

ADVISORY

July 2009

SEC ANNOUNCES ADDITIONAL STEPS TO PREVENT ABUSIVE SHORT SALES AND INCREASE MARKET TRANSPARENCY

On July 27, 2009, the US Securities and Exchange Commission (SEC) announced several initiatives aimed at preventing abusive short selling practices and allowing more short sale trading information to be accessible to the public.¹ As part of these initiatives, the SEC finalized amendments to Regulation SHO under the Securities Exchange Act of 1934 (Exchange Act) by making permanent interim final temporary Rule 204T (temporary Rule 204T) with certain limited modifications that address commenters' concerns.² In addition, the SEC announced that it was working together with several self-regulatory organizations (SROs) to make short sale volume and transaction data available through SRO websites. The SEC also announced its intention to host a roundtable to discuss whether additional measures are needed to further enhance market quality and transparency, as well as address short selling abuses.

The SEC's actions come at a time when two interim final temporary rules, Rule 204T and Rule 10a-3T, are set to expire on July 31, 2009 and August 1, 2009, respectively. The SEC also continues to actively consider proposals on short sale price tests and circuit breaker restrictions, although nothing about such proposals was discussed as part of the July 27, 2009 announcement.

RULE 204

On October 14, 2008, the SEC adopted temporary Rule 204T as an interim final rule.³ Rule 204T is set to expire July 31, 2009, on which date, new Rule 204 will become effective. Two of the goals of temporary Rule 204T were to reduce the number of fails to deliver and prevent abusive "naked" short selling in the market. Based on preliminary results from the SEC's Office of Economic Analysis (OEA), the SEC believes that the adoption of temporary Rule 204T helped to achieve these goals. Therefore, the SEC decided to adopt Rule 204 in substantially the same form as temporary Rule 204T, subject to certain modifications implemented to address commenters' operational concerns.

¹ SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency (July 27, 2009), available at: <http://www.sec.gov/news/press/2009/2009-172.htm>.

² SEC Release No. 34-60388 (July 27, 2009), available at: <http://www.sec.gov/rules/final/2009/34-60388.pdf>.

³ SEC Release No. 34-58773 (October 14, 2008), available at: <http://www.sec.gov/rules/final/2008/34-58773.pdf>.

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Financial Regulatory Reform

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As with temporary Rule 204T, Rule 204 imposes a penalty on any participant⁴ of a registered clearing agency,⁵ and any broker-dealer from which it receives trades for clearance and settlement, for having a fail to deliver position at a registered clearing agency in any equity security. Specifically, Rule 204 requires a participant of a registered clearing agency, subject to limited exceptions, to deliver securities for clearance and settlement on a long or short sale in any equity security by settlement date (three days after the sale transaction date, or T+3). If a participant has a fail to deliver at a registered clearing agency in any equity security for a short sale transaction in that equity security, by no later than the beginning of regular trading hours on the settlement day following the settlement date (T+4), the participant must immediately close out the fail to deliver position by borrowing or purchasing the securities in the market. If the fail demonstrably results from a long sale, the fail must be closed out within three days of the fail (T+6). A participant that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell that security either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail to deliver position is closed out. For additional information on temporary Rule 204T, please see our prior advisories describing temporary Rule 204T and its implications in more detail.⁶

4 The term “participant” has the same meaning as in Section 3(a)(24) of the Exchange Act, which defines it to mean, when used with respect to a clearing agency, any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is: (i) through another person who is a participant; or (ii) as a pledgee of securities.

5 The term “registered clearing agency” means a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to Section 17A of the Exchange Act. Pursuant to Section 3(a)(23)(A) of the Exchange Act, the term is defined as any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who: (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates; or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

6 SEC Adopts Rules Governing Short Sales and Reporting of Short Sales and Short Positions (October 2008), *available at*:

In response to commenters’ concerns regarding temporary Rule 204T, however, the SEC has made some modifications to Rule 204. These modifications include the following:

- Allowing clearing brokers to close out fail to deliver positions relating to a documented long sale by borrowing securities rather than being required to purchase them.⁷
- Expanding the scope of securities that are entitled to a longer settlement period from securities that are sold only pursuant to Rule 144 of the Securities Act of 1933 to all securities that a person is “deemed to own” pursuant to Rule 200 of Regulation SHO and that such person intends to deliver once all restrictions on that security have been removed. In addition, the SEC has revised the close-out period within which a participant must close out fails to deliver resulting from sales of such owned securities from 36 settlement days following the settlement date to 35 calendar days following the settlement date.⁸
- Allowing a market maker to close out any type of fail to deliver position by borrowing securities rather than just purchasing them.⁹
- Allowing a broker-dealer to purchase or borrow securities to obtain credit for closing out a position prior to the applicable close-out date.¹⁰
- In order to obtain pre-fail credit, requiring a broker-dealer to purchase or borrow a quantity of securities sufficient to cover the entire amount of that broker-dealer’s fail to deliver position, rather than the entire amount of the broker-dealer’s open short position.¹¹
- Eliminating the separate exception from the pre-borrowing requirements applicable only to market makers that can

http://www.arnoldporter.com/resources/documents/CA_SECAadoptsRulesGoverningShortSalesandReporting_102408.pdf; The SEC Extends Emergency Short Sale Orders (October 2008), *available at*: http://www.arnoldporter.com/resources/documents/CA_TheSECExtendsEmergencyShortSaleOrders_100308.pdf; SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (September 2008), *available at*: http://www.arnoldporter.com/resources/documents/CA_SECIssuesNewRulesToProtectInvestorsAgainst_091808.pdf.

7 See Rule 204(a)(1).

8 See Rule 204(a)(2).

9 See Rule 204(a)(3).

10 See Rule 204(e).

11 See Rule 204(e)(3).

demonstrate that they do not have an open position in the equity security at the time of any additional short sales.¹²

In its adopting release, the SEC also clarified that Rule 204(b) imposes a short sale pre-borrowing penalty until a participant closes out a fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency. Therefore, regardless of whether a participant borrows or receives delivery of securities in connection with short sale fails, the requirements of Rule 204(b) continue to apply until the participant purchases securities to close out the fail to deliver position and that purchase has cleared and settled at a registered clearing agency. In addition, the SEC has decided not to include a de minimis or odd-lot related exception to the close-out requirements at this time but said that it will continue to monitor whether such exemption is appropriate in the future.

INCREASE IN MARKET TRANSPARENCY

The SEC has also announced that it is working together with several SROs to make short sale volume and transaction data available through the SRO websites. According to the SEC, this effort will result in a substantial increase over the amount of information presently required under temporary Rule 10a-3T, which is set to expire August 1, 2009. Temporary Rule 10a-3T currently requires certain market participants to provide short sale and short position information on Form SH to the SEC. Temporary Rule 10a-3T, however, applied only to certain institutional money managers and did not require public disclosure. Instead of renewing this rule, the SEC and its staff, together with SROs, are working to substantially increase the public availability of short sale-related information through a series of other initiatives. Specifically, the SEC and its staff along with the SROs are working on publishing on SRO websites in the coming weeks the aggregate short selling volume in each individual equity security for each day and publishing on a one-month delayed basis information regarding individual short sale transactions in all exchange-listed equity

securities. It is also expected that the SEC will enhance the publication on its 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.

SEC ROUNDTABLE SCHEDULED

In addition, the SEC intends to hold a public roundtable on September 30, 2009 to discuss securities lending, pre-borrowing, and possible additional short sale disclosures. 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. Panelists will also consider whether it would be appropriate to impose a pre-borrow or enhanced "locate" requirements on short sellers, potentially on a pilot basis. Panelists will discuss issues related to securities lending such as compensation arrangements, disclosure practices, and methods of collateral and cash-reinvestment as well.

Arnold & Porter LLP will be closely monitoring any developments in this area and will prepare additional advisories as new information is provided. We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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¹² See 204(b). The SEC did not believe that this separate exception was necessary in Rule 204 because, as with other broker-dealers, a market maker is already excepted from the pre-borrowing 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 that is in compliance with certain requirements outlined in Rule 204(e).