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A legal update from Dechert's Financial Services Group

SEC and FSA Clamp Down on Short Selling of Financial Firms

October 3 Supplement[1]

As they had previously announced, the U.S. Securities and Exchange Commission ("SEC") and the UK Financial Services Authority ("FSA") have released further regulations designed to limit short selling of financial firms and increase market transparency and liquidity.

In the *DechertOnPoint* published on September 18, 2008, we discussed the emergency order the SEC issued on September 17, 2008, adopting a new temporary rule imposing restrictions designed to curb naked short selling and the resulting delivery failures and a new anti-fraud rule applicable to short sellers who fail to deliver securities by the delivery dates (the "September 17 Order").[2] We also reported that the FSA had agreed to introduce new requirements to prohibit the active creation or increase of net short positions in publicly quoted financial companies from midnight September 18, 2008.

In this *DechertOnPoint*, we discuss three further emergency orders issued by the SEC on September 18, 2008, as amended by the SEC on September 21, 2008, and subsequently extended, and expand on the FSA's short selling limitations announced on September 18, 2008, including further require-ments issued on September 23, 2008, and amended informal guidance issued by the FSA on September 26, 2008.

United States

On September 18, 2008, the SEC released three further emergency orders to increase market transparency and liquidity. According to the SEC press release, the SEC, "acting in concert with" the FSA, took these temporary actions to prohibit short selling in financial companies "to protect the integrity and quality of the securities market and strengthen investor confidence." On September 21, 2008, the SEC released technical amendments to two of those orders.

Ban on Short Selling "Covered Securities"

The first of the three emergency orders imposes a ban on short selling in the securities of financial institutions (the "Financial Firms Order").[3] This action follows an SEC emergency order issued in July limiting short sales in

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1 This *DechertOnPoint* supersedes the *DechertOnPoints* of the same title published on September 19, September 22, September 24, September 26, and October 2, 2008, and speaks as of 12:00 PM EDT on October 3, 2008. Further changes may be made without notice as market and regulatory events continue to unfold. The version of this *DechertOnPoint* available here will be the most up-to-date version available at the time it is viewed. You should not rely on this *DechertOnPoint* without first checking online for further updates.

2 *See DechertOnPoint* (Dechert LLP), September 2008, Issue 23.

3 *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,* SEC Rel. No. 34-58592 (Sept. 18, 2008).

Fannie Mae, Freddie Mac, and 17 other financial firms.[4] In the Financial Firms Order, the SEC explained that "[r]ecent market conditions have made [the SEC] concerned that short selling in the securities of a wider range of financial institutions may be causing sudden and excessive fluctuations of the prices of such securities in such a manner so as to threaten fair and orderly markets." The SEC also states that the recent sudden price declines in a wide range of securities "can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence, without a fundamental underlying basis. This crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences."[5]

The SEC amended the original Financial Firms Order on September 21, 2008, in order to "ensure the continued smooth operation of orderly markets, and to coordinate to the extent possible with similar actions restricting short sales by foreign regulators." The discussion below includes the details of the Financial Firms Order as revised by the amending order released on September 21.[6]

To prevent substantial disruption in the securities markets, the Financial Firms Order (as amended) temporarily prohibits any person from effecting a short sale in the publicly traded common equity securities of any issuer identified by any U.S. national securities exchange listing such securities as being a financial institution (each a "Covered Security" and collectively, "Covered Securities"). Each national securities exchange has published a list on its website of the individual listed companies with common equity that will be covered by the Financial Firms Order (as amended), and these lists are expected to include banks, savings associations, broker-dealers, investment advisers, and insurance companies, whether domestic or foreign, and the owners of any of those entities.[7] The national securities exchanges are authorized to exclude any issuers that do not want to be treated as a Covered Security under the Financial Firms Order (as amended).

The Financial Firms Order (as amended) includes five limited exceptions to the prohibition on short selling:

- registered market makers, block positioners, and other market makers obligated to quote in the over-the-counter markets are excepted from the requirements where they are selling short a Covered Security as part of a bona fide market making in that security;
- persons that effect a short sale in any Covered Security as the result of automatic exercise or assignment of an equity option, or in connection with settlement of a futures contract, held prior to the effectiveness of the Financial Firms Order (i.e., September 18, 2008) due to the expiration of an option or futures contract will be excepted;
- writers of call options that effect a short sale in any Covered Security as a result of assignment following exercise by the holder of the call;
- persons that effect a sale pursuant to Rule 144 of the Securities Act of 1933, as amended, in a Covered Security; and
- market makers, including over-the-counter market makers, are excepted from the Financial Firms Order (as amended) when selling short as part of bona fide market making and hedging activities related directly to bona fide market making in (a) derivative securities based on Covered Securities, or (b) exchange traded funds and exchange traded notes of which Covered Securities are a component, *provided, however*, that the market maker may not effect a short sale in the Covered Security if:
  - The customer or counterparty position in a derivative security based on a Covered Security is established after 12:01 AM EDT on September 22, 2008; and
  - 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., through actual positions, derivatives or otherwise) in the issued share capital of a firm covered by the Financial Firms Order (as amended).

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4 *See DechertOnPoint* (Dechert LLP), July 2008, Special Alert.

5 *Id.*

6 *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Rel. No. 34-58611 (Sept. 21, 2008).

7 The lists for the New York Stock Exchange and NASDAQ can be found at www.nyse.com/about/listed/1222078675703.html and www.nasdaqtrader.com/content/newsalerts/2008/regulatoryalerts/nq_ss_092208.xls, respectively.

Market makers relying on the fifth exception listed above, are required to, as soon as operationally possible, publish a notice on their website, that pursuant to the Financial Firms Order (as amended), the market maker may not knowingly effect a short sale as part of bona fide market making and hedging activity related to bona fide market making in a derivative security based on a Covered Security, if the customer's or counterparty's transaction will result in the customer or counterparty establishing or increasing an economic net short position (i.e., through actual positions, derivatives or otherwise) in the issued share capital of a firm covered by the Financial Firms Order (as amended).

In imposing the market maker requirements in the fifth exception, the SEC noted in the press release accompanying the amendments to the Financial Firms Order that the technical amendments incorporate concepts included on the limitations on increasing net short positions imposed by the FSA, but the SEC also notes that the requirements are not identical to those imposed by the FSA.

The Financial Firms Order became effective immediately upon its release on September 18, 2008, and it will remain in effect through the *earlier* of:

- three business days from the President's signing of the Economic Stabilization Act of 2008 (H.R. 1424); or
- 11:59 PM EDT on October 17, 2008.[8]

Disclosure of New Short Positions

The SEC's second emergency order issued on September 18 requires certain institutional investment managers to report information concerning daily short sales of securities (the "Disclosure Order").[9] The Disclosure Order applies to all institutional investment managers that exercised investment discretion with respect to accounts holding section 13(f) securities[10] having an aggregate fair market value on the last day of trading of any month of any calendar year of a least US$100,000,000, and that were required to file a Form 13F for the calendar quarter ended June 30, 2008.

Form SH, which is to be filed electronically on the SEC's EDGAR system, requires disclosure, for each calendar day of the prior week, of the following information in regards to each section 13(f) security:

- number of securities sold short;
- value of securities sold short
- opening short position;
- closing short position;
- largest intraday short position; and
- the time of the largest intraday short position.

Positions that are not required to be filed on Form SH include:

- Short positions in options; and
- Short positions constituting less than 0.25% of the class of the issuer's section 13(f) securities[11] and is less than US$1,000,000.

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8 *Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Rel. No. 34-58723 (Oct. 2, 2008).

9 *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,* SEC Rel. No. 34-58591 (Sept. 18, 2008). The Disclosure Order was subsequently amended by the SEC on September 21, 2008. *Amendments to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Rel. No. 34-58951A (Sept. 21, 2008). All references to the Disclosure Order in this *DechertOnPoint* are to the Disclosure Order as amended by the SEC on September 21.

10 Section 13(f) securities are generally U.S. equity securities traded on a U.S. exchange and/or certain other securities such as:

- ADRs;
- convertible or debt securities;
- swaps and other derivatives if these transactions result in an investment manager exercising investment discretion over the underlying which is a traded US equity security; and
- put and call options to the extent that they appear on the SEC's list of reportable securities.

Each quarter a complete list of section 13(f) securities is available at www.sec.gov/divisions/investment/13flists.htm.

11 The percentage is to be calculated based on the issuer's issued and outstanding equity securities as reported on the issuer's most recent annual or quarterly report, and any current report subsequent thereto, filed with the SEC pursuant to the Securities Exchange Act of 1934, as amended, unless the manager knows or has reason to believe the information contained therein is inaccurate.

Form SH only requires disclosure for short sales effected after the Disclosure Order became effective at 12:01 AM EDT on September 22, 2008, with the first Form SH disclosure to be filed on September 29, 2008.

No filing will be required when no short sales of a section 13(f) security have been effected since the previous filing of a Form SH.

The SEC has released a set of questions and answers regarding the disclosure requirements that should assist managers needing to file a Form SH.[12]

Although the SEC stated previously that it would make the disclosures on Form SH public two weeks after they were due, the SEC has now determined that Forms SH filed under the Disclosure Order, including those that were filed on September 29, 2008, will remain nonpublic to the extent permitted by law without the filer needing to submit a confidential treatment request.[13]

The Disclosure Order will expire at 11:59 PM EDT on October 17, 2008, but the SEC intends to continue these disclosure requirements without interruption in the form of an interim final rule.

Relaxation of Limitations on Issuers Repurchasing Their Own Securities

The third emergency order was designed to provide flexibility to issuers conducting repurchases of their own securities pursuant to the safe harbor under Rule 10b-18 of the Securities Exchange Act of 1934, as amended ("Repurchase Order").[14] The Repurchase Order alters the timing and volume conditions in Rule 10b-18 by suspending the timing provisions in paragraphs b(2)(i), (b)(2)(ii) and (b)(2)(iii) under the Rule and providing that the volume of purchases may not exceed 100% of the ADTV for the security. According to the SEC, the purpose of the Repurchase Order is to "give issuers more flexibility to buy back their securities, and help restore liquidity during this period of unusual and extraordinary market volatility." The Repurchase Order became effective at 12:01 AM EDT on September 19, 2008, and will expire on October 17, 2008.

United Kingdom

With effect from 12:01 AM on September 19, 2008, the FSA implemented new requirements prohibiting new or increased short positions in any publicly-traded UK bank, UK insurer, or any other UK-incorporated company that heads a financial services group with a UK bank or insurer as a member.[15] The new requirements also compel disclosure of any pre-existing short position in such companies that represent a net economic interest of 0.25% or more of the company's issued capital. They were approved by the FSA board on September 18 using emergency powers, and their text was published only a few hours before coming into effect.

These measures follow similarly structured requirements imposed in June 2008—also using emergency powers—to require disclosure of short positions of 0.25% or more in UK listed companies involved in a rights issue.[16]

As with the June short selling measures, the requirements form part of the FSA's Code of Market Conduct and represent the FSA's opinion that such short positions constitute market abuse.

Prohibitions of Short Positions

The requirements prohibit the establishment (or the increase) of any net short positions in relevant UK financial sector companies.

Because the requirements were adopted under a domestic part of the FSA's market abuse regime (i.e., not a part of the market abuse regime implementing the European Market Abuse Directive), they can apply only to companies with shares admitted to trading on a "prescribed market," which for these purposes means a market operated under the rules of a UK Recognized

12 *Division of Corporate Finance, Division of Investment Management, and Division of Trading and Markets Guidance Regarding the Commission's Emergency Order Concerning Disclosure of Short Selling*, available at www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm.

13 *Amendment to Order and Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Rel. No. 34-58724 (Oct. 2, 2008).

14 *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, SEC Rel. No. 34-58588 (Sept. 18, 2008).

15 The FSA instruments regarding these requirements may be viewed at http://fsahandbook.info/FSA/handbook/LI/2008/2008_50.pdf and at http://fsahandbook.info/FSA/handbook/LI/2008/2008_51.pdf.

16 *See DechertOnPoint* (Dechert LLP), June 2008, Issue 9.

FSA Code of Market Conduct (MAR 1)

MAR 1.9.2CE – Short selling in relation to financial sector companies

(1) A person who enters into a transaction that (whether by itself or in conjunction with other transactions) has the effect of:

(a) creating a net short position in a UK financial sector company; or

(b) increasing any net short position in a UK financial sector company that the person had immediately before September 19, 2008;

is, in the opinion of the FSA, engaging in behavior that is market abuse (misleading behavior).

(2) Paragraph (1) does not apply to a person acting in the capacity of a market maker.

(3) Paragraph (1) does not apply to a transaction entered into or an order placed before September 19, 2008.

(4) This provision ceases to have effect on January 16, 2009.

MAR 1.9.2DE – Disclosure of pre-existing positions

(1) Failure by a person who has a disclosable short position in a UK financial sector company to provide adequate ongoing disclosure of their position is behavior which, in the opinion of the FSA, is market abuse (misleading behavior).

(2) In paragraph (1), "adequate ongoing disclosure" means disclosure made on a RIS by no later than 3:30 PM on the business day following each day on which the disclosable short position is held. The disclosure must include the name of the person who has the position, the amount of the position and the name of the company in relation to which it has that position.

(3) The first disclosure required under this provision is by 3:30 PM on September 23, 2008 which should relate to positions held on September 19 and September22.

(4) This provision ceases to have effect on January 16, 2009.

Investment Exchange ("RIE"). Although non-UK companies listed on an RIE would generally fall within the FSA's market abuse regime, the new short selling requirements' definition of "UK financial sector company" limits its application to (a) UK incorporated banks, (b) general insurers with their head office in the UK, and (c) other UK incorporated companies with such a UK bank or insurer as a subsidiary where the main business of the group is financial services. The FSA has issued a list, compiled on a "best efforts" basis, of companies it believes are currently covered by the new requirements.[17]

The prohibition only applies to "net short positions" in relevant companies. This is defined to include any form of economic interest that gives rise to a short economic exposure to the issued capital of a relevant company. The FSA has indicated that this extends to any instruments giving rise to a direct or indirect exposure to the issued capital of a company and will include depository receipts and derivative instruments such as contracts for differences, spread bets, futures, and options.

The FSA considers capital to include stock. An economic exposure to an index, exchange traded fund (ETF) or basket of securities where the predominance of the components is UK financial sector companies must also be included in calculating any net short position.

In respect of an investment manager's or authorized fund manager's compliance with the new prohibitions, the FSA has issued the following guidance:

> Where an investment manager manages on a non-discretionary basis, both the short selling prohibition and disclosure requirements apply to the client. . . .
>
> Where an investment manager manages on a discretionary basis and where client positions are segregated from the investment manager and from each other in one or more accounts, the prohibition applies at the level of the individual clients.
>
> Where an authorized fund manager or investment manager manages collective investment schemes on a discretionary basis, the prohibition applies at the fund level. Where the fund in question is an umbrella fund with a number of sub-funds, the prohibition applies at the sub-fund level.

The new prohibition excludes any transactions entered into and orders placed before September 19. They also exempt short positions by persons acting in the capacity of a market maker.

Disclosure of Short Positions

The disclosure obligations fall on a holder of a "disclosable short position," meaning any "net short position" (calculated as above) that represents an economic

[17] The list is available at http://www.fsa.gov.uk/pages/Library/Policy/Handbook/short-selling.shtml.

interest of 0.25% or more of the issued capital of a relevant UK financial sector company.

Where an investment manager or authorized fund manager manages discretionary client portfolios containing relevant short positions, the disclosure obligation applies at the level of both the entity to which the prohibition applies and at the level of the investment manager or authorized fund manager. However, the discretionary fund manager may make a net short position disclosure on behalf of its client. In respect of itself, the investment manager or authorized fund manager is required to disclose its aggregate net short position across all of the funds it manages on a discretionary basis. Where a disclosure by an investment manager or authorized fund manager is the same as that being made for its client/fund/sub-fund, it is permitted to make a single disclosure provided that the disclosure makes it clear that it applies to both parties.

In the case of non-discretionary or advisory clients, the disclosure obligation will fall on the individual client. The investment manager may make a net short position disclosure on behalf of its client, but this disclosure must clearly identify that it is the client who holds the disclosable position.

Where the disclosure obligation applies, the holder is required to make "adequate ongoing disclosure," which means an announcement on the Regulatory Information Service ("RIS") no later than 3:30 PM on the business day following each day on which the disclosable short position (0.25%) is held. The RIS announcement must include: the name of the person that holds the disclosable short position; the name of the issuer of the relevant securities; the disclosable short position; and the date of the disclosable short position.

Once a holder's relevant net short position falls below 0.25%, a final disclosure of that fact is also required.

Expiration of the Requirements

In implementing these new short selling requirements, the FSA amended the Code of Market Conduct without the public consultation process and cost-benefit analysis normally required in the Financial Services and Markets Act 2000. In so doing, the FSA was relying on emergency powers to make changes where there is an urgent need. Perhaps for these reasons, the new requirements will expire on January 16, 2009. Even if this expiration date were not provided, the FSA's market abuse powers under which these requirements are based are themselves scheduled to expire on December 31, 2009.

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