News Bulletin

September 29, 2008

SEC Clarifies Short Sale Restrictions and Related Disclosure Requirements

In an effort to address continuing market volatility, the SEC issued a series of emergency orders to limit short sales and require reporting of short positions. Please see our September 22, 2008 Client Alert.[1] Given the speed with which these emergency orders were issued and the questions raised regarding their implementation, the SEC has since issued additional interpretive guidance to assist in the compliance with these new regulatory requirements.

Prohibition on Short Selling of "Included Financial Firms"

On September 18, 2008, the SEC issued an emergency order prohibiting short selling[2], as opposed to "naked short selling," of the publicly traded securities of 799 companies, each classified as an "Included Financial Firm" (the "Financial Firm Emergency Order"), subject to certain noted exceptions.

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 p.m. 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 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."

On September 21, 2008, the SEC issued an amendment to the Financial Firm Emergency Order. Among other things, the amendment extended and expanded for the life of the Financial Firm Emergency Order certain exclusions, including:

- market makers, including over-the-counter market makers, that effect short sales as part of bona fide market making and hedging activity related directly to bona fide market making in (1) derivative securities based on Covered Securities, or (2) exchange traded funds and exchange traded notes of which Covered Securities are a component, *provided, however*, that if a customer or counterparty position in a derivative security based on a Covered Security is established after 12:01 a.m. on September 22, 2008, a market maker may not effect a short sale in a Covered Security if the market maker knows that the

[1] http://www.mofo.com/news/updates/files/080922NewRestrictions.pdf
[2] The Financial Firm Emergency Order makes reference to Regulation SHO for the definition of "short sale" and related requirements for marking orders "long" or "short."

customer's or counterparty's transaction will result in the customer or counterparty establishing or increasing an economic net short position (though actual positions, derivatives, or otherwise) in the issued share capital of an Included Financial Firm;

- short sales that occur as a result of automatic exercise or assignment of equity options and short sales that occur as a result of the expiration/settlement of futures contracts, in each case held prior to the effectiveness of the Financial Firm Emergency Order;
- short sales effected by the writers of call options resulting from assignment following exercise by the holder of the call; and
- sales of Covered Securities pursuant to Rule 144 of the Securities Act of 1933.

The amendment confers the authority to designate companies as Included Financial Firms to the principal securities exchanges where the securities are traded. This change resulted in a number of additional companies being added as Included Financial Firms. The amendment also gives any firm included as an Included Financial Firm the ability to opt out of inclusion. The amendment clarifies that "Covered Securities" include only publicly traded common equity securities of such Included Financial Firms.

New Reporting Requirements for Short Sales by Institutional Investment Managers

On September 18, 2008, the SEC issued an emergency order implementing 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").[3] Institutional investment managers meeting these requirements and who conduct short sales of Section 13(f) securities[4] must file new Form SH via the SEC's EDGAR system to report detailed information regarding the securities sold short.[5] 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 Emergency Reporting 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 is required to be filed on September 29, 2008.**

On September 21, 2008, the SEC issued an amendment to the Short Sale Reporting Emergency Order.[6] The amendment makes certain technical changes to the Form SH and clarified that Forms SH, which must be filed using the SEC's EDGAR system, will not be made publicly available until two weeks after submission.

On September 24, 2008 the SEC's Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets issued guidance regarding the preparation and filing of Form SH in the form of 18 Frequently Asked Questions (the "FAQ's")[7]. We expect that, despite the helpful information provided in the FAQs, the SEC will likely issue additional guidance, whether formally or informally, in order the clarify the requirements associated with the reporting of short positions.

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[3] http://www.sec.gov/rules/other/2008/34-58591.pdf
[4] The terms "Section 13f securities" has the meaning set forth in Rule 13f-1(c).
[5] 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.
[6] http://www.sec.gov/rules/other/2008/34-58591a.pdf
[7] http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm

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