

SEC Adopts Interim Close-Out Requirements for Short Sales

October 16, 2008

As a follow up to the emergency order it issued in September, the Securities and Exchange Commission (SEC) has issued interim final rules imposing close-out requirements on short sales. The new rules take effect October 17, 2008 and expire on July 31, 2009. While these rules generally codify the SEC's earlier emergency order and related guidance from the SEC staff, the interim rules and the SEC's release modify certain aspects of the requirements under the emergency order. Accordingly, we have updated our Q&As regarding the close-out requirements; the following Q&As replace those we sent on September 25.

The SEC's interim rules require that clearing brokers deliver securities to settle long and short sale transactions on the scheduled settlement date for the security (generally Trade Date (T)+3) (Settlement Date). The rules also require that the clearing broker close out most fails to deliver at the beginning of the first settlement day following the Settlement Date, or T+4 (Close-Out Date).

Clearing brokers that do not close out fails in accordance with the interim rules become subject to a "borrowing penalty." Once a broker-dealer is subject to the borrowing penalty, the broker-dealer may not effect short sales without (1) pre-borrowing the security or (2) entering into a *bona fide* pre-borrow arrangement, in both cases until the broker-dealer purchases securities to close out the fail-to-deliver position and the purchase clears and settles at a registered clearing agency.

As explained below, the interim rules include exceptions from the close-out requirements and borrowing penalty for long sales and market-making activity. In addition, the interim rules allow a broker-dealer to allocate close-out responsibility to one or more of its correspondent firms, and allow a correspondent firm to avoid the borrowing penalty in a particular security by certifying to its clearing firm that it has not incurred a fail-to-deliver position in that security.

Throughout its release, the SEC emphasized the notion that "all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased." In this regard, the SEC expressly stated that clearing brokers should consider having in place policies and procedures to help ensure that delivery on sales of securities is being made by Settlement Date, and that the SEC intends to conduct examinations to determine whether clearing brokers' policies and procedures do in fact monitor for delivery by Settlement Date.

1. When does a clearing broker become subject to the borrowing penalty? How long does the penalty last?

Under the interim rules, a clearing broker with a fail position on Settlement Date does not become subject to the borrowing penalty as long as it **purchases or borrows** to close out the fail by no later than the beginning of regular trading hours on the Close-Out Date. A clearing broker that becomes subject to the borrowing penalty remains subject to the penalty until the covering purchase clears and settles. For example, if the clearing broker waits until T+5 to close out the fail, the firm remains penalized until T+8.

2. What constitutes purchasing or borrowing "by no later than the beginning of regular trading hours"?

The SEC's release states that "regular trading hours" has the same meaning as in Rule 600(b)(64) of Regulation NMS under the Securities Exchange Act of 1934 (Exchange Act), which provides generally that "[r]egular trading hours means the time between 9:30 a.m. and 4:00 p.m. Eastern Time." In addition, the release states that the clearing broker must take "affirmative action" to borrow or purchase securities before that time. The SEC also stated that a clearing broker must be able to demonstrate on its books and records that on the Close-Out Date it purchased or borrowed shares in the full quantity of its Settlement Date fail-to-deliver position and, therefore, that the participant has a net flat or net long position on its books and records in that equity security on the Close-Out Date.

With respect to **purchases** to satisfy the close-out requirement, the SEC staff previously had indicated that a purchase made on the Close-Out Date to satisfy the close-out requirement must be submitted in time for the market open that day and not be subject to limits on the time or price of the execution. In particular, a "market on open" order would satisfy the requirement. The SEC staff also indicated that as long as the order is submitted on time, it does not have to be executed immediately at the open of trading on the market. The interim rules do not allow for the satisfaction of the close-out requirement through "market on close" orders, volume weighted average price (VWAP) orders, or staggered executions (created, for example, to avoid driving up the price on a thinly traded security). However, the SEC did request comment on whether clearing brokers should be permitted to purchase securities at any time during the course of the Close-Out Date to satisfy the close-out requirement.

With respect to **borrowing** to satisfy the close-out requirement, the SEC staff previously had indicated that if a borrow request has been entered by a clearing broker no later than the beginning of regular trading hours on the Close-Out Date, then the borrowing penalty would not attach to the clearing broker even if the shares are not delivered on time to settle the trade, so long as the failure to deliver was not the fault of the clearing broker. The SEC staff noted, however, that the determination of whether the borrowing penalty should apply ultimately would be based on the particular facts and circumstances and each clearing broker must be able to document the steps it took to effect the borrow.

3. *May a clearing broker count securities delivered on the morning of the Close-Out Date to reduce a fail position in effect as of Settlement Date?*

In its release, the SEC stated that a clearing broker may not offset the amount of its Settlement Date fail-to-deliver position with shares that the participant receives or will receive on the Close-Out Date. However, in footnote 46 of the release, the SEC stated that, in determining its close-out obligation, a participant may rely on its net delivery obligation as reflected in its notification from the National Securities Clearing Corporation (NSCC) regarding its securities delivery and payment obligations, provided such notification is received prior to the beginning of regular trading hours on the Close-Out Date.

Presumably, the ability to rely on the NSCC notification will allow a clearing broker to offset the amount of its fail position with securities that are delivered on the Close-Out Date before the beginning of regular trading hours. For example, if the clearing broker's fail position is 1,000 shares on Settlement Date, and it receives 500 shares before the beginning of regular trading hours on the Close-Out Date, the clearing broker's close-out requirement would be reduced to 500 shares.

4. *How does the borrowing penalty extend to the clearing broker's customers and introducing firms?*

Generally, the borrowing penalty applies to short sales of all of the clearing broker's customers and correspondent firms, regardless of whether they were responsible for the fail. As a result, investors may find that their clearing broker or executing brokers will act quickly to buy them in and may not provide advance notice, as has been customary in the past, in an effort by the brokers to avoid becoming subject to the borrowing penalty.

However, the interim rules include two exceptions with respect to correspondent firms:

- **Allocation by Clearing Firms**

The interim rules provide that a clearing broker may reasonably allocate responsibility for a portion of the close-out requirement to another broker-dealer that is responsible for that portion of the fail

position (e.g., an introducing broker or an executing broker, including a market maker). The ability to allocate responsibility in this context allows flexibility among the parties to use the execution capabilities of the broker-dealers best positioned to handle the close-out. In its release, the SEC noted timeliness as a factor in determining whether the allocation is reasonable. Presumably an allocation would also be “reasonable” so long as the responsible broker-dealer has execution capabilities and systems sufficient to effect the close-out.

A broker-dealer with responsibility for the close-out requirement will become subject to the borrowing penalty if it does not close out the trade by the beginning of regular trading hours on the Close-Out Date, either by purchasing or borrowing the securities or through a Pre-Fail Credit (described below). The broker-dealer must notify the clearing broker immediately when it becomes subject to a borrowing penalty.

- **Certification to Clearing Firms**

Even if a clearing broker becomes subject to the borrowing penalty, a correspondent firm will not become subject to the borrowing penalty if it timely certifies to the clearing broker that it has not incurred a fail-to-deliver in the security on Settlement Date or is in compliance with the requirements for a Pre-Fail Credit (described below).

5. How may a broker-dealer effect an “early close out” using Pre-Fail Credits to avoid the borrowing penalty?

The interim rules permit early close-outs through purchases prior to the Close-Out Date. These purchase transactions, referred to as Pre-Fail Credits, must be (a) *bona fide*, (b) executed on or after the trade date but by no later than the end of regular trading hours on Settlement Date for the transaction, and (c) of a quantity of securities sufficient to cover the entire amount of the open short position. In addition, the broker or dealer must be able to demonstrate that it has a net long position or net flat position on its books and records on the transaction’s settlement day for which the broker or dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

In its release, the SEC stated that a purchase transaction will not be considered *bona fide* for purposes of the Pre-Fail Credit provisions if the broker-dealer enters into an arrangement with another person to purchase securities, and the broker-dealer knows or has reason to know that the other person will not deliver securities in settlement of the transaction. In addition, the SEC noted the requirement that the purchase must be of a quantity of securities sufficient to cover the entire amount of the open short position, presumably meaning that a broker-dealer may not close out a fail-to-deliver position by combining a Pre-Fail Credit with a purchase or borrow on the Close-Out Date.

6. How does the close-out requirement affect market makers?

The interim rules provide an exception to the close-out requirement for registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market (Market Makers). (The exception does not apply to block positioners.) Specifically, the close-out requirement is extended for fails to deliver attributable to *bona fide* market-making activities by Market Makers to the beginning of regular trading hours on the morning of the third settlement day after Settlement Date (i.e., T+6) rather than the usual Close-Out Date (i.e., T+4). The SEC staff has eliminated the requirement from the emergency order that any Market Maker to which a fail-to-deliver position at a registered clearing agency is attributable must submit a written attestation that the fail-to-deliver position at issue was established solely for the purpose of meeting its *bona fide* market-making obligations.

In order to allow Market Makers the necessary flexibility to facilitate customer orders in fast-moving markets, the interim rules except Market Makers from the borrowing penalty upon a failure to close out in accordance with the rules so long as the Market Maker can demonstrate that it does not have an open fail-to-deliver position at the time of any subsequent short sales.

7. What is the close-out requirement for long sales?

If a clearing broker can demonstrate on its books and records that a fail-to-deliver position resulted from a long sale, the broker has until the third settlement day following Settlement Date (T+6) to close out the fail without becoming subject to the borrowing penalty. Under these circumstances, the clearing broker must **purchase** the securities in question to close out the fail. (The SEC staff had previously indicated that if a clearing broker takes advantage of the T+6 close-out requirement, it may borrow or otherwise make delivery of the securities before T+6 if it completes delivery prior to that date, but it is required to close out through a purchase if it waits until the beginning of trading on T+6 to make delivery.)

8. What is the close-out requirement for Rule 144 securities? Does it apply to privately placed securities?

If a clearing broker has a fail-to-deliver position for 35 consecutive settlement days after the settlement date of a sale in an equity security sold pursuant to Rule 144 under the Securities Act of 1933 (1933 Act), the broker has until the 36th consecutive settlement day following Settlement Date to close out the fail without becoming subject to the borrowing penalty. Although the rule itself applies only to Rule 144 securities, footnote 92 of the SEC's release states that the extended close-out period also applies in the following circumstances:

- Fails to deliver resulting from sales of restricted equity securities made pursuant to an effective resale registration statement under Rule 415 under the 1933 Act, if the fails to deliver resulted from sales of securities that were outstanding at the time they were sold and the sale occurred after a registration has become effective.
- Fails to deliver resulting from sales pursuant to broker-assisted cashless exercises of compensatory options to purchase a company's stock.

Additionally, the SEC requested comment on whether the interim rules should include a similar exception for securities other than those sold pursuant to Rule 144.

9. Does the close-out requirement apply to syndicate short sales?

In footnote 50 of its release, the SEC stated that, with respect to a net syndicate short position created in connection with a distribution of a security that is part of a fail-to-deliver position at a registered clearing agency, the close-out requirements do not apply provided action is taken to close out the net syndicate short position by no later than the beginning of regular trading hours on the 30th day after commencement of sales in the distribution.

10. How do the interim rules affect prime brokerage arrangements?

Neither the interim rules nor the SEC's release discuss the effect of the close-out requirements on prime brokerage arrangements. Because the borrowing penalty applies at the clearing broker level, prime brokers may impose additional requirements on executing brokers to ensure that short sales effected by the executing brokers do not fail.

11. How will the interim rules affect securities lending practices?

In footnote 70 of its release, the SEC noted that 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, the person that has loaned the security will be "deemed to own" the security for purposes of Regulation SHO and the sale will not be treated as a short sale for purposes of interim rules. In those cases, the close-out requirements for long sales will apply.

Additionally, while the interim rules do not prohibit the use of locates in connection with short sales where the clearing broker is not subject to the borrowing penalty, it is possible that clearing firms may insist on receiving pre-borrows on all short sales if traditional stock lenders withdraw from the market. Stock lending agents and clearing brokers that rely on borrowings from those lenders may want to discuss the mechanics around borrowings in light of the new rules to ensure that there will be available borrowing to satisfy trade orders. In addition, securities lending firms may want to take steps to lock up the locates or pre-borrows they have given so that they are able to fulfill all of their commitments to lend.

The SEC also specifically requested comment on issues related to securities lending practices, including the effect of the interim rules on borrowing costs and whether the use of locates should be prohibited.

12. How does the close-out requirement apply to exercises and assignments of options?

The issue is not addressed by the interim rules, but the SEC staff previously had indicated that the close-out requirement applies to exercises of options but not to assignments.

To view the SEC's release, please visit: <http://www.sec.gov/rules/final/2008/34-58773.pdf>.

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