



## New Restrictions on Short Sales; Disclosure Requirements for Short Sales and Positions; and Relaxed Issuer Repurchase Requirements

On September 18, the SEC issued a series of emergency orders to address short sales and reporting of short positions.

### Prohibition on Short Selling of “Included Financial Firms”

Short selling refers to a sale of a security that the seller does not own and that is consummated by the delivery of a security borrowed by, or on behalf of, the seller. Short selling can be a legitimate investment tool; however, short selling also can magnify and accelerate downward pressure on securities and is subject to manipulative actions (such as circulating rumors intended to drive the price lower). On September 17, 2008, the SEC issued new rules regarding short selling, which are meant to rein in “naked short sales,” wherein the seller sells short securities without borrowing, or arranging to borrow, the subject securities (see our News Bulletin on the SEC’s new short sale rules: <http://www.mofo.com/news/updates/files/080917ShortSell.pdf>).

On September 18, 2008, the SEC issued an emergency order prohibiting short selling<sup>1</sup>, as opposed to “naked short selling,” of publicly traded securities<sup>2</sup> of 799 companies, each classified as an “Included Financial Firm”<sup>3</sup> (the “Financial Firm Emergency Order”). The Financial Firm Emergency Order includes the following limited exceptions:

- “registered market makers, block positioners<sup>4</sup>, or other market makers<sup>5</sup> obligated to quote in the over-the-counter market, in each case that are selling short a publicly traded security of an Included Financial Firm as part of bona fide market making in such security”; and

<sup>1</sup> The Financial Firm Emergency Order makes reference to Regulation SHO for the definition of “short sale and related requirements for marking order “long” or “short.”

<sup>2</sup> The Staff of the SEC has confirmed informally that the only securities covered by the Financial Firm Emergency Order are those ticker symbols referenced in the order. The Staff has also informally confirmed that the order does not apply to preferred stock, convertible debt or corporate bonds. The Staff has acknowledged that there are other companies that have been inadvertently omitted (and will work with the exchanges to create a more complete list) and there have been published reports of other companies that are actively seeking or may actively seek to be added to the list given the nature of their businesses.

<sup>3</sup> <http://www.sec.gov/rules/other/2008/34-58592.pdf>

<sup>4</sup> We believe the definition of “block positioner” intended by SEC is contained in Rule 3b-8(c): “The term “Qualified Block Positioner” means a dealer who

- 1) is a broker or dealer registered pursuant to section 15 of the Act,
- 2) is subject to and in compliance with Rule 15c3-1,
- 3) has and maintains minimum net capital, as defined in Rule 15c3-1 of \$1,000,000 and

- short sales that result from the automatic exercise or assignment of equity options held prior to the effectiveness of the order due to expiration of such options.

The Financial Firm Emergency Order was immediately effective and terminates at 11:59 p.m. on October 2, 2008, unless extended by the SEC. However, in view of options expiring on September 20, 2008, options market makers were exempt from the requirements until 11:59 on September 19 when “selling short as part of bona fide market making and hedging activities related directly to bona fide market making in derivatives on the publicly traded securities of any Included Financial Firm.”

On September 18, 2008 the UK’s Financial Services Authority (“FSA”) issued rules prohibiting the creation or increase of short positions in publicly traded financial companies. (See below for an additional discussion of the new FSA rules as well as our News Bulletin on the FSA’s new short sale rules: <http://www.mofo.com/news/updates/files/080919UKNewShort.pdf>). The Financial Firm Emergency Order and the FSA action differ in significant respects.

On September 19, 2008, the SEC’s Division of Trading and Markets issued a statement indicating that it would recommend to the Commission a modification of the Financial Firm Emergency Order to “extend, for the life of the order, the exemption for hedging activities by exchange and over-the-counter market makers in derivatives on the securities covered by the order. This exemption is consonant with short position restrictions of the U.K. Financial Services Authority.”

#### *Uncertainty for Derivatives, Structured Products and Convertibles Markets*

As noted above, the FSA issued rules prohibiting the creation or increase of short positions in publicly traded financial companies. The FSA’s approach differs from the SEC’s approach in that the SEC order targets **short sales** while the FSA targets **short positions**. The SEC’s approach would permit synthetic short positions (by pairing a long call with a short put position) *provided* there were no *actual* short sales involved in establishing the synthetic short. The FSA, meanwhile, permits the sale of borrowed shares provided there is no establishment or increase in a net short position.

While the Financial Firm Emergency Order was clearly a reaction to an emergency situation, its unintended effects on the derivatives, structured products and convertibles markets, unless modified or clarified, could be profound. For instance:

- Given the ambiguity of the Financial Firm Emergency Order, it is unclear what remedies are available under the terms of the industry standard documentation published by the International Swaps and Derivatives Association (“ISDA”) (i.e., does the order constitute a “change in law” or a “hedging disruption”). Unlike over-the-counter derivatives, which rely on standard ISDA documentation, structured products often do not contain standard clauses permitting the unwinding of transactions in the event of a material change of law (such as the order);

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- 4) except when such activity is unlawful, meets all of the following conditions:
- he engages in the activity of purchasing long or selling short, from time to time, from or to a customer (other than a partner or a joint venture or other entity in which a partner, the dealer, or a person associated with such dealer, as defined in section 3(a)(18) of the Act, participates) a block of stock with a current market value of \$200,000 or more in a single transaction, or in several transactions at approximately the same time, from a single source to facilitate a sale or purchase by such customer,
  - he has determined in the exercise of reasonable diligence that the block could not be sold to or purchased from others on equivalent or better terms, and
  - he sells the shares comprising the block as rapidly as possible commensurate with the circumstances.

<sup>5</sup> We believe the definition of “market maker” intended by the SEC can be found in Section 3(a)(38) of the Exchange Act: “The term “market maker” means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.”

- The order does not appear to exclude bona fide hedging by market makers or block positioners in order to accommodate client orders;
- Usually derivatives dealers acting in connection with their corporate and private wealth derivatives business would not define themselves as “market makers” in the context in which the term “market maker” is used in the order;
- The order would appear to cover convertible arbitrage, and, therefore, prohibit the simultaneous purchase of a convertible security and the short sale of the underlying security as a hedge; and
- The order would appear to limit certain hedging activities by issuers of structured products in order to respond to or manage market changes in the referenced assets or reference securities.

### New Reporting Requirements for Short Sales by Institutional Investment Managers

The second emergency order put into place new reporting requirements for institutional investment managers that exercise investment discretion over at least \$100 million of securities subject to reporting on Form 13F pursuant to the requirements of Section 13(f) of the Securities Exchange Act of 1934 (the “Exchange Act”), calculated on the last trading day of any calendar month (the “Short Sale Reporting Emergency Order”).<sup>6</sup> Institutional investment managers meeting these requirements and who conduct short sales of Section 13(f) securities must file new Form SH via the SEC’s EDGAR system to report detailed information regarding the securities sold short.<sup>7</sup> Form SH will be due on the first business day of every calendar week following a week in which short sales were executed. However, in the event a manager does not effect short sales during a particular week, no Form SH is required to be filed. Furthermore, short sales effected prior to the effective date of the Short Sale Reporting Emergency Order are not required to be reported. The Short Sale Reporting Emergency Order exempts reporting of short positions in Section 13(f) securities which represent less than 0.25% of the class of the issuers’ Section 13(f) securities issued and outstanding (as reported by the issuer in filings made with the SEC (such as quarterly reports on Form 10-Q and annual reports on Form 10-K) unless the institutional investment manager has reason to believe the reported information is wrong), and which have a minimum market value less than \$1 million. The Short Sale Reporting Emergency Order became effective at 12:01am on September 22, 2008 and terminates at 11:59pm on October 2, 2008, unless extended by the SEC. The first Form SH will be required to be filed on September 29, 2008.

In the UK, the FSA has been considering similar issues since last fall. Outside of a formal offer period in respect of the shares of a public company, in the UK the holder of a cash-settled derivative position, or contract for difference (“CFD”), in respect of a share listed on a UK regulated market or prescribed market is not obliged to disclose its interest publicly, so long as it has no enforceable right to acquire the share, nor to control the voting rights in respect of that share.<sup>8</sup> Following public consultation on three alternative approaches, the FSA issued a policy update on July 2, 2008 announcing its decision to adopt a general disclosure regime whereby the CFD holder is obliged to disclose its interest to the issuer company where the referenced shares reach or exceed 3% of its total issued shares (or 5% in the case of listed shares in a non-UK company), aggregating such long CFD position with its physical shareholdings. CFD writers, acting purely as intermediaries and providing liquidity, will be exempted from the disclosure regime. The FSA is due to release the draft rules for technical and drafting comments in late September 2008, with a view to publishing the final rules in February 2009.

<sup>6</sup> <http://www.sec.gov/rules/other/2008/34-58591.pdf>

<sup>7</sup> Number and value of securities sold short for each Section 13(f) security, except for short sales in options, and the opening short position, closing short position, largest intraday short position, and the time of the largest intraday short position, for that security during each calendar day of the prior week.

<sup>8</sup> A right to acquire listed shares, or to acquire voting rights in respect of listed shares, of at least 3% (for shares in a listed UK company) or 5% (in respect of a listed non-UK company) obliges the holder to notify such interest to the share issuer under the UK’s Disclosure and Transparency Rules (“DTR”), which implement the EU Transparency Directive.

## Temporary Loosening of Safe Harbor Requirements for Issuer Repurchases

The third emergency order suspends certain requirements associated with an issuer repurchase of its securities (the “Issuer Repurchase Emergency Order”). The Issuer Repurchase Emergency order temporarily suspends certain requirements of Rule 10b-18 under the Exchange Act that provide a safe harbor from an issuer repurchase being deemed manipulative. Specifically, the order suspends the timing conditions of Rule 10b-18(b)(2)(i) – (iii), which ordinarily restrict repurchases that are: (i) the opening purchase; (ii) effected during the 10 minutes prior to the scheduled closing of trading (for companies meeting the minimum volume and float requirements of Rule 10b-18(b)(ii)); or (iii) effected during the 30 minutes prior to the scheduled closing of trading (for less actively traded companies). In addition, the order raises the minimum volume condition of Rule 10b-18(b)(4), which typically eliminates from coverage by the safe harbor purchases by the issuer on a single day in excess of 25% of the securities’ average daily trading volume (“ADTV” as defined by Rule 10b-18), to 100% of ADTV. The Issuer Repurchase Emergency Order was effective at 12:01am on September 19, 2008 and will terminate at 11:59pm on October 2, 2008 unless extended by the SEC.

## New FSA prohibition on creation or increase of short positions in publicly traded financial companies.

On June 13, 2008 the FSA published Short Selling Instrument 2008<sup>9</sup>, which became effective on June 20, 2008 and amended the FSA’s Code of Market Conduct to require disclosure of certain types of short selling during rights issues.

This Instrument was issued by the FSA as an emergency method of stabilizing the market in the shares of UK listed companies, particularly banks and building societies, currently undergoing rights issues. The FSA was concerned that short-selling of such shares, while not in itself an abusive practice, creates opportunities for certain parties to engage in market abuse (such as circulating rumors intended to drive the share price lower), and, therefore, concluded that the market needs to be aware of which parties are engaging in short selling in the context of a rights issue.

Under the new rules, as clarified by the FSA’s Frequently Asked Questions (“FAQs”) 20th June 2008 Update<sup>10</sup>, a holder of a “disclosable short position” (*i.e.*, a net short position representing an economic interest of 0.25% or more of the issued capital of a company whose shares are admitted to trading on a UK regulated or prescribed market) during a rights issue period must make a public disclosure of its position in the prescribed manner. Failure to make “adequate disclosure” will render the short-selling a “market abuse” under the Financial Services and Markets Act 2000 (“FSMA”), either as “misleading behaviour” under section 118(8)(a) of FSMA or as a “distortion” under section 118(8)(b) of FSMA. For this purpose, an “economic interest” includes any instrument which gives the holder “an exposure, whether direct or indirect, to the shares” of the company (excluding shares held in a market maker capacity). Therefore, the disclosure obligation covers short positions under options and other derivative instruments referencing the shares, as well as shorting the shares themselves.

For the disclosure to be adequate, it must be made by means of an announcement, through an FSA-approved Regulatory Information Service (“RIS”), by 3.30pm (London time) on the next business day following the date on which a disclosable short position is obtained and must include the name of the holder, details of its disclosable short position and the name of the issuer of the shares.

On September 18, 2008, the FSA again amended the Code of Market Conduct, by Short Selling (No 2) Instrument 2008<sup>11</sup>, to prohibit the “active creation or increase of net short positions” in UK publicly traded financial

<sup>9</sup> [http://fsahandbook.info/FSA/handbook/LI/2008/2008\\_30.pdf](http://fsahandbook.info/FSA/handbook/LI/2008/2008_30.pdf)

<sup>10</sup> [http://www.fsa.gov.uk/pubs/other/Shortselling\\_faqs.pdf](http://www.fsa.gov.uk/pubs/other/Shortselling_faqs.pdf)

<sup>11</sup> [http://www.fsa.gov.uk/pubs/handbook/instrument2\\_2008\\_50.pdf](http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf)

companies. The FSA also has published a list of the banks and insurers covered by the new rules<sup>12</sup> as well as related FAQs.<sup>13</sup> While the FSA has indicated that the new rule only applies to UK “financial sector companies,” it “stands ready to extend this approach to other sectors” if necessary. (See our News Bulletin on the FSA’s new short sale rules: <http://www.mofo.com/news/updates/files/080919UKNewShort.pdf>.)

In addition, beginning on Tuesday, September 23, the FSA will require daily disclosure of *all* net short positions in excess of 0.25% of the ordinary share capital of the relevant companies held as of the close of the market on the prior day, whether or not the companies are conducting a rights issue. The new rules will remain in effect until January 16, 2009, although the FSA has indicated that they will be reviewed after 30 days.

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<sup>12</sup>[http://www.fsa.gov.uk/pubs/handbook/list\\_instrument200850.pdf](http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf)

<sup>13</sup>[http://www.fsa.gov.uk/pubs/other/short\\_selling\\_faqs.pdf](http://www.fsa.gov.uk/pubs/other/short_selling_faqs.pdf)