

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-57511; File No. S7-08-08]

RIN 3235-AK06

### “Naked” Short Selling Anti-Fraud Rule

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is proposing an anti-fraud rule under the Securities Exchange Act of 1934 (“Exchange Act”) to address fails to deliver securities that have been associated with “naked” short selling. The proposed rule is intended to highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date.

**DATES:** Comments should be received on or before May 20, 2008.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-08-08 on the subject line; or

- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-08-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10

a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

#### **FOR FURTHER INFORMATION CONTACT:**

James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Joan M. Collopy, Special Counsel, Todd E. Freier and Christina M. Adams, Staff Attorneys, Office of Trading Practices and Processing, Division of Trading and Markets, at (202) 551-5720, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6628.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting public comment on proposed Rule 10b-21 under the Exchange Act.

### **I. Introduction**

The Commission is proposing an anti-fraud rule, Rule 10b-21, aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO’s “locate” requirement.<sup>1</sup> The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.

A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive “naked” short selling. Although abusive “naked” short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.<sup>2</sup>

Although abusive “naked” short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,<sup>3</sup> proposed Rule 10b-21 would highlight the specific liability of

persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares.<sup>4</sup> We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer’s securities. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. In addition, the proposed rule could help reduce manipulative schemes involving “naked” short selling.

### **II. Background**

#### *A. Regulation SHO*

Short selling involves a sale of a security that the seller does not own and that is consummated by the delivery of a security borrowed by or on behalf of the seller.<sup>5</sup> In a “naked” short sale, a seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period.<sup>6</sup> As a result, the seller fails to deliver securities to the buyer when delivery is due (known as a “fail” or “fail to deliver”).<sup>7</sup> Sellers sometimes

<sup>4</sup> This conduct is also in violation of other provisions of the federal securities laws, including the anti-fraud provisions.

<sup>5</sup> 17 CFR 242.200(a).

<sup>6</sup> See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (“2004 Regulation SHO Adopting Release”) (stating that “naked” short selling generally refers to selling short without having borrowed the securities to make delivery).

<sup>7</sup> Generally, investors complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or “trade date plus three days”). T+3 means that when the investor purchases a security, the purchaser’s payment generally is received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the

<sup>1</sup> See 17 CFR 242.203(b)(1).

<sup>2</sup> See Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007) (“2007 Regulation SHO Amendments”); Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (“2006 Regulation SHO Proposed Amendments”).

<sup>3</sup> 17 CFR 240.10b-5.

intentionally fail to deliver securities as part of a scheme to manipulate the price of a security,<sup>8</sup> or possibly to avoid borrowing costs associated with short sales.

Although the majority of trades settle within the standard three-day settlement period,<sup>9</sup> the Commission adopted Regulation SHO<sup>10</sup> in part to address problems associated with persistent fails to deliver securities and potentially abusive “naked” short selling.<sup>11</sup> Rule 203 of Regulation SHO, in particular, contains a “locate” requirement that provides that, “[a] broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account,

seller generally delivers its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. In addition, Rule 15c6-1 prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1; Exchange Act Release No. 33023 (Oct. 7, 1993), 58 FR 52891 (Oct. 13, 1993). However, failure to deliver securities on T+3 does not violate Rule 15c6-1.

<sup>8</sup>In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of a corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with the stock, and depressed its price. See *Rhino Advisors, Inc. and Thomas Badian*, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, *SEC v. Rhino Advisors, Inc. and Thomas Badian*, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y.) (Feb. 26, 2003).

<sup>9</sup>According to the NSCC, 99% (by dollar value) of all trades settle within T+3. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle on time. The vast majority of these fails are closed out within five days after T+3. In addition, fails to deliver may arise from either short sales or long sales of securities. There may be legitimate reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in custodial or other form rather than book-entry form, thus causing a fail to deliver on a long sale within the normal three-day settlement period. The Commission’s Office of Economic Analysis (“OEA”) estimates that, on an average day between May 1, 2007 and January 31, 2008, trades in “threshold securities,” as defined in Rule 203(b)(c)(6) of Regulation SHO, that fail to settle within T+3 account for approximately 0.6% of dollar value of trading in all securities.

<sup>10</sup>17 CFR 242.200. Regulation SHO became effective on January 3, 2005.

<sup>11</sup>See 2007 Regulation SHO Amendments, 72 FR at 45544 (stating that “[a]mong other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date and to target potentially abusive “naked” short selling in certain equity securities”).

unless the broker or dealer has: (1) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (2) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (3) Documented compliance with this paragraph (b)(1).”<sup>12</sup> In the 2004 Regulation SHO Adopting Release, the Commission explicitly permitted broker-dealers to rely on customer assurances that the customer has identified its own source of borrowable securities, provided it is reasonable for the broker-dealer to do so.<sup>13</sup> We are concerned, however, that some short sellers may have been deliberately misrepresenting to broker-dealers that they have obtained a legitimate locate source.<sup>14</sup>

In addition, we are concerned that some short sellers may have made misrepresentations to their broker-dealers about their ownership of shares as an end run around Regulation SHO’s locate requirement.<sup>15</sup> Some sellers have also misrepresented that their sales are long sales in order to circumvent Rule 105 of Regulation M,<sup>16</sup> which prohibits certain short sellers from purchasing securities in a secondary or follow-on offering.<sup>17</sup> Under Rule 200(g)(1) of Regulation SHO, “[a]n order to sell shall be marked “long” only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section<sup>18</sup> and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) it is reasonably

<sup>12</sup>17 CFR 242.203(b). Market makers engaged in bona fide market making in the security at the time they effect the short sale are excepted from this requirement.

<sup>13</sup>See 2004 Regulation SHO Adopting Release, 69 FR at 48014.

<sup>14</sup>See, e.g., *Sandell Asset Management Corp., Lars Eric Thomas Sandell, Patrick T. Burke and Richard F. Ecklord*, Securities Act Release No. 8857 (Oct. 10, 2007) (settled order).

<sup>15</sup>See *id.*

<sup>16</sup>17 CFR 242.105.

<sup>17</sup>See *Goldman Sachs Execution and Clearing L.P.*, Exchange Act Release No. 55465 (Mar. 14, 2007) (settled order).

<sup>18</sup>Rule 200(b) of Regulation SHO provides that a seller is deemed to own a security if, “(1) The person or his agent has title to it; or (2) The person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or (3) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) The person has an option to purchase or acquire it and has exercised such option; or (5) The person has rights or warrants to subscribe to it and has exercised such rights or warrants; or (6) The person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.”

expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.”<sup>19</sup>

Under Regulation SHO, the executing or order-entry broker-dealer is responsible for determining whether there are reasonable grounds to believe that a security can be borrowed so that it can be delivered on the date delivery is due on a short sale, and whether a seller owns the security being sold and can reasonably expect that the security will be in the physical possession or control of the broker-dealer no later than settlement date for a long sale. However, a broker-dealer relying on a customer that makes misrepresentations about its locate source or ownership of shares may not receive shares when delivery is due. For example, sellers may be making misrepresentations to their broker-dealers about their locate sources or ownership of shares for securities that are very difficult or expensive to borrow. Such sellers may know that they cannot deliver securities by settlement date due to, for example, a limited number of shares being available to borrow or purchase, or they may not intend to obtain shares for timely delivery because the cost of borrowing or purchasing may be high. This result undermines the Commission’s goal of addressing concerns related to “naked” short selling and extended fails to deliver.

### B. Concerns About “Naked” Short Selling

We are concerned about persons that sell short securities and deceive specified persons about their intention or ability to deliver the securities in time for settlement, or deceive their broker-dealer about their locate source or ownership of shares, or otherwise engage in abusive “naked” short selling. Commission enforcement actions have contributed to our concerns about the extent of misrepresentations by short sellers about their locate sources and ownership of shares. For example, the Commission recently announced a settled enforcement action against hedge fund adviser Sandell Asset Management Corp. (“SAM”), its chief executive officer, and two employees in connection with allegedly (i) improperly marking some short sale orders “long” and (ii) misrepresenting to executing brokers that SAM personnel had located sufficient stock to borrow for short sale orders.<sup>20</sup>

<sup>19</sup>17 CFR 242.200(g)(1).

<sup>20</sup>See *Sandell Asset Management Corp.*, Securities Act Release No. 8857; see also *Goldman* Continued

As we have stated previously, we are concerned that fails to deliver may have a negative effect on the market and shareholders.<sup>21</sup> For example, fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending.<sup>22</sup> In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.<sup>23</sup> Moreover, sellers that fail to deliver securities on settlement date may be subject to fewer restrictions than sellers that are required to deliver the securities by settlement date, and such sellers may attempt to use this additional freedom to engage in trading activities that are designed to improperly depress the price of a security.<sup>24</sup> For example, by not borrowing securities and, therefore, not making delivery within the standard three-day settlement period, the seller does not incur the costs of borrowing.

In addition, issuers and investors have expressed concerns about fails to deliver in connection with “naked” short selling. For example, in response to proposed amendments to Regulation SHO in 2006<sup>25</sup> designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO’s “grandfather” provision, and limiting the duration of the rule’s options market maker exception, the Commission received a number of comments that expressed concerns about “naked” short selling and extended delivery failures.<sup>26</sup>

*Sachs Execution and Clearing L.P.*, Exchange Act Release No. 55465; *U.S. v. Naftalin*, 441 U.S. 768 (1979) (discussing a market manipulation scheme in which brokers suffered substantial losses when they had to purchase securities to replace securities they had borrowed to make delivery on short sale orders received from an individual investor who had falsely represented to the brokers that he owned the securities being sold).

<sup>21</sup> See 2007 Regulation SHO Amendments, 72 FR at 45544; 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; Exchange Act Release No. 56213 (Aug. 7, 2007), 72 FR 45558, 45558–45559 (Aug. 14, 2007) (“2007 Regulation SHO Proposed Amendments”).

<sup>22</sup> See *id.*

<sup>23</sup> See *id.*

<sup>24</sup> See *id.*

<sup>25</sup> See 2006 Regulation SHO Proposed Amendments.

<sup>26</sup> See, e.g., letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 (“Overstock”); letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006 (“TASER”); letter from John Royce, dated April 30, 2007 (“Royce”); letter from Michael Read, dated April 29, 2007 (“Read”); letter from Robert DeVivo,

To the extent that fails to deliver might be indicative of manipulative “naked” short selling, which could be used as a tool to drive down a company’s stock price,<sup>27</sup> such fails to deliver may undermine the confidence of investors.<sup>28</sup> These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.<sup>29</sup> In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors’ negative perceptions regarding fails to deliver in the issuer’s security.<sup>30</sup> Any unwarranted

dated April 26, 2007 (“DeVivo”); letter from Ahmed Akhtar, dated April 26, 2007 (“Akhtar”).

<sup>27</sup> See *supra*, note 8 (discussing a case in which the Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with the company’s stock, and depressed its price); see also *S.E.C. v. Gardiner*, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); *U.S. v. Russo*, 74 F.3d 1383, 1392 (2d Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b–5).

<sup>28</sup> In response to the 2006 Regulation SHO Proposed Amendments, the Commission received comment letters discussing the impact of fails to deliver on investor confidence. See, e.g., letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (“NCANS”); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (“Blumenthal”).

<sup>29</sup> In response to the 2006 Regulation SHO Proposed Amendments, the Commission received comment letters expressing concern about the impact of potential “naked” short selling on capital formation, claiming that “naked” short selling causes a drop in an issuer’s stock price and may limit the issuer’s ability to access the capital markets. See, e.g., letter from Congressman Tom Feeney—Florida, U.S. House of Representatives, dated Sept. 25, 2006 (“Feeney”); see also letter from Zix Corporation, dated Sept. 19, 2006 (“Zix”) (stating that “[m]any investors attribute the Company’s frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company “do something” about the perceived manipulative short selling. This perception that manipulative short selling of the Company’s securities is continually occurring has undermined the confidence of many of the Company’s investors in the integrity of the market for the Company’s securities.”).

<sup>30</sup> Due in part to such concerns, some issuers have taken actions to attempt to make transfer of their securities “custody only,” thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (“DTC”) or broker-dealers. See Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, at 62975 (Nov. 6, 2003). Some issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. See *id.* Withdrawing securities from DTC or requiring custody-only transfers would undermine the goal of a national clearance and settlement system, designed to reduce the physical movement of certificates in the trading markets. See *id.* We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a

reputational damage caused by fails to deliver might have an adverse impact on the security’s price.<sup>31</sup>

### III. Discussion of Proposed Rule

#### A. Proposed Anti-Fraud Rule

To further address potentially abusive “naked” short selling and fails to deliver, we are proposing a narrowly-tailored rule, Rule 10b–21, which would specify that it is unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser<sup>32</sup> regarding its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.<sup>33</sup> Scienter would be a necessary element for a violation of the proposed rule.<sup>34</sup>

The proposed rule would cover those situations where a seller deceives a broker-dealer, participant of a registered clearing agency, or a purchaser about its intention to deliver securities by settlement date, its locate source, or its share ownership, and the seller fails to deliver securities by settlement date. Proposed Rule 10b–21 would apply to the deception of persons participating in the transaction—broker-dealers, participants of registered clearing agencies, or purchasers. Further, because one of the principal goals of proposed Rule 10b–21 is to reduce fails

procedure to process issuer withdrawal requests. See Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

<sup>31</sup> See also 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Amendments, 72 FR at 45544; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558–45559 (providing additional discussion of the impact of fails to deliver on the market); see also Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (“2003 Regulation SHO Proposing Release”) (discussing the impact of “naked” short selling on the market).

<sup>32</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). The term “registered clearing agency” means a clearing agency, as defined in section 3(a)(23) 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), 78q–1 and 15 U.S.C. 78q–1(b), respectively.

<sup>33</sup> Proposed Rule 10b–21.

<sup>34</sup> *Ernst & Ernst v. Hochfelder, et. al.*, 425 U.S. 185 (1976). Scienter has been defined as “a mental state embracing the intent to deceive, manipulate or defraud.” *Id.* at 193, n.12. While the Supreme Court has not decided the issue (see *Aaron v. SEC*, 446 U.S. 686 (1980); *Ernst & Ernst*, 425 at 193 n.12), federal appellate courts have concluded that scienter may be established by a showing of either knowing conduct or by “an ‘extreme departure from the standards of ordinary care \* \* \* which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.’” *Dolphin & Bradbury v. SEC*, 512 F.3d 634 (D.C. Cir. Jan. 11, 2008) (quoting *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

to deliver, violation of the proposed rule would occur only if a fail to deliver results from the relevant transaction.

For purposes of the proposed rule, broker-dealers (including market makers) acting for their own accounts would be considered sellers. For example, a broker-dealer effecting short sales for its own account would be liable under the rule if it does not obtain a valid locate source and fails to deliver securities to the purchaser. Such broker-dealers defraud purchasers that may not receive delivery on time, in effect unilaterally forcing the purchaser into accepting an undated futures-type contract.<sup>35</sup>

As noted above, under Regulation SHO, the executing or order-entry broker-dealer is responsible for determining whether there are reasonable grounds to believe that a security can be borrowed so that it can be delivered on the date delivery is due on a short sale.<sup>36</sup> In the 2004 Regulation SHO Adopting Release, the Commission explicitly permitted broker-dealers to rely on customer assurances that the customer has identified its own locate source, provided it is reasonable for the broker-dealer to do so.<sup>37</sup> If a seller elects to provide its own locate source to a broker-dealer, the seller is representing that it has contacted that source and reasonably believes that the source can or intends to deliver the full amount of the securities to be sold short by settlement date. In addition, if a seller enters a short sale order into a broker-dealer's direct market access or sponsored access system ("DMA") with any information purporting to identify a locate source obtained by the seller, the seller would be making a representation to a broker-dealer for purposes of proposed Rule 10b-21.<sup>38</sup>

If a seller deceives a broker-dealer about the validity of its locate source, the seller would be liable under proposed Rule 10b-21 if the seller also fails to deliver securities by the date delivery is due. For example, a seller would be liable for a violation of proposed Rule 10b-21 if it represented that it had identified a source of borrowable securities, but the seller never contacted the purported source to

determine whether shares were available and could be delivered in time for settlement and the seller fails to deliver securities by settlement date. A seller would also be liable if it contacted the source and learned that the source did not have sufficient shares for timely delivery, but the seller misrepresented that the source had sufficient shares that it could deliver in time for settlement and the seller fails to deliver securities by settlement date; or, if the seller contacted the source and the source had sufficient shares that it could deliver in time for settlement, but the seller never instructed the source to deliver the shares in time for settlement and the seller otherwise refused to deliver shares on settlement date such that the sale results in a fail to deliver.

If, however, a seller is relying on a broker-dealer to comply with Regulation SHO's locate obligation and to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. For example, a seller might be relying on its broker-dealer to borrow or arrange to borrow the security to make delivery by settlement date. Alternatively, a seller might be relying on a broker-dealer's "Easy to Borrow" list. If a seller in good faith relies on a broker-dealer's "Easy to Borrow" list to satisfy the locate requirement, the seller would not be deceiving the broker-dealer at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. In discussing the locate requirement of Regulation SHO, in the 2004 Regulation SHO Adopting Release, the Commission stated that "absent countervailing factors, 'Easy to Borrow' lists may provide 'reasonable grounds' for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities."<sup>39</sup>

In addition, a market maker engaged in bona fide market making activity would not be making a representation at the time it submits an order to sell short that it can or intends to deliver securities on the date delivery is due, because such market makers are excepted from the locate requirement of Regulation SHO. Regulation SHO excepts from the locate requirement market makers engaged in bona-fide market making activities because market makers need to facilitate customer orders in a fast moving market without possible delays associated with

complying with the locate requirement.<sup>40</sup> Thus, at the time of submitting an order to sell short, market makers that have an exception from the locate requirement of Regulation SHO may know that they may not be able to deliver securities on the date delivery is due.

Under proposed Rule 10b-21, a seller would be liable if it deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its ownership of shares or the deliverable condition of owned shares and fails to deliver securities by settlement date. For example, a seller would be liable for a violation of proposed Rule 10b-21 for causing a broker-dealer to mark an order to sell a security "long" if the seller knows or recklessly disregards that it is not "deemed to own" the security being sold, as defined in Rules 200(a) through (f) of Regulation SHO<sup>41</sup> or if the seller knows or recklessly disregards that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the seller fails to deliver the security by settlement date. Broker-dealers acting for their own accounts would also be liable under the proposed rule for marking an order "long" if the broker-dealer knows or recklessly disregards that it is not "deemed to own" the security being sold or that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the broker-dealer fails to deliver the security by settlement date.<sup>42</sup>

However, a seller would not be making a representation at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due if the seller submits an order to sell securities that are held in a margin account but the broker-dealer has loaned out the shares pursuant to the margin agreement. Under such circumstances, it would be reasonable for the seller to expect that the securities will be in the broker-dealer's physical possession or control by settlement date.

Although the proposed rule is primarily aimed at sellers that deceive specified persons about their intention or ability to deliver shares or about their locate sources and ownership of shares, as with any rule, broker-dealers could be liable for aiding and abetting a

<sup>35</sup> See 2007 Regulation SHO Amendments, 72 FR at 45544; 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558-45559.

<sup>36</sup> See 17 CFR 242.203(b)(3)(1).

<sup>37</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48014.

<sup>38</sup> Broker-dealers may offer DMA to customers by providing them with electronic access to a market's execution system using the broker-dealer's market participant identifier. The broker-dealer, however, retains the ultimate responsibility for the trading activity of its customer.

<sup>39</sup> 2004 Regulation SHO Adopting Release, 69 FR at 48014.

<sup>40</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48015, n. 67.

<sup>41</sup> 17 CFR 242.200(a)-(f).

<sup>42</sup> Such broker-dealers would also be liable under Regulation SHO.

customer's fraud under the proposed rule. In addition, broker-dealers would remain subject to liability under Regulation SHO and the general anti-fraud provisions of the federal securities laws.

Proposed Rule 10b-21 is narrowly tailored to apply when a seller, including a broker-dealer trading for its own account, deceives specified persons about its ability or intention to deliver securities in time for settlement, or about its locate source or ownership of shares and that fails to deliver securities by settlement date. While "naked" short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, we believe that the proposed anti-fraud rule would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver.<sup>43</sup>

#### Request for Comment

The Commission seeks comment generally on all aspects of proposed Rule 10b-21. In addition, we seek comment on the following:

- Proposed Rule 10b-21 would apply to sales in all equity securities. Should we narrow the scope of the proposed rule to apply only to sales of "threshold securities" as that term is defined in Rule 203(c)(6) of Regulation SHO<sup>44</sup> or to certain types of securities? Why or why not? If so, to what types of securities should the proposed rule apply? If we narrow the proposed rule to apply only to certain types of securities, should exchange traded funds or other basket securities be excluded? Why or why not?

- The proposed rule highlights the specific liability of persons that deceive broker-dealers, participants of a registered clearing agency, or purchasers about their intention or ability to deliver securities in time for settlement. Are there other entities that could be deceived about a seller's intention or ability to deliver securities in time for

settlement that should be included in the proposed rule? As an alternative to listing who must be deceived, should the proposed rule provide that a person would be liable if it deceives "another person" about its intention or ability to deliver securities in time for settlement? Please explain.

- The proposed rule includes a person failing to deliver securities when delivery is due as an element for a violation of the proposed rule. What are the costs and benefits, including to broker-dealers or customers, for including delivery as an element of the violation? Would the inclusion of a fail to deliver as an element of the proposed rule encourage broker-dealers, as a service to customers, to deliver securities on behalf of customers to prevent customers from failing to deliver securities by settlement date? Would broker-dealers feel any additional obligation to purchase or borrow securities on behalf of their customers to deliver on a customer's sale? What would be the costs to broker-dealers if they were to take such actions, particularly if the sale involves an expensive or hard to borrow security? Would the inclusion of failing to deliver as an element for a violation of the proposed rule increase costs for customers for inadvertent fails? Should delivery be excluded as a required element for a violation? For example, should the rule language instead be: *"It shall 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 a security if such person deceives a broker or dealer, participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due"*? What would be the costs and benefits of excluding delivery as an element for a violation of the proposed rule? Would excluding failing to deliver as an element for liability under the proposed rule affect a self-regulatory organization's ability to surveil for violations of the rule?

- In the 2004 Regulation SHO Adopting Release, the Commission stated that a broker-dealer could satisfy the locate requirement of Regulation SHO by obtaining an assurance from a customer that the customer can obtain securities from another identified source in time to settle the trade, provided the broker-dealer reasonably believes the customer's assurance. Proposed Rule 10b-21 is aimed, in part, at sellers who make misrepresentations to their broker-dealers about their locate sources. Should we instead no longer permit a broker-dealer to rely on such customer

assurances in satisfying the locate requirement of Regulation SHO? What would be the costs and benefits of removing the ability of broker-dealers to rely on such customer assurances? What would be the impact on market participants (such as broker-dealers, stock lenders, investors)? Would smaller entities be affected more or less adversely than larger entities?

- What procedures do broker-dealers currently have in place to assist in making the determination that there are reasonable grounds to believe that customers' representations regarding a locate source are accurate? How do those procedures help to provide confidence regarding the accuracy of such representations?

- What procedures do broker-dealers currently have in place to determine the accuracy of a seller's representations that it owns the securities being sold and that the securities are reasonably expected to be in the broker-dealer's physical possession or control by settlement?

- Are there other types of transactions to which proposed Rule 10b-21 should not apply?

- Are there any issues with respect to the application of the proposed rule in the context of the use of DMAs? If so, please explain.

- Are there any issues with respect to the application of the proposed rule to trades submitted to, or effected on, electronic communications networks?

- To what extent, if any, would the proposed rule encourage or result in fewer executing broker-dealers relying on customer assurances to satisfy the locate requirement of Regulation SHO? To what extent would such a result of the proposed rule impact prime brokerage relationships? Please explain.

- Although the type of activity that would be illegal under the proposed rule is already prohibited by the general anti-fraud provisions of the federal securities laws, to what extent, if any, would the proposed rule impact liquidity and market quality in securities traded? Please explain. To what extent, if any, might the proposed rule result in short squeezes? What costs, if any, would the potential for short squeezes have on the efficiency of the market?

- To what extent, if any, would the proposed rule induce short sellers to execute trades in overseas markets?

#### IV. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed rule. Commenters are requested to provide empirical data to support their views and arguments related to

<sup>43</sup> The Commission would continue to monitor the effect of "naked" short selling practices to determine whether additional rulemaking is warranted.

<sup>44</sup> Rule 203(c)(6) defines "threshold securities" as "any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d))." 17 CFR 242.203(c)(6).

proposed Rule 10b–21. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed rule. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposals where appropriate.

## V. Paperwork Reduction Act

Proposed Rule 10b–21 does not contain a “collection of information” requirement within the meaning of the Paperwork Reduction Act of 1995.<sup>45</sup> An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

## VI. Consideration of Costs and Benefits of the Proposed Amendments

The Commission is considering the costs and benefits of proposed Rule 10b–21. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed rule.

### A. Benefits

Proposed Rule 10b–21 is intended to address abusive “naked” short selling and fails to deliver. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive broker-dealers, participants of a registered clearing agency, or purchasers about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. Among other things, proposed Rule 10b–21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation

SHO’s “locate” requirement.<sup>46</sup> The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.<sup>47</sup>

A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive “naked” short selling. As noted above, although abusive “naked” short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.<sup>48</sup> Such short selling may or may not be part of a scheme to manipulate the price of a security. Although “naked” short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b–5 under the Exchange Act,<sup>49</sup> proposed Rule 10b–21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. We believe that a rule specifying the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer’s securities. As noted above, issuers and investors have expressed concerns about fails to deliver in connection with “naked” short selling. For example, in response to proposed amendments to Regulation SHO in

2006<sup>50</sup> designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO’s “grandfather” provision, and limiting the duration of the rule’s options market maker exception, the Commission received a number of comments that expressed concerns about “naked” short selling and extended delivery failures.<sup>51</sup>

To the extent that fails to deliver might be indicative of manipulative “naked” short selling, which could be used as a tool to drive down a company’s stock price,<sup>52</sup> such fails to deliver may undermine the confidence of investors.<sup>53</sup> These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.<sup>54</sup> In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors’ negative perceptions regarding fails to deliver in the issuer’s security.<sup>55</sup> Any unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security’s price.<sup>56</sup>

Thus, to the extent that fails to deliver might create a misleading impression of the market for an issuer’s securities, the proposed rule would benefit investors and issuers by taking direct aim at an activity that may create fails to deliver. In addition, to the extent that “naked” short selling and fails to deliver result in an unwarranted decline in investor confidence about a security, the proposed rule should improve investor confidence about the security. In addition, the proposed rule could lead to greater certainty in the settlement of securities which should strengthen investor confidence in that process.

The proposed rule could result in broker-dealers having greater confidence that their customers have obtained a valid locate source and, therefore, that shares are available for delivery on settlement date. Thus, the proposed rule would aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. The proposed rule also may provide additional encouragement for broker-

<sup>50</sup> See 2006 Regulation SHO Proposed Amendments.

<sup>51</sup> See, e.g., letters from Overstock; TASER, Royce; Read; DeVivo; Akhtar.

<sup>52</sup> See *supra* note 27.

<sup>53</sup> See *supra* note 28.

<sup>54</sup> See *supra* note 29.

<sup>55</sup> See *supra* note 30 (discussing the fact that due to such concerns some issuers have taken actions to attempt to make transfer of their securities “custody only,” thus preventing transfer of their stock to or from securities intermediaries such as the DTC or broker-dealers).

<sup>56</sup> See *supra* note 31.

<sup>46</sup> See 17 CFR 242.203(b)(1).

<sup>47</sup> Proposed Rule 10b–21.

<sup>48</sup> See *supra* note 2.

<sup>49</sup> 17 CFR 240.10b–5.

<sup>45</sup> 44 U.S.C. 3501 *et seq.*

dealers to deliver shares by settlement date and, therefore, result in a reduction in fails to deliver. In addition, to the extent that sales of threshold securities do not result in fails to deliver, the proposed rule would reduce costs to broker-dealers because such broker-dealers would have to close out a lesser amount of fails to deliver under Regulation SHO's close-out requirement.<sup>57</sup>

In addition, the proposed rule could help reduce manipulative schemes involving "naked" short selling. We solicit comment on any additional benefits that could be realized with the proposed rule, including both short-term and long-term benefits. We solicit comment regarding benefits to market efficiency, pricing efficiency, market stability, market integrity and investor protection.

#### B. Costs

As an aid in evaluating costs and reductions in costs associated with proposed Rule 10b-21, the Commission requests the public's views and any supporting information.

The proposed rule is intended to address abusive "naked" short selling by highlighting the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. The Commission recognizes that the proposed rule might result in increased costs to broker-dealers to the extent that the proposed rule encourages or results in broker-dealers limiting the extent to which they rely on customer assurances in complying with the locate requirement of Regulation SHO. Because the failure to deliver securities by the date delivery is due is an element for a violation of the proposed rule, as a service to customers broker-dealers could feel an additional obligation to borrow or purchase securities to deliver on customer sales even though the broker-dealer did not enter into an arrangement with the customer to do so. The proposed rule could result in increased costs to customers who

inadvertently fail to deliver securities because such customers, in an attempt to avoid liability under the proposed rule, might purchase or borrow securities to deliver on a sale at a time when, but for the proposed rule, the seller would have allowed the fail to deliver position to remain open.

The Commission believes that the proposed rule would not compromise investor protection. We seek data, however, supporting any potential costs associated with the proposed rule. In addition, we request specific comment on any systems changes to computer hardware and software, or surveillance costs that might be necessary to implement the proposed rule. Specifically:

- What would be the costs and benefits of the proposed rule?
- Would the proposed rule create any costs associated with systems, surveillance, or recordkeeping modifications? Would these costs justify the benefits of better ensuring compliance with the federal securities laws?
- How much would the proposed rule affect compliance costs for small, medium, and large broker-dealers (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that may arise.

#### VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.<sup>58</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>59</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Proposed Rule 10b-21 is intended to address abusive "naked" short selling and fails to deliver. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker-dealer, about their intention or ability to deliver

securities in time for settlement and fail to deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement.<sup>60</sup> The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.<sup>61</sup>

Although "naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,<sup>62</sup> proposed Rule 10b-21 would highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also provide a measure of predictability for market participants. We believe proposed Rule 10b-21 would have minimal impact on the promotion of price efficiency. We seek comment regarding whether proposed Rule 10b-21 may adversely impact liquidity, disrupt markets, or unnecessarily increase risks or costs to customers.

In addition, we believe that the proposed rule would have minimal impact on the promotion of capital formation. The perception that abusive "naked" short selling is occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. We believe that any such effect on capital formation is limited by the relatively few securities from corporate issuers that persist on the Regulation SHO threshold list<sup>63</sup> and the fact that this persistence does not necessarily indicate abusive "naked" short selling

<sup>57</sup> Rule 203(b)(3)(iii) of Regulation SHO contains a close-out requirement that applies only to broker-dealers for securities in which a substantial amount of fails to deliver have occurred, also known as "threshold securities." Specifically, Rule 203(b)(3)'s close-out requirement requires a participant of a clearing agency registered with the Commission to take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement (CNS) system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.

<sup>58</sup> 15 U.S.C. 78c(f).

<sup>59</sup> 15 U.S.C. 78w(a)(2).

<sup>60</sup> See 17 CFR 242.203(b)(1).

<sup>61</sup> Proposed Rule 10b-21.

<sup>62</sup> 17 CFR 240.10b-5.

<sup>63</sup> On an average day over a nine month period from May 1, 2007 to January 31, 2008, approximately 50 securities had persisted on the threshold list for more than 17 days and had fails to deliver of 10,000 shares or more. However, the majority of these securities are exchange traded funds which suggests that only a small number of corporate issuers are potentially affected.

or a deleterious effect on the cost of capital for the issuer.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments to Regulation SHO would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. In response, commenters expressed concern about the potential impact of "naked" short selling on capital formation claiming that "naked" short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets.<sup>64</sup> Thus, to the extent that "naked" short selling and fails to deliver result in an unwarranted decline in investor confidence about a security, the proposed rule should improve investor confidence about the security. We note, however, that persistent fails to deliver exist in only a small number of securities and may be a signal of overvaluation rather than undervaluation of a security's price.<sup>65</sup> In addition, we believe that the proposed rule could lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

We also believe that proposed Rule 10b-21 would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. By specifying that abusive "naked" short selling is a fraud, the Commission believes the proposed rule would promote competition by providing the industry with guidance regarding the liability of sellers that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate sources or share ownership and that fail to deliver securities by settlement date. The Commission requests specific comment on whether the proposed rule would promote efficiency, competition, and capital formation.

### VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of

1996, or "SBREFA,"<sup>66</sup> we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or

- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

### IX. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),<sup>67</sup> regarding the proposed rule.

#### A. Reasons for the Proposed Action

Proposed Rule 10b-21 is intended to address fails to deliver associated with abusive "naked" short selling. While "naked" short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, proposed Rule 10b-21 would specify that it is a fraud for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its intention or ability to deliver securities on the date delivery is due and such person fails to deliver securities on or before the date delivery is due. Thus, the proposed rule would highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares.

#### B. Objectives

Proposed Rule 10b-21 is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a

broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also underscore that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer's securities. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. In addition, the proposed rule could help reduce manipulative schemes involving "naked" short selling.

#### C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 19 and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(h), 78j, 78k-1, 78o, 78o-3, 78q, 78q-1, 78s and 78w(a), the Commission is proposing a new anti-fraud rule, Rule 10b-21, to address fails to deliver associated with abusive "naked" short selling.

#### D. Small Entities Subject to the Rule

The entities covered by the proposed rule would include small broker-dealers, small businesses, and any investor who effects a short sale that qualifies as a small entity. Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10 under the Exchange Act<sup>68</sup> states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a-5(d); and is not affiliated with any person (other than a

<sup>64</sup> See, e.g., letter from Feeney.

<sup>65</sup> Persistent fails to deliver may be symptomatic of an inadequate supply of shares in the equity lending market. If short sellers are unable to short sell due to their inability to borrow shares, their opinions about the fundamental value of the security may not be fully reflected in a security's price, which may lead to overvaluation.

<sup>66</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>67</sup> 5 U.S.C. 603.

<sup>68</sup> 17 CFR 240.0-10(c)(1).



natural person) that is not a small business or small organization. As of 2006, the Commission estimates that there were approximately 894 broker-dealers that qualified as small entities as defined above.<sup>69</sup>

Any business, however, regardless of industry, could be subject to the proposed amendments if it effects a short or long sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the proposed rule is not feasible.

#### *E. Reporting, Recordkeeping, and Other Compliance Requirements*

The proposed rule is intended to address abusive “naked” short selling by highlighting the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. The Commission believes that the proposed rule could impose new or additional reporting, recordkeeping, or compliance costs on any affected party, including broker-dealers, that are small entities. To comply with Regulation SHO, small broker-dealers needed to modify their systems and surveillance mechanisms to comply with Regulation SHO’s locate, marking and delivery requirements. Thus, any systems and surveillance mechanisms necessary for broker-dealers to comply with the proposed rule should already be in place. We believe that any necessary additional systems and surveillance changes, in particular changes by sellers who are not broker-dealers, would be similar to the changes incurred by broker-dealers when Regulation SHO was implemented.

We solicit comment on what new recordkeeping, reporting or compliance requirements may arise as a result of this proposed rule.

#### *F. Duplicative, Overlapping or Conflicting Federal Rules*

The Commission believes that there are no federal rules that duplicate or conflict with the proposed rule. “Naked” short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b–5 under the Exchange Act,<sup>70</sup>

and, therefore, overlap to a certain extent with the proposed rule. Proposed Rule 10b–21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

#### *G. Significant Alternatives*

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Pursuant to Section 3(a) of the RFA,<sup>71</sup> the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

A primary goal of proposed Rule 10b–21 is to address abusive “naked” short selling. While “naked” short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, Rule 10b–21 would specify that it is a fraud for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its intention or ability to deliver the security on the date delivery is due and such person fails to deliver the security on or before the date delivery is due. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and who do not deliver securities by settlement date. Among other things, proposed Rule 10b–21 would target short sellers who deceive

their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO’s “locate” requirement.<sup>72</sup> The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.

We believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the Commission’s goal of addressing abusive “naked” short selling and fails to deliver. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposed rule to further clarify, consolidate, or simplify the proposed rule for small entities. Finally, the proposed rule would impose performance standards rather than design standards.

#### *H. Request for Comments*

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on (i) the number of small entities that will be affected by the proposed rule; and (ii) the existence or nature of the potential impact of the proposed rule on small entities. Those comments should specify costs of compliance with the proposed rule, and suggest alternatives that would accomplish the objective of the proposed rule.

#### **X. Statutory Authority**

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 19 and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(h), 78j, 78k–1, 78o, 78o–3, 78q, 78q–1, 78s and 78w(a), the Commission is proposing a new anti-fraud rule, Rule 10b–21, to address abusive “naked” short selling.

#### **List of Subjects in 17 CFR Part 240**

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

#### **Text of the Proposed Rule Amendments**

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

#### **PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The authority citation for part 240 continues to read, in part, as follows:

<sup>69</sup> These numbers are based on OEA’s review of 2006 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

<sup>70</sup> 17 CFR 240.10b–5.

<sup>71</sup> 5 U.S.C. 603(c).

<sup>72</sup> See 17 CFR 242.203(b)(1).

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

2. Add § 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.**

It shall 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 a 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 the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.

By the Commission.

Dated: March 17, 2008.

**Florence E. Harmon,**

*Deputy Secretary.*

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