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August 3, 2009

## SEC Adopts Short Selling Rule Giving Permanent Effect to Close-Out Requirement

On July 27, 2009, the Securities and Exchange Commission gave permanent effect to a short selling rule designed to reduce the potential for abusive “naked” short selling. The rule, which was adopted last fall on an interim final basis, requires market participants to close out short sales within three days after the transaction date.

The SEC deferred consideration of short sale disclosure rules, allowing a temporary rule requiring disclosure of short sales to the SEC on Form SH to expire on August 1, 2009. The SEC announced that it would be working with several self-regulatory organizations (“SROs”) to make short sale volume and transaction data available through the SRO websites.

### Hard T+3 Close-Out Requirement

The SEC’s new Rule 204 makes permanent, with limited modifications, the requirements of interim Rule 204T, which was adopted last fall to address the problem of abusive “naked” short selling – that is, selling an equity security short without owning or having borrowed the security. The SEC noted that since the adoption of Rule 204T last fall, the average daily number of fails to deliver for all equity securities has declined by 56%.

Rule 204 requires participants of a registered clearing agency (which includes broker-dealers) to deliver equity securities for clearance and settlement no later than the close of business on the settlement date (three days after the transaction date, or T+3). If there is a fail to deliver securities on the settlement date, then the participant must, by no later than the beginning of regular trading hours on the next following settlement date (*i.e.*, T+4), close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.

A participant who violates this close-out requirement is prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. This prohibition applies to all short sales in the same security effected by the participant, not just future sales for the particular “naked” short seller. The rule is designed to effectively prevent “naked” short selling by causing broker-dealers to require their short selling customers to pre-borrow, rather than run the risk of a failure to deliver.

Like Rule 204T, the close-out requirement of Rule 204 applies to the sale of all equity securities. In this respect, it is significantly broader than the prior close-out requirement in Regulation SHO, which applied only to “threshold securities” (defined as securities with large and persistent fails to deliver). The rule includes limited exceptions to the hard T+3 close-out requirement. If the fail

to deliver results from long sales or certain bona fide market making activities, the participant must close out the fail to deliver position by no later than the beginning of regular trading hours on the third settlement day after settlement date (*i.e.*, T+6). Fails to deliver resulting from the sale of equity securities that a person is “deemed to own” pursuant to Rule 200(a) of Regulation SHO, and which such person intends to deliver as soon as all delivery restrictions have been removed, must be closed out by no later than the beginning of regular trading hours on the 35th calendar day following the trade date. The exception in Rule 204T contained a time period of 35 settlement days, rather than calendar days, and was limited to sales of Rule 144 securities.

The SEC adopted the rules regarding credit for early close-outs from Rule 204T(e) with some modifications. Rule 204(e) allows broker-dealers to close out fail to deliver positions in advance of the close-out date by borrowing or purchasing shares to obtain credit. Unlike temporary Rule 204T(e), which required the purchase of securities sufficient to cover the entire amount of the broker-dealer’s open short positions, permanent Rule 204(e) allows for the borrowing or purchase of securities sufficient to cover only the broker-dealer’s fail to deliver positions.

The new Rule 204 is effective as of July 31, 2009.

### Short Sale Disclosure

Last fall, the SEC adopted on an interim final temporary basis a rule that required institutional money managers to report short sales to the SEC on a new Form SH. As noted above, the interim rule expired on August 1, 2009. Rather than adopt a permanent rule, the SEC announced that it will collaborate with the SROs to require the publication of short sale transaction and volume data on SRO websites.

### Continued Consideration of Short Sale Price Test and Circuit Breaker Restrictions

The SEC noted that it is continuing to consider proposals for a short sale price test and circuit breaker restrictions. A short sale price test, also known as the “uptick rule,” would apply to the entire market and would preclude short sales below either a national best bid or the last sale price or tick. Circuit breaker restrictions would apply to certain securities on a temporary basis to address potential severe market declines by imposing for the remainder of that day (i) a short selling ban, (ii) a short sale price test based on the national best bid or (iii) a short sale price test based on the last sale price or tick.

### Upcoming SEC Roundtable

The SEC plans to hold a roundtable open to the public on September 30, 2009 to discuss topics relating to short selling abuses, including the possibility of additional short sale disclosures, methods to foster transparency and a potential pre-borrowing requirement for short sellers.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning the short sale rules may be directed to:

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