

Asset Management / Financial Institutions Advisory | November 2008

## Short Sale update: SEC extends emergency actions through temporary and final rulemaking; short selling ban expires

SEC enacts interim final temporary Rule relating to “close out” of failed settlements and requiring institutional investment managers to file Form SH disclosing short sale activity (but makes such filings nonpublic); amends Regulation SHO to eliminate the “options market maker” exception; provides guidance regarding the “market maker” exemption under Regulation SHO; and enacts final antifraud Rule 10b-21 relating to “naked” short selling.

### Introduction

On September 17 and 18, 2008, the U.S. Securities and Exchange Commission (the “SEC”) adopted three emergency orders<sup>1</sup> that implemented important but temporary steps relating to the regulation of short selling.<sup>2</sup> These steps were:

- A ban on the short selling of securities of certain enumerated financial institutions, which expired at 11:59 pm on October 8, 2008;<sup>3</sup>
- A requirement that certain institutional money managers file a weekly form (“Form SH”) disclosing short positions over a threshold amount;
- The creation of penalties for maintaining a fail-to-deliver position;
- The elimination of the “options market maker” exception to the close-out requirement found in SEC Regulation SHO; and
- The adoption of a new antifraud rule, 10b-21, prohibiting any person from deceiving a broker-dealer or purchaser about its intention or ability to deliver a security on the date that delivery is due.

<sup>1</sup> See Release 34-58572, “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments” (September 17, 2008) (the “September 17 Order”); Release 34-58591, “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments” (September 18, 2008) (the “Form SH Order”); and Release 34-58592, “Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments” (September 18, 2008) (the “Short Sale Ban Order”, and together with the September 17 Order and the Form SH Order, the “Emergency Orders”). The Emergency Orders are available on the SEC’s Internet website, [www.sec.gov](http://www.sec.gov).

<sup>2</sup> For more information regarding the SEC’s Emergency Orders, please see: “Emergency actions by the SEC prohibit short selling on stocks of financial institutions; require notice of short sales by institutional investment managers; adopt amendments to Regulation SHO; and adopt new ‘naked’ short sale antifraud rule; New York Attorney-General announces criminal and civil probe into short selling activity”, (September 2008), available at: [http://www.shearman.com/am\\_092208/](http://www.shearman.com/am_092208/). For more information regarding short selling and Regulation SHO generally, please see “SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules” (March 2005), available at: [http://www.shearman.com/cm\\_0305/](http://www.shearman.com/cm_0305/).

<sup>3</sup> For a summary of the extension and expiration of the Emergency Orders, please see “Short Sale Update: Emergency order banning the short selling of securities of certain financial institutions to expire” (October 2008), available at: [http://www.shearman.com/am\\_100808/](http://www.shearman.com/am_100808/). Notwithstanding the expiry of the Short Sale Ban Order, authorities around the world have taken action to prohibit or place restrictions on short selling. For more information regarding international developments, please see, “Global Clampdown on Short Selling: an Overview” (October 2008), available at [http://www.shearman.com/esag\\_102408/](http://www.shearman.com/esag_102408/).

On October 14 and 15, 2008, the SEC issued four releases<sup>4</sup> that extended each of the Emergency Orders (other than the Short Sale Ban Order, which has expired) in the form of interim temporary final rules, or, in the case of amendments to Regulation SHO and Rule 10b-21, final rulemaking. The net effect of these releases was to make permanent (or semi-permanent, as the case may be) all but one of the extraordinary actions that were commenced with the Emergency Orders.

In addition to the SEC actions discussed in this note, authorities around the world have taken action to prohibit or place restrictions on short selling, the effect of which should be considered by financial institutions.<sup>5</sup>

The remainder of this client publication summarizes the Close-Out Rule Release, the Form SH Release, the Regulation SHO Amendments and the Rule 10b-21 Release.

## Interim Final Temporary Rule 204T: "Close-Out" Rule

Summary: Rule 204T requires close out of fail-to-deliver positions

Rule 204T of Regulation SHO imposes a penalty on any "participant"<sup>6</sup> of a "registered clearing agency",<sup>7</sup> and any broker-dealer from which it receives trades for clearance and settlement, for having a fail-to-deliver position at a registered clearing agency in any equity security.

Specifically, Rule 204T(a) provides that any participant of a registered clearing agency must, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out the fail-to-deliver position by borrowing or purchasing securities of like kind and quantity.

### Exceptions from the close-out requirement

Rule 204T(a) further provides three exemptions to this requirement:

- Participants that can demonstrate on their books and records that such fail-to-deliver position resulted from a long sale must deliver securities of like kind and quality by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date;
- Participants that have failed to deliver positions in Rule 144 securities must deliver securities of like kind and quality by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date; and
- Participants that have failed to deliver securities in connection with bona fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market (each, a "Market Maker") must deliver securities of like kind and quantity by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date.

### Penalties for failure to comply with the close-out requirement

Rule 204T(b) provides that any participant and related broker-dealer who does not comply with the settlement rules discussed above (a) will be prohibited from accepting a short sale order in the equity security from another person, and (b) will be prohibited from effecting a short sale in the equity security for its own account, without first borrowing the security or entering into a bona-fide arrangement to borrow the related security. Rule 204T(b) also recognizes two exceptions to these prohibitions:

<sup>4</sup> See SEC Release 34-58773, "Amendments to Regulation SHO" (October 14, 2008) (the "Close-Out Rule Release"); SEC Release 34-58774, "Naked Short Selling Antifraud Rule" (October 14, 2008) (the "Rule 10b-21 Release"); SEC Release 34-58775, "Amendments to Regulation SHO" (October 14, 2008) (the "Regulation SHO Amendments"); and SEC Release 34-58785, "Disclosure of Short Sales and Short Positions by Institutional Investment Managers" (October 15, 2008) (the "Form SH Rule Release").

<sup>5</sup> For more information regarding international developments, please see, "Global Clampdown on Short Selling: an Overview" (October 2008), available at [http://www.shearman.com/esag\\_102408/](http://www.shearman.com/esag_102408/), and also "Financial Institutions in a Time of Global Market Turbulence" (October 2008), available at [http://www.shearman.com/esag\\_102108/](http://www.shearman.com/esag_102108/).

<sup>6</sup> A footnote in the Close-Out Rule Release reads: "The term 'participant' has the same meaning as in section 3(a)(24) of the Exchange Act."

<sup>7</sup> A footnote in the Close-Out Rule Release reads: "The term 'registered clearing agency' means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act."

- A broker or dealer who timely certifies to the participant that (a) it has not incurred a fail-to-deliver position on a settlement date for a long or short sale in an equity security for which the participant has a fail-to-deliver position at a registered clearing agency or (b) it is in compliance with the Broker-Dealer Buy-In Exemption discussed below; and
- A Market Maker that can demonstrate that it does not have an open short position in the equity security at the time of any additional short sales.

### Allocation and buy-in exceptions

Rule 204T(c) provides two exceptions to the settlement requirements of Rule 204T(a) and trade prohibitions of Rule 204T(b):

- A participant who reasonably allocates a portion of a fail-to-deliver position to another registered broker or dealer for which it clears trades or from which it receives trades for settlement, based on such broker's or dealer's short position, will not be subject to these requirements and prohibitions. Rather, the registered broker or dealer that was allocated the fail-to-deliver position must comply with Rule 204T(a) and (b).<sup>8</sup>
- A broker or dealer who purchases securities prior to the beginning of regular trading hours on the settlement day after the settlement date for a long or short sale to close out an open short position will not be subject to these requirements and prohibitions; provided, (i) the purchase is bona fide, (ii) the purchase is executed on, or after, trade date but by no later than the end of regular trading hours on settlement date for the transaction, (iii) the purchase is of a quantity of securities sufficient to cover the entire amount of the open short position, and (iv) the broker or dealer can demonstrate that it has a net long or net flat position on its books and

records in the relevant security on the settlement date (the "Broker-Dealer Buy-In Exemption").

Furthermore, Rule 204T(c) provides that any participant must notify any broker or dealer from which it receives trades for clearance and settlement, including Market Makers, of the existence of a fail-to-deliver position that has not been closed out in accordance with the rule. Rule 204T(d) requires a broker-dealer that has been allocated a portion of a fail-to-deliver position and does not close out the position in accordance with Rule 204T(a) must notify the participant that it has become subject to the penalties for failure to comply with the close-out requirement.

Rule 204T went into effect on October 17, 2008 and will terminate on July 31, 2009.

### How is Rule 204T, as adopted in the Close-Out Rule Release, different than as enacted in the September 17 Order?

Rule 204T, as adopted, provides for a number of exemptions that were not contemplated by Rule 204T as enacted by the September 17 Order:

- Rule 204T, as adopted, recognizes a Market Maker exemption from the settlement requirements of Rule 204T(a).
- Rule 204T, as adopted, contains two exemptions from its trade prohibitions: one for brokers and dealers who make certain certifications and one for Market Makers.
- Rule 204T, as adopted, provides for the Broker-Dealer Buy-In Exemption from its settlement requirements and trade prohibitions.

### Interim Final Temporary Rule 10a-3T: Mandatory Submission of Form SH

#### Summary of Rule 10a-3T as adopted

**Rule 10a-3T, as adopted, requires institutional investment managers that exercise "investment**

<sup>8</sup> A broker or dealer that has been allocated a portion of a fail to deliver position that does not comply with the settlement requirements of Rule 204T must immediately notify the participant that it has become subject to Rule 204T(b).

discretion”<sup>9</sup> with respect to accounts holding “section 13(f) securities”<sup>10</sup> having an aggregate fair market value on the last trading day of any month of any calendar year of at least \$100,000,000 to file a new form with the SEC. This new form, Form SH,<sup>11</sup> will be nonpublic and must be filed electronically with the SEC on the last business day of every calendar week immediately following a week in which the manager effected short sales.<sup>12</sup>

For each section 13(f) security sold short during the previous week, Form SH requires the following daily information:

- The date of the transaction;
- The institutional investment manager by EDGAR Central Index Key;
- The issuer name and CUSIP for the relevant securities;
- The start-of-day short position;
- The gross number of securities sold short during the day; and
- The end-of-day short position.

The Form SH Rule Release further provides the following exceptions from the filing requirement:

<sup>9</sup> According to Rule 10a-3T(a)(1), the term “investment discretion” has the same meaning as in Exchange Act Rule 13f-1(b). That Rule generally refers back to Section 3(a)(35) of the Securities Exchange Act of 1934, which states that “A person exercises ‘investment discretion’ with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.”

<sup>10</sup> According to Rule 10a-3T(a)(1), the term “section 13(f) securities” has the same meaning as in Exchange Act Rule 13f-1(c). That Rule states that Section 13(f) securities are “equity securities of a class described in section 13(d)(1) of the Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association”.

<sup>11</sup> A copy of Form SH can be found at: <http://www.sec.gov/about/forms/formsh.pdf>.

<sup>12</sup> According to Rule 10a-3T(a)(2), the term “short sale” has the same meaning as in Rule 200(a) of Regulation SHO.

- No disclosure is required for any period during which no short sales have been effected since the previous filing of a Form SH; and
- No disclosure is required where on each calendar day during the calendar week, (a) the start-of-day short position, the gross number of securities sold short during the day and the end-of-day short position each constitute less than one-quarter of one percent of the class of the issuer’s section 13(f) securities issued and outstanding as reported on the issuer’s most recent annual, quarterly or current report, unless the manager knows or has reason to believe the information contained therein is inaccurate, and (b) the fair market value of the start-of-day short position, the gross number of securities sold short during the day and the end-of-day short position each are less than \$10,000,000.

The following short sales need not be reported on Form SH:

- Where on any calendar day of the calendar week, (a) the start-of-day short position, the gross number of securities sold short during the day or the end-of-day short position in the section 13(f) security constitutes less than one quarter of one percent of that class of the issuer’s section 13(f) securities issued and outstanding as reported on the issuer’s most recent annual or quarterly or current report, unless the manager knows or has reason to believe the information contained therein is inaccurate, and (b) the fair market value of the start-of-day position, the gross number of securities sold short during the day or the end-of-day short position is less than \$10,000,000; provided the institutional money manager designates its reliance on this exception on the Form SH; and
- Where a broker or dealer seeks to execute a customer order, either in whole or in part, through a riskless principal transaction, and a short sale results from a sale order of a customer who is net long the section 13(f) security, or a purchase order of a section 13(f) security.

Rule 10a-3T went into effect on October 18, 2008 and will expire on August 1, 2009.

How is Rule 10a-3T, as adopted in the Form SH Rule Release, different than as enacted in the September 17 Order?

Rule 10a-3T, as adopted, differs from the September 17 Order in eight aspects:

- While the September 17 Order defined “short positions” as those resulting from short sales, Rule 10a-3T(a)(2) defines “short position” as the aggregate gross short sales of an issuer’s section 13(f) securities, excluding options, less purchases to close out a short sale in the same issuer. Further, Rule 10a-3T(a)(2) clarifies that the Form SH short position is not net of any long positions in the related issuer.<sup>13</sup>
- In contrast to the September 17 Order, which required Form SH to be filed on the *first* business day of the calendar week following a calendar week in which short sales are effected, Rule 10a-3T requires that Form SH be filed on the *last* business day of the calendar week.
- Rule 10a-3T does not require Form SH filers to disclose the value of the securities sold short, the largest intraday short position, and the time of day of the largest intraday short positions, all of which were required by the September 17 Order. Rather, Rule 10a-3T requires that Form SH filers disclose only the short position at the beginning of the day, the gross number of securities sold short during the day, and the short position at the end of the day.
- Unlike the September 17 Order, which did not require Form SH filers to report short sales effected prior to the effective date of the Order, Rule 10a-3T requires Form SH filers to report all short positions, including short positions effected prior to September 22, 2008.
- While the September 17 Order provided a \$1 million fair market value threshold for reporting

short sales or positions, Rule 10a-3T raises that threshold to a fair market value of \$10 million.

- Unlike the September 17 Order, which did not require such tagging, Rule 10a-3T, requires Form SH filers to submit an XML tagged data file to the SEC providing the requested data.
- In contrast to the September 17 Order which provided that Form SH was to be a public filing, Rule 10a-3T provides that the Form SH will be nonpublic to the extent permitted by law.
- While the September 17 Order did not provide for any such exemption, Rule 10a-3T contains an exemption for short sales effected by brokers or dealers through riskless principal transactions.<sup>14</sup>

Rule 10a-3T went into effect on October 18, 2008 and will expire on August 1, 2009.

### Amendment to Regulation SHO: elimination of the “options market maker” exemption

Under the Regulation SHO Amendments, Rule 203(b)(3) of Regulation SHO was amended to eliminate the options market maker exception from Regulation SHO’s close-out requirement. Under Regulation SHO as it existed prior to this amendment, the requirement under Regulation SHO to close out failed positions in certain “threshold” securities<sup>15</sup> did not apply to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on an options position that was created before the security became a threshold security. In 2007, the SEC proposed to eliminate this

<sup>13</sup> Rule 204T(a)(2) further states that if a person that has loaned a security to another person sells the security and a bona fide recall is initiated within two business days after trade date, the person that has loaned the security is deemed to own the security and such sale will not be treated as a short sale.

<sup>14</sup> According to the Form SH Rule Release, “a ‘riskless principal’ transaction is generally described as trades in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction. See Exchange Act Rule 10b-10(a)(2)(ii)(A) [17 CFR 240.10b-10(a)(2)(ii)(A)]; Release No. 34-33743 (Mar. 9, 1994) at n.11.”

<sup>15</sup> For more information regarding the “close out” requirements of Regulation SHO, or regarding Regulation SHO generally, please see “SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules” (March 2005), available at [http://www.shearman.com/cm\\_0305/](http://www.shearman.com/cm_0305/).

exception.<sup>16</sup> On September 18, 2008, as part of the Emergency Orders, the SEC eliminated the options market maker exception. On October 14, 2008, the SEC adopted a final Rule eliminating the options market maker exemption in the same form as proposed in the September 17 Order.

The Regulation SHO Amendments went into effect on October 17, 2008.

### Guidance regarding “market maker” exemption under Regulation SHO

The Regulation SHO Amendments also provide guidance as to what constitutes bona-fide market making for purposes of the “market maker”<sup>17</sup> exception to the “locate” requirement of Rule 203(b)(1) of Regulation SHO.<sup>18</sup> The SEC has stated that a market maker engaged in bona-fide market making is a “broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market.”<sup>19</sup> Examples of the types of activities that would indicate that a market maker is engaged in a bona fide market making include:

- Participation in transactions in which the market maker incurs economic or market risk with respect to the securities (e.g., by putting its own

capital at risk to provide continuous two-sided quotes in markets);<sup>20</sup>

- Engaging in a pattern of trading that includes both purchases and sales in roughly comparable amounts so as to provide liquidity to customers or other broker-dealers;<sup>21</sup> and
- Providing continuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers.

### Final Rule 10b-21: “Naked” short sale antifraud rule

Rule 10b-21 is an antifraud Rule that prohibits any person from intentionally deceiving a broker-dealer, or a buyer, as to the intention or ability of that person to deliver shares on the settlement date. This Rule is not intended to limit or restrict the applicability of the general antifraud provisions of the federal securities laws. Rule 10b-21 is notable in that it is an antifraud rule, and therefore requires an intent to deceive on the part of the person making the sale in order to establish a violation.

The full text of Rule 10b-21 is as follows:

It shall also constitute a ‘manipulative or deceptive device or contrivance’ as used in section 10(b) of this Act for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.

<sup>16</sup> See SEC Release 34-56212, “Amendments to Regulation SHO” (August 7, 2007).

<sup>17</sup> The Regulation SHO Amendments provide that a “market maker” “includes any specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds itself out (by entering quotations in an inter-dealer quotation system or otherwise) as being willing to buy and sell such security for its own account on a regular or continuous basis.

<sup>18</sup> Rule 203(b)(1) provides that “[a] broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) documented compliance with this paragraph (b)(1).”

<sup>19</sup> See Exchange Act Release No. 32632 (July 14, 1993), 58 FR 39072, 39074 (July 21, 1993).

<sup>20</sup> A footnote to the Amendments to Regulation SHO provides that transactions where a market maker sells stock (short) with a synthetic short position to a client who then sells the stock (long) and retains the synthetic short position do not constitute a bona-fide market making activity.

<sup>21</sup> The Amendments to Regulation SHO provide that “even short selling into a declining market may be an indication that the market maker is engaged in bona-fide market making activity.”

For purposes of this rule, the term settlement date shall mean the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.

Rule 10b-21 was initially proposed by the SEC in March 2008<sup>22</sup> and was adopted as an interim final Rule by the September 17 Order. Rule 10b-21 was adopted as a final Rule in substantially the same form as in the September 17 Order. It should be noted that while Rule 10b-21 is an antifraud rule, it is the SEC's position that a seller will be liable for a violation of Rule 10b-21 for causing a broker-dealer to designate an order to sell a security "long" if that seller knows or recklessly disregards that it is not "deemed to own" the security being sold.<sup>23</sup>

<sup>22</sup> See SEC Release 34-57511, "*Naked Short Selling Anti-Fraud Rule*" (March 17, 2008), available on the SEC's Internet website at <http://www.sec.gov/rules/proposed/2008/34-57511.pdf>.

<sup>23</sup> See the Naked Short Selling Antifraud Rule Release at page 20.

The only change made in Rule 10b-21 as adopted is that the definition of "settlement date" has been clarified to mean "the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security," whereas previously it had the same meaning as used in §204T of Regulation SHO.

Rule 10b-21 went into effect on October 17, 2008.

## Conclusion

The Close-Out Rule Release, the Form SH Release, the Regulation SHO Amendments and the Rule 10b-21 Release have been adopted by the SEC in quick succession in response to extraordinary market events. Many of the consequences of these events have yet to unfold, and further amendments and interpretive guidance to these new rules will arise in the coming period.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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