September 22, 2008

SEC Issues Emergency Orders on Short Selling and Announces Expanded Market Manipulation Investigation

Late last week and over the weekend, in response to recent and increasing tumultuous market volatility, the Securities and Exchange Commission ("SEC") took emergency action to further regulate and temporarily prohibit certain short sale activities in public company securities by:

- completely prohibiting short sales of securities, initially in 799 designated public financial institutions but then amended by the SEC to cover those "banks, saving associations, broker-dealers, investment advisers, and insurance companies, whether domestic or foreign," designated by any national securities exchange listing such financial institutions,
- requiring institutional money managers (including some private fund managers) currently filing Schedule 13Fs with the SEC to report new short sales of most publicly traded securities weekly, and
- strengthening protections against "abusive naked short selling."[1]

The SEC also announced an expansion of its ongoing investigation into market manipulation of financial institutions' public securities.

Prohibition on Short Selling Securities of Public Financial Institutions

In light of last week's market turmoil, the rapid collapse of several financial institutions' stocks, the continuing pressure on many other financial institutions' stocks and increasing criticism of SEC inaction, the SEC issued an emergency order initially prohibiting short selling in securities of 799 designated public financial institutions. The SEC then determined that the short-selling ban should instead cover the securities of those "banks, savings associations, broker-dealers, investment advisers, and insurance companies, whether domestic or foreign," designated by each national securities exchange listing the securities. The SEC directed each such exchange to immediately publish a list on the exchange's website of such institutions. A financial institution is permitted to opt-out of such designation, in which case short sales of its securities would not be covered by the ban.

A short sale is defined as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Very limited exceptions allow short sales by certain market makers and in connection with market making and market intermediary hedging activities.

The prohibition is effective through October 2, 2008, unless extended by the SEC.

Reporting of Short Sales by Certain Institutional Investment Managers

The SEC also adopted an emergency order requiring institutional investment managers, including private fund managers, currently filing quarterly reports under Section 13(f) of the Securities Exchange Act of 1934 — which requires an institutional investment manager (e.g., an investment adviser, a private fund manager or a trust company) exercising investment discretion over at least $100 million (but excluding certain control positions in companies) of SEC designated Section 13(f) securities to file quarterly reports of such securities with the SEC — to file on a weekly basis a new Form SH, with the SEC for short sales effected during the preceding week. Form SH — which remains non-public for a period of two weeks after filing if designated as non-public by the investment manager in the filing — requires certain disclosures, including:

- disclosure of the number and value of Section 13(f) securities sold short (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.

However, the order contains an exception for reporting small short positions that otherwise would be reportable if both: (1) all of the institutional investment manager's short positions in a Section 13(f) security aggregates to less than 0.25% of the issuer's Section 13(f) securities issued and outstanding and (2) the fair market value of the aggregate short positions is less than $1,000,000.

This order is effective on September 22, 2008, and the first Form SH must be filed on September 29, 2008. The order is effective through October 2, 2008, unless extended by the SEC.

"Abusive Naked Short Sales" Protections

The SEC also issued an order directed at "abusive naked short selling," i.e., a short sale in which the seller does not actually borrow the securities and also fails to deliver the securities to the buyer. The order temporarily imposes a hard close-out requirement (i.e., a securities delivery requirement) for short sellers and their broker-dealers on the transaction settlement date (generally three business days after the short sale transaction date, or T+3) and penalties for failing to do so.

In addition, the order temporarily makes it a violation of the federal securities antifraud rules for any person to execute a short sale order if the person deceives a broker-dealer, market intermediary or purchaser about the short seller's delivery of the security on the settlement date (and such security is not so delivered).

This order is effective through October 1, 2008, unless extended by the SEC.

Expanded SEC Market Manipulation Investigation

The SEC also announced an expansion of its ongoing investigation into market manipulation in the securities of certain financial institutions. The expanded investigation requires hedge fund managers, broker-dealers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps to disclose, under oath, such positions to the SEC and provide certain other information. The SEC also approved a formal order of investigation allowing SEC enforcement staff to obtain additional documents and testimony by subpoena.

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1 The SEC also adopted an emergency order temporarily relaxing certain Rule 10b-18 timing conditions and volume limitations for a public company repurchasing its own securities during the current market conditions through October 2, 2008, unless extended by the SEC.

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact:

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