

## *SEC Issues Emergency Orders Regarding Short Selling in Effort to Curtail the Crisis of Confidence*

*by William L. Tolbert, Jr. and Elaine Wolff*

On September 18, in an effort to curb sudden price declines in securities of financial institutions “unrelated to true price valuation,” the SEC issued three emergency orders that:

- Ban short selling in the securities of 799 financial companies
- Require hedge funds and other large investors to report new short sales
- Ease restrictions on issuer repurchases

The ban on short sales in financial companies terminates in ten business days (October 2, 2008), but may be extended for up to a total of thirty calendar days.

Even before the announcement, at least one major entity, California Public Employees’ Retirement System, the nation’s largest pension fund, announced that it was no longer lending out shares of Goldman Sachs and Morgan Stanley and Wachovia to short sellers.

These moves followed a September 17 SEC order that effectively banned “naked” short selling on all public companies, as of 12:01 a.m. September 18, 2008; an expansion from the SEC’s July 15 Emergency Order which expired last month that applied to stocks of only 17 financial institutions and Fannie Mae and Freddie Mac (the “July Emergency Order”).

Following the July Emergency Order, there had been frequent calls for broadening the applicability of the

naked short selling rule beyond the 19 listed names. In fact, on July 21, former SEC Commissioner Roel Campos was quoted in a *Reuters* article as stating that “we cannot have a segregated market where only the large and connected get protected by the SEC.” Even at that time, Chairman Cox had announced that the Commission was considering other remedies for abusive naked short selling such as “reporting of substantial short positions.”

On Sunday, September 21, the SEC amended the emergency order requiring large investors to report new short sales. The amendment made the report non-public until two weeks after it is filed with the SEC when it will be publicly available on EDGAR.

### **Ban on short sales of 799 financial companies**

Concerns over the liquidity and ultimate viability of financial institutions prompted the ban on short sales of 799 financial companies. Similar to the ban in July, the SEC provided a limited exception for certain bona fide market makers. This action followed a U.K. ban on short selling in financial stocks.

Among the list of 799 financial institutions is Sallie Mae, the largest U.S. student lender; TD Ameritrade Holding Corp.; E\*Trade Financial Corp.; Charles Schwab Corp.; Principal Financial Group; Berkshire Hathaway Inc.; NYSE Euronext, the largest stock exchange; and some foreign financial companies whose stock is traded on U.S. exchanges such as Lloyds TSB Group PLC and China Life Insurance Co., Ltd.

## **Disclosure of short sales required by hedge funds and other large investors**

Hedge funds and managers with more than \$100 million invested in securities are required to report their daily short positions on a weekly basis. The new Form SH requires disclosure of the number and value of equity securities sold short, except short sales in options, and the opening short position, closing short position, largest intra-day short position and time of day of largest intra-day short position. No filing is required if the short position constitutes less than one-quarter of one percent (0.25 percent) of the issued and outstanding shares of that particular class of securities and the fair market value of the short position is less than \$1,000,000. The report will not be publicly available on EDGAR until two weeks after it is electronically filed. The order applies to short sales after the effective date of the order, which is 12:01 a.m. on September 22, 2008, and the first Form SH is due September 29, 2008. The form is due on the first business day of every calendar week immediately following a week in which short sales were made. If no short sales were made during the prior week then no filing is required. The order terminates in 10 business days at 11:59 p.m. on October 2, 2008, but may be extended for not more than a total of 30 calendar days.

## **Easing of restrictions on issuer repurchases**

Recognizing that issuer repurchases can represent an important source of liquidity, the SEC's order eases restrictions on the timing and volume conditions of Rule 10b-18 of the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 10b-18 provides a safe harbor from the anti-manipulation provisions of Section 9(a)(2) of the Exchange Act or Rule 10b-5 for issuer or affiliated purchaser repurchases that satisfy the Rule's conditions on timing, price and amount of such purchases. Until the order terminates at 11:59 p.m. on October 2, 2008, issuers may repurchase shares under Rule 10b-18 without regard to the Rule's limitations on:

- timing of purchases (currently limits on opening purchases and purchases made during the last 10 or 30 minutes of a trading session); and

- volume of purchases, as long as the amount of the purchases does not exceed 100 percent of the ADTV for the security (currently 25% of prior four weeks' ADTV).

All other conditions of Rule 10b-18, including the manner and price of purchase conditions are not affected by the order.

## **Ban on "naked" short selling of all public companies**

Noting that the Commission's concerns are no longer limited to just financial institutions that were the subject of the July Emergency Order, the Commission effectively banned naked short sales of all public companies effective 12:01 a.m. September 18, 2008. Naked short selling occurs when traders sell a stock short without borrowing or locking-up securities for future delivery before entering into the short contract. The new order adds and makes immediately effective a temporary rule to Regulation SHO that requires short sellers and their broker-dealers to deliver securities and close out short sales no later than the close of business on the settlement date, which is three days after the transaction date (T+3). If a broker-dealer does not close out the short position, the broker-dealer may not effect any short sales in the same security unless the shares are not only located but also borrowed.

Currently, Regulation SHO, adopted in 2004, requires broker-dealers, before they accept short sale orders, to first borrow the security to be shorted or enter into a contract to borrow it. However, Regulation SHO offers an alternative to these requirements if the broker has "reasonable grounds" to believe that the security can be borrowed. In practice, under the current Regulation SHO brokers look at how many shares are available to borrow and allow a client to short the amount the broker thinks the broker can reasonably borrow on the client's behalf. Currently, shorting without locating the shares first is prohibited by Regulation SHO. However, the actual contract to borrow the shares may be executed by the broker after the brokerage client executes the short sale. This order will force a broker to actually borrow the shares before allowing a client to short.

The SEC also eliminated the exemption provided in July that allowed options market makers to continue to hedge put and call positions by exempting them from having to pre-borrow shares before executing a short sale in the 19 listed companies. Now options market makers, like all broker-dealers, will be required to pre-borrow as well as close out trades within T+3.

Finally, the SEC made immediately effective a naked short selling antifraud rule, Rule 10b-21, that prohibits short sellers from deceiving their broker-dealers or other market participants about their intention or ability to deliver securities in time for settlement.

### **Future Moves**

It remains to be seen whether these emergency actions will prompt the SEC to reinstate the so-called "Uptick Rule," repealed in June 2007, that allowed short sales only when the last sale

price was higher than the previous price. The Uptick Rule meant that a trader could not short a stock if the movement prior to the short sale was down. The Uptick Rule was originally adopted in 1938 to restrict selling in a declining market. In eliminating the Uptick Rule, the SEC pointed to studies indicating that the Uptick Rule did not really make a difference to volatility or to how the market performed. Calls for reinstating the Uptick Rule have come from a variety of fronts and legislation to reinstate the Uptick Rule was introduced on July 16, 2008 by Rep. Gary Ackerman, a Democrat from New York (H.R. 6517).

Other unknowns include the extent of the impact on the ability to raise capital through convertible bond offerings since investors generally buy a convertible bond and then short the stock, and the extent of the increase in the options market as investors use options to bet against companies.

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