

U.S. and U.K. Regulators Adopt New Short Selling Rules to Address Market Turmoil

Over the last 24 hours, both the U.S. Securities and Exchange Commission (“SEC”) and the U.K. Financial Services Authority (“FSA”) have adopted historical changes to the manner in which the short selling of securities is conducted. A week of market turmoil in both countries has led to a series of provisions prohibiting certain conduct and significantly increasing the amount of reporting and disclosure that is required.

U.S. Developments

This morning, the SEC announced that it is suspending short selling in the stock of 799 financial institutions. The SEC acted pursuant to its emergency powers under Section 12k of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), in light of the significant drop in the stock prices of numerous financial institutions during the current financial crisis.

The SEC expressed concern that the market fluctuations of prices generally and the current disruption in the markets could threaten fair and orderly markets. Similarly, the SEC issued an order that requires institutional investment managers to report information regarding daily short sales of securities. Only yesterday, the SEC issued an order banning “naked” short selling.

Ban on Short Selling of Financial Stocks

The SEC’s order prohibits any short selling of publicly traded securities of any Included Financial Firm. The order provides a limited exception to registered market makers, block positioners, and other market makers obligated to quote in the over-the-counter market, provided they are selling short a publicly traded security of any Included Financial Firm as part of a market making in a security.

The SEC also allows any person to make a short sale of the equity of any Included Financial Firm as a result of automatic exercise or assignment of an equity option held prior to September 19, 2008 upon its expiration.

The order is effective immediately. The order is temporary and expires on October 2, 2008, unless extended by the SEC.

For a list of Included Financial Firms, see Exhibit A at the following link:
<http://www.sec.gov/rules/other/2008/34-58592.pdf>.

Reporting by Institutional Money Managers of New Short Sales

The SEC also ordered that institutional investment managers¹ that exercise investment discretion with respect to accounts holding “section 13(f) securities”² having an aggregate value on the last trading day of any month of at least \$100,000,000 must file a new form with the SEC. Any institutional investment manager that has filed or was required to file a Form 13F for the quarter ended June 30, 2008 under section 13(f) of the Exchange Act and Rule 13f-1(a) thereunder must file “Form SH” with the SEC on the first business day of each week immediately following a week in which it effected a short sale after September 19, 2008. It is unclear how institutional investment managers that were filers prior to, or become filers after June 30, 2008, but may not have filed for the quarter ended June 30, 2008 and were not required to file, will be treated by the SEC.

¹ In general, an “institutional investment manager” is: (i) an entity that invests in, or buys and sells, securities for its own account; or (ii) a person or an entity that exercises investment discretion over the account of any other person or entity. Institutional investment managers can include investment advisers, banks, insurance companies, broker-dealers, pension funds, and corporations.

² “Section 13(f) securities” shall mean equity securities of a class described in section 13(d)(1) of the Exchange Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. In determining what classes of securities are section 13(f) securities, an institutional investment manager may rely on the most recent list of such securities published by the SEC pursuant to section 13(f)(3) of the Exchange Act.

Form SH will be publicly available and will disclose the 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 day of the prior week. No Form SH disclosure is required if: (i) the short position in the section 13(f) securities constitutes less than 0.25% of the class of the issuer's section 13(f) securities issued and outstanding; and (ii) the value of the short position in the section 13(f) securities is less than \$1,000,000.

The order was effective immediately and expires on October 2, 2008, unless extended by the SEC.

Ban on Naked Short Selling

Yesterday, the SEC adopted a new temporary rule requiring that short sellers and their broker-dealers deliver securities by the close of business within T+3 ("Close-Out Requirement") and imposing penalties for failure to do so.

If a short sale violates the Close-Out Requirement, 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. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales for any customer. The order was effective yesterday and expires on October 1, 2008, unless extended by the SEC.

Short Selling Anti-Fraud Rule

The SEC enacted Rule 10b-21, which expressly targets fraudulent short selling transactions. The new rule covers short sellers who deceive broker-dealers or any other market participants. Specifically, the new rule makes clear that those who commit fraud with respect to their intention or ability to deliver securities in time for settlement are in violation of the Exchange Act when they fail to deliver such securities.

U.K. Developments

Yesterday, the FSA announced that it would be introducing new provisions to its Code of Market Conduct to prohibit the active creation or increase of net short positions in publicly quoted financial companies from midnight on that day. It also announced that from Tuesday, September 23, it would require daily disclosure of all net short positions in excess of 0.25% of the ordinary share capital of such companies held at market close on the previous day (and, in relation to the disclosure on September 23, on September 19 also). No further details of the changes were given at that time, other than that they would remain in force until January 16, 2009 and that a "comprehensive review" of short selling would be published in January.

This morning, before the London markets opened, the FSA published the details of their proposals. Under the changes, a person who enters into a transaction that creates a net short position in a U.K. financial sector company, or increases such a position that was held immediately before September 19, 2008, is in the FSA's opinion engaging in market abuse, unless the person concerned is a market-maker, or the transaction was entered into or the order was placed before September 19. "U.K. financial sector company" is defined as a U.K. bank, U.K. insurer or U.K. parent of either, and "net short position" includes any form of economic interest in the shares of a company. The changes take the form of amendments to MAR 1.9.2 and consequential changes to the Glossary.

The FSA has published a list of the companies affected, which can be found at the following link:
http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf.

The disclosure provisions are similar to the disclosure provisions for short positions in shares which are the subject of a rights issue that the FSA introduced in June this year. If a person has a net short position of 0.25% or more in a U.K. financial sector company, it must be disclosed to the market via a regulatory information service by 3:30 p.m. on the following business day. As with short selling generally, a failure to disclose will, in the FSA's opinion, constitute market abuse.

Questions and answers addressing the new rules can be found on the FSA Web site:
http://www.fsa.gov.uk/pubs/other/short_selling_faqs.pdf.

Conclusion

Both the SEC and the FSA have acted quickly to adopt their new short selling regulatory regime, and many questions from market participants and observers remain unanswered.

Investors and market participants should be cautious in assessing these rules and the possible regulatory implications with respect to current trading activities. These orders may significantly curb short selling, and also increase costs and transparency of short selling.

The FSA's move has come as a surprise, particularly as its chief executive, Hector Sants, was publicly saying as recently as Wednesday that short selling had a legitimate role to play in the markets. The new FSA view appears to be that short selling is still a "legitimate market technique," but only "in normal market conditions." One interesting question is whether, in the next bull market, the regulators will take a similar step, now that a precedent has been set. It is also worth noting that, though market conditions are currently not "normal" from the viewpoint of the FSA, the FSA seems content for persons to continue to short other types of shares, including shares of companies operating elsewhere in the financial services industry. Interestingly, the FSA's press release yesterday contained a hint that it might extend the short selling prohibition to other sectors if it judged that necessary.

Many observers may claim that these moves by the SEC and the FSA wrongly attempt to put the blame for the current market turbulence on the short sellers, rather than on those who presided over the structure that allowed the turbulence to develop, and on those institutions whose business models have been all too clearly exposed as inadequate to survive the current conditions.

For now, however, the primary focus of market participants will most likely be on implementing the necessary changes to their daily compliance and reporting regimes to ensure that they are not in violation of these new requirements.

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