

October 24, 2008

## SEC Adopts Short Selling Rules Giving Effect to Emergency Orders

On October 14 and 15, 2008, the Securities and Exchange Commission adopted four short selling rules designed to give continued effect to emergency measures taken last month. Specifically, the SEC approved:

- Amendments to Regulation SHO requiring market participants to close out short sales on a “T+3” basis;
- Amendments to Regulation SHO eliminating the options market maker exception to the close-out requirement;
- A new disclosure rule requiring institutional investment managers to report short sales on new Form SH; and
- A new antifraud rule that expressly targets short selling transactions.

All of the rules are currently effective. The new close-out requirement and disclosure rule were adopted as interim final temporary rules and will become permanent following a comment period and further SEC action.

### Hard T+3 Close-Out Requirement

The SEC adopted a new temporary rule that effectively requires market participants to close out short sale transactions on a T+3 basis. The new rule, which gives continued effect to an emergency order issued on September 17, is designed to address the problem of abusive “naked” short selling – that is, selling an equity security short without owning or having borrowed the security.

Rule 204T requires participants of a registered clearing agency (which include broker-dealers) to deliver equity securities for clearance and settlement no later than the close of business on the settlement date (three days after the transaction date, or T+3). If there is a failure to deliver securities on the settlement date, then the participant must, by no later than the beginning of regular trading hours on the next following settlement date, close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity.

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A participant who violates this close-out requirement is prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. This prohibition applies to all short sales in the same security effected by the participant, not just future sales for the particular “naked” short seller. The rule is designed to effectively prevent “naked” short selling by causing broker-dealers to require their short selling customers to pre-borrow, rather than run the risk of a failure to deliver.

The new close-out requirement applies to sales of all equity securities. In this respect, it is significantly broader than the current close-out requirement in Regulation SHO, which applies only to “threshold securities” (defined as securities with large and persistent fails to deliver). The new rule provides limited exceptions for sales attributable to bona fide market making activities (close-out required by the third settlement date following the fail to deliver) and sales pursuant to Rule 144, which frequently entail processing delays (close-out required by the 35th settlement date following the fail to deliver).

The new rule was adopted on an interim final temporary basis, which means that the rule is effective immediately and that the SEC will seek public comment before adopting a final rule. Comments are due on December 16, 2008. The interim rule will expire if the SEC has not adopted a final rule by July 31, 2009.

### **Elimination of Options Market Makers Exception**

The SEC also approved a final rule to eliminate the options market maker exception from the close-out requirements applicable to “threshold securities” in Regulation SHO. As a result, options market makers will be treated in the same way as all other market participants for purposes of these requirements.

When the SEC adopted Regulation SHO in 2004, it provided a limited exception for options market makers who were engaged in short selling for hedging purposes prior to the time a given equity security became a threshold security. The SEC has since observed that substantial fails to deliver have continued to persist in threshold securities and that a significant number of such fails appear to be the result of sales by options market makers. The new rule eliminating the exception gives continued effect to an SEC emergency order issued on September 17.

### **Requirement to Disclose Short Sales**

The SEC has adopted short sale disclosure requirements that, with some modifications, give continued effect to the measures adopted by emergency order last month. The new disclosure rule requires institutional investment managers that file reports on Form 13F to report short sales of publicly traded securities on new Form SH on a weekly basis. Options and short sales of options on Section 13(f) securities are not required to be reported. Form SH is a non-public report that must be filed electronically with the SEC using an XML tagged data format (beginning with reports due on November 7).

In adopting the new rules, the SEC modified certain of the reporting and disclosure requirements from those included in its prior emergency orders. The new deadline for Form SH is the *last* business day of each calendar week following a calendar week in which short sales are

effected (under the emergency orders, the deadline had been the *first* business day of the following week). If a Form SH is required to be filed as a result of a short sale, then the investment manager must report *all* short positions (other than those below the threshold described below), even positions that did not involve any short selling activity during the prior calendar week. It remains the case that Form SH need not be filed if no short sales were effected during the prior calendar week.

The new Form SH still requires disclosure of the start of day short position, the intraday number of securities sold short and the end of day short position. However, the SEC has eliminated the requirements to disclose the value of the securities being sold short, the largest intraday short position and the time of day of the largest intraday short position. Importantly, the new rule requires disclosure of all short positions, including those established prior to the effectiveness of the initial emergency order (the emergency orders had only required disclosure of short positions established on or after September 22, 2008). Short positions established before September 22 must be disclosed beginning with reports due on November 7.

An investment manager need not report short sales or short positions otherwise reportable if (i) the fair market value of the start of the day short position, the gross number of securities sold during the day and the end of the day short position each are less than \$10 million (up from \$1 million in the emergency orders) and (ii) the start of the day short position, the gross number of securities sold during the day and the end of the day short position each constitutes less than one-quarter of one percent of that class of the issuer's issued and outstanding Section 13(f) securities.

The new disclosure rule was adopted on an interim final temporary basis and comments are due on December 16, 2009. The interim rule will expire if the SEC has not adopted a final rule by August 1, 2009.

### **Short Sale Antifraud Rule**

The SEC adopted a new antifraud rule under the Securities Exchange Act of 1934 that expressly targets "naked" short selling. The rule was originally proposed in March 2008 and implemented by emergency order on a temporary basis in September 2008. The final rule was adopted substantially as proposed.

Under new Rule 10b-21, a person selling an equity security is liable for securities fraud if the person deceives a broker-dealer, registered clearing agency or purchaser about its intention or ability to deliver the security on or before the settlement date *and* the person fails to deliver the security by such date. The new rule targets short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement (which provides that a broker-dealer effecting a short sale must have reasonable grounds to believe that the security can be borrowed prior to the settlement date). The rule also applies to sellers who misrepresent to their broker-dealers that they own the shares being sold. A violation of the rule requires a showing of scienter.

For purposes of Rule 10b-21, broker-dealers (including market makers) acting for their own accounts are considered sellers. Market makers engaged in bona fide market making activities are not covered by the rule because they are exempt from the locate requirement of Regulation SHO.

The SEC has acknowledged that deceptive short selling may also constitute a violation of the general antifraud provisions of Section 10(b) and Rule 10b-5 under the Exchange Act, and the preliminary note to new Rule 10b-21 states explicitly that the rule is not intended to restrict the general antifraud provisions of the federal securities laws. The SEC's stated purpose in adopting the new rule is to focus the attention of market participants on the illegality of manipulative short selling and to provide a measure of predictability for such participants.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning the short sale rules may be directed to:

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