

FS Regulatory Briefs*

Short Sale Regulatory Developments

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Target Audience: Broker/Dealers, Asset Managers

On September 17, 2008, the SEC took decisive action that has been hinted at for weeks. It announced a formal crackdown on abusive short selling and market manipulation, giving the examination and enforcement staffs additional "weapons in their arsenal," according to Chairman Cox. Also on September 17th, Chairman Cox announced that the SEC is considering a new disclosure requirement for short positions. One day later on September 18th, the FSA took the extraordinary step of banning short selling of financial services companies and introduced new disclosure requirements.

Decisive Action

The specific actions go beyond the recent SEC emergency orders which applied temporary special rules to short sales of certain large financial services firms with access to the Federal Reserve's Primary Dealer Credit Facility. The new rules will apply to short sales of all publicly traded companies.

The SEC's actions can be summarized as follows:

- The Commission adopted, on an interim final basis, a new rule requiring that short sellers and their broker-dealers deliver securities by T+3 and imposing penalties for failure to do so. If a short sale fails to settle, then any broker-dealer acting on any customer's behalf will be prohibited from further short sales in the same security unless the shares are located and pre-borrowed. This rule will be effective immediately (beginning 9-18-08), but the Commission is seeking comment during a period of 30 days.
- The Commission eliminated the options-market maker exception for meeting the three-day settlement window. This amendment to Reg SHO would take effect five days after the rulemaking appears in the *Federal Register*. Thus options dealers would be treated as all other short-sale participants and naked short selling would be 100% banned in all circumstances.

- The Commission adopted Rule 10b-21, an anti-fraud rule focused on short sale traders. The new rule makes it explicitly illegal for short sellers to deceive broker-dealers or any other market participants by lying about their intention or ability to deliver securities in time for settlement. This rule also becomes effective immediately on 9-18-08.

New Disclosure Requirements

In addition to new short sale rules, Chairman Cox announced that the SEC will consider a new disclosure rule that would require hedge funds and other large investors with more than \$100 invested in securities to disclose their short positions. The Chairman noted that these managers "...would be required to promptly begin public reporting of their daily short positions." Market participants should note that this does not necessarily mean that this reporting will be required on a daily basis.

UK Bans Short Selling in Financial Companies

On September 18, 2008, the Financial Services Authority (FSA) in the UK announced that it will introduce new rules to prohibit the establishment or increase of net short positions in publicly traded financial companies, effective at midnight on the 18th. Additionally, starting September 23, the FSA will require a daily disclosure of all net short positions in excess of .25 percent of a stock. The FSA is also mandating the disclosure of such positions held at the close of trading on September 19th and on September 23rd. The FSA notes that it will extend this requirement to other sectors if necessary.

These provisions will remain in effect until January 2009, but the FSA will review them after 30 days. The FSA plans to publish a comprehensive review of the rules on short selling in January.

Broker Dealer Response

All broker-dealers and buy-side firms that participate in short-selling strategies should immediately review these SEC and FSA actions and take steps to build in compliance and reporting controls. Firms should closely monitor developments related to the SEC's consideration of a new disclosure rule.

Additional Information

We will continue to follow new developments in this area and update our clients as necessary. If you have questions about the topic discussed in this FS Regulatory Brief, please call:

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