

MEMO# 22379

March 28, 2008

SEC Proposes Anti-Fraud Short Sale Rule

[22379]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 14-08

ETF ADVISORY COMMITTEE No. 5-08

SEC RULES MEMBERS No. 29-08

CLOSED-END INVESTMENT COMPANY COMMITTEE No. 11-08 RE: SEC PROPOSES ANTI-FRAUD SHORT SALE RULE

The Securities and Exchange Commission has proposed Rule 10b-21 under the Securities Exchange Act of 1934 – an anti-fraud rule designed to address failures to deliver securities that have been associated with “naked” short selling. [\[1\]](#) The Release states that the proposed rule is intended to highlight the liability of persons that deceive certain specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about the source or ownership of shares, and that fail to deliver securities by settlement date. Comments are due to the SEC by May 20. [\[2\]](#)

According to the Release, the proposed rule is designed to target fails to deliver because such fails: (1) can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending; (2) may create a misleading impression of the market for an issuer’s securities; and (3) can create a situation in which the sellers that fail to deliver the securities are subject to fewer rule restrictions, such as incurring the costs of borrowing the shorted securities. In addition, the Release states that the proposed rule would aid broker-dealers in complying with the locate requirement of Regulation SHO [\[3\]](#) and could help reduce manipulative schemes involving “naked” short selling.

Proposed Rule 10b-21 would specify that it is unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer, a participant of a registered clearing agency, or a purchaser regarding the person’s 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. For purposes of the proposed rule, a seller may be deceptive about its intention to deliver securities by settlement date, its locate source, or its share ownership. Scienter would be a necessary element to establish a violation of the proposed rule. In addition, because one of the principal goals of the proposed rule is to reduce fails to deliver, the Release states that a violation of the proposed rule would occur only if a fail to deliver results from the relevant transaction.

Under the proposed rule, broker-dealers (including market makers) acting for their own accounts would be considered sellers. In addition, broker-dealers could be liable for aiding and abetting a customer's fraud under the proposed rule.

The Release provides several examples of conduct that would and would not trigger application of the proposed rule. For example, if a seller is relying on a broker-dealer to comply with Regulation SHO's locate obligation and to make delivery on a sale, the seller would not be representing at the time that it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. Likewise, a seller would not be making a representation that it can or intends to deliver securities on the date delivery is due, if the seller submits an order to sell securities that are held in a margin account but the broker-dealer has loaned out the shares pursuant to the margin agreement.

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endnotes

[1] See SEC Release No. 57511 (March 17, 2008), 73 FR 15375 (March 21, 2008) ("Release"). The Release may be found at:
<http://www.sec.gov/rules/proposed/2008/34-57511.pdf>.

[2] The Release specifically seeks comment on whether the scope of the proposed rule should be narrowed to apply only to certain types of securities, and whether exchange traded funds or other basket securities should be excluded.

[3] See SEC Release No. 50103 (July 28, 2004) 69 FR 48008 (August 6, 2004) (providing that "[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.]").

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