

**SEC ADOPTS FINAL RULE 204 OF REGULATION SHO TO REDUCE
FAILS TO DELIVER**

The Securities and Exchange Commission (the “SEC”) has, effective July 31, 2009, adopted final amendments to Rule 204 of Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”) by making permanent changes contained in Interim Final Temporary Rule 204T (“Temporary Rule 204T”), with some modifications in response to comments.¹ The adoption of the amendments is intended to maintain the reduction in fails to deliver² achieved by Temporary Rule 204T and thus address abusive “naked” short selling of equity securities.

Background

The SEC adopted Temporary Rule 204T of Regulation SHO in October 2008 as an “interim final temporary rule” with an expiration date of July 31, 2009.³ Temporary Rule 204T imposed stricter close-out requirements under Regulation SHO for failures to deliver securities resulting from sales of equity securities. It did so by requiring, subject to certain limited exceptions, that participants of registered clearing agencies (“Participants”) having a fail-to-deliver position (“fail”) to immediately purchase or borrow securities to close out the fail by not later than the beginning of regular trading hours on the settlement day after the fail occurred. The adopted amendments further provide that a Participant that does not comply with this close-out requirement is subject to a special limitation on further short sales in the affected security. Specifically, Rule 204(b) provides that, until the fail has been closed out, the Participant and any broker-dealer from which it receives trades for clearance and settlement cannot sell the affected security short either for itself or for the account of another, unless it has previously borrowed or arranged to borrow the security.

In adopting Rule 204, the SEC maintained the structure of Temporary Rule 204T with limited modifications to address commenters’ concerns.

Close-Out Period

As amended, Rule 204(a) provides that a Participant must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, and that a Participant that has a fail for a long or short sale transaction in that equity security shall,

¹ See SEC Exchange Act Release No. 34-60388 (July 27, 2009) available at <http://www.sec.gov/rules/final.shtml>.

² Fails to deliver occur when a seller does not deliver securities to the buyer when delivery is due.

³ See SEC Release No. 34-58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) (“Rule 204T Adopting Release”). Rule 204T imposed stricter close-out requirements under Regulation SHO by applying close-out requirements to fails to deliver resulting from sales of all equity securities and reducing the time within which fails to deliver must be closed out.

by not later than the beginning of regular trading hours⁴ on the settlement day⁵ following the settlement date (i.e., T+4), immediately close-out the fail by borrowing or purchasing securities of like kind and quantity. The SEC recognized commenters' concerns regarding the potential market impact of the close-out requirements of Temporary Rule 204T, particularly at the market open, but it stated the benefits of Rule 204(a) justify the potential effects and it adopted the close-out requirements without changing the deadline from the beginning to the end of regular trading hours.

Under certain circumstances, Rule 204 provides additional time during which fails may be closed out. Rule 204(a)(1) and (a)(3) provide that, subject to certain conditions, fails resulting from long sales or certain bona fide market making activity must be closed out by no later than the beginning of regular trading hours on the third settlement day after settlement date (i.e., T+6).

Specifically, Rule 204(a)(1) provides that if a Participant has a fail in an equity security and can demonstrate on its books and records that the fail resulted from a long sale, the Participant shall purchase or borrow securities of like kind and quantity to close out the fail by no later than the beginning of regular trading hours on the third settlement day thereafter.⁶

The SEC also stated that a Participant must take affirmative action to close out a fail by purchasing or borrowing securities and may not offset the amount of its fail with shares that the Participant receives or will receive during the applicable close-out date (i.e., during T+4 or T+6, as applicable). In addition, to meet its close-out obligation, a Participant must be able to demonstrate on its books and records that it purchased or borrowed shares in the full quantity of its fail on the applicable close-out date, and, therefore, that it had a net flat or net long position on its books and records on the applicable close-out date (i.e., during T+4 or T+6, as applicable).

As in Temporary Rule 204T, the close-out requirements of Rule 204 apply to fails to deliver in all equity securities. This differs from the close-out requirements of Rule 203(b)(3) of Regulation SHO which applies the close-out requirements of that rule only to those securities with a large and persistent level of fails to deliver, i.e., threshold securities.

The SEC did not extend Rule 204 to securities other than equity securities. The SEC stated, however, that it will consider on a case-by-case basis whether Rule 204, and Regulation SHO more generally, should apply to securities whose "equity" status is unclear.

⁴ "Regular trading hours" has the same meaning as in Rule 600(b)(64) of Regulation NMS, which provides that "Regular trading hours means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to § 17 C.F.R. § 242.605(a)(2)."

⁵ The term "settlement day" is defined in Rule 203(c)(5) of Regulation SHO as: ". . . any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency."

⁶ Temporary Rule 204T(a)(1) required Participants to purchase securities to close out fails resulting from long sales. Commenters argued that borrowing securities serves the same purpose as purchasing securities to close out fails, and noted that allowing a borrow to close out such fails would be consistent with the close-out requirements for short sales. After considering the comments received, the SEC decided to allow a Participant to purchase or borrow securities to close out fails resulting from a long sale.

Borrowing Requirement

The SEC retained in Rule 204(b) the requirements of Temporary Rule 204T(b). Specifically, Rule 204(b) provides that if the Participant has a fail that it does not close out in compliance with the close-out periods in 204(a), the Participant and any broker-dealer from which it receives trades for clearance and settlement, including introducing and executing brokers and any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,⁷ may not accept a short sale order in an equity security from another person, or effect a short sale order in such equity security for its own account, to the extent that the broker-dealer submits its short sales to that Participant for clearance and settlement, without first borrowing or arranging to borrow the security, until the Participant closes out the fail by purchasing securities of like kind and quantity and such purchase has been cleared and settled at a registered clearing agency. As described below, however, to the extent that the Participant can identify the broker-dealer(s) that contributed to the fail and the Participant has reasonably allocated the close-out obligation to the broker-dealer(s), the requirement to borrow or arrange to borrow before effecting further short sales in that security will apply to only those particular broker-dealer(s).

In response to commenters the SEC confirmed that regardless of whether a Participant borrows or receives delivery of securities, the requirements of Rule 204(b) will continue to apply until the Participant purchases securities to close out the fail and that purchase has cleared and settled at a registered clearing agency.

Rule 204(b) retains without change an exception from the borrowing requirements for any broker-dealer that can demonstrate it was not responsible for any part of a Participant's fail. It provides that a broker-dealer shall not be subject to paragraph (b) of Rule 204 if it timely certifies to the Participant that the broker-dealer has not incurred a fail at a registered clearing agency or that the broker-dealer is in compliance with the requirements of Rule 204(e).

Notification Requirement

Rule 204(c) carries forward from the temporary rule the requirement for Participants to notify all broker-dealers from which they receive trades for clearance and settlement that a fail has not been closed out in accordance with Rule 204, and when the purchase made by the Participant to close out the fail has cleared and settled at a registered clearing agency.

Allocation of Fails

Temporary Rule 204T(d) provided that a Participant may reasonably allocate its responsibility to close out a fail to another broker-dealer from which the Participant receives trades for clearance and settlement. As now adopted, Rule 204(d) provides that if a Participant reasonably allocates a portion of a fail to another registered broker or dealer for which it clears trades or from which it

⁷ That section sets forth SHO's "locate" requirement for short sales effected by a market maker in connection with bona fide market making activities in the securities for which the exception is claimed.

receives trades for settlement, the provisions of Rule 204(a) and (b) relating to the fail will apply to such registered broker or dealer receiving the allocation and not to the Participant.

Participants able to identify the accounts of broker-dealers for which they clear or from which they receive trades for settlement may therefore allocate the responsibility to close out the fail to the particular broker-dealer account(s) whose trading activities have caused the fail if the allocation is reasonable (e.g., the allocation must be timely). However, the Participant would remain subject to the close-out requirement if it is not able to make such an identification.

The SEC has also determined to retain in Rule 204(d) the requirement that a broker-dealer that has been allocated a portion of a fail that does not comply with Rule 204(a) must immediately notify the Participant that it has become subject to the borrowing requirements of Rule 204(b).

Credit for Early Close-Outs

To encourage early close-outs of fails, Rule 204(e) provides that even if a Participant has not closed out a fail at the clearing agency in accordance with Rule 204(a), or has not allocated a fail to a broker-dealer in accordance with Rule 204(d), a broker-dealer will not be subject to the requirements of Rule 204(a) or (b) if the broker-dealer purchases or borrows⁸ the securities, and complies with the conditions set forth in Rule 204(e)(1) through (4), as described in more detail below.

As in Temporary Rule 204T(e)(1), to obtain pre-fail credit under Rule 204(e), a purchase or borrow must be “bona fide.” Where a broker-dealer enters into an arrangement with another person to purchase or borrow securities, and the broker-dealer knows or has reason to know that the other person will not deliver securities in settlement of the transaction, the purchase or borrow will not be “bona fide.”

As in the temporary rule, Rule 204(e)(2) provides that to obtain pre-fail credit, *i.e.*, credit for purchases or borrows to close out fails resulting from short sales, the purchase or borrow must be executed after the trade date but by no later than the end of regular trading hours on settlement date (*i.e.*, T+3) for the transaction. Therefore, the borrow or purchase must be executed on T+1, +2, or +3.

Temporary Rule 204T(e)(3) provided that the purchase must be of a quantity of securities sufficient to cover the entire amount of the broker-dealer’s open short position. In response to comments, Rule 204(e)(3) provides that a broker-dealer must purchase or borrow a quantity of securities sufficient to cover the entire amount of that broker-dealer’s fail at a registered clearing agency in that security, rather than the entire amount of the broker-dealer’s open short position.

⁸ In contrast to Temporary Rule 204T(e), Rule 204(e) permits a broker-dealer to borrow as well as purchase securities to close out a fail before the applicable close-out date.

In addition, to help ensure that broker-dealers purchase enough shares to close out their fails, Rule 204(e)(4) incorporates the condition of Temporary Rule 204T(e)(4) that the broker-dealer purchasing or borrowing securities must be net flat or net long in that security on its books and records on the day of the purchase. As in the temporary rule, Rule 204(e)(4) requires the broker-dealer to demonstrate that it has complied with this requirement. The SEC indicated it believes this requirement will enable the SEC and self-regulatory organizations to monitor more effectively whether or not a broker-dealer has complied with the rule.

Market Makers

Rule 204(a)(3), as in the temporary rule, provides special treatment for market makers. If a Participant has a fail that is attributable to 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, the Participant has until the start of trading on T+6 to close out the fail, as opposed to T+4. As noted above, the SEC declined to extend the close-out period to the end of the regular trading hours on the close-out date.

In contrast to Temporary Rule 204T(a)(3), however, Rule 204(a)(3) permits a Participant to borrow securities to close out a fail.

As in the temporary rule, the close-out requirements of Rule 204 require that a broker-dealer take affirmative action to close out the fail by purchasing or borrowing securities. Therefore, a market maker may not, under Rule 204(a)(3), offset the amount of a fail with shares that it receives or will receive during the close-out date.

Temporary Rule 204T(b)(2) included an exception from the borrowing requirements of Temporary Rule 204T(b) for market makers that can demonstrate they do not have an open short position in the equity security at the time of any additional short sales. The SEC did not provide a similar exception in Rule 204(b). The SEC noted Rule 204(b) includes an exception applicable to all broker-dealers, including market makers, if the broker timely certifies to the Participant that it has not incurred a fail on the settlement date, eliminating the need for a separate market maker exception.

Sales of Certain Deemed to Own Securities

Temporary Rule 204T(a)(2) provided that fails resulting from sales of securities pursuant to Rule 144 under the Securities Act of 1933 (“Rule 144 Securities”) must be closed out by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date.

The SEC modified the close-out requirement to be no later than the beginning of regular trading hours on the thirty-fifth consecutive *calendar day* following the trade date for the transaction,⁹ and

⁹ The SEC stated it should make the longer close-out period in 204(a)(2) consistent with the 35 *calendar day* delivery period in Rule 203(b)(2)(ii) of Regulation SHO.

expanded its scope to cover not only Rule 144 securities but the sale of any equity security that a person is “deemed to own” pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed.¹⁰

Sham Close-Outs

The SEC has included in rule text in subparagraph (f) of Rule 204 that a Participant shall not be deemed to have fulfilled the requirements of Rule 204 where the Participant enters into an arrangement with another person to purchase or borrow securities as required by Rule 204, and the Participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow (“sham close-outs”).

No *De Minimis* Fails

The SEC determined not to include a *de minimis* or odd-lot related exception that would permit such fails to deliver to not have to be closed out. In declining to provide such an exception the SEC noted it would permit certain fails to persist indefinitely, and thereby undermine the goal of reducing fails to deliver.

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¹⁰ The SEC indicated that such circumstances could include the situation where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by the settlement date, as well as providing other examples of processing delays outside a seller or broker-dealer’s control.