

MEMO# 22884

September 18, 2008

SEC Issues New Rules to Combat Naked Short Selling

[22884]

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TO: SEC RULES MEMBERS No. 89-08

EQUITY MARKETS ADVISORY COMMITTEE No. 42-08

CLOSED-END INVESTMENT COMPANY MEMBERS No. 34-08

ETF ADVISORY COMMITTEE No. 22-08 RE: SEC ISSUES NEW RULES TO COMBAT NAKED
SHORT SELLING

The Securities and Exchange Commission issued an emergency order implementing three coordinated actions to address concerns with “naked” short selling. [\[1\]](#) The Order adopts a temporary rule imposing enhanced delivery requirements on sales of all equity securities, eliminates the options market maker exemption from Regulation SHO, and adopts an antifraud short sale rule. The Order became effective at 12:01 a.m. ET on Thursday, September 18, 2008, and will terminate at 11:59 p.m. ET on October 1, 2008, unless further extended by the Commission. The Commission also published guidance for broker-dealers on avoiding failures to deliver securities. Finally, the Commission issued a press release stating that it was considering a new disclosure rule that will require hedge funds and other large investors to publicly report their short positions.

The Order explains that the Commission has concluded that, “there continues to exist a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets.” Further, the threat is not limited to the financial institutions that were the subject of the July Emergency Order, [\[2\]](#) but extends to issuers that have become temporarily weakened by current market conditions and may be the target of inappropriate short selling. Specifically, the Order states the Commission’s concern that sudden and

unexplained declines in the price of securities can create a crisis of confidence without a fundamental underlying basis. This crisis in confidence can in turn impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences.

Adopt Hard T+3 Close-Out Requirement

The Commission has adopted new temporary Rule 204T to Regulation SHO, [\[3\]](#) requiring that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (the third business day after the transaction date, or T+3) and imposing a temporary penalty for failure to do so. Specifically, if there is a failure to deliver the security, no later than the beginning of regular trading hours on the next settlement date following T+3, subject to certain exceptions noted below, the seller and the broker-dealer acting on the seller's behalf would be prohibited from further short sales in the same security unless the shares are both located and pre-borrowed. The pre-borrow penalty on the broker-dealer's activity would apply to further short sales in the subject security on behalf of any of its customers and would remain in effect until the fail to deliver position is closed out. Rule 204T is immediately effective but applies only to fails to deliver resulting from trades that occur after the issuance of the Order.

Rule 204T differs from the July Emergency Order in that it applies to all publicly traded companies and it does not require, as a matter of course, that broker-dealers pre-borrow shorted securities. Instead, it requires that a participant [\[4\]](#) or its broker-dealer deliver the equity securities that are the subject of a long or short sale by T+3. The pre-borrow penalty provision applies if this deadline is missed. There are two exceptions to this requirement. First, if there is a delivery failure and the participant can document that the failure was in connection with a long position, then it has until the start of trading on the third settlement day following T+3 to close out the position through a buy-in of securities of like kind and quantity. Second, if there is a delivery failure with respect to securities sold pursuant to Rule 144 under the Securities Act of 1933, then the broker-dealer has until the beginning of regular trading hours on the 36th settlement day after T+3 to close out the position through a buy-in of securities of like kind and quantity.

Eliminate Options Market Maker Exemption from Regulation SHO

As adopted, Regulation SHO included two exemptions to the mandatory close-out requirements for short sales: (1) the grandfather provision for fails to deliver established prior to a security becoming a threshold security and (2) the option market maker exception for fails to deliver in threshold securities resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security. Earlier this year, the Commission eliminated the grandfather provision; the Commission also re-opened the comment period on its proposal to limit or eliminate the options market maker exemption. [\[5\]](#)

The Order makes immediately effective amendments to Rule 203(b)(3) of Regulation SHO to eliminate the options market maker exception from the close-out requirement. It states the Commission's belief that it is necessary to impose enhanced delivery requirements on sales of all equity securities. Accordingly, as a result of the amendments, options market makers would be treated in the same way as all other market participants, and required to abide by the hard T+3 closeout requirements in new temporary Rule 204T (discussed above).

The amendments include two linked provisions for options market makers. The first provision provides that a participant of a registered clearing agency that has an outstanding fail to deliver position, which was eligible for the exemption prior to the effective date of the amendments, must close out that fail to deliver position within 35 consecutive settlement days of the effective date of the amendment by purchasing securities of like kind and quantity. The second provision applies to a participant (1) entitled to rely on the 35-consecutive settlement day close-out requirement in the first provision and (2) for which the 35-day period runs from the effective date of the amendment. It provides that the participant and any broker-dealer for which it clears transactions, including any market maker, may not accept a short sale order in the security from another person, or effect a short sale in the security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quality.

Adopt Anti-Fraud Short Sale Rule

The Commission has adopted Rule 10b-21 under the Securities Exchange Act of 1934, which would make it an anti-fraud violation for a short seller to deceive broker-dealers or other specified market participants about their intention or ability to deliver securities in time for settlement, and that fail to deliver the securities at settlement. The Institute filed a comment letter on May 20, 2008, strongly supporting the intent of the proposed rule, but seeking clarification on several issues relating to the proposal – including application of the rule to ETFs. [\[6\]](#)

The Order makes immediately effective new Rule 10b-21 essentially as proposed, [\[7\]](#) but does not provide clarification on some of the questions raised by the Institute. It states only that adoption of the rule, in conjunction with the other components of the Order, should impose powerful disincentives to those who might otherwise exacerbate artificial price movements through naked short selling. The rule text includes two modifications from the proposal. First, it includes a preliminary note specifying that the new rule is not intended to limit the applicability of the general anti-fraud provisions of the federal securities laws, such as Section 10(b) of the Securities Exchange Act. Second, in discussing delivery of a security, it replaces the phrase “date delivery is due” with “settlement date,” and states that “settlement date” is as defined in new temporary Rule 204T, as discussed above.

Broker-Dealer Guidance

The Commission Staff, along with Financial Industry Regulatory Authority and NYSE Regulation, issued guidance to assist broker-dealer firms in preventing failures to deliver securities. [\[8\]](#) Specifically, the guidance provides some brief information on eight topics, including earmarking, documenting the source of the shares, and direct market access/sponsored access. The guidance specifies that the described practices are not required practices but are designed to help broker-dealer firms establish policies and procedures to avoid failures to deliver.

Other Proposals

Yesterday, the Commission announced in a press release that it would consider, on an emergency basis, a new disclosure rule that would require hedge funds and other large investors to disclose their short positions in order “to ensure transparency in short selling.”

The disclosure requirement under consideration would subject managers with more than \$100 million invested in securities to public reporting of their daily short positions. We are seeking additional information on the proposed rule and will keep you apprised of any developments with respect to this potential new reporting requirement.

In addition, the Commission announced in the same press release an expansion of its ongoing investigations into alleged market manipulation, specifying that it would review the trading of “significant hedge funds and other institutional traders” and that “those institutions will also be required immediately to secure all of their communication records in anticipation of subpoenas for these records.”

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endnotes

[1] See 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) (“Order”). The Order may be found at: <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

[2] See Order Extending 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. 58248 (July 29, 2008) (“July Emergency Order”). See also Memorandum to Equity Markets Advisory Committee No. 30-08 Committee and SEC Rules Committee No. 48-08, dated July 16, 2008 [22700], Memorandum to Equity Markets Advisory Committee No. 32-08 Committee and SEC Rules Committee No. 51-08, dated July 18, 2008 [22716] and Memorandum to Equity Markets Advisory Committee No. 35-08 Committee and SEC Rules Committee No. 55-08, dated July 31, 2008 [22751].

[3] See SEC Release No. 34-54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (adopting Regulation SHO).

[4] A “participant” for purposes of the new rule means any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. It does not include a person whose use of a clearing agency is (1) through another person who is a participant or (2) as a pledgee of securities. See 15 U.S.C. 78(c)(a)(24).

[5] See Memorandum to SEC Rules Members No. 42-07, Equity Markets Advisory Committee No. 17-07, Closed-End Investment Company Members No. 23-07, and ETF Advisory Committee No. 15-07, dated April 2, 2008 [21012].

[6] See Memorandum to Equity Markets Advisory Committee No. 23-08, ETF Advisory Committee No. 12-08, SEC Rules Members No. 45-08 and Closed-End Investment Company Members No. 18-08, dated May 21, 2008 [22550].

[7] See Securities Exchange Act Release No. 57511 (March 17, 2008), 73 FR 15375 (March 21, 2008) (proposing anti-fraud short sale rule).

[8] See Regulators Provide “Tips” for Broker-Dealers on Avoiding Failures to Deliver Securities, SEC Spotlight, September 17, 2008. The guidance may be found at: <http://www.sec.gov/about/offices/ocie/shortsaletips.pdf>.

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