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September 18, 2008

# SEC TAKES EMERGENCY ACTION REGARDING NAKED SHORT SELLING

## INVESTMENT FUNDS ALERT

On September 17, 2008, the Securities and Exchange Commission (SEC) took action pursuant to an emergency order to curb naked shorting of securities by (1) adopting an interim final rule to require the closing out of "failures to deliver" securities (the "Close-Out Rule"), (2) adopting a previously proposed anti-fraud rule targeting deception of market participants about a seller's ability to deliver securities at settlement (the "Anti-Fraud Rule") and (3) amending Regulation SHO to eliminate the option market maker exemption from closing out fails to deliver in threshold securities. The emergency order and the rules thereunder were effective as of 12:01 a.m. on September 18, 2008, and will expire at 11:59 p.m. on October 1, 2008, unless extended by the SEC. The Close-Out Rule will only apply to orders entered after the effectiveness of the rule.

In addition to the above rules, SEC Chairman Christopher Cox and SEC Enforcement Division Director Linda Chatman Thomsen indicated that they intend to take further immediate action. Mr. Cox stated on September 17, 2008, that he would ask the SEC to consider an emergency rule to require hedge funds and other investors with $100 million in securities to disclose their daily short positions. Further, Ms. Thomsen stated that the Division of Enforcement will expand its enforcement efforts against market manipulation.

### THE CLOSE-OUT RULE

The Close-Out Rule, or Rule 204T of Regulation SHO, requires all clearing brokers or other participants of a registered clearing agency (a "clearing firm") to close out any sales of equity securities (including short sales and certain long sales that cannot be properly documented) for which the seller fails to deliver equity securities by the settlement date by borrowing or purchasing securities of like kind and quantity by the beginning of trading on the business day following the original settlement date. If the clearing firm fails to deliver securities and does not close out the failure to deliver by the next settlement day, the clearing firm with the failure to deliver will not be able to accept any short sale order in that equity security from any person without first borrowing the security or arranging to borrow the security until such clearing firm closes out the original failure to deliver. Under current SEC rules, the settlement date for the sale of securities must be no later than the third business day after entering into the trade (T+3).

## THE ANTI-FRAUD RULE

The Anti-Fraud Rule, or Rule 10b-21 under the Securities Exchange Act of 1934, as amended, deems any person who deceives a broker, dealer, clearing firm, purchaser as to such person's ability or intention to deliver securities in connection with the sale of an equity security to be a "manipulative or deceptive device or contrivance" in violation of 10(b) if such person fails to deliver the security. The deception may include a representation to the broker that the seller has arranged to borrow the securities or by marking the securities as a long sale when the seller does not own the securities or maintain a long position.

## ELIMINATION OF THE OPTION MARKET MAKER EXCEPTION

Prior to amendment, Rule 203 of Regulation SHO required clearing firms to close positions in any security designated as a threshold security by a self regulatory organization within 13 days after a failure to deliver, but Rule 203 did not apply to certain short sales by options market makers. The SEC has now amended Rule 203 to eliminate the exception for options market makers. Clearing firms will now be required to close out any open transactions in threshold securities for which an options market maker has failed to deliver securities by the 36th consecutive settlement date after the effectiveness of the amendment. If they fail to close out the transaction, they will be required to borrow the securities or arrange to borrow the security for all transactions in a manner similar to the Close-Out Rule.

## CONCLUSION

The SEC's new rules curb naked short selling of equity securities by (1) shortening the period in which securities transactions must be closed out to the standard three-day settlement cycle, (2) applying the close-out requirements to all securities and (3) providing new anti-fraud enforcement tools. Presumably, broker-dealers will require stronger assurances that short sellers have arranged to borrow securities in order to avoid being required to buy in securities to close out trades. We will provide you further information as it becomes available regarding changes to the short selling rules, including requirements to disclose short positions.

## CONTACT INFORMATION

If you have any questions regarding this alert, please contact–


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