Financial Crisis Advisory: SEC Extends Emergency Short-Sale Restrictions and Reporting Requirements

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The SEC used its emergency authority to extend a series of orders protecting against “naked” short selling and short sales in financial institutions, requiring money managers to disclose short positions, and enabling issuers to repurchase their own securities. This client advisory assesses the current status of the SEC’s emergency actions.

Extension of Order Protecting against “Naked” Short Selling

The SEC said it intends that the enhanced delivery requirements, the elimination of the options market maker exception, and the “naked” short selling anti-fraud rule will provide “powerful disincentives to those who might otherwise exacerbate artificial price movements through “naked” short selling.”[1] The components of this ban include the following:

Hard T+3 Close Out Requirement[2]

The SEC added to Regulation SHO a new temporary rule, Rule 242.204T, requiring delivery of securities sold short by the settlement date (three days after the sale transaction date or “T + 3”) and imposes penalties for failure to do so. If a short sale violates the new delivery 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. This prohibition on the broker-dealer applies to short sales for the particular naked short seller as well as short sales for any customer. The emergency extension of this provision is set to expire on October 17, 2008 but the SEC intends that the order will remain in effect beyond that date without interruption in the form of an interim final rule.[3]

Exceptions for Options Market Makers[4]

The SEC amended Rule 203(b)(3) of Regulation SHO that eliminates the options market maker exception from Regulation SHO’s close-out requirement. This exception had permitted option market makers to maintain fail-to-deliver positions indefinitely, thereby facilitating hedging by market makers of options positions created before the security became a “threshold security” under Regulation SHO. The SEC made the amendments to Rule 203(b)(3) effective immediately in its September 18, 2008 Emergency Order,[5] which was subsequently extended until October 17, 2008 at 11:59 p.m. in the SEC’s extension order.[6]

Rule 203(b)(3) previously created an exception for the close-out requirement if a participant had a fail-to-deliver position attributed to short sales effected by a registered options market maker to establish or maintain a hedge-on-options position that were created before the security became a threshold security.

The amendments eliminate that exception by stating that, if a participant has a fail-to-deliver position in a particular security as of September 18, 2008 that previously would have fallen under the exception, then the participant shall immediately close-out of that position within 35 consecutive settlement days from September 18, 2009 by purchasing securities of like kind and quantity.[7] Additionally, if a participant, who is entitled to rely on the 35 consecutive day settlement close-out requirement, has a fail-to-deliver position in the security for 35 consecutive days, then the participant and any broker or dealer for which it clears transactions, may not accept a short-sale order from another person or effect a short sale for its own account in the security without borrowing the security or entering into an arrangement to borrow the security, until the participant covers its fail-to-deliver position by purchasing securities of like kind and quantity.[8]

New Short-Selling Anti-Fraud Rule

Effective September 18, 2008, short sellers who deceive broker-dealers or any other market participants about their intention or ability to deliver securities in time for settlement will be subject to liability. Specifically, Rule 10b-21 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.”[9] This provision means that both (1) short sellers and (2) broker-dealers and clearing agencies organized as trust companies must monitor carefully short-seller communications about covering short sales—short sellers due to the potential securities fraud liability arising under the new rule; and broker-dealers and clearing agencies organized as trust companies due to certain obligations to report to the government when there is reason to suspect transactions involving securities fraud.

Extension of US Prohibition against Short Selling of Financial Institution Stocks; Similar UK Rule

On October 2, 2008, the SEC extended[10] its September 18, 2008 order prohibiting people from selling short the securities of financial institutions identified in that order.[11] The SEC expects “the prohibition to restore investor and market confidence by preventing short selling from being used to drive down the prices of securities in financial institutions even where there is no fundamental basis for a price decline other than general market conditions.” The extension was scheduled to expire on Wednesday October 8, 2008 at 11:59 p.m. as a result of the President signing the Emergency Economic Stabilization Act of 2008 into law on October 3, 2008.[12]

The UK ban against short selling will be in effect for a longer period of time than the US ban. On September 18, 2008, the UK Financial Services Authority (“FSA”) announced that effective at midnight that day, it was prohibiting the “active creation or increase of net short positions” in a list of 29 UK financial services companies. The FSA also announced that, beginning on Tuesday, September 23, 2008, daily disclosure would be required of all net-short positions in excess of 0.25 % of outstanding shares. These restrictions are to remain in force until January 19, 2009.[13] Australia, Taiwan, Japan, the Netherlands, and Canada, among others, also enacted bans against short selling.

Extension of Order Enabling Issuers to Repurchase Their Own Securities

The SEC extended its September 18, 2008 order broadening Rule 10b-18’s safe harbor from liability for issuer repurchases in order to facilitate orderly markets.[14] The SEC explained that “[i]ssuer repurchases can represent an important source of liquidity during these times of market volatility.”[15] Using its emergency authority, the SEC extended the order for a total effective period of up to 30 calendar days, now ending at 11:59 p.m. on October 17, 2008.

Extension of Order Requiring Institutional Investment Managers to Report Short Sales

The SEC extended its September 18, 2008[16] order (as amended on September 21, 2008[17]) requiring institutional investment managers to report short sales of certain publicly traded securities.[18] The SEC concluded that it “remains necessary to require certain institutional investment managers to report information concerning short sales of securities” because “some persons may take advantage of issuers that have become temporarily weakened by current market conditions to engage in inappropriate short selling in the securities of such issuers.”[19]

According to the instructions for new Form SH, those institutional investment managers who are required to file Forms 13F[20] for the calendar quarter ending June 30, 2008, must file a non-public report on Form SH with the SEC to report certain information about short sales and short positions. Forms SH must be filed on the Monday following the previous calendar week in which the investment manager entered into any new short positions with respect to any Section 13(f) securities, except for any short positions for options.[21]

Institutional investors filing such reports on Form SH, due on October 6, 2008 and October 14, 2008, will be making nonpublic submissions. The SEC explained that “the nonpublic submission of Form SH may help prevent artificial volatility in securities as well as further downward swings that are caused by short selling, while at the same time, providing the

Commission with useful information to combat market manipulation that threatens investors and capital markets." Forms SH are nonpublic submissions because the SEC believes that in the current state of the market, "Form SH data could give rise to additional, imitative short selling that was not intended by the Commissions Order."[22] The SEC also noted that "disclosure under the emergency order will be made only to the SEC."[23]

Using its emergency authority, the SEC extended the September 18, 2008 order for a total effective period of up to 30 calendar days, now ending at 11:59 p.m. on October 17, 2008. The SEC indicated that it intends for the order to continue beyond October 17, 2008 without interruption in the form of an interim rule and that it will seek comments on all aspects of the anticipated rulemaking.[24]

Mintz Levin will continue to monitor developments in the tightening regulation of short selling closely. For the latest developments, visit Financial Crisis Central at Mintz.com.

Endnotes

[1] *See* Securities Exchange Act, Release No. 58711 (Oct. 1, 2008).

[2] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008).

[3] *See* SEC Press Release, No. 2008-235 (Oct. 1, 2008).

[4] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008).

[5] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008).

[6] *See* Securities Exchange Act, Release No. 58711 (Oct. 1, 2008).

[7] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008) at p. 6, citing amended paragraph § 242.203(b)(3)(iii).

[8] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008) at p. 6, citing amended paragraph § 242.203(b)(3)(v).

[9] *See* Securities Exchange Act, Release No. 58572 (Sept. 17, 2008).

[10] *See* Securities Exchange Act, Release No. 58723 (Oct. 2, 2008).

[11] *See* Securities Exchange Act, Release No. 58592 (Sept. 18, 2008); *see also* Securities Exchange Act, Release No. 58611 (Sept. 21, 2008).

[12] *See* SEC Press Release, No. 2008-238 (Oct. 3, 2008).

[13] *See* FSA Statement on Short Positions in Financial Stocks (Sept. 18, 2008).

[14] *See* Securities Exchange Act, Release No. 58588 (Sept. 18, 2008).

[15] *See* Securities Exchange Act, Release No. 58703 (Oct. 1, 2008).

[16] *See* Securities Exchange Act, Release No. 58591 (Sept. 18, 2008).

[17] *See* Securities Exchange Act, Release No. 58591A (Sept. 21, 2008).

[18] *See* Securities Exchange Act, Release No. 58724 (Oct. 2, 2008).

[19] *See* Securities Exchange Act, Release No. 58274 (Oct. 2, 2008).

[20] The SEC publishes an official list of Section 13(f) securities. Institutional Investment Managers holding securities on this list are required to file a Form 13F for accounts holding Section 13(f) securities that have an aggregate fair market value on the last trading day of any month of any calendar year of at least $100 million. Rule 13f-1 provides the timing for filing Forms 13F. *See* Form SH, Information Required of Institutional Investment Managers Pursuant to Emergency Order, Securities Exchange Act, Release No. 58591A (Sept. 21, 2008); Emergency Order, Securities Exchange Act, Release No. 58724 (Oct. 2, 2008) at p. 2.

[21] *See* Form SH, Information Required of Institutional Investment Managers Pursuant to Emergency Order, Securities Exchange Act, Release No. 58591A (Sept. 21, 2008); Emergency Order, Securities Exchange Act, Release No. 58724 (Oct. 2, 2008).

[22] *See* Securities Exchange Act, Release No. 58274 (Oct. 2, 2008).

[23] *See* SEC Press Release, No. 2008-235 (Oct. 1, 2008).

[24] *See* SEC Press Release, No. 2008-235 (Oct. 1, 2008).

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