

Client Advisory

September 2008

New Emergency Short Sale Rules Effective September 18, 2008

The SEC has issued new rules to limit “naked” short selling abuses. Through the use of an emergency order, the SEC has adopted temporary Rule 204T and previously proposed Rule 10b-21. Additionally, the SEC passed a previously proposed rule that eliminates the existing options market maker exception from the current Regulation SHO close-out requirement. All of these rules came into effect at 12:01 a.m. (EST) on September 18, 2008.

Rule 204T: Hard Close-Out Requirements

Rule 204T applies to every participant of a registered clearing agency (“Clearing Firms”) and each broker-dealer from which such participant receives trades for clearance and settlement (“Introducing Brokers”). Rule 204T expires at 11:59 p.m. (EST) on October 1, 2008.

Hard T+3 Close-Out Requirements

Under the Rule, Clearing Firms are required to deliver securities to NSCC for clearance and settlement on all long and short sales by settlement date (“T+3”). If the Clearing Firm has a fail to deliver position on T+3, it will be required to immediately close out the fail by borrowing or purchasing securities of like kind and quantity by no later than the beginning of regular trading hours on the settlement day following the settlement date (“T+4”).

If, however, the Clearing Firm can demonstrate that any fail resulted from a long sale, it is allowed until the beginning of regular trading hours on the third consecutive settlement day following the settlement date (“T+6”) to close out such fail.

Further, if the Clearing Firm has a fail to deliver position at a registered clearing agency in restricted stock sold pursuant to Rule 144 for thirty-five consecutive days, the Clearing Firm is required to close out such fail by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement day for the transaction (“T+39”).

Pre-Borrow Requirement Applies When Fails Are Not Closed Out

If a Clearing Firm has a fail to deliver position in a security that is not closed out in accordance with the timeframes set forth above, both the Clearing Firm and its Introducing Brokers (including market makers) are required to have borrowed or made arrangement to borrow the security before accepting any customer short sale orders for such security or effecting any short sales for its own account. Thus, when there is a fail to deliver that has exceeded the Rule 204T timeframes for close-out, a broker cannot merely “locate” that security, it must pre-borrow it. If the Clearing Firm subsequently closes out the fail to deliver position and the close-out transaction had settled, the “pre-borrow” requirement is lifted for subsequent short sales.

Clearing Firm Notice Requirement

If a Clearing Firm has a fail to deliver position in any equity security that exceeds the Rule 204T timeframes set out above, it is required to notify its Introducing Brokers regarding the fail situation and when such situation is resolved (so that the Introducing Broker can comply with the pre-borrow requirements discussed above).

Rule 10b-21: Short Selling Anti-fraud Rule

The emergency order adopted new Rule 10b-21, which clarifies that persons who deceive specified persons such as brokers about their intention or ability to deliver securities in time for settlement and that fail to deliver at settlement have engaged in a “manipulative or deceptive device or contrivance” in section 10(b) of the Exchange Act.

Elimination of Options Market Maker Exception

The emergency order amends Regulation SHO Rule 203(b)(3) to immediately eliminate the options market maker exception from the current SHO close-out requirement.

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