



## Short Sale Regulation Update: Permanent Adoption of Hard Close-Out Requirement, Expiration of Form SH and Public Disclosure of Volume and Transaction Data

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### INTRODUCTION

Amid the financial market volatility of late 2008, the Securities and Exchange Commission took a number of emergency actions targeting short selling activity and related disclosure. These actions included temporary bans on short sales of certain financial stocks, the abolition of the Regulation SHO market maker exemption, the implementation a short selling antifraud rule and the adoption of interim final temporary rules regarding delivery and disclosure.<sup>1</sup>

As the expiration of the interim final temporary rules approached, the SEC permanently adopted a slightly modified form of Rule 204T, which required sales of equity securities to be closed out no later than the open of trading on the day after the settlement date, but the SEC did not extend Rule 10a-3T, which required certain institutional investors to provide the SEC with information about their short positions and activity on Form SH.<sup>2</sup> Although Form SH is no longer required, the SEC announced that it is working with self-regulatory organizations to develop mechanisms for providing more short sale data to the public. In addition, the SEC has scheduled a public roundtable on September 30, 2009 to discuss short sale issues, including the possible adoption of a short sale price test or short sale circuit breaker to replace the “uptick rule” that was repealed in 2007.

### 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>3</sup> So-called “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>4</sup> to address, among other issues, concerns that naked short selling and persistent “fails to

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<sup>1</sup> See, e.g., Simpson Thacher & Bartlett LLP Client Memorandum, “[Latest SEC Actions Regarding Short Selling](#)” (October 24, 2008).

<sup>2</sup> Final Rule, Amendments to Regulation SHO, [Exchange Act Release No. 60388](#) (July 27, 2009).

<sup>3</sup> Rule 200(a) of Regulation SHO.

<sup>4</sup> Final Rule, Short Sales, [Exchange Act Release No. 50103](#) (July 28, 2004). Regulation SHO became effective on January 3, 2005.

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 (1) has borrowed the security, or entered into a bona fide arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the settlement date.<sup>5</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.

### HARD CLOSE-OUT REQUIREMENT

By adopting permanent Rule 204 in substantially the same form as Rule 204T, which expired on July 31, 2009, the SEC seeks to continue to deter abusive naked short selling and to promote further reductions in fails to deliver. Like Rule 204T, Rule 204 is applicable to short and long sales of all equity securities and requires the prompt close-out of any fail to deliver position. The SEC declined to extend the hard close-out requirement to debt securities.

Rule 204 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, purchase or borrow securities to close out any fail to deliver position 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 participant has closed out the fail to deliver position, the participant and any broker-dealers from which the participant receives trades for clearance and settlement (including introducing and executing brokers) 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 204 can subject broker-dealers to pre-borrow requirements, it includes a notification provision pursuant to which a participant must notify broker-dealers (1) when it has a fail to deliver position that has not been closed out in accordance with Rule 204 and (2) when such a position has been cleared and settled.

For fails to deliver related to (1) long sales and (2) 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 204 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). One of the minor changes made in response to comments is that Rule 204 allows participants to close out fails to deliver from long sales and market making activities by borrowing securities as well as by purchasing securities, whereas Rule 204T required such fails to deliver to be closed out by purchasing securities.

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<sup>5</sup> Rule 203(b) of Regulation SHO.

## DISCLOSURE

Rule 10a-3T, which expired on August 1, 2009, obligated institutional investment managers required to make 13F filings<sup>6</sup> to file with the SEC on a weekly basis a non-public Form SH to report daily short sale information.

The SEC announced that it is working with self-regulatory organizations to enable them to publicly disclose the following data on their websites:

- § daily aggregate short selling volume in each equity security; and
- § information about individual short sale transactions one month after they occur.

The SEC will also update its own website twice each month, rather than once per quarter, with data about fails to deliver for all equity securities, regardless of the level of such fails to deliver at any particular company.<sup>7</sup>

## ROUNDTABLE

On September 30, 2009, the SEC will convene a public roundtable, which will feature input from investors, companies, industry participants and academics, to discuss an array of short sale issues, including securities lending, mandatory pre-borrow or enhanced locate requirements, the addition of a short sale indicator to tapes reporting transactions in exchange-listed securities and public disclosure of large individual short positions. Also likely to be considered at the roundtable are a pending SEC proposal to amend Regulation SHO to add a short sale price test or short sale circuit breaker to replace the “uptick rule” that was repealed in 2007<sup>8</sup> and a proposal from a group of U.S. Senators that the SEC and The Depository Trust & Clearing Corp. develop a central database of stock loan information and require identification of actual shares to be borrowed to cover a short sale (essentially, a “hard locate” requirement that would prevent the same shares from being used to satisfy the locate requirement for multiple short sales).

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<sup>6</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.

<sup>7</sup> This information is available at <http://www.sec.gov/foia/docs/failsdata.htm>.

<sup>8</sup> Proposed Rule, Amendments to Regulation SHO, [Exchange Act Release No. 59748](#) (April 10, 2009).

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