.htm> (Sept. 22, 2008).

Rule 10b-18

Under the extended order, the temporary amendments to Rule 10b-18 under the Exchange Act implemented on September 18, 2008 remain in effect.²⁵ The SEC temporarily amended paragraphs (b)(2) and (4) of the rule to enhance the ability of issuers to repurchase their own common stock within the “safe harbor” from manipulation charges. During the period of the order, issuers can:

1. bid for and purchase their shares during the entire primary trading session in each market where the purchase is made; and
2. purchase up to 100 percent of the average daily trading volume in their shares each day.

The “one broker or dealer” and price conditions of Rule 10b-18(b)(1) and (3) are unchanged.

* * * * *

If you have any questions regarding this memorandum, please contact Roger D. Blanc (1 212 728-8206, rblanc@willkie.com), Larry E. Bergmann (1 202 303-1103, bergmann@willkie.com), Martin R. Miller (1 212 728-8690, mmiller@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

October 3, 2008

Copyright © 2008 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York’s Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.

²⁵ SEC Release No. 34-59588 (Sept. 18, 2008).