

**SEC ANNOUNCES SETTLEMENT OF ENFORCEMENT ACTIONS  
TARGETING “NAKED” SHORT SALES**

On Wednesday August 5, 2009, the Securities and Exchange Commission issued orders instituting two administrative and cease-and-desist proceedings relating to violations of its rules intended to prevent abusive “naked” short selling, and accepted Offers of Settlement with respect to those proceedings.<sup>1</sup> These are the Commission’s first enforcement actions related to those rules. The Commission instituted the proceedings against two registered broker-dealers and certain associated individuals for violating the “locate” and “close out” provisions of Regulation SHO.<sup>2</sup>

**Violations of the “Locate” Requirement**

According to the Commission, Hazan Capital Management, LLC (“Hazan”) and TJM Proprietary Trading, LLC (“TJM”) (together, the “firms”) entered into “reverse conversion” transactions, which involved creating synthetic long positions by purchasing call options and selling put options for Regulation SHO threshold securities,<sup>3</sup> while simultaneously selling short the underlying securities. These transactions allowed the firms to earn a profit from the sale of the put options while minimizing market risk by hedging the synthetic long positions (that is, the combination of short put and long call positions) with the short sales.<sup>4</sup> In selling short the relevant stocks, Hazan and TJM did not perform a “locate” of those securities, as required under Rule 203(b)(1) of Regulation SHO. Rule 203(b)(1) prohibits a broker-dealer from effecting a

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<sup>1</sup> See *In re TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Securities Exchange Act Release No. 60440, Administrative Proceeding File No. 3-13569 (Aug. 5, 2009); *Hazan Capital Management, LLC and Steven M. Hazan*, Securities Exchange Act Release No. 60441, Administrative Proceeding File No. 3-13570 (Aug. 5, 2009), available at <http://www.sec.gov/news/press/2009/2009-179.htm>.

<sup>2</sup> 17 CFR 242.200 *et seq.* (2009).

<sup>3</sup> Under Rule 203(c)(6), a “threshold security,” in relevant part, is “any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act ... [f]or which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding[, and] [i]s included on a list disseminated to its members by a self-regulatory organization.”

<sup>4</sup> According to the Commission, Hazan engaged in the reverse conversion transactions between 2005 and 2007, and TJM engaged in the same sort of transactions in 2007.

The Commission notes in the Hazan order that the counterparty to the reverse conversion, which is engaging in a “conversion,” profits from the underlying transactions because it acquires a long position perfectly hedged by the synthetic short options position. The counterparty can lend the shares of the stock received on the short sale in return for what can be significant fees; the stocks are threshold securities, which are hard to borrow and therefore tend to command high stock loan fees.

short sale of an equity security for its own account unless it (1) has borrowed the security; (2) has entered into a bona fide arrangement to borrow the security; or (3) has reasonable grounds to believe that the security can be borrowed for delivery on the delivery date and has documented compliance with the locate requirement. Rule 203 includes specified exceptions to the locate requirement.

The Commission alleged that the firms violated the locate requirement of Rule 203 by improperly relying on the market maker exception to that requirement. Paragraph (b)(2)(iii) of Rule 203 excepts a broker-dealer from the locate requirement for short sales effected as part of bona fide market making activity. Although Hazan and TJM were both market makers, the Commission determined that the trading that gave rise to the proceedings did not qualify as bona fide market making activity.<sup>5</sup>

### **Violations of the “Close Out” Requirement**

The Commission also asserted that the firms used sham “reset” transactions to circumvent their obligations to close out their “fail-to-deliver” positions in connection with their short sale trades in the stocks. Rule 203(b)(3) of Regulation SHO requires participants of registered clearing agencies (typically clearing firms) to close out any fail-to-deliver position in a threshold security that lasts for 13 consecutive settlement days. A clearing firm may allocate a fail-to-deliver position to a broker-dealer whose sale resulted in such a position. Hazan and TJM were each allocated fail-to-deliver positions by their clearing firms in connection with their short sales.

The Commission’s orders state that Hazan and TJM entered into transactions intended to give the appearance of satisfying their close out obligations under Rule 203 of Regulation SHO. The firms purchased the securities required to close out the fail-to-deliver position from market participants, while simultaneously purchasing short-term, deep in-the-money put options, or selling short-term, deep in-the-money call options, for the same securities with the same market participants. These transactions gave the appearance of closing out the fail-to-deliver positions by purchasing the necessary securities even though the securities were then resold (without being delivered to Hazan or TJM) to the sellers nearly immediately because the deep in-the-money options were almost certain to be exercised. The Commission stated that these arrangements were merely “sham transactions” that were not adequate to satisfy Regulation SHO’s close out requirements.

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<sup>5</sup> In its orders, the Commission did not state the basis for its conclusion that these transactions were not “bona fide market making” activities. The Commission stated in the release adopting Regulation SHO that trading activity that does not constitute bona fide market making includes (1) activity that is related to speculative selling strategies of the broker-dealer and is disproportionate to the broker-dealer’s usual market making patterns or practices; (2) activity whereby the market maker posts continually at or near the best offer but does not also post at or near the best bid; and (3) transactions whereby the market maker enters into an arrangement with another broker-dealer or customer to use the market maker’s exception to avoid compliance with the locate requirement. Short Sales, Securities Exchange Act Release No. 50103, 69 FR 48008, 48015 (Aug. 6, 2004).

The firms agreed to disgorge the estimated profits gained from the reverse conversion transactions and to pay additional fines for the Regulation SHO violations. Individuals associated with the firms were suspended from trading activities for periods of three months, nine months, and five years.

### Considerations

The proceedings appear to be part of the Commission's broader efforts to combat abusive "naked" short selling specifically and market abuses generally. The Commission recently adopted Rule 204 of Regulation SHO. That rule requires, among other things, a participant in a registered clearing agency that fails to deliver a security for a short sale by the settlement date to close out the fail by the beginning of regular trading hours on the following settlement day (i.e., T+4) by borrowing or purchasing securities of like kind and quantity.<sup>6</sup> The Commission's adoption of Rule 204 makes it more difficult to enter into a short sale without first arranging to borrow the securities to be delivered on the sale. The Commission also has recently announced the formation of a group within the Division of Enforcement specializing in market abuse investigations and enforcement actions. This action appears to signal that the Commission is likely to bring more enforcement actions related to its technical trading rules going forward.

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<sup>6</sup> See Securities Exchange Act Release No. 34-60388 (July 27, 2009), available at [www.sec.gov/rules/final.shtml](http://www.sec.gov/rules/final.shtml). For an overview of Rule 204, please see our client memo at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/3065/SEC%20Adopts%20Final%20Rule%20204%20of%20Regulation%20SHO.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3065/SEC%20Adopts%20Final%20Rule%20204%20of%20Regulation%20SHO.pdf).