

July 30, 2009

## SEC Makes Short Selling Rule Permanent and Plans to Increase Short Sale Transparency

The Securities and Exchange Commission has amended Regulation SHO under the Securities Exchange Act of 1934, as amended (Exchange Act), by making Interim Final Temporary Rule 204T (Rule 204T) permanent and redesignating it as Rule 204. As discussed below, Rule 204 will adopt substantially all of the requirements of Rule 204T in an effort to reduce the potential for abusive “naked” short selling in the securities market. Rule 204 is effective on July 31.

Additionally, the SEC is working with several self-regulatory organizations (SROs) to make short sale volume and transaction data available through the SROs’ websites. The SEC also intends to hold a public roundtable on September 30 to discuss securities lending, pre-borrowing and possible additional short sale disclosure requirements.

### SEC Rule 204: Close-Out Requirements

Rule 204(a) adopts the close-out requirements of Rule 204T(a) without modification and will require a participant of a registered clearing agency to deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date. If a participant of a registered clearing agency has a fail to deliver position on the settlement date, the participant is required to immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity not later than the beginning of regular trading hours on the settlement day following the settlement date (i.e., T+4).

**Long Sales:** Recognizing that fails to deliver may occur from long sales for legitimate reasons, such as human or operational errors, Rule 204(a)(1) adopts the provisions of Rule 204T(a)(1) relating to closing out fails to deliver resulting from long sales. In contrast to Rule 204T(a)(1), however, Rule 204(a)(1) permits a participant to close out a fail to deliver long position by borrowing securities as well as purchasing securities.

**All Equity Securities:** Consistent with Rule 204T, the close-out requirements of Rule 204 apply to fails to deliver in all equity securities. This differs from the close-out requirement of Rule 203(b)(3) of Regulation SHO that applies only to those securities with a large and persistent level of fails to deliver (i.e., threshold securities).

**Policies and Procedures:** Broker-dealers are required to have policies and procedures to monitor their compliance with the requirements of Rule 204. The SEC stated that they will be examining participants to ensure that they comply with this requirement.

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**Allocation and Notification:** Consistent with Rule 204T(d), Rule 204(d) provides for allocation of a fail to deliver position by a participant to a broker-dealer and requires such a broker-dealer to immediately notify the participant that it has become subject to the borrowing requirements of Rule 204(b). Such allocation must be reasonable (e.g., the allocation must be timely) and must be to the broker-dealer whose activities caused the fail to deliver position.

## SEC Rule 204(b): Borrowing Requirement

Rule 204(b) adopts the borrowing requirements of Rule 204T(b) without modification. If a participant does not purchase or borrow shares to close out a fail to deliver position in accordance with Rule 204, the participant violates the close-out requirement of the rule. Rule 204(b) also imposes on the participant and on all broker-dealers from which that participant receives trades for clearance and settlement (including introducing and executing brokers) a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security.

As discussed above with respect to Rule 204(d), to the extent that a participant can identify the broker-dealer(s) that contributed to the fail to deliver position, and the participant has reasonably allocated the close-out obligation to the broker-dealer(s), the requirement to borrow or arrange to borrow prior to effecting further short sales in that security will apply only to those particular broker-dealer(s).

**Allocation:** Rule 204(b) incorporates the language of Rule 204T(b)(1) that exempts from the borrowing requirements any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant.

**Notification Requirement:** Without modification to Rule 204T(c), under Rule 204(c) participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position has not been closed out in accordance with Rule 204.

**Credit for Early Close-Outs:** To continue to encourage broker-dealers to close out fail to deliver positions prior to the close-out date, the SEC has incorporated the conditions of Rule 204T(e) into Rule 204 with some limited modifications. In recognition that a broker-dealer's open short position could far exceed its open fail to deliver position, and in contrast to Rule 204T(e)(3), Rule 204(e)(3) provides that a broker-dealer must purchase or borrow a quantity of securities sufficient to cover the entire amount of that broker-dealer's fail to deliver position at a registered clearing agency in that security, rather than the entire amount of the broker-dealer's open short position.

**Market Makers:** Similar to Rule 204T(a)(3), Rule 204(a)(3) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security that 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 participant must immediately close out the fail to deliver position by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date (i.e., T+6). Unlike Rule 204T(a)(3), Rule 204 will permit a borrow as well as a purchase to close out such a fail to deliver position.

**Sales of Certain Deemed to Own Securities:** With slight modifications, Rule 204(a)(2) adopts Rule 204T(a)(2), which includes an exception from the close-out requirements of Rule 204T(a) for sales of securities pursuant to Rule 144 of the Securities Act of 1933, as amended. Unlike Rule 204T(a)(2), Rule 204(a)(2) is not limited to Rule 144 transactions but applies to any equity security 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. One such example is a convertible security, option or warrant that has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date. Additionally, Rule 204(a)(2) modifies the expanded close-out period to provide that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in such a security, the participant must close out the fail to deliver position by purchasing securities of like kind and quantity no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction.

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**Sham Close-Outs:** Participants of a registered clearing agency shall not be deemed to have fulfilled the requirements of Rule 204 where the participant enters into an arrangement with another person to purchase or borrow securities as required by Rule 204 if the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.

## SRO Websites: Increasing Transparency around Short Sales

Instead of renewing Rule 10a-3T, which requires certain market participants to provide short sale and short position information to the SEC (such information provided on Form SH), the SEC and the SROs are working to increase the public availability of short sale-related information. The SEC is working together with several SROs in the following areas:

- **Daily Publication of Short Sale Volume Information:** It is expected in the next few weeks that the SROs will begin publishing on their websites the aggregate short selling volume in each individual equity security for that day.
- **Disclosure of Short Sale Transaction Information:** It is expected in the next few weeks that the SROs will begin publishing on their websites on a one-month delayed basis information regarding individual short sale transactions in all exchange-listed equity securities.
- **Twice Monthly Disclosure of Fails Data:** It is expected in the next few weeks 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

The SEC intends to hold a public roundtable on September 30 to solicit the views of investors, issuers, financial services firms, SROs and the academic community regarding a variety of trading and market-related practices. Among the topics the roundtable will consider are the potential impact of a program requiring short sellers to pre-borrow their securities and adding a short sale indicator to the tapes to which transactions are reported for exchange-listed securities.

Click [here](#) to read the SEC press release.

Click [here](#) to read the SEC adopting release.

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