

MEMO# 23660

July 29, 2009

SEC Takes Action on Short Sale Reform

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TO: ACCOUNTING/TREASURERS MEMBERS No. 34-09
CHIEF COMPLIANCE OFFICER COMMITTEE No. 11-09
CLOSED-END INVESTMENT COMPANY MEMBERS No. 30-09
COMPLIANCE MEMBERS No. 35-09
ETF ADVISORY COMMITTEE No. 23-09
EQUITY MARKETS ADVISORY COMMITTEE No. 34-09
INVESTMENT ADVISER MEMBERS No. 11-09
SEC RULES MEMBERS No. 81-09 RE: SEC TAKES ACTION ON SHORT SALE REFORM

The Securities and Exchange Commission ("SEC") has announced three measures it is taking to protect against abusive short sales and to provide public availability to more short sale information. [1] First, it is making permanent an interim final rule which requires broker-dealers to promptly purchase or borrow securities to close out a fail to deliver position on a short sale. [2] Second, it is allowing for the expiration of an interim final rule which requires institutional investment managers to report to the SEC certain information concerning their short sales and short positions. Instead, the SEC is undertaking joint efforts with several self-regulatory organizations ("SRO") to make short sale volume and transaction data available through the SRO Web sites. Third, it is hosting a public roundtable on September 30 to discuss securities lending, pre-borrowing, and possible additional short sale disclosure requirements.

Permanent Close-Out Requirement

In October of 2008, the SEC adopted interim final Rule 204T under the Securities Exchange Act of 1934, imposing a close-out requirement in which clearing firms or their participating broker-dealers must purchase or borrow securities of like kind and quantity to close out any positions in which shares of equity securities have not been delivered by the close of business on settlement date [3] ("fail to deliver"). [4] Failure to satisfy the close-out requirement results in a penalty under which a clearing firm, or its participating broker-dealer, cannot accept a short sale order in the relevant security or effect a short sale in the security for its own account, unless it first borrows or enters into a bona fide agreement to borrow the security ("pre-borrow requirement"). The restriction remains in place until the

clearing firm closes out the fail position by purchasing securities of like kind and quantity and the purchase has been cleared and settled. The SEC has made permanent the requirements of the interim final rule by adopting Rule 204.

Close-Out Requirements

The close-out and pre-borrow requirements in Rule 204 are largely the same as the interim final rule – i.e., broker-dealers must promptly purchase or borrow securities to close out a fail to deliver position on a short sale in all equity securities. [5] The close-out periods remain the same: no later than the beginning of regular trading on the day following the settlement date (T+4), except that, subject to certain conditions, fails to deliver resulting from long sales or certain bona fide market making activity must be closed out by no later than the beginning of the third day following the settlement date (T+6). [6] In contrast with the interim final rule, Rule 204 will permit a fail to deliver position resulting from a long sale to be closed out by purchasing or borrowing securities.

Rule 204 will continue to allow a clearing firm to allocate a fail to deliver position to an introducing broker-dealer who caused the position provided the allocation is reasonable. The notification requirements in the interim final rule also will remain a part of Rule 204. Of note, Rule 204 includes a new subsection to address attempts to evade the rule's requirements through sham close-outs. It specifies that the purchase or borrow of securities will not qualify as a close-out if the participant knows or has reason to know the securities will not actually be delivered in settlement.

Pre-Borrow Requirements

Rule 204 will include without modification the penalty and pre-borrow requirements from the interim final rule. In particular, regardless of whether a clearing firm or a participating broker-dealer borrows or receives delivery of securities, the pre-borrow requirements of Rule 204 will continue to apply until the firm or broker-dealer purchases securities to close out the fail to deliver position and that purchase has cleared and settled at a registered clearing agency. Rule 204 also will include an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position and timely certifies its claim.

Exceptions to Delivery and Close-Out Requirements

The exceptions to the delivery and close-out requirements in Rule 204 are similar to those provided in the interim final rule. For example, a broker-dealer will be able to satisfy the requirements by obtaining "pre-fail credits" by executing early close outs of fail to deliver positions through the purchase of securities in accordance with various conditions. In a departure from the interim final rule, broker-dealers will be permitted to borrow as well as purchase shares to obtain credit for closing out a position prior to the applicable close-out date. In addition, a broker-dealer will be allowed to purchase or borrow a quantity of securities sufficient to cover the entire amount of its fail to deliver position at a registered clearing agency in that security, rather than the entire amount of the broker-dealer's open short position.

Rule 204 also will retain the exception for 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. Here again, Rule 204 diverges from the interim final rule by

permitting a market maker to borrow securities to close-out a fail to deliver position. It also eliminates an exception that existed under the interim final rule for market makers that can demonstrate that they do not have an open short position in the equity security at the time of any additional short sales. The SEC determined that the exception was unnecessary because market makers, like other broker-dealers, can be relieved from the borrowing requirements if they timely certify that they have not incurred a fail to deliver position.

Finally, Rule 204 will provide an exception from the close-out requirements for sales of certain “deemed to own” securities, including securities not yet received after exercising an option or warrant; restricted securities under Rule 144 of the Securities Act of 1933; sales pursuant to broker-assisted cashless exercises of compensatory options to purchase a company’s stock; and restricted securities that sellers wish to sell pursuant to an effective resale registration statement under Rule 415 under the Securities Act. The interim final rule provided an exception solely for Rule 144 securities. Rule 204 also reduces the close-out timeframe for these securities from the thirty-sixth consecutive settlement day to the thirty-fifth calendar day following the trade date for the transaction.

SEC and SRO Disclosure of Short Sale Information

In October of 2008, the SEC adopted a short sale reporting interim rule, Rule 10a-3T under the Securities Exchange Act. [\[7\]](#) The rule requires certain institutional investment managers to provide short sale and short position information for Section 13(f) securities (excluding options) to the SEC on Form SH. The information submitted on Form SH is classified as non-public. The SEC has determined to let Rule 10a-3T expire on July 31, 2009.

Instead of making permanent the interim final rule, the SEC has announced that it is working together with several SROs to increase the public availability of short sale-related information through a series of other actions. These actions, planned to commence in the next few weeks, include:

Daily Publication of Short Sale Volume Information. The SROs will begin publishing on their Web sites the aggregate short selling volume in each individual equity security for that day.

Disclosure of Short Sale Transaction Information. The SROs will begin publishing on their Web sites on a one-month delayed basis information regarding individual short sale transactions in all exchange-listed equity securities.

Twice Monthly Disclosure of Fails Data. The SEC will enhance the publication on its Web site of fails to deliver data so that fails to deliver information is provided twice per month and for all equity securities, regardless of the fails level.

SEC Roundtable

The SEC has announced that it intends to hold a public roundtable on September 30, 2009 as part of its examination as to whether additional measures are needed to further enhance market quality and transparency, as well as address short selling abuses. The roundtable will focus on issues related to securities lending, pre-borrowing, and possible additional short sale disclosures. Specifically, panelists will consider, among other things, additional means to foster transparency, such as adding a short sale indicator to the tapes to which transactions are reported for exchange-listed securities, and requiring public disclosure of individual large short positions. Panelists will also consider whether it would be appropriate to impose a pre-borrow or enhanced “locate” requirement on short sellers, potentially on a

pilot basis. Additionally, panelists will discuss issues related to securities lending such as compensation arrangements, disclosure practices, and methods of collateral and cash-reinvestment.

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endnotes

[1] See SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency, SEC Press Release 2009-172, July 27, 2009, available at: <http://www.sec.gov/news/press/2009/2009-172.htm>.

[2] See Securities Exchange Commission Release No. 60388 (July 27, 2009), available at: <http://www.sec.gov/rules/final.shtml>.

[3] Settlement date is defined as the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security (generally, T+3).

[4] See Letter from Heather Traeger, Assistant Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities Exchange Commission, dated December 16, 2008 (providing the Institute's comments on interim final Rule 204T), available at: <http://www.ici.org/pdf/23128b.pdf>.

[5] The SEC clarified in its release that it will consider on a case-by-case basis whether the provisions of Rule 204, and Regulation SHO more generally, apply to those securities for which market participants believe the "equity" status is unclear.

[6] The SEC noted in the release that if a broker-dealer has a fail to deliver position at a registered clearing agency that it must close out in accordance with Rule 204 of Regulation SHO, it may satisfy the close-out requirement to purchase securities of like kind and quantity with a volume weighted average price ("VWAP") order provided: (i) the order to purchase the equity security on a VWAP basis is irrevocable and received by no later than the beginning of regular trading hours on the applicable close-out date; and (ii) the final execution price of any such transaction is not determined until after the close of regular trading hours when the VWAP value is calculated and the execution is on an agency basis.

[7] See Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities Exchange Commission, dated December 16, 2008 (providing the Institute's comments on interim final Rule 10a-3T), available at: <http://www.ici.org/pdf/23128a.pdf>.