

## INVESTMENT FUNDS ALERT

### SEC ADOPTS NEW RULES ON SHORT SELLING

On October 14, 2008, and October 15, 2008, the Securities and Exchange Commission (SEC) adopted rules that continue the effectiveness of certain emergency orders issued by the SEC on September 17, 2008, and September 18, 2008. The SEC's new rules include (1) an interim final temporary rule that continues the requirement of persons filing Form 13Fs to report their short sales and short positions (the "Short Sale Reporting Rule"), (2) an interim final temporary rule to require the closing out of "failures to deliver" securities (the "Close-Out Rule"), (3) a final rule targeting deception of market participants about a seller's intention or ability to deliver securities at settlement (the "Anti-Fraud Rule") and (4) a final amendment to Rule 203 of Regulation SHO that eliminates the option market maker exemption from the requirement to close out failures to deliver in threshold securities. The Short Sale Reporting Rule and the Close-Out Rule contain significant changes from the previously published emergency orders, which changes are described in more detail below. The Anti-Fraud Rule and the elimination of the market maker exception are substantially similar to the previously published emergency orders.

The Short Sale Reporting Rule will be effective from October 18, 2008, to August 1, 2009. The Close-Out Rule will be effective from October 17, 2008, until July 31, 2009. The Anti-Fraud Rule and the elimination of the market maker exception will be effective on October 17, 2008, and extend indefinitely.

#### SHORT SALE REPORTING RULE

The Short Sale Reporting Rule, or Rule 10a-3T under the Securities Exchange Act of 1934, requires any person that files a Form 13F for the relevant calendar quarter, to file a Form SH on a weekly basis reporting any daily short sales and changes in short positions. The SEC revised the Short Sale Reporting Rule included in the previous emergency orders and Form SH by, among other things, (1) changing the due date of Form SH, (2) eliminating certain reporting requirements from Form SH, (3) changing the de minimis exception, (4) eliminating the grandfather provision for short positions entered into prior to September 22, 2008, and (5) requiring the filing of Form SH in XML format.

- **Due Date of Form SH.** The Form SH filing must be made on the last business day of each calendar week immediately following the calendar week in which any new short positions with respect to Section 13(f) securities (excluding options) were effected.

- **Elimination of Categories on Form SH.** Form SH no longer requires reporting (i) the value of securities sold short, (ii) the largest intraday stock position and (iii) the time of the largest intraday short position.
- **De minimis Exception.** The revised Short Sale Reporting Rule increases the “de minimis” exception for reporting short sales or short positions to \$10 million in market value and 0.25 percent of the issued and outstanding Section 13(f) securities.
- **Elimination of Grandfather Provision.** Filing persons must now include short positions that existed prior to September 22, 2008. There is an optional two-week phase-in period for reporting pre-September 22 short positions. If a filing person takes advantage of the phase-in period by excluding pre-September 22 short positions from its Form SH report to be filed on October 24, 2008, and/or October 31, 2008, the lower de minimis exception threshold of \$1 million in market value and 0.25 percent of the issued and outstanding class of the relevant 13(f) securities continues to apply for the phase-in period.
- **XML Formatting.** A Form SH must be filed electronically through EDGAR as an XML tagged data file.

Form SH will remain nonpublic to the extent permitted by law. A manager must continue to label its Form SH as nonpublic by adding the phrase **NONPUBLIC** (in bold and capital letters) at the top and bottom of each page of the form, with the exception of the XML tagged data file containing transaction data.

## THE CLOSE-OUT RULE

The revised Close-Out Rule, or Rule 204T of Regulation SHO, is similar to the version of the Close-Out Rule included in the SEC’s emergency order issued on September 17, 2008, but contains certain modifications, including several exceptions, and allows clearing brokers or other participants of a registered clearing agency (each a “clearing firm”) to delegate some responsibilities to the firms for which they clear (each an “introducing firm”).

The revised Close-Out Rule requires a clearing firm or introducing 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 or introducing firm fails to deliver securities and does not close out the failure to deliver by the next settlement day, such firm 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 and closing 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 above requirements apply differently for certain long sales, for certain market making activities and for sales pursuant to Rule 144 under the Securities Act of 1933, as amended. Transactions that a clearing firm can demonstrate on its books and records resulted from a long sale, or transactions that are 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 are required to be closed out by the beginning of trading hours on the third consecutive settlement day following the original settlement day. Sales of equity securities pursuant to Rule 144 are required to be closed out by the 36th consecutive settlement day following the original settlement date.

In addition, the borrowing requirements of the revised Close-Out Rule do not apply to market makers if they meet certain requirements or to clearing firms or introducing firms that have purchased securities prior to a failure to deliver.

Market makers are exempted from the borrowing requirements of the Close-Out Rule if they can demonstrate that they do not have any open short positions at the time of any additional short sales. The revised Close-Out Rule also allows clearing firms and introducing firms to purchase securities prior to a failure to deliver, so long as (1) the purchase is bona fide, (2) the purchase is executed on or after the trade date but by no later than the end of regular trading hours on the settlement date for the transaction, (3) the purchase is of a quantity of securities sufficient to cover the entire amount of the open short position and (4) the clearing firm or introducing firm can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the clearing firm or introducing firm is seeking to demonstrate that it has purchased shares to close out its open short position.

Our previously published client alerts on the September Emergency Order and Form SH can be found [here](#).

## CONTACT INFORMATION

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