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## Short Sale Developments: "Close-Out" Requirement Made Permanent and Additional Regulatory Initiatives Expected from the Securities and Exchange Commission

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On July 27, 2009, the Securities and Exchange Commission (the "Commission") issued a final rule adopting various amendments imposing the so-called "close-out" requirement in Interim Temporary Final Rule 204T of Regulation SHO (the "Temporary Rule") under the Securities and Exchange Act of 1934 (the "Exchange Act").<sup>1</sup> As discussed below, the Commission decided to modify the Temporary Rule only to a limited extent,<sup>2</sup> citing its effectiveness in combating abusive "naked" short selling practices.<sup>3</sup> On the same day, the Commission also announced that Interim Temporary Rule 10a-3T will expire without being extended or renewed.<sup>4</sup> Accordingly, the short sale and position reporting requirements on Form SH will no longer be necessary after August 1, 2009. It is anticipated that a new reporting regime for disclosing short sale data will be proposed by the Commission in the near future. Separately, the Commission will host another public roundtable on September 30, 2009 to discuss securities lending, pre-borrowing and possible additional short sale disclosures.<sup>5</sup>

### I. Rule 204 under Regulation SHO

While most provisions contained in the Temporary Rule will continue to operate as before,<sup>6</sup> Rule 204 includes certain limited modifications as follows:

- Rule 204(a)(1) provides the ability for a participant to close out a fail to deliver position at a registered clearing agency resulting from a long sale by either purchasing or *borrowing* securities no later than the beginning of the third consecutive settlement day following the settlement date (that is, T+6). Previously, under the Temporary Rule, participants were required to purchase securities to close-out fails to deliver resulting from long sales. Commenters noted that borrowing securities serves the same purpose as purchasing securities to close out fails to deliver and that allowing a borrow to close out such fails would be consistent with the close-out requirement for short sales.<sup>7</sup> A similar provision is also added to Rule 204(a)(3), permitting the T+6 close-out by means of borrowing securities in the case of a fail to deliver position 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 market.

- Rule 204(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position resulting from a sale of any equity security that a person is "deemed to own" and that such person intends to deliver as soon as the applicable restrictions have been removed, the participant must, by no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date, immediately close out the fail to deliver position by purchasing securities of like kind and quantity. Previously, under the Temporary Rule, the extended settlement provision applied only to sales of equity securities pursuant to Rule 144 of the Securities Act of 1933. Rule 204(a)(2) includes sales of other equity securities that a person is "deemed to own" pursuant to Rule 200 of Regulation SHO and intends to deliver as soon as all restrictions on delivery have been removed.<sup>8</sup> In addition, the close-out period of Rule 204(a)(2) is revised to track the delivery period contained in Rule 203(b)(2)(ii) of Regulation SHO: that is, thirty-five consecutive *calendar* days from the trade date, rather than thirty-six consecutive *settlement* days from the *settlement* date.
- Rule 204(b) no longer contains an exception 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 Commission believes that this exception is unnecessary because a market maker, like all broker-dealers, is excepted from the so-called "pre-borrow" requirements of Rule 204(b) if it timely certifies to the participant that 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 is in compliance with Rule 204(e), as discussed below.
- Consistent with the above-discussed change in Rule 204(a), Rule 204(e) permits a broker-dealer to borrow the security (instead of requiring the broker-dealer to purchase the security) when it engages in an early close-out to claim a "pre-fail credit." As for the quantity of securities to be purchased or borrowed, Rule 204(e) states that it must be sufficient to cover the entire amount of the broker-dealer's *fail to deliver* position at a registered clearing agency, rather than the entire amount of the broker-dealer's *open short* position. Several commenters strongly advocated for this change because a broker-dealer's open short position could far exceed its fail to deliver position.<sup>9</sup> Rule 204(e) also includes the original requirement under the Temporary Rule stipulating that the broker-dealer claiming the pre-fail credit must be net flat or net long on its books and records. In this context, we have been informally advised by the Commission staff that securities borrowed by a broker-dealer should be treated as if they were purchased for the limited purposes of determining the broker-dealer's net position under Rule 204(e).
- Finally, Rule 204(f) provides that a participant of a registered clearing agency will not be deemed to fulfill the requirements of Rule 204 if it enters into an arrangement with another person to purchase or borrow securities as required by Rule 204 and knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow. Although the Commission has previously noted that Regulation SHO prohibits market participants from engaging in "sham close-out" practices, the Temporary Rule did not include a provision that explicitly prohibited this practice.

## II. Form SH

Rule 10a-3T, which was adopted by the Commission in October 2008, required certain managers to report short sale and short position information to the Commission on a weekly basis on Form SH. The Press Release confirmed that the Commission will not renew or extend the rule beyond the August 1, 2009 expiration date. It also was noted in the Press Release that the Commission made the rule temporary "so that it could evaluate whether the benefits from the data justified the costs associated with the rule." Since adoption, numerous industry commentators have raised objections based on the burdens associated with the frequency of reporting the seemingly arbitrary categories of market participants who were required to report, and the limitations on the reported data.

Although the Commission has not published any formal guidance on the effect of the timing of the expiration of the rule on filings that straddle the August expiration date, members of the Commission staff have informally confirmed that no filing is required after the expiration. Therefore, the final Form SH filing deadline is Friday July 31, 2009 (reporting activity for the prior week).

Instead of extending or renewing Rule 10a-3T, the Commission is working with self-regulatory organizations ("SROs") to make short sale volume and transaction data available through the SROs' websites. It is anticipated that the amount of information that will be available will be a substantial increase from the information currently required by Rule 10a-3T. Specifically, the Commission is working with SROs to provide the following information:

- Daily publication of short sale volume information. It is expected that, in the next few weeks, SROs will begin publishing on their websites the aggregate short selling volume in each individual security for that day.
- Disclosure of short sale transaction information. It is expected that, in the next few weeks, the SROs will begin publishing on their websites on a one-month delayed basis information regarding individual short sale transactions in all exchange-listed equity securities. To date, neither the Commission nor its staff has indicated what specific information will be published regarding individual transactions.
- Twice monthly disclosure of fails data. It is expected that, in the next few weeks, the Commission will enhance the publication on its website of fails to deliver so that such information is provided twice per month and for all equity securities, regardless of fails level.<sup>10</sup>

## III. Roundtable

The Commission intends to host a public roundtable on September 30, 2009 to discuss securities lending, pre-borrowing and possible additional short sale disclosures. The roundtable will consider the following topics: the potential impact of requiring short sellers to pre-borrow their securities, possibly on a pilot basis; 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.

<sup>1</sup> Exchange Act Release No. 60, 388 (Jul. 27, 2009) (the "Final Release"), available [here](#). These amendments take effect on July 31, 2009, the same date that the Temporary Rule is set to expire.

<sup>2</sup> For our previous analysis of the Temporary Rule, click [here](#).

<sup>3</sup> The Commission frequently refers to the preliminary results from the Office of Economic Analysis (the "OEA") to prove the effectiveness of the rule. See Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, November 26, 2008 *available here*; see also Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, March 20, 2009 *available here*; Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, April 16, 2009, *available here*.

<sup>4</sup> See SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency (July 27, 2009), *available here* (the "Press Release").

<sup>5</sup> The Commission previously hosted a roundtable on May 5, 2009, which focused on various pending proposals to restrict the amount of short selling in general. A transcript of the roundtable is available [here](#).

<sup>6</sup> Note that the close-out requirement applies only to equity securities. In the case of structured products where the "equity" status is not clear, the Commission will consider these products on a case-by-case basis to decide whether the provisions of Rule 204 and Regulation SHO should apply more generally.

<sup>7</sup> See e.g., Letter from Stuart Kaswell, Executive Vice President and General Counsel, Managed Funds Association, (Dec. 15, 2008) *available here*.

<sup>8</sup> Such circumstances could include the situation where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date. See Final Release (*citing* 2004 Regulation SHO Adopting Release, 69 Fed Reg 48004, 48015 (Aug. 6, 2004)).

<sup>9</sup> See e.g., Amal Aly, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, (Dec. 16, 2008) *available here*.

<sup>10</sup> For current fail to deliver information, see [www.sec.gov/foia/docs/failsdata.htm](http://www.sec.gov/foia/docs/failsdata.htm).

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