

**MEMO# 23013**

October 23, 2008

## **SEC Adopts Series of Rules to Address Short Selling**

[23013]

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TO: ETF ADVISORY COMMITTEE No. 32-08  
EQUITY MARKETS ADVISORY COMMITTEE No. 56-08  
SEC RULES COMMITTEE No. 74-08  
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 33-08  
ACCOUNTING/TREASURERS COMMITTEE No. 13-08  
CHIEF COMPLIANCE OFFICER COMMITTEE No. 17-08  
COMPLIANCE ADVISORY COMMITTEE No. 17-08  
INVESTMENT ADVISERS COMMITTEE No. 10-08    RE: SEC ADOPTS SERIES OF RULES TO ADDRESS SHORT SELLING

As a follow up to a series of emergency orders [\[1\]](#) it issued in September, the Securities and Exchange Commission has published four releases aimed at addressing a number of issues related to short selling. In the first release, the SEC has extended through an interim final rule the requirement that institutional investment managers provide the SEC with certain reports about their short sales and short positions in equity securities. The other three releases address components of Regulation SHO raised in the emergency orders, including: (1) temporary adoption through an interim final rule of the hard T+3 delivery and immediate close-out requirements; (2) elimination of the options market maker exception; and (3) adoption of the anti-fraud short sale rule. The SEC has sought comment on the two releases adopting interim final rules – the disclosure of short sales and positions by institutional investment managers and the hard T+3 and immediate close-out requirements. Comments on these releases are due on December 16, 2008. The most significant aspects of the SEC releases are summarized below.

We have scheduled a conference call for Tuesday, October 28, at 2 p.m. Eastern Time to discuss the SEC's interim final rules and the Institute's comment letter. In preparation for the conference call, please review the requests for comment highlighted in this memorandum. The dial-in number for the conference call will be 1-800-369-1793 and the passcode for the call will be 19263. If you plan to participate on the call, please contact

Jennifer Odom by email at [jodom@ici.org](mailto:jodom@ici.org) or by phone at 202-326-5833.

## I. Reporting of Short Sales and Short Positions

The SEC has issued a release adopting interim final temporary Rule 10a-3T under the Securities Exchange Act of 1934, which extends with some modifications the requirement, imposed by emergency order in September, that certain institutional investment managers file Form SH to report short sales in Section 13(f) securities. [\[2\]](#) The interim final temporary rule and Form SH are effective from October 18, 2008, until August 1, 2009.

### A. Requirements

New Rule 10a-3T requires that certain institutional investment managers file Form SH following any Sunday to Saturday calendar week in which the manager has effected a short sale in a Section 13(f) security (excluding options). The Form SH filing must include all short positions, not only those short sales triggering the reporting requirement. [\[3\]](#) According to the release, a manager is subject to the Form SH reporting requirement if it filed, or was required to file, a Form 13F for the most recent calendar quarter. [\[4\]](#) The manager must file the form with the SEC in an XML tagged data file (rather than an ASCII or HTML formatted file) on the last business day of the ensuing calendar week. [\[5\]](#) It will be classified as “non-public” to the extent permitted by law. [\[6\]](#)

Rule 200 of Regulation SHO defines a “short sale” to mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller. [\[7\]](#) For purposes of new Rule 10a-3T, the release provides that 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 release also provides that, consistent with staff guidance regarding the September emergency order, if a person that has loaned a security to another person sells the security and a bona fide recall is initiated within two business days after trade date, the person that has loaned the security is deemed to own the security for purposes of Rule 200, and such sale would not be treated as a short sale.

The SEC also has revised the information to be disclosed in Form SH. Filings no longer need to include the value of the securities sold short, the largest intraday short position, or the time of day of the largest intraday short position. Starting on the October 24, 2008 filing date, institutional investment managers are required to identify the following in Form SH: trade date; the Central Index Key (CIK) of the institutional investment manager; the issuer name; the CUSIP for the relevant securities; and with respect to each day of the Form SH reporting period in which short sale trading activity occurred – the start of day short position, the gross number of securities sold short during the day, and the end of day short position.

### B. Exceptions to and Exclusions from Reporting

The new rule provides that filing is not required if: (1) short sales of Section 13(f) securities have not been effected during the reporting period or (2) with respect to a security, on each

calendar day during the relevant week, the start of day short position, the gross number of securities sold short during the day, and the end of day short position constitute less than 0.25% of the class of securities issued by the issuer [8] and the fair market value of these three figures is less than \$10 million. [9] In addition, the SEC's release states that short sales need not be reported on Form SH where they occur as part of certain scenarios in which customer orders are handled on a riskless principal basis. Specifically, a short sale need not be reported if it occurs in connection with a broker-dealer's attempt to execute on a riskless principal basis a sale order of a customer who has a net long position in the Section 13(f) security or a purchase order of a Section 13(f) security.

### C. Transitional Period

The release includes two transitional provisions for Form SH reports due on October 24 and October 31, 2008. Specifically, new Rule 10a-3T applies to reports filed on those dates, except that an institutional investment manager required to file Form SH:

- May exclude disclosure of short positions due to short sales before September 22, 2008. If such short sales are excluded, the manager need not report short positions that otherwise would be reportable if the short position constitutes less than 0.25% of the class of securities issued by the issuer and the fair market value of the short position is less than \$1 million.
- May file Form SH on EDGAR (as the form was filed pursuant to the Form SH emergency order), rather than in XML format in accordance with the special filing instructions posted on the SEC's website.

### D. Request for Comment and Questions for Members

The SEC requests comment on numerous aspects of the rule, including the following:

- Whether the rule covers the appropriate category of short sellers or whether a subset of institutional investment managers should be required to file Form SH;
- Whether there may be better ways to collect information about short sales and whether the information should be provided to the self-regulatory organizations;
- Whether the SEC should consider harmonizing the short sale reporting and regulations under the SEC regime with foreign regulators;
- Whether the SEC should require public notice filings for short sale activity or positions crossing a specified threshold (such as 5% of the public float) and whether the specified thresholds are appropriate;
- Whether the information required by Form SH should be altered in any way, such as reporting of only new positions instead of all short positions, and whether managers have significant difficulty collecting the required information;
- Whether Form SH reporting should be required beyond August 1, 2009;
- Whether Form SH filings should be made public, with or without a delay; and
- Whether Form SH filings should be made with a different frequency, such as daily or bi-weekly, monthly, or quarterly.

In addition, we would like to discuss the following questions on the conference call:

- Have members experienced any operational or regulatory difficulties in filing Form SH?
- Have there been any inordinate costs associated with the filings?

## II. Hard T+3 Delivery and Immediate Close-Out Requirements

The SEC has adopted temporary Rule 204T of Regulation SHO as an interim final rule, which extends the hard T+3 delivery and immediate close-out requirements that were imposed by its September 17th emergency order. [\[10\]](#) The new temporary rule will be effective during the period from October 17, 2008, through July 31, 2009.

### A. Requirements

#### 1. Hard T+3 Delivery and Immediate Close-Out Requirements

Under Rule 204T, clearing firms must settle sales of equity securities that clear through a registered clearing agency by delivering shares by the close of business on settlement date (generally T+3). [\[11\]](#) In the event of a failure to deliver, the fail must be closed out by the clearing firm no later than the beginning of trading on the day following the settlement date (the "Close-Out Date") through a purchase or borrow of securities of like kind and quantity. The release explains that the firm must take affirmative action to purchase or borrow the shares to fulfill this close-out obligation, and it may not rely on shares it receives or will receive on the Close-Out Date to offset this obligation. [\[12\]](#) The new rule allows the clearing firm until the beginning of trading on the third day after settlement (generally T+6) to effect a close-out in connection with a failure to deliver if it can demonstrate that the failure to deliver resulted from a long sale. As with new Rule 10a-3T (discussed above), the release states that a sale will not be treated as a short sale for purposes of temporary Rule 204T if a person that has loaned a security to another person sells the security and a bona fide recall of the security is initiated within two business days after trade date, because the person that has loaned the security will be "deemed to own" the security for purposes of Rule 200 of Regulation SHO.

Consistent with prior guidance under the September emergency order, to the extent that a clearing firm can identify in a timely manner the introducing broker-dealer(s) to which a fail-to-deliver position is attributable, new Rule 204T permits the firm to allocate the close-out obligation to the responsible broker-dealer(s). Where the clearing firm has reasonably allocated the close-out obligation, only the relevant broker-dealer(s) must comply with the pre-borrow requirement, as described below.

#### 2. Pre-Borrow Requirement

The SEC's release explains that if a clearing firm fails to comply with the close-out requirement, the clearing firm – and any introducing broker-dealer, to the extent it submits its short sales to that clearing firm for clearance and settlement – may not 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. This pre-borrow requirement also applies to an introducing broker-dealer that is a market maker otherwise entitled to rely on the market maker exception from the locate requirement, unless the market maker can show that it does not have an open fail-to-deliver position at the time of any additional short sales. The release specifies that 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.

### 3. Notification Requirement

To facilitate the pre-borrow requirement, new Rule 204T imposes a notification requirement on a clearing firm that has a fail-to-deliver position that has not been closed out in accordance with the rule. According to the release, the firm must notify its introducing brokers (1) that it has a fail-to-deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with Rule 204T, and (2) when the firm's purchase to close out the fail has cleared and settled. Thus, introducing brokers will be on notice that the pre-borrow requirement applies to short sales in a particular security, as well as when it ceases to apply.

#### B. Exceptions to Delivery and Close-Out Requirements

##### 1. Pre-Fail Credit Exception

The new temporary rule includes a provision allowing for "pre-fail credit" to avoid the close-out and pre-borrow requirements, consistent with guidance provided under the September emergency order. Specifically, to qualify for pre-fail credit, a broker-dealer must purchase securities before the start of regular trading hours on the Close-Out Date to close out an open short position, and:

- The purchase must be bona fide;
- The purchase must be executed on or after trade date, but no later than the end of regular trading hours on the settlement date;
- The purchase must cover the entire amount of the open short position; and
- The broker-dealer must be able to demonstrate through its books and records that it has a net long or net flat position on the settlement day for which it is seeking to show that it has purchased shares to close its open short position.

The release explains that if any fail is not closed out within the specified period, the clearing firm and any introducing broker from which it receives trades for clearance and settlement will be prohibited from effecting any short sales in the security for any customer or proprietary account unless the security is pre-borrowed. This pre-borrow requirement would remain in effect until the fail is resolved through settled purchases.

##### 2. Certification Exception from Pre-Borrow Requirement for Introducing Firms

New Rule 204T permits an introducing firm to avoid the pre-borrow requirement if it provides timely certification to the clearing firm that (1) it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or (2) the introducing broker-dealer qualifies for “pre-fail credit” with respect to the position.

### 3. Exception for Market Makers

The temporary rule includes an exception for market makers. As described in the release, where a fail to deliver is attributable to 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 markets, the clearing firm must close out the position by the beginning of regular trading hours on T+6, rather than T+3. In addition, Rule 204T’s pre-borrow requirement does not apply to a market maker that can show it does not have an open fail-to-deliver position at the time of any additional short sales. In a departure from guidance given under the September emergency order, the temporary rule does not require a market maker to which a fail to deliver is attributable to attest in writing that the fail position was established solely to satisfy bona fide market making obligations.

### 3. Exception for Rule 144 Sales

Rule 204T includes an exception for sales of equity securities pursuant to Rule 144 of the Securities Act of 1933. The exception provides that a clearing firm with a fail-to-deliver position in such a security for 35 consecutive days after the settlement date must, by the beginning of regular trading hours on the thirty-sixth consecutive settlement day, close out the position by purchasing securities of like kind and quantity. The 35-day period applicable to Rule 144 securities is intended to be consistent with other accommodations under Regulation SHO for sales of such securities. Accordingly, the release states that the exception also is applicable to fails to deliver when sellers that own restricted equity securities wish to sell pursuant to an effective resale registration statement under Rule 415 under the Securities Act, provided the fail-to-deliver position resulted from sales of securities that were outstanding at the time they were sold and the sale occurred after a registration has become effective. Fail-to-deliver positions not closed out within this time frame will trigger new Rule 204T’s pre-borrow requirement.

### C. Request for Comment

The SEC requests comment on numerous aspects of the rule, including the following:

- The appropriateness of the various time parameters including T+3, T+6, and the Close-Out Date;
- Whether the rule should apply to debt as well as equity securities;
- What are the costs associated with purchasing versus borrowing securities to close

out a fail to deliver position and whether participants should be permitted to close out a fail to deliver position for long sale transactions by borrowing as well as purchasing securities;

- What impact the rule will have on borrowing cost and on legitimate short selling and market efficiency;
- Whether the notification requirement in the rule imposes operational or systems costs on participants;
- To what extent the pre-fail credit provision of the rule will encourage broker-dealers to close out a fail to deliver position prior to the Close-Out Date; and
- How the rule will affect lending rates.

### III. Elimination of Options Market Maker Exception to Regulation SHO and Guidance on “Bona Fide” Market Making

The SEC has amended Regulation SHO to eliminate the exception from the Regulation SHO close-out requirement for options market makers that sell short to hedge options positions established before the securities became “threshold securities.” [\[13\]](#) According to the release, the amendments include a one-time close-out period of 35 consecutive settlement days for existing fail-to-deliver positions that previously had been excepted from the close-out requirement. The release further states that the 35-day period for fails to deliver in threshold securities being closed out pursuant to the SEC’s September emergency order will run from September 17 rather than starting over with the date of the amended rule change. [\[14\]](#) Any fails to deliver in securities that became or become threshold securities after September 17th will be subject to the close-out provisions of Regulation SHO applicable to other market participants, rather than within 35 consecutive settlement days of the effective date of the amendments. [\[15\]](#)

In the same release, the SEC has provided guidance regarding what constitutes bona fide market making activity for purposes of the market maker exemption from Regulation SHO’s locate requirement. The guidance explains that the analysis of what qualifies for bona fide market making activity will depend on the particular facts and circumstances. It identifies several factors that would and would not constitute bona fide market making. For example, according to the release, factors that may indicate bona fide market making include: (1) economic or market risk incurred by the market maker with respect to the securities; (2) a pattern of trading in which purchases and sales occur in roughly comparable amounts to provide liquidity to customers or other broker-dealers; and (3) continuous quotations that are at or near the market on both sides, provided the quotations are widely accessible to investors and other broker-dealers.

On the other hand, the release specifies that bona fide market making does not include: (1) trading that is related to the broker-dealer’s speculative selling strategies or investment purposes and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security; (2) trading that attempts to transfer to a client the benefit of the market maker’s exemption from the locate requirement; (3) posting of quotations continually at or near the market on only one side; or (4) continual execution of short sales away from the broker-dealer’s posted quotes.

#### IV. New Anti-Fraud Short Sale Rule

The SEC has adopted Rule 10b-21 under the Securities Exchange Act. [\[16\]](#) The new rule deems it fraudulent for any person to sell an equity security if it deceives a person participating in the transaction about its intention or ability to deliver the security by settlement and in fact fails to deliver the security by settlement. Scienter is a necessary element for a violation of the new rule, and the SEC's release specifies that the scienter requirement under Rule 10b-21 is the same as that required under Rule 10b-5 of the Securities Exchange Act. The release also states that the new rule is not intended to limit or restrict the applicability of the general antifraud provisions of the federal securities laws.

Regulation SHO requires broker-dealers to "locate" securities that are the subject of a short sale; the release provides a number of examples for satisfying this requirement without violating new Rule 10b-21. First, a short seller that provides its own locate source to a broker-dealer is representing that it has contacted the source and reasonably believes that the source can or intends to deliver the securities by the settlement date of the short sale. Second, a short seller that enters a short sale order into a broker-dealer's direct market access or sponsored access system along with information as to a locate source is making the same representation. Third, a short seller that relies on a broker-dealer to satisfy the locate requirement, including reliance on the broker-dealers "easy to borrow" list, is not making a representation regarding its intention or ability to deliver the security being sold short.

The release also provides clarity on several other potential violations of the new anti-fraud rule. For example, a short seller that causes a broker-dealer to mark a sell order long may be liable under new Rule 10b-21 if the seller knows or recklessly disregards that either (1) it is not "deemed to own" the security in accordance with Regulation SHO or (2) the security is not or cannot reasonably be expected to be in the broker-dealer's physical possession or control by the date deliver is due. In addition, a market maker that has an exception from the locate requirement under Regulation SHO would not be making a representation about its intention or ability to deliver the security by settlement.

The release clarifies that a broker-dealer may be liable for aiding and abetting a customer's fraud under the new rule and that a private right of action may be brought under the new rule.

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## endnotes

[1] 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, dated September 18, 2008 [22884] and Memorandum to SEC Rules Members No. 90-08, Equity Markets Advisory Committee No. 43-08, Closed-End Investment Company Members No. 36-08, and ETF Advisory Committee No. 23-08, dated September 19, 2008 [22888].

[2] See SEC Release No. 58785 (October 15, 2008), 73 FR 61678 (October 17, 2008). The release may be found at: <http://www.sec.gov/rules/final/2008/34-58785.pdf>.

[3] The release specifies that “all short positions” would include those effected prior to September 22, 2008, the effective date of the September emergency order requiring filing of the first Form SH.

[4] An institutional investment manager is subject to the new rule if it filed, or was required to file, a Form 13F for the most recent calendar quarter, rather than – as provided in the September emergency order – only the quarter ended June 30, 2008.

[5] This timing differs from the September emergency order which imposed a filing deadline of the first business day of the ensuing calendar week.

[6] According to the release, filers should mark Form SH “non-public” but should not submit requests for confidential treatment.

[7] The release includes two examples of options-related transactions that are short sales and must be reflected on Form SH. First, if an institutional investment manager exercises a put and is net short pursuant to Rule 200, the resulting transaction is a short sale. Second, if the manager effects a short sale as a result of assignment to it as a call writer, upon exercise, the resulting transaction is a short sale.

[8] Specifically, the class of securities must be that issued and outstanding as reported on the issuers most recent annual, quarterly or current report filed with the SEC pursuant to Section 13(f), unless the manager knows or has reason to believe the information contained in the report is inaccurate.

[9] Under Rule 10a-3T, the fair market value prong of the de minimis exception has increased from \$1 million to \$10 million.

[10] See SEC Release No. 58773 (October 14, 2008), 73 FR 61706 (October 17, 2008). The release may be found at: <http://www.sec.gov/rules/final/2008/34-58773.pdf>.

[11] The temporary rule defines “settlement date” 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.

[12] The release clarifies, however, that the firm may rely on its net delivery obligation as reflected in its notification from the National Securities Clearing Corporation provided notification is received prior to the beginning of regular trading hours on the Close-Out Date.

[13] See SEC Release No. 58775 (October 14, 2008), 73 FR 61690 (October 17, 2008). The

release may be found at: <http://www.sec.gov/rules/final/2008/34-58775.pdf>. “Threshold securities” are defined under Regulation SHO as equity securities in which there is an aggregate fail to deliver position for five consecutive settlement days of 10,000 shares or more, and that is equal to at least 0.5% of the issue’s total shares outstanding, and that is included on a list disseminated to its members by a self-regulatory organization.

[14] The SEC had eliminated temporarily the exception for options maker in its September 17 emergency order.

[15] In other words, for the duration of temporary Rule 204T, fails to deliver in all equity securities, regardless of whether or not the security is a threshold security, must be closed out in accordance with the requirements of the temporary rule as discussed above.

[16] See SEC Release No. 58774 (October 14, 2008), 73 FR 61666 (October 17, 2008). The release may be found at: <http://www.sec.gov/rules/final/2008/34-58774.pdf>.

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