

Securities Lending Alert

A report
for clients
and friends
of the firm July 2004 (2)

SEC Adopts New Rules For Short Sales

In the October 2003(2) *Securities Lending Alert*, we discussed proposed rules of the SEC involving short sales. On July 28, 2004, the SEC adopted Regulation SHO (effective 30 days after publication in the *Federal Register*) which requires, among other things, that short sellers in all equity securities "locate" securities to borrow before selling and also imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred.

Rule 203(b), as adopted, prohibits a broker-dealer from accepting a short sale order in any equity securities from another person, or effecting a short sale order for the broker-dealer's own account, unless the broker-dealer has (i) borrowed the securities or entered into an arrangement to borrow the securities or (ii) has "reasonable grounds" to believe that the security can be borrowed in time for delivery on the settlement date. The "locate" must be effected by the broker-dealer and documented prior to effecting a short sale, regardless of whether the seller's short position may be closed out by purchasing securities the same day. The "reasonable grounds" determination can be based on an "Easy-to-Borrow" list if the information used to generate the list is less than 24 hours old and securities on the list are readily available such that it is unlikely that a failure to deliver would occur. Alternatively, a broker-dealer may obtain assurances from its customer that the customer can obtain securities from another identified source in time to settle the trade. A broker-dealer should document such assurances by specifically identifying the source of securities cited by the customer and showing that reliance on the customer assurances is reasonable under the circumstances through, for example, documentation evidencing that previous borrowings arranged by the customer resulted in timely settlement deliveries.

There are several exceptions to the locate requirement. One is where a registered broker-dealer receives a short sale order from another registered broker-dealer that is itself required to comply with Rule 203; for instance, where an introducing broker-dealer submits a short sale for execution (either on a principal or agency basis) to another broker-dealer, the introducing broker-dealer has the responsibility of complying with the locate requirement.

Another exception is for short sales executed by market-makers in connection with "*bona fide market-making activities*." This exception is deemed necessary because market-makers may need to facilitate customer orders in a fast-moving market without delay. Bona fide market-making excludes speculative selling strategies and transactions whereby a market-maker enters into an arrangement with another broker-dealer or customer in order to use the market-maker's exception for the purpose of avoiding compliance with Rule 203 by the other broker-dealer for the customer.

A third exception is where a broker-dealer effects a sale on behalf of a customer that is deemed to own the security although, through no fault of the customer or the broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date (which is technically a "short" sale). These situations include convertible securities which have been tendered for conversion or exchange but the underlying security is not reasonably expected to be received by settlement date. It also includes situations where former Rule 144 restricted stock is able to be sold without restriction, but there are delays in effecting de-legending. For these situations, Rule 203 requires that delivery be made on the sale as soon as all delivery restrictions have been removed and, in any event, no later than 35 days after trade date, at which time the broker-dealer that sold on behalf of the person must either borrow securities or close out the open position by purchasing securities of like kind and quantity.

The SEC declined to except from the locate and delivery requirements, short sales that result in bona fide fully hedged or arbitrated positions. The SEC also declined to except transactions in exchange-traded funds. These situations are to be handled through the exemptive process.

With respect to “delivery,” Rule 203 requires any participant of a registered clearing agency to take action on all failures to deliver that exist in “threshold securities” ten days after the normal settlement date (or 13 consecutive settlement days). A threshold security is defined as any equity security of a registered issuer where, for five consecutive settlement days: there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per securities; the level of fails is at least equal to ½ of 1% of the issuer’s total shares outstanding, and the security is included on a list published by a self-regulatory organization. It is estimated that approximately 3.9% of all exchange-listed and NASDAQ securities, and 4% of all securities, will meet this threshold.

If the fail in a threshold security remains open for 13 consecutive settlement days, the participant must close out the fail by purchasing securities of like kind and quantity and the participant, and any broker-dealer for which it clears transactions (including market-makers that could otherwise rely on the bona fide market-making exception), is prohibited from effecting further short sales in the particular threshold security without borrowing the security unless the fail-to-deliver position is closed out.

The SEC also adopted Rule 203(a) on long sales. Rule 203(a) requires that if a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. This delivery obligation does not apply in three circumstances: (1) the loan of a security through the medium of a loan to another broker or dealer; (2) where the broker or dealer knows or has been reasonably informed by the seller that the seller owns the security and will deliver it to the broker or dealer prior to the scheduled settlement of the transaction and the seller fails to make such delivery; or (3) where an exchange or securities association finds, prior to the loan or arrangement to loan any security for delivery, or failure to deliver, that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price. In addition, Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it concluded that the customer owned the shares and would be able to deliver the security prior to settlement.

The extent to which these provisions will affect the securities lending/borrower market remains to be tested. Clearly, the locate and delivery requirements will act as a brake on naked short selling (selling without having borrowed the securities to make delivery) and curb abuses that have resulted from such practices.

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Client Alert

Proskauer’s Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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