

## SEC Emergency Orders on Short Selling

### FINRA Provides Clarification on SEC Guidance Regarding Emergency Orders Concerning Short Selling

#### Executive Summary

On July 15, 2008, the Securities and Exchange Commission (SEC) issued an Emergency Order concerning short selling and on July 18, 2008, issued an Amendment to Emergency Order (Orders). On July 18, 2008, the SEC staff of the Division of Trading and Markets issued *Guidance Regarding the Commission's Emergency Order Concerning Short Selling* (Guidance). The Orders and Guidance address the naked short selling of 19 public companies.

In part, the Orders provided that “no person may effect a short sale in these securities using the means or instrumentalities of interstate commerce unless such person or its agent has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting such short sale and delivers the security on settlement date.” Questions have arisen as to how to document and operationally handle these pre-borrows, especially in light of the possession and control requirement under Securities Exchange Act (SEA) Rule 15c3-3.

This *Regulatory Notice* explains that when using pre-borrowed shares to make delivery on a short sale of a security covered by the Orders, the firm must clearly document the link between the borrow, the short sale and the related delivery, so as to demonstrate that it has not otherwise violated possession or control requirements of SEA Rules 15c3-3(b) and (d). Failure to follow these steps will likely cause violations of the Orders or SEA Rule 15c3-3.

Questions regarding this *Notice* should be directed to Yui Chan, Managing Director, Risk Oversight & Operational Regulation, at (646) 315-8426.

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#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

#### Key Topic(s)

- Short Selling
- Possession or Control

#### Referenced Rules & Notices

- SEA Rule 15c3-3

## Background and Discussion

Several firms have indicated that they intend to comply with the Orders by borrowing or arranging to borrow a security prior to effecting the short sale of that security for themselves or their customers. Since the borrow or arrangement to borrow must take place no later than trade date of the short sale (*i.e.*, three business days before settlement date), other activity in that security, such as the possession or control requirements of SEA Rule 15c3-3, can interfere with the use of the borrowed shares to satisfy the delivery obligations under the Orders. For example, if a firm arranges to borrow shares and then on settlement date finds it has a possession or control deficit in the same security, under the normal operation of Rule 15c3-3, part or all of the borrowed shares would need to be retained to satisfy the deficit before the remaining shares, if any, were delivered in satisfaction of the short sale delivery requirement. The SEC addresses this issue in Question 7 of the Guidance, which reads as follows:

**Question:** How does the Order apply if a broker-dealer that has a delivery obligation with respect to a short sale of a security subject to this Order has a deficit in its possession-and-control obligation for that security under Exchange Act Rule 15c3-3(b)?

**Answer:** The broker-dealer must comply with the applicable provisions of Rule 15c3-3(b). Generally, a delivery of securities that are in a possession-and-control deficit is prohibited if it would create or increase a deficiency in the quantity of securities by class and issuer required to be in possession and control. The SEC staff has issued no-action relief from certain possession and control provisions of Rule 15c3-3 to broker-dealers that conduct a securities-borrowed-and-loan-“conduit” business. That relief also applies to the publicly traded securities traded under the ticker symbols listed in Appendix A to the Order.

FINRA has received several inquiries from firms regarding the operational implementation of Question 7 as it relates to the “conduit” interpretation. As a result of these inquiries, FINRA has discussed with the SEC Staff of the Division of Trading and Markets how the no-action relief related to “conduit” business may be used to comply with the Orders.

In 1991, SEC staff issued a no-action letter that required six conditions to be met in order for a broker-dealer to conduct a conduit securities borrow and loan business outside of the limits of Rule 15c3-3(d). If all six conditions were met, the broker-dealer did not need to recall securities loaned in the conduit account to ameliorate a possession or control deficit because the securities that were part of the conduit account were considered separate from the customer-related securities borrows and loans. SEC staff is using the same concept to allow securities borrowed to be used in making a delivery on the short sale of any security covered by the Orders.

Specifically, SEC staff has stated that a broker-dealer may use borrowed shares to meet its delivery obligation under the Orders, if it can satisfy two conditions similar to those contained in the 1991 no-action letter addressing conduit business, without regard to the segregation requirements of SEA Rule 15c3-3(b). First, the firm must be able to identify in its books and records that the securities to be delivered have been borrowed to complete the short sales. It is up to each firm to devise an acceptable method of identifying such shares and attributing those shares to specific short sales. Acceptable methods include the use of ledger codes, separate internal account types or subaccounts. Second, the borrowed shares may not be commingled with other customer or proprietary positions and must be distinguished from other securities lending transactions. The prohibition on commingling may be satisfied through the firm's records as described above; a separate clearance account is not required.

If these conditions can be met, the firm will be allowed to use borrowed shares to meet its delivery requirements under the Orders, irrespective of whether a possession or control deficit under SEA Rule 15c3-3 exists. Firms should note that use of the borrowed shares to meet their delivery requirements under the Orders does not alleviate their responsibility to take appropriate and timely action, as required by SEA Rules 15c3-3(b) and (d), to reduce to possession or control securities affected by the Orders.