



# CLIENT MEMORANDUM

## Latest SEC Actions Regarding Short Selling

*October 24, 2008*

### INTRODUCTION

As part of its continuing efforts to respond to recent stock market volatility, the Securities and Exchange Commission (the "SEC") has adopted additional rules governing short selling and settlement of equity transactions. Some of the objectives of these rules, which are described in more detail in this memorandum, are to combat abusive "naked" short selling, to ensure timely transaction settlement and to provide the SEC with information about the short selling positions and the activity of certain institutional investors.

Specifically, on October 14, 2008, the SEC (i) adopted Rule 10b-21 as a "naked" short selling antifraud rule, (ii) amended Regulation SHO to eliminate the options market maker exception and (iii) adopted Rule 204T, which enhances the delivery requirements for equity securities, as an interim final temporary rule and solicited comments from the public. On October 15, 2008, the SEC also modified and extended its Form SH reporting requirements as an interim final temporary rule and solicited comments from the public.

### BACKGROUND

Short selling involves any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>1</sup> "Naked" short selling generally refers to selling short without having securities available for delivery within the standard three-day settlement cycle (T+3).

In 2004, the SEC restructured the short selling regulatory framework by adopting Regulation SHO<sup>2</sup> to address, among other issues, concerns that "naked" short selling and persistent "fails to deliver" securities by the standard settlement date undermine confidence in the settlement system. Regulation SHO requires broker-dealers to "locate" securities that are the subject of a short sale. A broker-dealer is prohibited from effecting short sales in equity securities unless it either (i) has borrowed the security, or entered into a bona fide

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<sup>1</sup> 17 CFR 242.200(a).

<sup>2</sup> See [Exchange Act Release No. 50103](#) (July 28, 2004). Regulation SHO became effective on January 3, 2005.

arrangement to borrow the security, or (ii) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the settlement date.<sup>3</sup> Regulation SHO permits broker-dealers to rely on customer assurances that the customer has identified its own source of borrowable securities, provided that it is reasonable for the broker-dealer to do so.

The SEC remains concerned that some short sellers may make misrepresentations to broker-dealers regarding (i) whether they have located securities to deliver to settle short sales or (ii) whether they are deemed to own securities for purposes of marking a sale as "long" under Regulation SHO or circumventing Rule 105 of Regulation M,<sup>4</sup> which prohibits certain short sellers from purchasing securities in a secondary or follow-on offering.

### "NAKED" SHORT SELLING ANTIFRAUD RULE

#### *Rule 10b-21*

Rule 10b-21 under the Securities Exchange Act of 1934 (the "Exchange Act") provides that it is unlawful for any person to submit an order to sell an equity security if (i) such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding its intention or ability to deliver the security on the date delivery is due and (ii) such person fails to deliver the security on or before the date delivery is due.<sup>5</sup> In addition, a seller will be liable for a violation of Rule 10b-21 for causing a broker-dealer to mark an order to sell a security "long" if such seller knows or recklessly disregards that it is not "deemed to own" the security being sold, as defined in Rules 200(a) through (f) of Regulation SHO,<sup>6</sup> or if the seller knows or recklessly disregards that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the seller fails to deliver the security by the settlement date.

For purposes of Rule 10b-21, broker-dealers (including market makers) acting for their own accounts will be considered sellers. Scienter is a necessary element for a violation of the rule.<sup>7</sup> A private plaintiff able to prove all those elements in a situation covered by Rule 10b-21 would

be able to assert a claim under Section 10(b) of the Exchange Act.

#### *Relationship of Rule 10b-21 to Other Antifraud Provisions of the Federal Securities Laws*

Rule 10b-21 does not affect the operation of Rule 10b-5 or other antifraud rules, but rather supplements the existing antifraud rules. The SEC originally proposed Rule 10b-21 on March 17, 2008.<sup>8</sup> After soliciting public comments, the SEC decided not to adopt the rule at that time; although it is unclear what incremental effect, if any, Rule 10b-21 is meant to or will have on the SEC's enforcement of liability associated with abusive "naked" short selling. To clarify the continued applicability of the general antifraud provisions outside of the strict context of Rule 10b-21, the SEC added a preliminary note to the rule as adopted, which states: "This rule is not intended to limit, or restrict, the applicability of the general antifraud provisions of the federal securities laws, such as section 10(b) of the [Exchange] Act and rule 10b-5 thereunder."

#### **Elimination of the Options Market Maker Exception and Guidance Regarding Bona Fide Market Making Activities**

In addition to adopting Rule 10b-21,<sup>9</sup> the SEC amended Regulation SHO to eliminate the options market maker exception, under which options market makers were not required to close out certain fail to deliver positions in threshold securities<sup>10</sup> in accordance with the Regulation

<sup>3</sup> 17 CFR 242.203(b).

<sup>4</sup> 17 CFR 242.105.

<sup>5</sup> See [Exchange Act Release No. 58774](#) (October 14, 2008).

<sup>6</sup> 17 CFR 242.200(a)-(f).

<sup>7</sup> Scienter has been defined as "a mental state embracing the intent to deceive, manipulate or defraud." [Ernst & Ernst v. Hochfelder, et. al.](#), 425 U.S. 185, at 193 n.12 (1976). The SEC intends the scienter requirement of Rule 10b-21 to be the same as that required under Rule 10b-5.

<sup>8</sup> See [Exchange Act Release No. 57511](#) (March 17, 2008).

<sup>9</sup> See [Exchange Act Release No. 58775](#) (October 14, 2008).

SHO close-out requirements<sup>11</sup> if the purpose of the short sales was to establish or maintain a hedge on options positions that were established before the subject security became a threshold security.

#### *Elimination of the Options Market Maker Exception*

In a September 17, 2008 emergency order,<sup>12</sup> the SEC temporarily eliminated the options market maker exception. On October 14, 2008, the SEC permanently removed the options market maker exception from Rule 203(b)(3) of Regulation SHO. It will no longer be possible for fails to deliver threshold securities by option market makers to remain open indefinitely.

#### *Bona Fide Market Making Activities*

Market makers engaged in bona fide market making in a security at the time they effect a short sale in that security are excepted from Regulation SHO's locate requirement. The SEC provided guidance about the scope of bona fide market making activities. The SEC has stated that a market maker engaged in bona fide market making is a "broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market." The SEC also discussed some factors that would indicate that a market maker is engaged in bona fide market making activity. Examples of such factors are (i) whether the market maker incurs economic or market risk in the course of its market making activities (risk suggests bona fide activities), (ii) whether the market maker engages in both purchases and sales in roughly comparable amounts and (iii) whether the market maker has continuous quotations that are at or near the market on both the bid and ask side of the market and makes such quotations generally accessible to the public.

#### **HARD CLOSE-OUT REQUIREMENT**

The SEC has also adopted interim Rule 204T,<sup>13</sup> which is applicable to both short and long sales of equity securities, to replace the existing close-out requirements under Regulation SHO. Rule 204T accelerates the close-out

requirements and expands their scope to all equity securities rather than only threshold securities. Because Rule 204T has not been included in a proposing release, it will be subject to public comments until December 16, 2008 before it can be adopted as a final rule.

#### *Interim Rule 204T*

Rule 204T, which the SEC originally adopted through an emergency order on September 17, 2008,<sup>14</sup> will be in effect until July 31, 2009. Rule 204T generally requires that participants of a clearing agency registered with the SEC either deliver equity securities by the settlement date or, if they have not delivered such securities by the settlement date, close out any fail to deliver positions by no later than the beginning of regular trading hours on the settlement day after the failure to deliver (the "Close-Out Date"). Assuming a three-day settlement cycle (T+3), the Close-Out Date would be the fourth settlement day after the transaction date (T+4). Until the broker-dealer has closed out the fail to deliver position by purchasing<sup>15</sup> securities of like kind and quantity, the broker-dealer may not engage in short sales in that security without borrowing, or entering into a bona fide arrangement to borrow, the security. This is referred to as the "pre-borrow" requirement. Because Rule 204T can subject broker-dealers to pre-borrow requirements, it includes a notification provision pursuant to which a participant must notify broker-dealers (i) when it has a fail to deliver position that has not been

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<sup>10</sup> A "threshold security" is any equity security registered under Section 12 of the Exchange Act (i) for which there is an aggregate fail to deliver position for five consecutive settlement days that is at least 10,000 shares and 0.5% of the total outstanding shares and (ii) that is included on the list of threshold securities issued by a self-regulatory organization.

<sup>11</sup> Prior to the adoption of Rule 204T, Regulation SHO generally required parties to close out fails to deliver threshold securities that persisted for more than 13 consecutive settlement days.

<sup>12</sup> See Exchange Act Release No. 58572 (September 17, 2008).

<sup>13</sup> See Exchange Act Release No. 58733 (October 14, 2008).

<sup>14</sup> See Footnote 12 above.

<sup>15</sup> On the Close-Out Date, but not afterwards, a broker-dealer may also use borrowed shares to close out a position.

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closed out in accordance with Rule 204T and (ii) when such a position has been cleared and settled.

For fails to deliver related to (i) long sales and (ii) 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, the Rule 204T close-out requirement is extended to the beginning of regular trading hours on the morning of the third settlement day after the settlement date (T+6 in a standard settlement cycle).

### DISCLOSURE OF SHORT SALES AND SHORT POSITIONS

The SEC has determined that institutional investment managers required to make 13F filings<sup>16</sup> should be required to file a somewhat modified version Form SH to report short sales on a non-public basis until August 1, 2009. The SEC believes that the Form SH filings will provide data to aid the SEC in monitoring short selling activity and identifying patterns of manipulative short selling.

#### *Interim Rule Requiring Short Selling Disclosure*

On October 15, 2008, the SEC adopted Rule 10a-3T under the Exchange Act. This interim rule modifies the Form SH filing requirements that the SEC initially imposed pursuant to an emergency order (the "Short Sale Disclosure Emergency Order")<sup>17</sup>, and extends the obligation to make Form SH filings until August 1, 2009.<sup>18</sup>

- Rule 10a-3T requires each institutional investment manager that is required to make 13F filings to file a report on Form SH with the SEC via EDGAR prior to 5:30 p.m. (Eastern Time) on the last<sup>19</sup> business day of the calendar week immediately following a calendar week (Sunday to Saturday) in which a manager effects a reportable short sale with respect to any Section 13(f) security<sup>20</sup> that is not an option.<sup>21</sup>
- Because it extends for a longer time period than the Short Sale Disclosure Emergency Order, the revised Form SH filing requirement is applicable to institutional investment managers required to

file a Form 13F for the last completed calendar quarter rather than only for the quarter ended June 30, 2008.

- The revised Form SH requires disclosure of (i) the short position at the start of the day, (ii) the gross number of securities sold short on that day and (iii) the short position at the end of the day.<sup>22</sup> These short positions should reflect purchases to close out short sales but should not be net of any long positions in the securities that the filer also holds.
- The SEC has indicated that, if a short sale during a Form SH reporting period triggers a filing requirement, the filer must disclose its outstanding

<sup>16</sup> Institutional investment managers that exercise investment discretion over Section 13(f) securities with an aggregate fair market value on the last trading day of any month of \$100 million or more are subject to Form 13F filing requirements. An institutional investment manager includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person, including a natural person, exercising investment discretion with respect to the account of another person.

<sup>17</sup> See [Exchange Act Release No. 58591A](#) (September 21, 2008).

<sup>18</sup> See [Exchange Act Release No. 58785](#) (October 15, 2008).

<sup>19</sup> Under the Short Sale Disclosure Emergency Order, the Form SH filing deadline was the first business day of the calendar week immediately following a calendar week in which a manager effected reportable short sales. The SEC extended the filing deadline to allow filers more time to compile and verify Form SH data.

<sup>20</sup> In determining which securities are Section 13(f) securities, institutional investment managers may rely on the list of such securities made available on the SEC's website. Generally, the list includes exchange-traded stocks, equity options and warrants, shares of closed-end investment companies, certain convertible debt securities and shares of exchange-traded funds. See [Division of Investment Management: Frequently Asked Questions About Form 13F](#) (May 2005).

<sup>21</sup> Although short positions in options are excluded for purposes of Form SH, transactions involving options, such as the exercise of a put option or the assignment of a call option, can constitute reportable short sales.

<sup>22</sup> Form SH filings under the Short Sale Disclosure Emergency Order were required to disclose: the number and value of each security sold short, the opening short position and closing short position in such security, the largest intraday short position and the time of the largest intraday short position in such security during each calendar day of the prior week.

short positions in Section 13(f) securities other than options, subject to the de minimis exception, including short positions established prior to September 22, 2008.<sup>23</sup>

- Pursuant to a de minimis exception, a Section 13(f) security that is not an option need not be included in a Form SH filing if, on each day during the applicable week, (i) the start of day short position, (ii) the gross number of securities sold short during the day and (iii) the end of day short position<sup>24</sup> all meet both of the following tests:
  - o The short position or sale constitutes less than one-quarter of one per cent (0.25%) of the class of securities issued and outstanding as reported on the issuer's most recent annual or quarterly report, and any current report subsequent thereto (unless the investment manager knows or has reason to believe that the information contained therein is inaccurate); and
  - o The fair market value<sup>25</sup> of the short position or sale is less than \$10,000,000.<sup>26</sup>
- Rather than submitting Form SH in HTML or ASCII format, filers will be required to submit Form SH in XML tagged data format to allow the SEC to more easily review transaction information.<sup>27</sup>

As under the Short Sale Disclosure Emergency Order, all filings made with the SEC on revised Form SH must be filed via EDGAR but will remain non-public to the extent permitted by law. The SEC is concerned that making the Form SH data publicly available could lead to imitative short selling activity. The SEC also confirmed that revised Form SH will continue not to require disclosure of transactions executed on behalf of customers on a "riskless principal" basis.

#### *Request for Public Comments*

This interim disclosure rule will be subject to public comments until December 16, 2008, and the SEC may adopt a final rule prior to the interim rule's expiration on August 1, 2009. Among other issues, the SEC is seeking

comments about whether Form SH filings should be required more or less frequently, whether the reporting requirement should be extended beyond August 1, 2009, whether Form SH filings should remain non-public, whether it is appropriate to limit the Form SH disclosure requirement to 13F filers, whether there are other preferable ways to collect information about short sales, whether market participants should be required to maintain much more detailed books and records regarding short selling activity and whether disclosure requirements should extend to synthetic instruments.

*This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, [www.simpsonthacher.com](http://www.simpsonthacher.com).*

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<sup>23</sup> As a transitional matter, the Form SH filings due on October 24, 2008 and October 31, 2008 may exclude short positions existing prior to September 22, 2008 that must be disclosed in Form SH filings starting with the filing due on November 7, 2008. The short positions reported under the Short Sale Disclosure Emergency Order reflected only trades effected on or after September 22, 2008. All positions existing prior to September 22, 2008 were considered to be "grandfathered" from Form SH reporting requirements under the Short Sale Disclosure Emergency Order.

<sup>24</sup> If only one of these data elements meets the de minimis test, the filer may report "N/A" in the column for that data element.

<sup>25</sup> The fair market value is calculated by multiplying the number of shares by the per share closing price on the relevant day.

<sup>26</sup> Any filer not disclosing pre-September 22 positions in the Form SH filings due on October 24, 2008 and October 31, 2008 will continue to be subject to the \$1,000,000 fair market value test that was applicable under the Short Sale Disclosure Emergency Order for those filings rather than the new de minimis threshold of \$10,000,000.

<sup>27</sup> As a transitional matter, the Form SH filings due on October 24, 2008 and October 31, 2008 may be made using HTML or ASCII rather than the XML format that will be required for subsequent Form SH filings starting with the filing due on November 7, 2008.

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