

Frequently Asked Questions About Recent SEC Orders Relating to Short Sales

The recent emergency amendments made by the Securities and Exchange Commission ("SEC") to its regulation of short selling have raised numerous questions about their scope and interpretation. We have prepared the following summary of questions we are frequently asked and our responses, based upon currently available sources, in order to help industry participants remain knowledgeable about these issues. Given how rapidly these changes were adopted by the SEC, many issues remain unresolved. We expect that there will be further developments regarding these issues in the coming weeks.

Background

Q. What do the SEC orders do?

A. The SEC has made several temporary changes, on an emergency basis, to the current regulatory framework for short sales.

The SEC issued its first emergency order on September 17 ("Original Order").¹ The Original Order generally (i) penalizes broker-dealers for having "fail to deliver" positions in securities and (ii) makes deceiving a broker-dealer or purchaser as to the intent or ability to deliver securities on or before settlement a "manipulative or deceptive device or contrivance" in an attempt to curtail "naked" short selling.

The SEC then issued three additional orders on September 18² and amended two of those

orders on September 21.³ These orders, in their amended form, as applicable:

- prohibit virtually all short sales of publicly-traded common equity securities ("Covered Securities") of financial companies appearing on lists prepared by the national securities exchanges ("Financial Firms Order");⁴

³ SEC Rel. Nos. 34-58591A and 34-58611 (Sep. 21, 2008).

⁴ The Financial Firms Order has exceptions for (i) bona fide market makers; (ii) short sales that occur as a result of automatic exercise or assignment of an equity option or in connection with the settlement of a futures contract (entered into prior to September 18, 2008) due to expiration of the option or futures contract; and (iii) writers of call options that effect short sales in Covered Securities as a result of an assignment following exercise by the holder of the call.

¹ SEC Rel. No. 34-58572 (Sep. 17, 2008).

² SEC Rel. Nos. 34-58592, 34-58591 and 34-58588 (Sep. 18, 2008).

- require persons subject to a Form 13F filing requirement to disclose most short selling activity entered into on or after September 22 in securities subject to Form 13F reporting (“Section 13(f) securities”) on new Form SH (“Filing Order”);⁵ and
- expand a safe harbor for issuers, allowing the issuers to more easily repurchase their own shares, which can be “an important source of liquidity during times of market volatility.”

Q. When do the orders expire?

A. The Original Order expires at 11:59 p.m. EDT on October 1, 2008. The other orders, including the Financial Firms Order and the Filing Order, expire at 11:59 p.m. EDT on October 2, 2008. The SEC has the authority to extend (or reissue) each of the orders, which seems possible given the current unstable market environment.

Q. Has the SEC or its staff given any further guidance?

A. The SEC staff has provided a significant amount of additional guidance on the Original Order and the Filing Order, which is available on the SEC website.⁶

⁵ Form SH requires disclosure relating to daily short selling activity on a weekly basis. Filers may elect to make the EDGAR filings non-public for two weeks following the due date for the Form SH filing by making appropriate notations in the filing. There are exceptions for short sales on options that are Section 13(f) securities and for de minimis positions, defined as where the position: (i) constitutes less than one-quarter of one percent of that class of the issuer’s Section 13(f) securities as calculated pursuant to the Filing Order; and (ii) the fair market value of the short position in the Section 13(f) securities is less than \$1,000,000.

⁶ See 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 (Sep. 24, 2008), available at <http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm>; Guidance Regarding Temporary Rule 204T (Sep. 23, 2008), available at <http://www.sec.gov/divisions/marketreg/204tfaq.htm>; and Regulators Provide “Tips” to Broker-Dealers on Avoiding Failures to Deliver Securities (Sep. 18, 2008), available at <http://www.sec.gov/about/offices/ocie/bdguidance.htm>.

Q. Does the Financial Firms Order apply both to equity and debt securities or just to equity securities?

A. There was some question as to the reach of the Financial Firms Order before it was amended. As amended, the Financial Firms Order makes clear that it applies only to the “publicly traded common equity securities” of the affected financial firms. Preferred and debt securities (including convertible preferred and debt) are excluded from the prohibition since they are not Covered Securities.

Q. Does the Financial Firms Order significantly impede the operation of registered 130/30 funds or other funds? If so, should sticker supplements for such funds be considered?

A. An adviser may find it advisable to sticker the prospectus of a 130/30 fund if: (i) the fund takes sizable short positions in Covered Securities as a part of its investment strategy and (ii) the adviser anticipates that the Financial Firms Order will impede the fund’s investment objective and strategies and potentially adversely affect the fund’s performance. In fact, some funds have already stickered their prospectuses. That being said, the Financial Firms Order currently is in effect only until October 2, 2008 (although the term of the order may be extended), so funds with no anticipated near-term need to enter into short sales of Covered Securities in furtherance of their investment objective and strategies may decide that they do not need to sticker.

Q. How broad is the ban on shorting Covered Securities? Is it an outright ban or is it a ban on net short positions?

A. The Financial Firms Order is an outright ban on short selling Covered Securities and is not necessarily intuitive for portfolio managers thinking in terms of economic exposure. The order indicates that all persons (not just institutional money managers) are prohibited from engaging in short sales with respect to any Covered Securities of the financial firms designated by the national securities exchanges. In this regard, the SEC has adopted the definition of “short sale” in Rule 200(a) of Regulation SHO for purposes of determining what should be considered to be a “short sale” for purposes of the Financial Firms Order. Rule 200(a) of Regulation SHO defines the term “short sale” to mean “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”

Accordingly, any sale of a Covered Security where the seller is not deemed to “own” the security or has consummated the sale with borrowed securities would be a prohibited short sale for purposes of the Financial Firms Order. Regulation SHO defines a person as “owning” a security in a manner that is not necessarily the same as being “long” with respect to the security. Thus, money managers will need to be especially vigilant about their positions to avoid being tripped up by the peculiarities of the prohibition.

For example, for purposes of the Financial Firms Order, a person will be deemed to own a Covered Security for which the person holds a convertible or exchangeable security only if the person has tendered the security for conversion or exchange. Likewise, a call option to purchase or acquire a Covered Security must be exercised before the owner of the call option will be considered to “own” the security. In addition, a person will be deemed to own a Covered Security that is the subject of a long security futures position only if the person has been notified that the position will be physically settled and is irrevocably entitled to receive the security. Moreover, a person must be net long in a security to be considered to “own” the security and then only to the extent the person is net long.

Q. Is it necessary to unwind existing short positions in Covered Securities for purposes of the Financial Firms Order, or just not add to them?

A. The Financial Firms Order applies to short selling Covered Securities. It uses the definition of “short sale” found in Rule 200(a) of Regulation SHO, which (as indicated above) defines a “short sale” to be “any *sale* of a security which the seller does not own or any *sale* which is consummated by the delivery of a security borrowed by, or for the account of, the seller” (emphasis added). Therefore, the prohibition is on the “sale” of the Covered Security to be sold short as opposed to the resulting economic exposure caused by the sale. As a result, the Financial Firms Order does not appear to require the unwinding of short positions already held.

Q. Have fund families stopped lending securities?

A. We are not aware of any current guidance by the SEC or its staff regarding how the SEC orders would affect the securities lending practices of fund families. We understand, based on press coverage, that some fund families have stopped lending their portfolio securities out of concerns regarding the uses to which borrowers may put the borrowed securities and/or how the Original Order and Financial Firms Order may apply in the context of securities lending.

Q. Have the prohibitions of the Financial Firms Order affected investors’ ability to trade in single stock futures?

A. No. In this regard, OneChicago—a futures exchange specializing in single-stock futures—has made an announcement that it is conducting trading as usual with respect to investors who wish to trade in single stock futures.

Q. Under the Financial Firms Order, is it permissible to short an index that may include Covered Securities, through (for example) shorting an exchange-traded fund?

A. It would be permissible to do so, as long as the short sale is accomplished by entering into a short position with respect to a security or instrument that is not covered by the order. In other words, shorting shares of exchange-traded funds (“ETFs”) tracking indexes containing Covered Securities would not appear to be prohibited by the Financial Firms Order.

Q. Are syndicate shorts, index, and convertible arbitrage transactions covered by the SEC orders?

A. We understand that the SEC staff has advised that syndicate shorts are not prohibited by the Financial Firms Order. In addition, the SEC has stated that it is aware that the orders present issues for those who effect index and convertible arbitrage transactions and is considering whether and how to address those transactions.

Q. Is it permissible to purchase a put option on a Covered Security?

A. The Financial Firms Order does not prohibit purchasing a put on a Covered Security, although the purchaser must use care not to exercise the put in a way that could be deemed to be a short sale (e.g., by exercising the put and delivering a borrowed security). It is important to recognize that there is some uncertainty in this area.

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This update was authored by Jane A. Kanter (+1 202 261 3302; jane.kanter@dechert.com), Elliott R. Curzon (+1 202 261 3341; elliot.curzon@dechert.com), David A. Vaughan (+1 202 261 3355; david.vaughan@dechert.com), and Frederick H. Sherley (+1 704 339 3151; frederick.sherley@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Karen L. Anderberg

London
+44 20 7184 7313
karen.anderberg@dechert.com

Peter D. Astleford

London
+44 20 7184 7860
peter.astleford@dechert.com

Margaret A. Bancroft

New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber

Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier

New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm

Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian

Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon

Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick

Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Peter Draper

London
+44 20 7184 7614
peter.draper@dechert.com

Jennifer O. Epstein

London
+44 20 7184 7403
jennifer.epstein@dechert.com

Ruth S. Epstein

Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin

Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming

Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox

Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox

Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

Richard Frase

London
+44 20 7184 7692
richard.frase@dechert.com

David M. Geffen

Boston
+1 617 728 7112
david.geffen@dechert.com

John Gordon

London
+44 20 7184 7524
john.gordon@dechert.com

David J. Harris

Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Richard L. Heffner

London
+44 20 7184 7665
richard.heffner@dechert.com

Robert W. Helm

Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Andrew Hougie

London
+44 20 7184 7373
andrew.hougie@dechert.com

Paul Huey-Burns

Washington, D.C.
+1 202 261 3433
Paul.huey-burns@dechert.com

Jane A. Kanter

Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon

Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

Stuart Martin

London
+44 20 7184 7542
stuart.martin@dechert.com

George J. Mazin

New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy

Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon

Boston
+1 617 728 7111
john.ohanlon@dechert.com

Jeffrey S. Poretz

Washington, D.C.
+1 202 261 3358
jeffrey.poretz@dechert.com

Jon S. Rand

New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson

Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson

Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat

Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Kevin P. Scanlan

New York
+1 212 649 8716
kevin.scanlan@dechert.com

Frederick H. Sherley

Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley

Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo

Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan

Washington, D.C. / New York
+1 202 261 3355 / +1 212 698 3652
david.vaughan@dechert.com

Anthony H. Zacharski

Hartford
+1 860 524 3937
anthony.zacharski@dechert.com



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