

# Compliance Corner

## Adapting to the Regulatory Clamp Down on Short Selling: The Investment Manager's Perspective

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To date, the response of the Securities and Exchange Commission (the "SEC" or the "Commission") to the credit crisis has largely been directed at market manipulation through a combination of abusive short selling activities and false rumor mongering. In this respect, the SEC not only issued a new slate of short sale-related rules, but also launched sweeping investigations into the possible market manipulation of the securities of certain financial institutions. The U.S. Attorney's Office for the Southern District of New York, the New York Attorney General, Andrew Cuomo, and other state regulators have also launched investigations into market manipulation linked to short selling. These actions have required market participants to revise their compliance policies and supervisory procedures to reflect the substantive requirements of the new rules, and to take preventative steps to avoid the problematic activities identified by regulatory authorities. This article discusses these developments from the investment manager's perspective, and suggests possible compliance measures to address these issues.

### I. Reporting Requirements — New Rule 10a-3T Under the Securities Exchange Act of 1934 (the "Exchange Act") and Form SH

Pursuant to new interim final temporary Rule 10a-3T, effective October 18, 2008 until August 1, 2009, certain "institutional investment managers" are required to report on Form SH certain specified information concerning their short sales of and short positions in Exchange Act section 13(f) securities, other than options. The key elements of the rule are as follows:

**A. Institutional Investment Managers Required to Report.** An institutional investment manager who exercises investment discretion with respect to accounts holding section 13(f) securities is required to file Form SH if: (1) at the end of the most recent calendar quarter it was required to file a Form 13F for the quarter (*i.e.*, the manager exercised investment discretion with respect to accounts holding section 13(f) securities having an aggregate fair market value on the last trading day of any month of the prior calendar year of at least \$100,000,000), *and* (2) it effected a short sale in a section 13(f) security, other than options, during a Sunday to Saturday calendar week.

**B. Definitions of "Short Sales" and "Short Positions."** For purposes of Rule 10a-3T, "short sale" has the same meaning as under Rule 200 of Regulation SHO. A "short position" for purposes of Form SH is the aggregate gross short sales of an issuer's section 13(f) securities (other than options), less purchases to close out a short sale in the same issuer. It is not net of long positions. If a manager sells a security that was loaned to another person, and a *bona fide* recall is initiated within two business days of trade date, the sale should be treated as "long" for purposes of Form SH. Options and short sales of options are not reported on Form SH, except that the manager will have Form SH short sales if it (1) exercises a put option and is net short for purposes of Regulation SHO; or (2) effects a short sale as a result of assignment to it as a call writer, upon exercise.

**C. Public Availability of Information.** The SEC remains sensitive to concerns about additional, imitative short selling and will treat Forms SH as nonpublic "to the extent permitted by law." Filers do not need to submit a Freedom of Information Act (FOIA) confidential treatment request, but should instead label their reports as **NONPUBLIC** (in bold, capitalized letters) pursuant to the Form SH instructions.

**D. Exceptions to the Reporting Requirements.** An institutional investment manager is not required to report short sales and short positions if: (1) it has not effected any short sales of section 13(f) securities during the relevant reporting period; or (2) short positions or short sales are *de minimis*. For purposes of Form SH reporting requirements, *de minimis* means that (a) during the reporting period, the start of day short position, the gross number of securities sold short during the day, and the end of day short position constitute less than 0.25% percent of the class of the issuer's section 13(f) securities issued and outstanding, *and* (b) the fair market value of the start of day, the gross number of securities sold short during the day, and the end of day short position is less than \$10,000,000. The analysis is made on a per column and per day basis, and the manager may report "N/A" for any data element where the exception is available. Under Rule 10a-3T, managers are no longer able to exclude short positions attributable to short sales effected before September 22, 2008,

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subject to an optional two reporting period phase-in.

**E. Formatting Requirements; Required Information.** Beginning with the report for the calendar week ending November 1, 2008, certain information must be submitted in XML tagged data format with additional identification within the data file; *i.e.*, the date, the filer's CIK (Central Index Key), the identity and CUSIP number of the issuer, the short position at the start of the day, the number of securities sold short on that day, and the short position at the end of the day. The formatting requirements are intended to facilitate data analysis by the Commission staff. The report must contain a signature block for the person signing on behalf of the manager and additional information about the report type (see F, below) and managers covered.

**F. Three Form SH Reports.** Similar to Form 13F, there are three Form SH report types: *Form SH Entries Report* (used if all of the information an institutional investment manager is required to report is included in the Form SH filing), *Form SH Notice* (used if all of the information a manager is required to include is reported in another manager's report), and *Form SH Combination Report* (used if a portion of the manager's entries are filed in the manager's report and a portion are reported by another manager; the latter must be identified in the combined report).

**G. Timing.** Beginning with the report for the week ended October 18, 2008, Form SH is due on the last business day of the calendar week subsequent to a week in which reportable short sales were effected.

**H. Opportunity to Comment.** Comments are due to the Commission on a broad range of issues raised by Rule 10a-3T and Form SH by December 16, 2008. Among other issues, managers may wish to comment on: (1) possible public notice requirements if short sales or positions cross a specific "significant" threshold; (2) whether the SEC should harmonize its reporting requirements with those of other jurisdictions, particularly the United Kingdom; (3) potential additional disclosure regarding synthetic short transactions; (4) the appropriateness of the current reporting threshold and whether another standard be adopted; (5) the costs versus benefits of tracking and reporting all short positions; and (6) possible new books and records requirements.

To the extent still relevant, the SEC stated in the adopting release that institutional investment managers may look to the staff guidance relating to the September and October 2008 Emergency Orders regarding reporting short sales and positions on Form SH.

## **II. The "Naked" Short Selling Antifraud Rule — Exchange Act Rule 10b-21**

On October 14, 2008, the SEC adopted new Rule 10b-21, effective October 17, 2008, which is intended to address abusive "naked" short selling, which the Commission noted occurs when a seller of equity securities deceives its broker about its intention or ability to deliver the relevant securities on or before settlement date, and fails to deliver securities on or before settlement date.

Unlike Regulation SHO, Rule 10b-21 gives the SEC direct authority over short sellers who are not broker-dealers, although the SEC specifically stated that the rule does not impose any additional liability or requirements beyond those otherwise applicable under any Exchange Act rule. Nevertheless, sellers who knowingly or recklessly misrepresent to their broker that they own the securities being sold "long," or have obtained a locate for securities sold "short" expose themselves to liability for engaging in a "manipulative or deceptive device or contrivance" in violation of Exchange Act Section 10(b). Potential risk situations for investment managers include the ability to accurately determine long and short positions, and recklessly identifying locate brokers to executing brokers, such as by programming an execution management system to automatically populate the locate field with the market participant identifier of a prime broker without taking appropriate steps to obtain the required locate from the broker. A seller's good faith reliance on a broker's "easy to borrow" list to satisfy Regulation SHO's locate requirements does not violate Rule 10b-21.

The SEC confirmed that a private right of action exists under Section 10(b) and Rule 10b-5, and that if a plaintiff is able to prove the elements of a Rule 10b-21 violation, an actor in violation of Rule 10b-21 may face private litigation in addition to regulatory sanctions.

## **III. Parallel SEC and Criminal Investigations of Possible Market Manipulation**

On September 19, 2008, the SEC announced a "sweeping expansion" of its ongoing investigation of possible manipulative short selling in the equity securities of certain financial institutions by broker-dealers and hedge fund managers and other institutional investors. One of the most noteworthy aspects of the SEC's investigation is the requirement that respondents provide sworn statements regarding market positions, compliance with existing short sale

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rules, and details of all information shared or received about the financial institutions specified.

As noted above, other governmental agencies, including the U.S. Attorney's Office for the Southern District of New York and the New York State Attorney General, Andrew Cuomo, have launched similar investigations. As this article goes to print, the targets of these inquiries, primarily hedge funds and broker-dealers, continue to submit the required information, particularly communications, to the SEC. We understand the SEC staff will load the information into a database for collation and analysis—a process expected to prompt follow-on requests.

#### **IV. Compliance Steps for Investment Managers to Consider**

##### **A. Tracking Short Sales and Managing Locates**

- o Regularly inventory all accounts in which short sales are conducted and short positions are held;
- o Review processes for identifying whether sales are "long" or "short" when communicating with brokers;
- o Review procedures for recording locates and pre-borrows, consider when appropriate to borrow any securities *before settlement*, rather than simply entering into an agreement to borrow such securities;
- o Train relevant personnel on new requirements, including Rule 10b-21; and
- o Inventory stock borrowing agreements and monitor the performance of prime brokers and other securities lenders.

##### **B. Limiting Risks From False Rumors**

- o Review existing compliance policies, ensuring their clear prohibition of the initiation and circulation of rumors, and inclusion of appropriate attribution; update as appropriate;
- o Consider whether all or certain personnel should receive supplementary training on oral and written communications;
- o Train personnel on how to handle the receipt of rumors and other potentially problematic information. Encourage and sensitize personnel to raise their hands and not go it alone;
- o Review sales literature, advertisements, radio and television presentations, and similar presentations or public statements to ensure they include no misleading information, exaggeration, or rumor;
- o Spot check relevant emails, instant messages, chat rooms, bulletin boards, and other communications for suspicious terms. Review lexicons to determine if additional words or terminology should be included;
- o Consider the use of rumor lists for names that are the subject of rumors, and review the list as a spot check for suspicious trading in firm or personal accounts; and
- o Review trading surveillance protocols for inclusion of the securities of issuers who are the subject of rumors to detect potentially manipulative trading.

##### **C. Evidencing Overall Compliance Culture**

- o Document implementation of all steps taken to address these issues, including date, time, process, personnel, etc.; and
- o Update your written compliance procedures to reflect any changes made.

##### **D. Compliance with Document and Data Hold Requirements**

- o If you are the subject of an SEC 21(a) order or a government subpoena requiring that you secure records, review procedures to evaluate whether you have taken appropriate steps to encompass all communications, trading records, and other records that you are required to retain.

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