

SEC Announces Actions on Short Sales

August 10, 2009

On July 27, the Securities and Exchange Commission (SEC) announced several actions in its continuing examination of short sale regulation. First, the SEC adopted Rule 204 of Regulation SHO under the Securities Exchange Act of 1934 (Exchange Act), making permanent its interim rule imposing close-out requirements on short sales. Second, the SEC announced that it would not extend its interim rule requiring the filing of short sale disclosures on Form SH (Rule 10a-3T under the Exchange Act), and would instead be working with the SROs to develop alternative means of disclosure. Third, the SEC announced that it would hold another roundtable on trading- and market-related practices in short selling, this one on September 30, 2009. The SEC has not announced official plans to take action on its April 2009 proposal to amend Regulation SHO, leaving it unclear for the moment as to whether it will postpone action on the proposal until after the September 30 roundtable.

Final Rule 204 of Regulation SHO

As adopted, Rule 204 of Regulation SHO is substantially similar to the SEC's interim Rule 204T. Generally speaking, Rule 204 requires that broker-dealers close out most fail positions at the beginning of the first settlement day following the Settlement Date, generally T+4. Broker-dealers that do not close out fail positions in accordance with Rule 204 become subject to a "borrowing penalty" until the broker-dealer purchases securities to close out the fail position and the purchase clears and settles at a registered clearing agency.

A broker-dealer has until the third settlement day following settlement date (T+6) to close out the fail position without becoming subject to the borrowing penalty if (1) the broker-dealer can demonstrate on its books and records that a fail position resulted from a long sale or (2) the fail position is attributable to 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 final rule includes some modifications from the interim rule:

- **Early Close Outs Using Pre-Fail Credits.** Rule 204 continues to permit early close outs through the use of so called "Pre-Fail Credits." However, Rule 204 now provides that a broker-dealer may use either purchases or borrows to obtain the Pre-Fail Credits, rather than being limited to purchases. In addition, Rule 204 provides that a broker-dealer is only required to obtain Pre-Fail Credits to cover its open fail position, rather than having to cover the entire amount of its open short position.
- **Using Borrowed Shares to Close Out Fail Positions.** As noted above, Rule 204 continues to allow broker-dealers until T+6 to close out a fail position without becoming subject to the borrowing penalty if the fail position results from long sales or from bona fide market making activity. However, broker-dealers now may either borrow or purchase securities to close out those fail positions, rather than being limited to purchases.
- **Allowing Extended Close Out Period for All "Deemed to Own" Securities.** Rule 204 incorporates the provision of Rule 204T stating that fail positions resulting from sales of securities pursuant to Rule 144 under the Securities Act of 1933 must be closed out by no later than the beginning of regular trading hours on the 35th consecutive calendar day following Settlement Date. However, Rule 204 extends the application of that time frame beyond Rule 144 securities to all securities that a person is "deemed to own"

pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed.

- **Explicit Prohibition on Sham Close Outs.** Rule 204 now includes specific language to provide that a broker-dealer will not be deemed to have fulfilled the requirements of Rule 204 where the broker-dealer enters into an arrangement with another person to purchase or borrow securities as required by Rule 204, and the broker-dealer knows or has reason to know that the other person will not deliver securities to settle the purchase or borrow.

Increased Disclosure of Short Sale Activity

As noted above, the SEC neither extended nor permanently approved interim Rule 10a-3T under the Exchange Act, which required disclosure of certain short selling activity on Form SH. Instead, the SEC stated that it, along with its staff, is working with the SROs to increase the public availability of short sale-related information.

Specifically, the SEC indicated that there would be increased disclosure in the following areas, all of which it expects to begin in the next few weeks:

- **Daily Publication of Short Sale Volume Information.** The SEC stated that the SROs are expected to begin publishing on their websites the aggregate short selling volume in each individual equity security for that day.
- **Disclosure of Short Sale Transaction Information.** The SEC stated that the SROs are expected to begin publishing on their websites, on a one-month delayed basis, information on individual short sale transactions in all exchange-listed equity securities.
- **Twice Monthly Disclosure of Fail Position Data.** The SEC stated that it will enhance the publication on its own website of fails-to-deliver data so that fails-to-deliver information is provided twice per month and for all equity securities, regardless of the fails level. Current fail-to-deliver information is available on the SEC's website at <http://www.sec.gov/foia/docs/failsdata.htm>.

The SEC did not provide any additional information about these disclosure mechanisms, although it is important to note that there is nothing in the SEC's statements to indicate that any such disclosure will reveal the identities of the underlying trading parties involved in the transactions.

SEC Roundtable—September 30, 2009

The SEC will hold a public roundtable on September 30, 2009, to consider trading and market practices relating to short sales. The SEC indicated that the roundtable panelists will consider, among other things:

- Additional means to foster transparency, such as 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
- Whether it would be appropriate to impose a pre-borrow or enhanced "locate" requirement on short sellers, potentially on a pilot basis
- Issues related to securities lending, such as compensation arrangements, disclosure practices and methods of collateral and cash-reinvestment

It is not clear at this time how the September roundtable will affect the timing of the SEC's consideration of its April 2009 proposals to reinstate price restrictions on short sales. Particularly given its recent record before the D.C. Circuit, the SEC may be continuing to examine the legal justification for imposing those restrictions. For example, the comment letter submitted by the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association (the ABA Letter) discussed the legal requirements applicable to a government agency that is reinstating a regulatory requirement. In particular, the ABA Letter quoted a recent Supreme Court decision, *FCC v. Fox Television Stations, Inc.*, in which the Court stated that, when an agency is changing policy, "a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the

prior policy.” The ABA Letter suggested further that, if the SEC decides to adopt a price test, it should “articulate a clear nexus between the adopted test and the public interest, particularly the protection of investors.”

In the meantime, the topics of the upcoming roundtable continue to be of great interest to industry participants, with the prospect of a mandatory pre-borrow of particular concern to the securities industry. Members of Congress have already weighed in, with seven senators writing to SEC Chairman Mary Schapiro, urging the SEC to consider a “hard locate” requirement prohibiting execution of a short sale unless a unique identification number for the specified number of shares to be sold is obtained, and identifying DTCC as a potential provider of an automated centralized system to facilitate such hard locates.

On that topic, the comment letter submitted by the Securities Industry and Financial Markets Association (SIFMA) expressed strong opposition to any pre-borrow requirement. SIFMA noted in particular the unintended consequences of the SEC’s temporary pre-borrow requirement on short sales of certain securities during July 2008, including: (1) a significant reduction in stock loan liquidity in some of the subject securities; (2) significantly higher borrowing costs; and (3) substantial balance sheet costs for many firms related to financing pre-borrows. In addition, SIFMA noted that many of its observations are substantiated by studies that have focused on the impacts of the July 2008 requirements, including a study by the SEC’s Office of Economic Analysis, which generally concluded that the pre-borrow requirement had the effect of reducing liquidity and increasing borrowing costs.

The SEC’s Adopting Release is available at <http://www.sec.gov/rules/final/2009/34-60388.pdf>.

The study by the SEC’s Office of Economic Analysis is available at <http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf>.

The ABA and SIMFA letters are available at <http://www.sec.gov/comments/s7-08-09/s70809.shtml>.

The letter from the seven senators is available at http://kaufman.senate.gov/press/press_releases/release/?id=58553367-AF70-47F7-8308-D9AB25AE0842.

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