



Interim Temporary Rule 204T is No Longer Temporary

On July 27, 2009, the Securities and Exchange Commission announced that it made Interim Temporary Rule 204T of Regulation SHO a permanent rule. According to the Commission, Interim Temporary Rule 204T of Regulation SHO was approved in 2008 in response to continuing concerns regarding “fails to deliver” and potentially abusive “naked” short selling. With some modifications, permanent Rule 204T was adopted in the same form as the temporary rule. In general, permanent Rule 204(a) provides that, subject to certain exceptions, a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by the applicable settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity. The exemptions include fail to deliver positions related to (i) long sales that can be demonstrated in the books and records of the clearing agency, (ii) the sale of securities that a person is deemed to own pursuant to Rule 200 of Regulation SHO (such as restricted shares that are transferable under Rule 144), provided that the person intends to deliver the securities as soon as all restrictions on delivery of the securities have been removed and (iii) positions at a registered clearing agency in any equity security that is 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. Such positions are not exempted from Rule 204T completely; rather, the clearing agency has a longer period to close out such positions. The Commission has stated many times that it believes that strengthening the close-out requirements of Regulation SHO protects and enhances the operation, integrity, and stability of the markets, and helps reduce potential short selling abuses.

The Commission reported that an analysis conducted by its Office of Economic Analysis, which followed the adoption of the close-out requirement of Rule 204T and the elimination of the “options market maker” exception, showed the number of “fails” declined significantly. As adopted, Regulation SHO included an exemption for options market makers. In an emergency order adopted in September 2008, which was made final in October 2008, the Commission eliminated this exemption. For a detailed discussion of Regulation SHO and other issues relating to short selling and the reforms thereof, consult our Client Alerts posted in the Short Selling Reform section of our Financial Crisis Website located at <http://www.mofo.com/news/updates/files/14605.html>.

According to the Office of Economic Analysis’ report, since the fall of 2008, fails to deliver in all equity securities have decreased by approximately 57% and the average daily number of threshold list securities has declined from a high of approximately 582 securities in July 2008 to 63 in March 2009. The Commission believes that the strict close-out requirements of Interim Temporary Rule 204T have helped reduce fails to deliver by providing a disincentive to those who, but for the rule, may have failed to deliver securities by settlement date. The Commission further noted that participants have been operating pursuant to the close-out requirements of the temporary rule, as adopted, and appear to have adjusted to the requirements of the rule. The Commission did not

address whether and to what extent other factors may have contributed to the decrease in fails to deliver and the number of threshold securities. The last year witnessed a substantial decline in capital market transactions, such as follow-on offerings and PIPEs, which have, in the past, attracted the interest of short sellers. The decline in transactions that have whetted the appetite of short sellers may have also contributed to the decrease in fails to deliver. In addition, the substantial increase in redemption requests by shareholders of hedge funds, many of which often act as short sellers, may have forced some hedge funds to limit their shorting activity. Last, the substantial decrease in the market capitalization of many of the issuers of threshold securities may have created a financial incentive for many short sellers to finally cover or close out their short positions. The Office of Economic Analysis noted in its report that the results may be mitigated or exacerbated by behavioral changes or other factors, although it was more concerned about steps that market participants may take to make it seem that they are in compliance with Regulation SHO when they are not. However, even if the temporary rule is not the sole factor behind the statistics cited by the Office of Economic Analysis' report, the numbers certainly support the Commission's position that the temporary rule advanced its goal of reducing fails to deliver.

The adoption of a permanent Rule 204T is not the only action taken by the Commission recently to regulate short selling. In April 2009, the Commission voted unanimously to seek public comment on short sale price restrictions and "circuit breaker" restrictions. The Commission voted to propose two approaches to restrictions on short selling: one approach would apply on a market wide and permanent basis and the other approach would apply only to a particular security during severe market declines in that security, or "circuit breakers". The Commission has requested comments on two different proposals relating to market wide and permanent restrictions and three proposals relating to circuit breakers. The Commission is currently continuing to collect comment letters regarding these proposals.

On July 27, 2009, the Commission announced that it and its staff are working together with several self-regulatory organizations (SROs) to make short sale volume and transaction data available through the SRO Web sites. The Commission claims that this effort will result in substantially more information being available than that which is required by Temporary Rule 10a-3T. Temporary Rule 10a-3T, which will expire on August 1, 2009, applies only to certain institutional money managers and does not require public disclosure.

On July 27, 2009, the Commission also announced that it intends to hold a public roundtable on September 30, 2009, to discuss securities lending, pre-borrowing and possible additional short sale disclosures. The Commission stated that the roundtable will consider, among other topics, the potential impact of a program requiring short sellers to pre-borrow their securities, possibly on a pilot basis, and adding a short sale indicator to the tapes to which transactions are reported for exchange-listed securities.

In an earlier Client Alert, we noted our expectation that the Commission would adopt regulations to address fails to deliver but would not adopt an express prohibition on naked short selling. In light of the developments discussed in this Client Alert, we have not changed our expectations. While the Commission is clearly dedicated to increasing the regulatory oversight over short selling, it remains hesitant about adopting an express, absolute prohibition on naked short selling, notwithstanding the potential for manipulative behavior provided by such transactions. Despite calls on the Commission to adopt regulations that declare naked short sales illegal, it has not gone so far at this time and we do not anticipate that it will. The Commission has stated on a number of occasions that not all naked short sales are illegal, only those that are abusive. In its press release announcing the adoption of permanent Rule 204T, the Commission expressly noted that naked short sales are permitted because there is no legal requirement that a short seller actually borrow the shares before effecting a short sale. It is hard to predict what the Commission's next step will be, but we will continue to monitor the Commission's balancing of its desire to address abusive naked short selling, and other short selling transactions, while ensuring that the market efficiencies that may be realized by short sales and similar hedging transactions will remain available to market participants.

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