

MEMO# 22906

September 24, 2008

SEC Staff Issues Guidance on Temporary Naked Short Selling Rule

[22906]

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TO: SEC RULES MEMBERS No. 98-08
ETF ADVISORY COMMITTEE No. 26-08
EQUITY MARKETS ADVISORY COMMITTEE No. 47-08
CLOSED-END INVESTMENT COMPANY MEMBERS No. 39-08 RE: SEC STAFF ISSUES
GUIDANCE ON TEMPORARY NAKED SHORT SELLING RULE

The Securities and Exchange Commission's staff has issued guidance regarding the Commission's emergency order concerning "naked" short selling abuses. [\[1\]](#) Specifically, the Division of Trading and Markets has issued a series of four questions and answers regarding temporary Rule 204T. [\[2\]](#) Temporary Rule 204(a) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that 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 the fail to deliver position by borrowing or purchasing securities of like kind and quantity. If the participant fails to close out the position as required by the rule, it must borrow or arrange to borrow securities prior to effecting any further short sales in that security until it purchases securities to close-out the fail to deliver position and the purchase clears and settles at a registered clearing agency.

The questions and answers are as follows:

Question 1: May a participant of a registered clearing agency allocate responsibility for Rule 204T's close-out requirement (and its restriction on short selling if it does not comply with the close-out requirement) to another broker-dealer that is responsible for the fail position? Answer: Yes. A participant of a registered clearing agency may allocate

responsibility for Rule 204T's close-out requirement to another broker-dealer that is responsible for the fail position, and thereby avoid application of the restrictions to other broker-dealers clearing through the participant if such allocation is reasonable.

Question 2: May a broker-dealer claim credit for purchases made to close out an open short position prior to settlement date? Answer: Yes. Even if the broker-dealer's clearing broker has not closed out or allocated its CNS fail position, a broker-dealer may receive credit for purchasing securities prior to the beginning of regular trading hours on the settlement day after the settlement date, including on trade date ("T"), T+1, 2, or 3 ("Pre-Fail Credit"), if:

Question 3: If a participant becomes subject to the requirement that the participant, and any broker-dealer that clears through the participant, must borrow securities prior to effecting any further short sales (the "pre-borrow penalty"), but the participant has not allocated the responsibility for the fail to another broker-dealer that it clears for, how would a broker-dealer that clears through that participant demonstrate that it should not be included in the pre-borrow penalty? Answer: A broker-dealer that timely certifies to the participant that it has not incurred a fail to deliver in the security on settlement date would not be subject to the pre-borrow penalty if it is in compliance with (a) through (d) of Question 2 above.

Question 4: How does Rule 204T apply to registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market, that are selling securities as part of bona fide market making? Answer: The SEC is extending temporary Rule 204(a)'s close-out requirement for fails to deliver attributable to bona fide market making activities by registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market (collectively, "Market Makers"). Thus, a participant must close out the fail to deliver position attributable to a Market Maker by no later than the beginning of regular trading hours on the morning of the third settlement day after the settlement date for the transaction that resulted in the fail to deliver position.

In addition, any Market Maker to which a fail to deliver position at a registered clearing agency is attributable must attest in writing to the market on which it is registered that the fail to deliver position at issue was established solely for the purpose of meeting its bona fide market making obligations. Such written attestation must describe the steps the Market Maker has taken in an effort to deliver securities to its registered clearing agency.

To allow Market Makers to facilitate customer orders in a fast moving market without possible delays associated with complying with this requirement of temporary Rule 204(b), the SEC is not applying the borrowing requirements of the rule to Market Makers provided the Market Maker can show that it does not have an open fail to deliver position at the time of any additional short sales.

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endnotes

[\[1\]](#) See Division of Trading and Markets: Guidance Regarding the Commission's Emergency

Order Concerning Rules to Protect Investors against “Naked” Short Selling Abuses, September 24, 2008 (“Guidance”). The Guidance may be found at: <http://www.sec.gov/divisions/marketreg/204tfaq.htm>.

[2] See Memorandum to SEC Rules Members No. 89-08, Equity Markets Advisory Committee No. 42-08, Closed-End Investment Company Members No. 34-08, and ETF Advisory Committee No. 22-08, September 18, 2008 [22884] and Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, SEC Release No. 34-58572 (September 17, 2008). The order may be found at: <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

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