



MEMO #: 1647-08

**MEMORANDUM**

TO: Options Members and Member Organizations

FROM: Tom Wittman  
Charles Rogers  
Edith Hallahan

DATE: September 18, 2008

RE: **New SEC Rules on Short Selling Now In Effect**

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Yesterday, we advised you that the Securities and Exchange Commission announced that new rules were adopted relating to short selling. The new rules took the form of an Emergency Order that became available last night and became effective just after midnight. The Order expires at 11:59 p.m. on October 1, 2008 unless further extended or otherwise amended by the SEC.

From our reading thus far, the SEC imposed enhanced delivery requirements on sales of all equity securities. Specifically, the SEC imposed a hard T + 3 delivery requirement that applies to all fails to deliver resulting from trades that occur beginning today, including fails that would have previously been covered by the options market maker exception to the close-out requirement.

Fails resulting from trades occurring **before today** continue to be governed by the previous requirements of Reg SHO, except that the SEC also eliminated the market maker exception; accordingly, **fails in threshold securities that were previously not required to be closed out because of the market maker exception must now be closed out within 35 days after today, the effective date of this Order.**

Of course, member organizations should be communicating with their clearing firms on how these new delivery requirements will operate and how short sales will be handled going forward. These are significant changes and members should focus carefully on how this might affect operations and compliance obligations. We understand that many questions have been raised and the staff continues to monitor developments. We will continue to update you in the event that the SEC issues further guidance in this area.

The Order is attached for your convenience and contains the newly adopted language. Please note that the Order does not reprint all of Reg SHO, but rather only the new text.

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
RELEASE NO. 34-58572/ September 17, 2008

EMERGENCY ORDER PURSUANT TO SECTION 12(k)(2) OF THE SECURITIES  
EXCHANGE ACT OF 1934 TAKING TEMPORARY ACTION TO RESPOND TO  
MARKET DEVELOPMENTS

The Commission continues to be concerned that there is a substantial threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets that could threaten fair and orderly markets. As evidenced by our recent publication of an emergency order under Section 12(k) of the Securities Exchange Act of 1934 (the “July Emergency Order”),<sup>1</sup> we are concerned about the possible unnecessary or artificial price movements based on unfounded rumors regarding the stability of financial institutions and other issuers exacerbated by “naked” short selling. Our concerns, however, are no longer limited to just the financial institutions that were the subject of the July Emergency Order. In addition, we have become concerned that some persons may take advantage of issuers that have become temporarily weakened by current market conditions to engage in inappropriate short selling in the securities of such issuers.

Given the importance of confidence in our financial markets as a whole, we have become concerned about sudden and unexplained declines in the prices of securities. Such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental

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<sup>1</sup> See Exchange Act Release No. 58166 (July 15, 2008).

underlying basis. This crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences.

As a result of these recent developments, the Commission concluded that there continues to exist a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets. Based on this conclusion, the Commission is exercising its powers under Section 12(k)(2) of the Securities Exchange Act of 1934.<sup>2</sup> Pursuant to Section 12(k)(2), in appropriate circumstances the Commission may issue summarily an order to alter, supplement, suspend, or impose requirements or restrictions with respect to matters or actions subject to regulation by the Commission.

We have concluded that it is necessary to impose enhanced delivery requirements on sales of all equity securities, by adding and making immediately effective a temporary rule to Regulation SHO, Rule 204T. The temporary rule imposes a penalty on any participant<sup>3</sup> of a registered clearing agency,<sup>4</sup> and any broker-dealer from which it receives trades for clearance and settlement, for having a fail to deliver position at a registered clearing agency in any equity security. In addition, we have concluded it is necessary to make immediately effective amendments to Rule 203(b)(3) of Regulation SHO that eliminate the options market maker exception from Regulation SHO's close-out

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<sup>2</sup> This finding of an "emergency" is solely for purposes of Section 12(k)(2) of the Exchange Act and is not intended to have any other effect or meaning or to confer any right or impose any obligation other than set forth in this Order.

<sup>3</sup> The term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24).

<sup>4</sup> The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A) and 78q-1, respectively.

requirement. We are also making immediately effective Rule 10b-21, a “naked” short selling antifraud rule.<sup>5</sup> We intend these enhanced delivery requirements and the antifraud rule to impose powerful disincentives to those who might otherwise exacerbate artificial price movements through “naked” short selling.

In addition, in these unusual and extraordinary circumstances, we believe such requirements are in the public interest and for the protection of investors to maintain fair and orderly securities markets, and to prevent substantial disruption in the securities markets.

This emergency requirement should significantly reduce any possibility that “naked” short selling may contribute to the disruption of markets in these securities. We described in the releases in which we proposed and adopted Regulation SHO the bases for the current delivery requirements Regulation SHO imposes. We believe, however, that the unusual circumstances we now confront require the enhanced requirements we are imposing today.

IT IS ORDERED that, pursuant to our Section 12(k)(2) powers, we are adding § 242.204T to read as follows:

**§ 242.204T Short Sales.**

- (a) 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 settlement date, or if a participant of a registered clearing agency has a

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<sup>5</sup> Rule 204T, as set forth in this Order, applies only to fails to deliver resulting from trades that occur after this Order becomes effective. Rule 203(b)(3) of Regulation SHO, as amended by this Order, continues to apply to fails to deliver that occurred prior to the Order becoming effective. For example, if a participant has a fail to deliver position in a threshold security that has persisted for six consecutive settlement days prior to the effective date of this Order and the fail continues to persist until the thirteenth settlement day, the participant must still close out its position pursuant to Rule 203(b)(3).

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; Provided, however:

- (1) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, immediately close out the fail to deliver position by purchasing securities of like kind and quantity; or
- (2) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security sold pursuant to § 230.144 of this chapter for thirty-five consecutive settlement days after the settlement date for a sale in that equity security, the participant shall, by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity;
- (b) If a participant of a registered clearing agency has a fail to deliver position in any equity security at a registered clearing agency and does not close out such fail to deliver position in accordance with the requirements of paragraph (a) of this section, the participant and any broker or dealer from which it receives trades for

clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in § 242.203(b)(2)(iii), may not accept a short sale order in the equity security from another person, or effect a short sale in the equity security for its own account, to the extent that the broker or 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, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency;

(c) The participant must notify any broker or dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in § 242.203(b)(2)(iii):

(1) That the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of paragraph (a) of this section; and

(2) When the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency; and

(d) Definitions: (1) For purposes of this section, the term settlement date shall mean the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.

(2) For purposes of this section, the term regular trading hours has the same meaning as in Rule 600(b)(64) of Regulation NMS (17 CFR 242.600(b)(64)).

IT IS FURTHER ORDERED that, pursuant to our Section 12(k)(2) powers, § 242.203(b)(3)(iii) of Regulation SHO is amended by revising paragraphs (b)(3)(iii) and (b)(3)(v) to read as follows:

(iii) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment and which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (i.e., because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

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(v) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(i), (b)(3)(ii), or (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale

order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

IT IS FURTHER ORDERED that, pursuant to our Section 12(k)(2) powers, we are adding § 240.10b-21 to read as follows:

**§ 240.10b-21 Deception in connection with a seller's ability or intent to deliver securities on the date delivery is due.**

PRELIMINARY NOTE to rule 10b-21: This rule is not intended to limit, or restrict, the applicability of the general antifraud provisions of the federal securities laws, such as section 10(b) of the Act and rule 10b-5 thereunder.

It shall also constitute a “manipulative or deceptive device or contrivance” as used in section 10(b) of this Act for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date. For purposes of this section, settlement date is as defined in § 242.204T of this chapter.



This Order shall be effective at 12:01 a.m. EDT on September 18, 2008, and shall terminate at 11:59 p.m. on October 1, 2008 unless further extended by the Commission.

By the Commission.

Florence E. Harmon  
Acting Secretary