

SEC PROPOSES “NAKED” SHORT SELLING ANTIFRAUD RULE

On March 17, 2008, the Securities and Exchange Commission (the “SEC”) proposed a new antifraud rule, Rule 10b-21, under the Securities Exchange Act of 1934 (the “Exchange Act”) to address failures to deliver securities in settlement of securities trades, with a particular focus on “naked” short selling.¹ “Naked” short selling refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement period. The proposed Rule is intended to highlight the liability of persons that deceive persons specified in the rule about their intention or ability to deliver securities in time for settlement.

Background

On July 28, 2004, the SEC adopted Regulation SHO under the Exchange Act to provide a framework for the regulation of short sales in securities.² The perceived need for Regulation SHO grew out of longstanding problems involving failures to deliver stock by the end of the standard three-day trade settlement period, some of which were symptoms of abusive naked short selling. To help avoid failed settlements, Regulation SHO includes a “locate” requirement: “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: (1) borrowed the security, or entered into a bona fide arrangement to borrow the security; or (2) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (3) documented compliance with this [requirement].”³

The broker-dealer executing or entering a short sale order is responsible under Regulation SHO for obtaining and documenting the locate. When it adopted Regulation SHO, the SEC explicitly permitted broker-dealers to rely on customer assurances that the customer had identified a source of borrowable securities, provided that it was reasonable for the broker-dealer to do so under the circumstances. In the Proposing Release, the SEC expressed concern that some short sellers might have made misrepresentations to their broker-dealers about the location of securities to satisfy Regulation SHO’s requirement. In addition, the SEC stated that some short sellers have misrepresented that their sales are long sales in order to circumvent Rule 105 of Regulation M.⁴

¹ See Securities Exchange Act Release No. 57511, File No. S7-08-08 (March 17, 2008), available at: www.sec.gov/rules/proposed.shtml (the “Proposing Release”).

² **Short Sales**, Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (August 6, 2004) (the “Adopting Release”). See Willkie Farr & Gallagher LLP Client Memorandum, “SEC Adopts Regulation SHO Governing Short Sales” (Aug. 5, 2004).

³ 17 CFR 242.203(b)(1).

⁴ Rule 105 of Regulation M provides in general that, if a person has sold short a security within the five business days before the pricing of a firm commitment offering of that security, that person is prohibited from purchasing the offering securities from broker-dealers participating in the offering.

The Proposing Release states that, to the extent that failures to deliver might be indicative of manipulative naked short selling, such failures to deliver may undermine the confidence of investors, cause issuers to suffer unwarranted reputational damage, and could be used as a tool to drive down a company's stock price. Although manipulative short selling is already covered by the general antifraud and antimanipulation provisions of the federal securities laws, the SEC proposed Rule 10b-21 to further address potentially abusive naked short selling and failures to deliver.

Proposed Rule

Rule 10b-21 would provide: "It shall 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 a 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 the date delivery is due, and such person fails to deliver the security on or before the date delivery is due." Therefore, a violation of the Rule would occur when a seller of a security:

- (1) makes a misrepresentation to 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 date delivery is due;
- (2) fails to deliver the security on or before the date delivery is due; and
- (3) acts with scienter.⁵

Discussion

Securities covered. Although the Rule applies to orders to sell "a security," the Proposing Release notes that the Rule would apply to sales in "all equity securities." Therefore, at this point, the coverage of the Rule is not clear. A limitation to equity securities would be consistent with Regulation SHO.

Broker-dealers. The Proposing Release states that broker-dealers, including market makers, are subject to the Rule in connection with their sales of securities. However, according to the SEC, a broker-dealer engaged in "bona fide" market making activity would not be making a representation at the time it sells a security that it can or intends to deliver the security on the date that delivery is due, because the market maker is excepted from the locate requirement of Regulation SHO. The Proposing Release, however, does not contain any discussion of the relatively undefined concept of "bona fide" market making.

Broker-dealer customers. If a customer deceives a broker-dealer about its ownership of securities or about a locate and the customer's transaction fails to settle, a violation of Rule 10b-21 may result. The Proposing Release says, however, that where the customer relies on a broker-

⁵ Scienter is generally defined as a "mental state embracing intent to deceive, manipulate, or defraud," or reckless conduct. See Proposing Release, n. 34.

dealer to comply with Regulation SHO's locate obligation and to make delivery on the sale, the customer would not be representing at the time it submits its order to sell that it can or intends to deliver securities on the date delivery is due. And where a customer relies in good faith on a broker-dealer's "Easy to Borrow" list to satisfy the locate requirement, the customer would not be deceiving the broker-dealer at the time it submits its order to sell a security that it can or intends to deliver such security on the date delivery is due. The Proposing Release also notes that, if a customer enters a short sale order into a broker-dealer's direct market access or sponsored access system with any information to identify a locate source obtained by the customer, the customer would be making a representation to the broker-dealer for purposes of the Rule. In the long sale context, the Proposing Release states that a customer would not be making a representation that it can or intends to deliver securities at settlement if the customer submits an order to sell securities that are held in a margin account and the broker-dealer has loaned out the securities pursuant to the customer's margin agreement.

Scope of Liability. The Proposing Release is silent as to the scope of liability that would apply to persons that violate the Rule. Presumably, the SEC could bring a civil or administrative action against violators, and willful violations of Exchange Act rules can result in criminal liability. The SEC also states, without elaboration, that broker-dealers could be liable for aiding and abetting their customers' fraud under the Rule.

Request for Comment. The Proposing Release solicits comment on the potential scope, effects, and costs of Rule 10b-21, and whether some interpretations of Regulation SHO should be changed. Comments are due within 60 days of publication of the Proposing Release in the Federal Register (i.e., by approximately May 20, 2008).

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If you have any questions concerning this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), or the attorney with whom you regularly work.

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