

## **Recent SEC Regulatory Developments Regarding Short Sales**

Recently, the Securities and Exchange Commission (“SEC”) has been actively engaged in regulating short sales of public equities and has placed a number of additional restrictions on the practice through a series of releases and emergency orders. The SEC’s actions have been largely aimed at “naked” short sales in an attempt to address abusive “naked” short selling of equity securities. The steps taken by the SEC will generally:

- require that participants of clearing agencies registered with the SEC deliver securities by the settlement date or, in the alternative, purchase or borrow securities to close out fail to deliver positions by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position;
- eliminate the exception to the close-out requirement of Regulation SHO for fail to deliver positions in threshold securities that result from hedging activities by options market makers;
- impose liability on short sellers who are deceitful with respect to their intention or ability to deliver securities in time for settlement and who fail to deliver securities by the settlement date; and
- require certain institutional investment managers to report information with respect to their short sales and positions of Section 13(f) securities on Form SH on a weekly basis.

### **I. Background**

Regulation SHO, which became effective on January 3, 2005, established uniform “locate” and “close-out” requirements for broker-dealers in order to address problems associated with failures to deliver, including potentially abusive “naked” short selling and marked the SEC’s first update to short sale regulations since 1938.<sup>1</sup> Specifically, Regulation SHO required that (i) broker-dealers be able to locate securities that they reasonably believed could be delivered within the standard three-day settlement period before effecting any short sale of an equity security and (ii) participants of registered clearing agencies purchase shares to close out fails to deliver of “threshold securities”<sup>2</sup> that persisted for thirteen consecutive settlement days before being able to engage in further short sales in such threshold securities without first borrowing or arranging to borrow the securities.<sup>3</sup>

As adopted, Regulation SHO included two major exceptions to the close-out requirement which exempted (i) fails to deliver that were established prior to securities becoming threshold securities (the “grandfather exception”) and (ii) fails to deliver in threshold securities resulting from short sales effected by registered options market makers to establish or maintain hedges on options positions created before the securities became threshold

---

<sup>1</sup> SEC, *Division of Market Regulation: Key Points About Regulation SHO* (April 11, 2005) available at [http://www.sec.gov/spotlight/keyregshoissues.htm#P73\\_12989](http://www.sec.gov/spotlight/keyregshoissues.htm#P73_12989).

<sup>2</sup> Threshold securities are generally defined as equity securities of issuers who are registered or are required to file reports with the SEC, that have an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and equal at least 0.5% of the issuer’s total shares outstanding. *See* Reg. SHO Rule 203(c)(6).

<sup>3</sup> *See* Reg. SHO Rule 203(b)(3).

securities (the “options market maker exception”).<sup>4</sup> The locate requirement of Regulation SHO also contains an exemption for market makers “engaged in bona-fide market making activities.”<sup>5</sup>

The SEC eliminated the “grandfather exception” to the close-out requirement pursuant to an amendment to Regulation SHO effective on October 15, 2007.<sup>6</sup>

## II. Requirement to Close Out Fail to Deliver Positions

In an Emergency Order dated September 17, 2008, the SEC promulgated Rule 204T (the “Rule”) of Regulation SHO proposing new close-out and borrowing requirements aimed at discouraging the practice of abusive “naked” short selling.<sup>7</sup> The rule was adopted as an interim final temporary rule initially set to expire on October 1, 2008. Its expiration date was thereafter extended to July 31, 2009.<sup>8</sup>

The close-out requirement in temporary Rule 204T(a) provides that registered participants must either deliver securities by the settlement date or purchase or borrow equity securities to close out any fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred,<sup>9</sup> subject to the following exceptions:

- Long sales of equity securities. Paragraph (a)(1) provides that a participant who can demonstrate that a fail to deliver position resulted from a long sale of equity securities is not required to close out the fail to deliver until the beginning of regular trading hours on the *third* consecutive day following the settlement date.<sup>10</sup>
- 144 Securities. Paragraph (a)(2) gives participants with fails to deliver in equity securities sold pursuant to Rule 144 *thirty-five* consecutive settlement days to close-out their position, stating that fail to deliver positions falling under this exception must be closed out no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day.<sup>11</sup>
- Market Makers. Paragraph (a)(3) provides a limited exception for fails to deliver attributable to “bona fide market making activities” and states that a participant will have until the beginning of

---

<sup>4</sup> Release No. 34-58775; File No. S7-19-07 *Amendments to Regulation SHO*, at 8 (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58775.pdf>.

<sup>5</sup> See Reg. SHO Rule 203(b)(2)(iii).

<sup>6</sup> Release No. 34-56212; File No. S7-12-06 *Amendments to Regulation SHO* (August 7, 2007) available at <http://www.sec.gov/rules/final/2007/34-56212.pdf>.

<sup>7</sup> Release No. 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* at 2 (September 17, 2008) available at <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

<sup>8</sup> Release No. 34-58773; File No. S7-30-08 *Amendments to Regulation SHO* (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58773.pdf>.

<sup>9</sup> *Id.* The rule applies to fails to deliver in all equity securities regardless of whether they are “threshold” securities. *Id.* at 18.

<sup>10</sup> *Id.* at 25.

<sup>11</sup> *Id.* at 32.

regular trading hours on the *third* consecutive settlement day following the settlement date to close out such positions.<sup>12</sup>

If a participant does not close out a fail to deliver position in an equity security in accordance with paragraph (a) of the rule, the participant becomes subject to the borrowing requirement of Rule 204T(b) and must borrow or arrange to borrow securities (for their own trades and for all broker-dealers from which it receives trades) before accepting or effecting any additional short sales in that security.<sup>13</sup> There are two exceptions to the borrowing requirement:

- Broker or dealer certification. Paragraph (b)(1) provides that a broker or dealer will be exempt from the requirements of paragraph (b) if it timely certifies to a participant with a fail to deliver position on a long or short sale in an equity security that it has not incurred a fail to deliver position on the settlement date for such security, or that such broker or dealer is in compliance with paragraph (e) of the rule.<sup>14</sup>
- Market Makers. Paragraph (b)(2) states that market makers are not required to comply with the borrowing requirement if they can show that they do not have an open short position in the relevant equity security at the time of any additional short sale.<sup>15</sup>

In addition to the above exceptions, Rule 204T contains limited exceptions that allow (i) a participant to place some of the responsibility for closing out fail to deliver positions on another registered broker or dealer for which it clears trades or from which it receives trades for settlement by reasonably allocating the portions of the fail to deliver positions based on such other broker's or dealer's short position<sup>16</sup> and (ii) broker-dealers to obtain a "pre-fail credit," thereby satisfying the close-out requirement, by purchasing securities to close out an open short position 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, subject to certain qualifications.<sup>17</sup>

Finally, paragraph (c) of the Rule includes a notification element, requiring participants to notify brokers or dealers from which they receive trades for clearance and settlement of any fail to deliver positions that have not been closed out in accordance with the Rule.<sup>18</sup>

---

<sup>12</sup> *Id.* at 31.

<sup>13</sup> *Id.* at 25.

<sup>14</sup> *Id.* at 28.

<sup>15</sup> *Id.* at 32.

<sup>16</sup> *Id.* at 17.

<sup>17</sup> *Id.* at 29-30.

<sup>18</sup> *Id.* at 27.

### III. Elimination of the Options Market Maker Exception to the Regulation SHO Close-Out Requirement

In Release No. 34-58775, effective October 17, 2008, the SEC amended Regulation SHO to permanently eliminate the options market maker exception to its close-out requirement.<sup>19</sup> As a result,

“all fails to deliver in a threshold security resulting from short sales by a registered option market maker effected to establish or maintain a hedge on options positions established before the security became a threshold security will, like all other fails to deliver in threshold securities, have to be closed out in accordance with the close-out requirements of Regulation SHO.”<sup>20</sup>

The Emergency Order originally provided for a one-time phase in period allowing thirty-five consecutive settlement days from the date of issuance for any previously exempt fail to deliver position in a threshold security to be closed.<sup>21</sup> In its release adopting the permanent rule, the SEC clarified that the thirty-five consecutive settlement day phase-in period does not re-start with the adoption of the permanent rule, but will continue to run from September 17, 2008. Further, the phase-in period does not apply to any fails to deliver in securities that became threshold securities after September 17, 2008.<sup>22</sup>

In addition to eliminating the options market maker exception to Regulation SHO’s “close-out” requirement, the SEC also provided guidance with respect to “bona-fide market making” in connection with the market maker exception to the “locate” requirement of Regulation SHO. Among other things, the SEC included a list of factors that may indicate whether a market maker is or is not engaged in bona-fide market making activities.<sup>23</sup>

### IV. “Naked” Short Selling Antifraud Rule

Exchange Act Rule 10b-21, or the “Naked” Short Selling Antifraud Rule, makes it

“unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.”<sup>24</sup>

The rule is aimed at targeting, among other things, short sellers who deceive their broker-dealer about the source of borrowable shares under the locate requirement of Regulation SHO or their ownership of the securities to be sold short. *Scienter* is a required element for violation of the rule.<sup>25</sup>

---

<sup>19</sup> Release No. 34-58775, *supra* note 4.

<sup>20</sup> *Id.* at 16-17.

<sup>21</sup> See Release No. 34-58572, *supra* note 7, at 6.

<sup>22</sup> See Release No. 34-58775, *supra* note 4, at 18.

<sup>23</sup> *Id.* at 30-33.

<sup>24</sup> Release No. 34-58774; File No. S7-08-08 “Naked” Short Selling Antifraud Rule at 15 (October 14, 2008) available at <http://www.sec.gov/rules/final/2008/34-58774.pdf>.

<sup>25</sup> *Id.*

The rule was originally proposed on March 17, 2008,<sup>26</sup> and was later adopted on a temporary basis pursuant to an Emergency Order on September 17, 2008.<sup>27</sup> It has now been permanently adopted as a final rule, effective as of October 17, 2008.<sup>28</sup>

## V. Reporting Requirement

In Emergency Orders issued on September 18,<sup>29</sup> September 21,<sup>30</sup> and October 2, 2008,<sup>31</sup> the SEC established non-public reporting requirements for certain institutional investment managers.<sup>32</sup> In Release No. 34-58785, which became effective on October 18, 2008, the SEC adopted an interim final temporary rule, extending the requirements until to August 1, 2009, with some modifications.<sup>33</sup>

As written, the temporary rule requires that institutional investment managers exercising investment discretion with respect to accounts holding non-option Section 13(f) securities<sup>34</sup> with an aggregate fair market value of \$100 million or more must file a Form SH with SEC on the last business day of each calendar week for each calendar week following a calendar week in which the institutional investment manager effected a reportable short sale.<sup>35</sup> The report must disclose the date of the transaction, the issuer's identity, the CUSIP number of the security, the manager's start of day short position, the number of securities sold short during the day and the end of day short position, for each calendar day in which short sale trading activity occurred.<sup>36</sup>

Form SH reports are not required to be submitted if (i) no new short sales have been effected during the calendar week since the previous Form SH filing; (ii) the short sale or position in the reportable security constitutes less than ¼ of 1% of that class of the issuer's reportable securities issued and outstanding; (iii) the short sale or position has a fair market value of less than \$10 million; and (iv) a short sale results from a sale order

---

<sup>26</sup> Release No. 34-57511; File No. S7-08-08 "*Naked*" *Short Selling Antifraud Rule* (Mar. 17, 2008) available at <http://sec.gov/rules/proposed/2008/34-57511.pdf>.

<sup>27</sup> See Release No. 34-58572, *supra* note 7, at 7.

<sup>28</sup> Release No. 34-58774, *supra* note 23.

<sup>29</sup> Release No. 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) available at <http://www.sec.gov/rules/other/2008/34-58591.pdf>.

<sup>30</sup> Release No. 34-58591A, *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments* (September 21, 2008)(clarifying certain technical issues) available at <http://www.sec.gov/rules/other/2008/34-58591a.pdf>.

<sup>31</sup> Release No. 34-58724, *Amendment to Order and Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments* (October, 2008) available at <http://www.sec.gov/rules/other/2008/34-58724.pdf>.

<sup>32</sup> Release No. 34-58785; File No. S7-31-08, *Disclosure of Short Sales and Short Positions by Institutional Investment Managers* (October 15, 2008) available at <http://www.sec.gov/rules/final/2008/34-58785.pdf>.

<sup>33</sup> *Id.*

<sup>34</sup> Section 13(f) of the Securities Exchange Act of 1934, as amended.

<sup>35</sup> *Id.* at 8. It is not considered a short sale 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 the trade date." *Id.* at 46.

<sup>36</sup> *Id.* at 48.

---

# CAHILL

---

of a customer who is “net long” of the security.<sup>37</sup> Options and short sales of options on reportable securities are also exempt from the reporting requirements, however a Form SH filing may be required in connection with certain transactions involving options if the end result is a short sale.<sup>38</sup> The Form SH reports will be non-public to the extent permitted by law.<sup>39</sup>

In addition, in adopting the temporary rule, the SEC noted that existing or outstanding short sale positions held before September 22, 2008 are also required to be reported even though they were excluded in the original Emergency Order.<sup>40</sup>

\* \* \*

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); or Heather Lusk at 212.701.3480 or [hlusk@cahill.com](mailto:hlusk@cahill.com).

---

<sup>37</sup> *Id.* at 16-19.

<sup>38</sup> *Id.* at 14.

<sup>39</sup> *Id.* at 24.

<sup>40</sup> *Id.* at 18.