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Client**Advisory**

SEC Adopts Final Short Selling Rules

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Effective October 17, 2008, the Securities and Exchange Commission ("SEC") adopted four rules revising prior emergency orders regarding short sales. The rules are:

- Rule 10a-3T, a continuation of the short sale disclosure requirements;
- Rule 10b-21, a continuation of the short sale antifraud provisions;
- An amendment to Regulation SHO which abolishes the market maker exemption from the new close-out requirements; and
- Rule 204T, a continuation of the hard delivery requirement for equity securities.

Short Sale Disclosure Requirements

Interim final temporary Rule 10a-3T, which is effective through August 1, 2009, extends the requirement that certain institutional investment managers disclose their short sales and positions weekly on Form SH.[1] Under the Rule, a manager must disclose if it was required to file a Form 13F for the most recent quarter.[2] Disclosure is required from a covered manager on the last business day following any week in which it effects a short sale in any Section 13(f) security other than options.[3]

The Rule requires all short positions to be disclosed, including those effected prior to September 22, 2008, which were previously exempted by a grandfather provision. Filers are no longer required to include the value of the securities sold short, the largest intraday short position, or the time of day of the largest position. Additionally, the *de minimis* exception has been increased from $1 million to $10 million, and filers must submit their disclosures as XML tagged data files. Disclosure is not required with respect to a security if, on each calendar day of the relevant week, (i) the start of day short position, (ii) the gross number of securities sold short during the day, and (iii) the end of day short position make up less than 0.25% of the class of securities issued by issuer and the fair market value of these three figures is less than $10 million.

There are two transitional provisions which apply to the Form SH reports due on October 24 and October 31. The Rule does apply to the disclosures filed on those dates, but managers:

i. May exclude disclosure of short positions reflecting short sales before September 22, 2008. If the manager chooses to exclude, it need not report short positions that would otherwise be reportable if the short position is equal to less than 0.25% of the class of securities issued by the issuer and the fair market value of the short position is less than $1 million.[4]

ii. Do not have to file Form SH in XML format, and may continue filing on EDGAR in the same way it was filed pursuant to the Emergency Orders.

The SEC is requesting public comments on the Rule, which should be received within 60 days of its publication in the Federal Register.

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1 Exchange Act Release No. 58,785 (Oct. 15, 2008).

2 A manager is required to file a Form 13F if it exercises investment discretion over accounts holding Section 13(f) securities which have an aggregate fair market value of at least $100 million on the last trading day of any month of any calendar year.

3 The Official List of 13(f) Securities, which may be relied on, can be found here.

4 Note that if the manager chooses to exclude short sales effected or positions established prior to September 22, 2008, the lower $1 million *de minimis* standard is the correct threshold to utilize.

Short Sale Antifraud Provision

Rule 10b-21 of the Securities Exchange Act of 1934, which went into effect on October 17, 2008, prohibits short sellers from using deceptive practices.[5] A short seller may not deceive broker-dealers by expressing the intention or ability to deliver securities in time for settlement, knowing it is unable to do so, and then failing to deliver on the settlement date.[6] Both elements, a misrepresentation and a failure to deliver, must be present for the seller to be liable. Although focused on short selling, the Rule also applies to long sales in which both factors are present. The Rule applies only to equity securities.

Scienter is a required element under the Rule, so a seller must knowingly or recklessly make a false statement to be liable. A seller that provides a locate source to a broker-dealer in connection with a short sale represents that it has a reasonable basis for believing that the source can and will deliver the securities by the settlement date, and will be liable if the representation is false. Conversely, a seller who relies upon a broker-dealer's "Easy to Borrow" list does not make such a representation, and would not be liable for deceiving the broker if the stock could not be borrowed. A broker-dealer acting for its own account is subject to the Rule, whether it is a market maker or not.

Abolition of the Market Maker Close-Out Exemption

The permanent abolition of the options market maker exception to the close-out requirements of Regulation SHO went into effect on October 17, 2008.[7] Options market makers now must close out their fail to deliver positions resulting from hedging activities at the beginning of the day after the fail occurs. The Rule is subject to a one-time 35-day phase-in period for existing fail to deliver positions that previously had been exempted from the new requirement. However, under new Rule 204T, if the fail to deliver position is attributable to a registered market maker in the course of bona fide market making activities, the clearing firm has two additional days to close out the position.[8]

Under Rule 203(b)(1) of Regulation SHO, market makers engaged in bona fide market making activities are also exempt from Regulation SHO's locate requirement. The locate requirement prevents a broker-dealer from accepting a short sale order or effecting a short sale for its own account in an equity security unless it has borrowed the security or knows that it can be borrowed, and has documented its compliance. In determining whether market making activities are bona fide, the SEC will look at whether the market maker puts its own capital at risk, stands against the market, takes the other side of trades when there are imbalances, or attempts to prevent excess volatility. Making quotes that are not close to the market price and activities related to speculative selling strategies are not bona fide market making activities.

To the extent that block positioners are engaged in bona fide block positioning activities, they also may rely on the exception in Rule 203(b)(1). A block positioner is a registered broker-dealer which maintains minimum net capital of $1 million and (i) purchases long and sells short from or to a customer a block of stock worth $200,000 or more in a single transaction, or several transactions at the same time, from a single source to facilitate a sale or purchase by the customer, (ii) has reasonably determined that the block could not be sold to or purchased from others on equal or better terms, and (iii) sells the shares of the block as quickly as possible under the circumstances.[9]

Hard Delivery Requirement for Equity Securities

Interim final temporary Rule 204T, which is effective through July 31, 2009, extends the hard close-out provisions of the SEC's September 17, 2008 Emergency Order.[10] Fails to deliver which are caused by short sales are required to be closed out by clearing firms at the beginning of the day after the fail occurs, and long sales must be closed out at the beginning of the third day after the fail occurs.

The close-out is to be accomplished by borrowing or purchasing securities of like kind and quantity. The clearing firm must take affirmative action to obtain the securities, and may not offset the amount of its position with shares that it receives or will receive on the settlement date. If the clearing firm responsible for the failure to deliver does not close out the position

5 Exchange Act Release No. 58,774 (Oct. 14, 2008).

6 Settlement date is defined in the Rule as "the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security." *See id*. at fn. 58.

7 Exchange Act Release No. 58,775 (Oct. 14, 2008).

8 Exchange Act Release No. 58,773 (Oct. 14, 2008).

9 Exchange Act Release No. 58,775, at 30 (Oct. 14, 2008).

10 Exchange Act Release No. 58,773 (Oct. 14, 2008).

on time, it will be subject to fines and sanctions. Additionally, no other firm may accept a short sale in that security from the offending firm unless it has pre-borrowed the security. However, to the extent the firm can identify the broker-dealer whose activities caused the fail, it can allocate the close-out position to that broker-dealer. This subjects the broker-dealer to the Rule's requirements and penalties, instead of the firm.

The Rule has an allowance for a "pre-fail credit" to avoid the close-out and pre-borrow requirements. To qualify for a credit, a broker-dealer must purchase securities before the start of regular trading hours on the day after the settlement date to close out the open position and: (i) the purchase must be bona fide, (ii) the purchase must be executed on or after the trade date, but no later than the end of regular trading hours on the settlement date, (iii) the purchase must cover the entire amount of the short position, and (iv) the broker-dealer must be able to demonstrate through its books and records that it has a net long or net flat position on the settlement date for which it is seeking to show that it purchased shares to close out the open short position.

The Rule permits an introducing broker-dealer to avoid the pre-borrow requirements if it provides a timely certification to its clearing firm that it has not incurred a fail to deliver position on the settlement date for a long or short sale in an equity security for which the clearing firm has a fail to deliver position. Alternatively, the introducing broker-dealer can certify that it qualifies for a "pre-fail credit" with respect to the failed position.

The Rule also has an exception to the close-out provisions for securities sold pursuant to Rule 144 of the Securities Act of 1933. Specifically, the Rule provides that if a clearing firm has a fail to deliver position in an equity security sold pursuant to Rule 144 for 35 consecutive days after the settlement date, the clearing firm must, by no later than the beginning of regular trading hours on the 36th consecutive day, immediately close out the position by purchasing securities of like kind and quantity.

Finally, as noted above, the Rule includes an exception for registered market makers engaged in bona fide market making activities. Such market makers have two additional days to close out their positions. Additionally, market makers are no longer required to attest in writing that the fail was due to bona fide market making activities.

The SEC is requesting public comments on the Rule, which should be received before December 16, 2008.

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