SEC ISSUES EMERGENCY ORDER AND ANNOUNCES OTHER ACTIONS TO RESPOND TO MARKET CRISIS

Introduction

Surprises continue to flow from the Securities and Exchange Commission ("SEC") in its efforts to battle perceived problems related to "naked short selling" and current volatility in the financial markets. Rather than issuing orders to adopt proposed rules and an unusual "interim final rule," as previously announced in a press release on the morning of September 17, 2008,[1] the SEC took the even more extraordinary step of issuing an emergency order later in the day to adopt rules on a temporary basis ("September Emergency Order").[2] The SEC's order is effective from 12:01 a.m. on September 18, 2008 until 11:59 p.m. on October 1, 2008, unless extended for a total maximum of 30 days. This is only the third time that the SEC has used its emergency powers in Section 12(k) of the Securities Exchange Act of 1934 ("Exchange Act"), and the first time that the authority has been used to adopt rules on a temporary basis.

In addition, on September 18, Chairman Cox and Linda Thomsen, the Director of the Division of Enforcement, issued a press release announcing (1) that Chairman Cox will ask the SEC to consider on an emergency basis a new disclosure rule to require hedge funds and other institutions to disclose their short positions in securities, and (2) an expansion of the SEC's ongoing investigations of possible market manipulation focussed on significant hedge funds and other institutional traders.[3]

These actions go beyond the SEC's previously issued emergency order ("July Emergency Order"), which was limited to the securities of 19 financial firms with access to the Federal Reserve's Primary Dealer Credit Facility.[4] The September Emergency Order enhances transaction settlement delivery requirements on sales of all equity securities. The SEC intends these temporary rules to impose powerful disincentives to market participants who might otherwise exacerbate artificial price movements through naked short selling. However, the rules and other prospective actions will have a significant impact on all market participants.

We discuss these actions below.

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1 SEC Press Release No. 2008-204 (Sept. 17, 2008).

2 SEC Release No. 34-58572 (Sept. 17, 2008).

3 SEC Press Release No. 2008-209 (Sept. 17, 2008).

4 SEC Release No. 58166 (July 15, 2008). *See SEC Emergency Order on "Naked" Short Selling*, Willkie Farr & Gallagher LLP Client Memorandum (July 18, 2008), available at www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2668%5CSEC_Emergency_Order_On_Naked_Short_Selling.pdf. The Order was amended on July 18, 2008. Securities Exchange Act Release No. 58190 (July 18, 2008) ("Amendment"). *See SEC Issues Amendment to Emergency Order and Publishes Staff Guidance*, Willkie Farr & Gallagher LLP Client Memorandum (July 21, 2008), available at www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2670%5CSEC_Issues_Amendments_to_Emergency_Order.pdf.

Temporary Rule 204T of Regulation SHO imposes a "hard" T+3 delivery requirement on all sales of equity securities and a "penalty" for failing to settle trades. The temporary rule, which was not previously issued for public comment, is not a model of clarity. The September Emergency Order states that it is designed to impose a "penalty" on any participant ("participant") of a registered clearing agency ("clearing agency"), and any broker-dealer from which the participant receives trades for clearance and settlement, for having a fail to deliver position at a registered clearing agency. The rule contains two obligations: (1) a participant must deliver securities to a registered clearing agency by settlement date (normally, three business days after the trade date, or T+3) on a long or short sale of an equity security; and (2) if a participant has a fail to deliver position at a clearing agency in an equity security, the participant "shall, by no later than the beginning of regular trading hours on the next settlement day [T+4], immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity." Special provisions relate to long sales, where the period for making purchases to close out a fail position is extended for three additional settlement days (T+6); and to sales of restricted securities pursuant to Rule 144 under the Securities Act of 1933, where the closeout purchases must be made after the fail position is outstanding for 35 settlement days (T+39).

If a participant does not close out a fail to deliver position as required above, the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker, may not accept a short sale order in the equity security from another person or effect a short sale for its own account (if the broker-dealer submits its short sales to the participant for clearance and settlement) without first borrowing the security, or entering into a bona-fide arrangement to borrow the security ("preborrow requirement'), until the participant has closed out the fail position and the purchase has cleared and settled at a clearing agency. The participant must advise the broker-dealers for which it clears and settles trades when the participant has a fail to deliver position that has not been immediately closed out (thus triggering the preborrow requirement), and when the purchases to close out the fail position have cleared and settled (thereby terminating the preborrow requirement).

On September 18, 2008, the SEC published "tips" from the staffs of the SEC's Trading and Markets Division and the Office of Compliance Inspections and Examinations, and self-regulatory organizations, to assist broker-dealers in preventing failures to deliver.[5]

Observations

1. The obligations imposed by this temporary rule apply only to fails to deliver that result from trades effected after the September Emergency Order became effective, *i.e.*, 12:01 a.m. on September 18, 2008.

2. This rule is not limited to short positions in "threshold securities,"[6] but applies to long and short sales in any equity security.

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[5] "Regulators Provide 'Tips' for Broker-Dealers on Avoiding Failures to Deliver Securities" (Sept. 18, 2008), available at http://sec.gov/about/offices/ocie/bdguidance.htm ("Staff Tips").

[6] Regulation SHO, which became effective in 2005, is largely concerned with preventing failures to deliver securities at the time of trade settlement. The regulation includes various measures to avoid failures to deliver and corrective steps if failures to deliver in certain securities (called "threshold securities") are relatively large and persistent.

3. If action is taken immediately to close out a fail to deliver, it may be closed out by either purchasing or borrowing the security. This is different from the general closeout provisions in Regulation SHO, which require fails to be closed out only by purchases of securities. Moreover, for purchases, compliance is achieved on the trade date of the purchase, not on the the settlement date.

4. The preborrow requirement continues until all closeout purchases are settled at a clearing agency.

5. This rule can be expected to have negative effects on market makers if their short sales become subject to a preborrow requirement.

6. We believe that, during the pendency of the September Emergency Order, the prudent course for traders may be to preborrow securities, with the possible exception of "easy to borrow" securities. Moreover, as a result of this rule, clearing firms possibly may impose a preborrow requirement on their customers.[7]

Amendments to Rule 203(b)(3) of Regulation SHO that eliminate the options market maker exception from Regulation SHO's close-out requirement. This rule eliminates the options market maker exception from the close-out requirement of Rule 203(b)(3)(ii) in Regulation SHO. This means that options market makers will be treated in the same way as all other market participants, and required to abide by the hard T+3 settlement requirement of Rule 204T. The rule requires options market makers to close out previously exempted fail positions by purchasing securities within 35 settlement days of the effective date of the amendment. If the position is not closed out within that time, the preborrow requirements apply until the position is closed out.

Observations

1. Options market makers repeatedly commented on the SEC's proposal to eliminate their closeout exception that its removal would adversely affect their ability to hedge options positions, and therefore their ability and willingness to act as options market makers.

2. The amendment leaves in place the exception from the "locate" provision for market makers in Rule 203(b)(2)(ii) of Regulation SHO.

Rule 10b-21 prohibits deception in connection with securities sales. The SEC adopted Rule 10b-21, which targets sellers that misrepresent their intention or ability to deliver securities to make timely settlement of their trades. This rule covers long and short sellers who deceive broker-dealers, a participant, or a purchaser. The preliminary note to the rule states that the rule does not limit or restrict the applicability of the general antifraud provisions of the securities laws, such as Rule 10b-5 under the Exchange Act.

[7] *See also* Staff Tips, n.5 above. Consideration also must be given to Federal Reserve Board Regulation T, however. Under Section 220.10(a) of Regulation T, a broker-dealer may borrow securities in anticipation of a short sale or fail transaction up to one standard settlement cycle in advance of the trade date.

Observation

Rule 10b-21 as proposed received considerable comment relating to the necessity for the rule and pointing out interpretive ambiguities.[8] The text of the rule as adopted makes nonsubstantive changes to the proposed rule, with the exception that the rule has been clarified to limit it to equity securities.

Short position reporting proposal. Chairman Cox has stated that he will ask the SEC to consider a new disclosure rule on an emergency basis requiring hedge funds and other investors that manage $100 million or more in securities to disclose their short positions. This is apparently an analogue of a combination of the reports required under Sections 13(d) and (f) of the Exchange Act. As described by Chairman Cox, the position reports would be public, and would disclose daily short positions.

Observations

1. We understand that the reporting rule would be temporary, and would require periodic (*e.g.*, weekly) reports of daily short positions.

2. The SEC may be considering an exception from reporting for *de minimis* short positions.

3. By limiting the reporting obligation to managers with $100 million or more in securities, the rule may allow the managers to utilize processes and procedures that they have in place to report long positions under Section 13(f).

Expanded investigations focusing on manipulation. The SEC Division of Enforcement has announced that it is undertaking a series of additional measures against market manipulation. "The Enforcement Division will obtain disclosure from significant hedge funds and other institutional traders of their past trading positions in specific securities. Those institutions will also be required immediately to secure all of their communication records in anticipation of subpoenas for these records."

Observations

1. In general, market participants that are not registered with the SEC are not required to maintain records for any length of time, and many firms have established procedures for retention and disposition of records.

2. We do not believe that the SEC staff statement imposes any affirmative obligations on firms that have not received a request for documents from the SEC staff or have otherwise learned of a pending or likely request. However, firms considering any changes to their recordkeeping procedures should carefully consider the SEC's interest and expectations as stated by Director Thomsen, and should consider consulting with counsel.

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[8] *See* SEC Release No. 34-57511 (Mar. 17, 2008), 73 Fed. Reg. 15376 (comment letters in File No. S7-08-08).

Concluding Observations

These temporary measures will challenge firms from business, regulatory, and operational perspectives. We can expect the SEC to implement these rules on a permanent basis before the expiration of the September Emergency Order. Moreover, the short position disclosure rule is likely to be implemented on an emergency basis very soon, and large trading firms can expect detailed requests for records from the SEC staff. Finally, it is likely that this is not the end of the SEC's efforts to deal with the current market turmoil. The SEC frequently consults with the United Kingdom Financial Services Authority ("FSA") on regulatory matters. On September 18, 2008, the FSA introduced two significant rules. The FSA banned the creation or increase of net short positions in publicly quoted financial stocks as of midnight on that date, and will require daily disclosure beginning on September 23, 2008 of all net short positions in excess of 0.25 percent of an issuer's ordinary share capital. These rules are expected to be in effect until January 16, 2009. We will continue to advise on further developments.

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