THE SEC ADOPTS AMENDMENTS TO SHORT SELLING RULES

On October 14 and 15, 2008, the U.S. Securities and Exchange Commission (the "SEC") published two final rules and two interim final temporary rules related to short selling. The SEC adopted:

- **Rule 10a-3T and Form SH**: interim final temporary Rule 10a-3T under the Securities Exchange Act of 1934 (the "Exchange Act"), which requires certain institutional investment managers to file information on Form SH concerning their short sales and short positions in Exchange Act Section 13(f) securities, other than options.[1] Rule 10a-3T becomes effective on October 18, 2008 and the comment period expires 60 days after the date of the rule's publication in the Federal Register. The rule expires on August 1, 2009.
- **Rule 10b-21**: Rule 10b-21 under the Exchange Act, the "naked" short selling antifraud rule, which becomes effective on October 17, 2008.[2]
- **Rule 204T**: interim final temporary Rule 204T to Regulation SHO, which requires a participant to close out a fail to deliver position in a security by the next settlement day after the settlement date for the relevant security transaction.[3] The rule becomes effective on October 17, 2008 and the comment period expires 60 days after the date of the rule's publication in the Federal Register. The rule expires on July 31, 2009.
- **Options market makers**: amendments to Regulation SHO that eliminate the options market maker exception to that regulation. The amendments become effective on October 17, 2008.[4]

A description of these rules follows.

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[1] Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 58785 (Oct. 15, 2008). http://www.sec.gov/rules/final/2008/34-58785.pdf.

[2] "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 58774 (Oct. 14, 2008). http://www.sec.gov/rules/final/2008/34-58774.pdf.

[3] Amendments to Regulation SHO, Exchange Act Release No. 58773 (Oct. 14, 2008). http://www.sec.gov/rules/final/2008/34-58773.pdf.

[4] Amendments to Regulation SHO, Exchange Act Release No. 58775 (Oct. 14, 2008). http://www.sec.gov/rules/final/2008/34-58775.pdf.

Form SH

Rule 10a-3T extends the reporting requirements established by the SEC's Emergency Orders dated September 18, 2008, September 21, 2008 and October 2, 2008, with some modifications. Institutional investment managers who, as of the end of the most recent calendar quarter, filed, or were required to file, a Form 13F for the calendar quarter and during a Sunday-to-Saturday calendar week effected a short sale in a Section 13(f) security (other than options) must file a Form SH. For purposes of Rule 10a-3T, a short position is 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.

The Form SH weekly filing deadline is 5:30 p.m. Eastern Time on the last business day of the calendar week following a calendar week in which short sales were effected, instead of the first such business day as required by the Emergency Orders. This will provide filers with additional time to gather and verify the necessary information and file the forms. The next filing date for Form SH is October 24, 2008.

Form SH filers no longer are required to disclose the value of the securities sold short, the largest intraday short position, and the time of day of the largest intraday short position. The data elements required by Rule 10a-3T include the date, manager's CIK, name of issuer, CUSIP of issuer, start of day short position, end of day short position, and gross number of securities that the manager sold short each day.

Form SH filers are required to report all short positions, including short positions effected prior to September 22, 2008. The fair market value threshold for filing and reporting short sales or short positions has been raised from $1 million to $10 million (please see the next paragraph). However, a manager who is required to file Form SH on October 24, 2008 or October 31, 2008 may exclude disclosure of short positions reflecting short sales effected before September 22, 2008 from the Form SH report filed on either or both of those dates. If, however, the manager excludes such disclosure, the relevant fair market value threshold for reporting short sale positions remains at $1 million.

Short positions and aggregate daily short sales are not required to be reported if (1) on each calendar day during the calendar week, the start of day short position, the gross number of securities sold short during the day and the end of day short position each constitutes less than 0.25 percent of that class of the issuer's Section 13(f) securities issued and outstanding; and (2) the fair market value of the start of day short position, the gross number of securities sold during the day and the end of day short position each is less than $10 million. To determine whether the threshold fair market value has been met, a manager must multiply the number of shares the manager sold short that day by the primary market's price as of the time of close of trading at the NYSE on that day (generally 4:00 p.m. Eastern Time). A manager may continue to respond "N/A" when a data element (such as the value of securities sold short) falls below the reporting threshold.

Form SH must be filed in an XML tagged data file in accordance with the special filing instructions posted on the SEC's website beginning with the calendar week ending November 1, 2008. However, managers are not required to file Form SH in XML format for Form SH reports on October 24, 2008 or October 31, 2008, and for these two weeks may continue filing Form SH in HTML or ASCII formats.

Rule 10a-3T states that all Forms SH filed with the SEC will be nonpublic to the extent permitted by law, provided that they are labeled "NONPUBLIC" in bold, capital letters at the top and bottom of each page of the form. The SEC notes that the Freedom of Information Act ("FOIA") provides at least two potential exemptions under which the SEC has authority to withhold Form SH information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for regulation or supervision of financial institutions." According to the SEC, filers should not submit a confidential treatment request to the SEC for Form SH.

Rule 10b-21

The SEC adopted Rule 10b-21 under the Exchange Act, the "naked" short selling antifraud rule, substantially as proposed. Under the rule, any person who submits an order to sell an equity security engages in a "manipulative or deceptive device or contrivance" in violation of Section 10(b) of the Exchange Act if that person (i) deceives a broker-dealer, participant of a registered clearing agency or purchaser about its intention or ability to deliver the security on or before the settlement date, its source of securities for delivery or its share ownership, and (ii) fails to deliver the security on or before the settlement date.

To clarify that Rule 10b-21 is not intended to limit the applicability of existing antifraud rules, the SEC added a preliminary note to the rule stating that the "rule is not intended to limit, or restrict, the applicability of the general antifraud provisions of the federal securities laws." Furthermore, the SEC added the word "also" to the text of Rule 10b-21 in stating that violation of the rule is a violation of Section 10(b) of the Exchange Act to emphasize that the rule is cumulative of other antifraud provisions. The SEC noted, however, that the rule does not impose any additional liability or requirements on any person beyond those of any existing Exchange Act rule.

Rule 10b-21 applies to all sellers of equity securities. A broker-dealer, including a market maker, acting for its own account is considered a seller.

Regulation SHO requires a broker-dealer effecting the short sale in an equity security to "locate" a source of securities to be delivered to settle a short sale. A short seller may provide the broker-dealer with its own locate source for the security. In that case, the SEC views the seller to be making a representation that it has contacted that source and reasonably believes that the source can or intends to deliver the full amount of the securities to be sold short by the settlement date. If a seller enters a short sale order into a broker-dealer's direct market access or sponsored access

system with any information purporting to identify a locate source obtained by the seller, the seller likewise makes a representation to a broker-dealer for purposes of Rule 10b-21.

A short seller may rely on a broker-dealer to perform the locate required under Regulation SHO. In that situation, a seller relies on a broker-dealer to comply with locate obligations and to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. If a short seller in good faith relies on a broker-dealer's "Easy to Borrow" list to satisfy the locate requirement, the seller would not be representing to the broker-dealer at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due.

Rule 10b-21 contains a bona fide market maker exception. A market maker engaged in bona fide market making activity would not be making a representation at the time it submits an order to sell short that it can or intends to deliver securities on the date delivery is due, because such market makers are excepted from the locate requirement of Regulation SHO.

Rule 10b-21 also applies to long sales. A seller may be engaged in deception if it causes a broker-dealer to mark an order to sell a security long and the seller knows or recklessly disregards that it is not "deemed to own" the securities being sold, as defined in Rule 200(a) through (f) of Regulation SHO, or if the seller knows or recklessly disregards that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the seller fails to deliver the security by the settlement date. The same is true for a broker-dealer acting for its own account.

A seller would not be making a representation at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due for an order to sell securities that are held in a margin account and the broker-dealer has loaned out the shares pursuant to the margin agreement. Under such circumstances, it would be reasonable for the seller to expect that the securities will be in the broker-dealer's physical possession or control by the settlement date.

The SEC noted that scienter is an element of a violation of Rule 10b-21. It also took the position that recklessness is sufficient to meet the scienter element. In addition, a broker-dealer could be liable for aiding and abetting a customer's fraud under Rule 10b-21. Although commenters sought clarification on the latter position, the SEC reiterated its position that Rule 10b-21 does not impose new liability or obligations, and stated that aiding and abetting liability is a question of fact, determined on a case-by-case basis.

The SEC addressed whether a private right of action would be available under Rule 10b-21. According to the SEC, if a private plaintiff can "prove all those elements in a situation covered by Rule 10b-21," it could assert a private cause of action under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The availability of a private right of action may expose sellers who fail to deliver securities, even inadvertently, to lawsuits.

Rule 204T to Regulation SHO

Interim final temporary Rule 204T contains two obligations: (1) a participant must deliver securities to a registered clearing agency by the settlement date (normally, three business days after the trade date, or T+3) on a long or short sale of an equity security,[5] and (2) if a participant has a fail to deliver position[6] at a clearing agency in an equity security, "the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity."[7] The "next settlement day" for a: (1) short sale is T+4; (2) long sale is T+6; and (3) sale of a restricted security pursuant to Rule 144 under the Securities Act of 1933 is T+39, as are formerly restricted securities on a shelf resale registration statement and cashless options exercises. Rule 204T is a "no fault" rule; the reason for the failure to deliver is irrelevant. The Rule 204T close-out requirements effectively override the close-out requirements in the present Regulation SHO.

If the participant acts immediately on T+4, it may borrow securities to meet its close-out obligations. If, however, the participant closes out its fail to deliver position on any of the later permitted settlement days, it must purchase securities to meet its close-out obligations. The close-out requirement cannot be satisfied with the expected delivery of securities. The borrow or purchase, moreover, must be completed before, or at the opening of, trading. Later completion would not satisfy the close-out requirement. It is unclear whether this completion requirement would apply to a large order that must be "worked". An arrangement to borrow does not require a contract. Sham borrows or purchases are not deemed to fulfill the borrow or purchase requirements.

If a participant does not close out a fail to deliver position as required, the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker, may not accept a short sale order in the equity security from another person or effect a short sale for its own account (if the broker-dealer submits its short sales to the participant for clearance and settlement) without first borrowing the security, or entering into a bona fide arrangement to borrow the security (a "preborrow requirement"), until (1) the participant has closed out the fail position by purchasing the security, and (2) the purchase has cleared and settled at a clearing agency. The participant must notify all affected broker-dealers if the preborrow requirement is triggered and when close-out purchases have cleared and settled.

The preborrow requirement applies to market makers that clear through a participant that has a close-out requirement. This application of the preborrow requirement supersedes the exception to the locate requirement otherwise available to market makers.

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[5] A broker-dealer should consider having policies and procedures in place to help ensure that delivery is being made by the settlement date.

[6] Fails may be allocated to a broker-dealer.

[7] The broker-dealer must maintain books and records to support the action to close out a fail to deliver.

A broker-dealer is not subject to the preborrow requirement if it (1) certifies to the participant that it has not incurred a fail to deliver position on the settlement date for a long or short sale for which the participant has a fail; or (2) purchases securities before the beginning of the closeout date to cover a short position so that the broker-dealer is net long or flat. The broker-dealer must document the applicability of this exception.

If the person initiates a bona fide recall of the loaned securities within two business days after the trade date of the sale, the person is deemed to own the securities for purposes of Rule 200(g)(1) of Regulation SHO, and the sale of the securities would not be treated as a short sale for purposes of Rule 204T. A broker-dealer may mark such orders as long sales in accordance with Rule 200(c) of Regulation SHO, which provides that a person is deemed to own a security only to the extent that he has a net long position in the security.

Rule 204T does not apply "to a net syndicate short position created in connection with a distribution of a security that is part of a fail to deliver position at a registered clearing agency" under specified circumstances. Action must be "taken to close out the net syndicate short position by no later than the beginning of regular trading hours on the thirtieth day after commencement of sale in the distribution."

The SEC posed a number of questions for comment in the release publishing Rule 204T, including whether:

- there should be a de minimis exception to the closeout requirement;
- the suggestion to have policies and procedures to help ensure delivery by the settlement date should be codified;
- short sales should be prohibited while there is a close-out obligation; and
- the locate option should be eliminated from Regulation SHO, i.e., whether a preborrow always should be required.

Elimination of the Options Market Maker Exception

The SEC eliminated the options market maker exception to the close-out requirement of Regulation SHO. Effective October 17, 2008, all fails to deliver in a "threshold security" resulting from short sales effected by a registered options market maker to hedge options positions established before the security became a threshold security must be closed out in accordance with the close-out requirements of Regulation SHO, which is consistent with the treatment of all other fails to deliver in threshold securities. The amendment includes a one-time, 35 consecutive settlement day phase-in period; any fail to deliver position in a threshold security excepted as of the effective date of the amendments must be closed out within 35 consecutive settlement days of that effective date.

The SEC provides examples of bona fide market making for purposes of the locate exception. Examples include assumption of economic or market risk with respect to securities in which the market maker is excepted. A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers tends to indicate

that the market maker is engaged in bona fide market making activity. These examples of market making activity may be relevant in other contexts in which "bona fide" market making is a condition to claiming an exception.

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