DAVIS POLK & WARDWELL

Date: October 21, 2008

To: Interested Persons

Re: **SEC Adopts Final Short Sale Rules**

On October 14, 2008, the U.S. Securities and Exchange Commission ("**SEC**") published final rules under the Securities Exchange Act of 1934 ("**Exchange Act**") (i) adopting temporary Rule 204T, which contains a firm delivery requirement for long and short sales, (ii) eliminating the options market maker exception (the "**Options Market Maker Exception**") from the close-out requirement of Rule 203(b)(3) of Regulation SHO, and (iii) adopting the "naked" short selling anti-fraud rule, Rule 10b-21.[1] These rules are effective as of October 17, 2008. Rule 204T will expire on July 31, 2009, but the other rules are permanent. The adopting releases for these rules provide significant new interpretive guidance concerning short sales and related matters.

Rule 204T

The SEC initially adopted Rule 204T as part of temporary emergency actions (the "**Emergency Orders**") taken by the SEC in September and early October 2008. Final Rule 204T does not significantly modify the earlier versions of the Rule, but codifies various staff interpretations.

Rule 204T imposes a firm delivery requirement for clearance and settlement of sales of equity securities by the settlement date (ordinarily, T+3). If a participant in a registered clearing organization does not make the required delivery on the settlement date, it must generally close out the position by the opening of business on the next settlement day by either purchasing or borrowing the security.

Final Rule 204T contains a number of exceptions to the general close-out requirement, including:

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[1] Exchange Act Release Nos. 58773, 58774 and 58775 (October 14, 2008). In addition to the actions describe above, on October 15, 2008, the SEC adopted, on a final basis, new temporary Rule 10a-3T under the Exchange Act requiring large institutional investment managers to report short sales. For more information on Rule 10a-3T, please refer to Davis Polk Newsflash: SEC Issues Interim Final Temporary Rule Extending Short Sale Reporting (October 20, 2008).

- *Long sales.* If a fail to deliver resulted from a documented long sale, the participant has until the opening of business on the third business day after the original settlement date to close out the position by purchasing securities of like kind and quantity.
- *Sales under Rule 144.* If a fail to deliver occurs with respect to securities sold under Rule 144 pursuant to the Securities Act of 1933, it must be closed out by the 36th settlement day following the original settlement date by purchasing securities of like kind and quantity.[2]
- *Market Makers*. If a participant has a fail to deliver attributable to bona fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the fail must be closed by the opening of business on the third consecutive settlement day following the original settlement date by purchasing securities of like kind and quantity.

If a participant fails to comply with the close-out requirement, then it (and any broker-dealer from which it accepts trades for clearance and settlement) may not accept a short sale order in the relevant equity security from another person, or effect a short sale for its own account, to the extent that the broker-dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security or entering into a bona fide arrangement to borrow the security.[3] This "pre-borrowing" requirement remains in effect until the participant closes out the fail to deliver position. There are a number of exceptions to this requirement, including:

- *Allocations.* A participant may reasonably allocate responsibility for all or a portion of a fail to deliver position to a broker-dealer for whom it acts as clearing agent (and give notice to that broker-dealer), based upon such broker-dealer's short positions (*i.e.*, the participant may reasonably allocate fails to deliver to the broker-dealer determined to be at fault), in which case, the broker-dealer, and not

[2] The adopting release for final Rule 204T states that fails in securities sold under Rule 415 of the Securities Act of 1933 may also be closed out pursuant to this exception (*i.e.*, must be closed out by the 36th settlement day following the original settlement date) if the fails to deliver "resulted from sales of securities that were outstanding at the time they were sold and the sale occurred after a registration has become effective." In addition, a fail to deliver as a result of an exercise of a cashless compensatory option to purchase a company's stock that is effected at a broker-dealer is also subject to this extended close-out requirement.

[3] Clearing organization participants who become subject to this restriction are also subject to certain requirements to notify broker-dealers for whom they act.

the participant, will be subject to the close-out and, potentially, the pre-borrow requirement.

- *"Good Boys."* If a broker-dealer certifies to the clearing organization participant that it is not responsible for the participant's fail to deliver (or that it will qualify for pre-fail credit, as described below), the broker-dealer will not be subject to the pre-borrow requirement.
- *Market Makers.* Market makers are exempt from the pre-borrow requirement under Rule 204T if they can demonstrate that they do not have an open short position in the security that experienced a fail to deliver at the time of any additional short sales.
- *Pre-Fail Credit.* Under Rule 204T(e), a broker-dealer will be deemed to have complied with the close-out requirements, despite a fail to deliver, if it makes a bona fide purchase of securities covering the entire amount of the open short position prior to the beginning of regular trading hours on the settlement day following the original settlement date for a long or short sale to close out an open short position as long as (i) the purchase is executed on or after the trade date but by the end of regular trading hours on the original settlement date, and (ii) the broker-dealer can demonstrate that it has a net long position or net flat position on the settlement day for which the broker-dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

The adopting release for Rule 204T also reiterates prior interpretive guidance on several important issues, including:

- *Recalls of Loaned Securities.* If a person who has loaned a security to another then sells the security and initiates a bona fide recall of the security within two business days following the trade date, such sale will be treated as a long sale for purposes of Rule 204T.
- *Syndicate Short Positions.* Rule 204T will not apply to a net syndicate short position created in connection with a distribution of a security that is part of a fail to deliver position at a registered clearing agency, provided that action is taken to close out the net syndicate short position by no later than the beginning of regular trading hours on the 30th day after commencement of sales in the distribution.

The Rule 204T adopting release directs participants to implement policies and procedures to ensure delivery is made by the scheduled settlement date.

One important practical effect of Rule 204T is to temporarily override the existing close-out requirements in Rule 203(b)(3) of Regulation SHO (discussed below), since Rule 204T's pre-borrow requirement will apply in a much shorter

timeframe than the close-out requirement for threshold securities found in Rule 203(b)(3) (generally, T+13).

The adopting release requests comment on many aspects of Rule 204T, including whether there are any operational or compliance issues relating to the time in which participants must close out securities positions. Comments are requested by December 16, 2008. As noted above, Rule 204T remains in effect only until July 31, 2009.

Elimination of the Options Market Maker Exception; Guidance on "Bona Fide Market Making"

Rule 203(b)(3) of Regulation SHO establishes a close-out requirement for fails to deliver at a registered clearing agency for certain "threshold securities" (generally, equity securities for which there are persistent fails to deliver that exceed specified levels) at a registered clearing agency after 13 days (in most cases).[4] As originally adopted, and until the Emergency Orders, Regulation SHO contained an exception from the close-out requirements for any fail to deliver position in threshold securities that are attributed to a registered options market maker effecting short sales to establish or maintain a hedge on options positions that were created prior to the security becoming a threshold security. The exception essentially allowed fail to deliver positions created by options market makers in threshold securities to remain open. The Emergency Orders temporarily eliminated the Options Market Maker Exception to Regulation SHO's close-out requirement. As a result, fail to deliver positions in threshold securities resulting from options market maker hedging activities were no longer excepted from the Rule 203(b)(3) close-out requirement. The final rule eliminates the Options Market Maker Exception on a permanent basis.

In the adopting release for the elimination of the Options Market Maker Exception, the SEC also provides additional guidance regarding what is bona fide market making for purposes of complying with the market maker exception to the "locate" requirement of Regulation SHO.[5] To qualify for the locate exception, it

[4] Rule 203(b)(3) also imposes a prohibition on participants in a clearing agency and broker-dealers for whom they act from accepting short sale orders in a threshold security that is subject to these close-out requirements without borrowing or entering into an arrangement to borrow the security until the fail is closed out.

[5] The "locate" requirement of Rule 203(b)(1) provides that a broker-dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has borrowed the security, or entered into a bona fide arrangement to borrow the security or has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. A broker-dealer must also document compliance with these conditions.

is necessary to be a market maker in the security being sold and the market maker must be engaged in bona fide market making activities in that security at the time of the short sale. According to the SEC's guidance in the adopting release, the following factors would tend to indicate that a market maker is engaged in bona fide market making activities:

- economic or market risk with respect to the securities incurred by the market maker (*e.g.*, providing liquidity to a security's market, taking the other side of the trades when there are short-term imbalances in customer orders, or attempting to prevent excess volatility);
- a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customer or other broker-dealers (*e.g.*, selling short into a declining market); and
- continuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to other investors and other broker-dealers.

In addition, the SEC provides examples of activities that it would *not* consider to be bona fide market making, such as:

- an activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security;
- where a market maker continually posts at or near the best offer, but does not also post at or near the best bid; and
- if a market maker continually executing short sales away from a market maker's posted quotes.[6]

Rule 10b-21: "Naked" Short Selling Anti-Fraud Rule

Rule 10b-21 specifies that it is unlawful for *any person* to submit an order to sell an equity security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding its intention or ability to deliver the security on the date delivery is due, and such person in fact fails to deliver the security on or before the date delivery is due. After receiving over 700 comment letters in response to the Rule 10b-21 proposing release, the SEC chose to adopt Rule 10b-21 substantially as proposed in March of this year.

[6] The adopting release also gives the following specific example of a transaction that would not be considered to be bona fide market making: "where a market maker sells stock (short) together with a synthetic short position (*e.g.*, a conversion) to a client and then sells the stock (long) retaining the synthetic short position…." The release states that such a transaction "would be as if the market maker had 'rented' its exemption to the client."

The adopting release discusses at length the interaction of new Rule 10b-21 and Regulation SHO. The SEC notes that under Regulation SHO, the executing or introducing broker-dealer is responsible for determining whether there are reasonable grounds to believe that a security can be borrowed so that it can be delivered on the date delivery is due on a short sale. Regulation SHO allows broker-dealers to rely on a customer's assurance that they have identified their own locate source, provided that it is reasonable for the broker-dealers to do so. If a seller elects to provide its own locate source, it is representing that it has contacted that source and reasonably believes that the source can and will deliver the full amount of the securities to be sold short by the settlement date. Similarly, if a seller enters a short sale order into a broker-dealer's direct market access or sponsored access system with any information purporting to identify a locate source obtained by the seller, the seller has made a representation to the broker-dealer for purposes of Rule 10b-21.

According to the adopting release, a seller could potentially be deemed to have violated Rule 10b-21 if it fails to deliver the securities on settlement date and deceives the broker-dealer about the validity of its locate source by any of the following: (i) never contacting the purported source to determine whether shares were available; (ii) contacting the source and learning that it could not borrow sufficient shares for timely delivery; or (iii) contacting the source, which had sufficient shares that it could deliver in time for settlement, but never instructing the source to deliver the shares in time for settlement and the seller otherwise refusing to deliver shares on settlement date such that the sale results in a fail to deliver.[7] However, the SEC clarified in the adopting release that if the seller in good faith relies on a broker-dealer's "easy to borrow" list to satisfy the locate requirement, the seller would not be deceiving the broker-dealer at the time it submits its short sale order.

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If you have questions regarding this client memorandum, please call your regular Davis Polk contact.

[7] The latter example is somewhat confusing since Regulation SHO does not require, and industry practice does not always result in, the affirmative determination being obtained from the firm that ultimately delivers the securities to settle the transaction. For example, an investor may obtain the affirmative determination from its executing broker but ultimately deliver securities borrowed from its prime broker.