# NEW UTAH LAW TARGETS FAILURES TO DELIVER ON SECURITIES TRADES

## Description of the Law

On May 26, 2006, the Governor of Utah signed an amendment to the state securities law that requires broker-dealers licensed in Utah to notify the Utah state securities authority of failures to deliver securities in connection with certain securities trades.[1] The law applies to failures to settle occurring on or after **October 1, 2006**.

The new provision affects every Utah-licensed broker-dealer that sells or purchases securities for a customer or its own account involving shares of a company domiciled in Utah or with its principal office located therein ("Utah securities"), whose shares are designated as "threshold securities" under Securities and Exchange Commission Regulation SHO.[2] The requirement will apply whether or not the trade is for a customer in Utah.

The broker-dealer must notify the Utah Division of Securities ("Division") within 24 hours if a trade in a threshold Utah security fails to settle by delivery of the securities. The notification must identify the company whose shares were the subject of the trade, the date of the trade for which delivery failed, the amount of the shares that were not delivered, and the identity of the customer account or broker-dealer account for which the sale was made in the case of a selling broker-dealer, or the identity of the account that failed to deliver the securities in the case of a purchasing broker-dealer. The Division will make this information available to the public.

A broker-dealer who fails to provide such notice is liable for a substantial monetary penalty, which amount accrues directly to the company whose securities were the subject of the trade.[3]

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1 UTAH CODE § 61-1-5(d).

2 Rule 203(c)(6) of Regulation SHO, 17 C.F.R. 242.203(c)(6), defines threshold security as:

> [A]ny 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)):
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> > (i) For which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding;
> >
> > (ii) Is included on a list disseminated to its members by a self-regulatory organization; and
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> > (iii) Provided, however, that a security shall cease to be a threshold security if the aggregate fail to deliver position at a registered clearing agency does not exceed the level in [17 C.F.R. 242.203(c)(6)(i)] for five consecutive settlement days.

3 Additional parties are made jointly and severally liable under the law. This includes a principal of the broker-dealer, a person who directly or indirectly controls the broker-dealer, a partner, officer or director of the broker-dealer, a person occupying a similar status or performing a similar function to a partner, officer or director of the broker-dealer, and an employee of the broker-dealer who has a duty to assure the filing of the required notice and recklessly fails in that duty. UTAH CODE § 61-1-5(d)(v).

The penalty is $10,000 for each business day that the broker-dealer fails to provide the required notice if the failure is for at least one business day but fewer than six business days. If the failure is for six or more business days, the broker-dealer must pay the greater of $10,000 for each business day or the aggregate price of the subject securities that are not delivered. The issuer of the securities and the Division may sue in law or equity to enforce such payments plus interest, costs, and reasonable attorney's fees. The court or Division may waive the amounts owed upon a showing of reasonable cause for the failure to deliver, including exceptions provided in Regulation SHO.

## Industry Views

The Securities Industry Association (the "SIA"), an industry trade group, strongly opposed the legislation. The SIA sent a letter to Utah Governor Huntsman expressing concern that the new legislation would injure Utah-based companies and investors if broker-dealers curtail dealings in Utah securities to avoid the law and its attendant liabilities.[4]

The SIA letter also referred to the state law preemption provision in the National Securities Markets Improvement Act of 1996 ("NSMIA"). NSMIA added Section 15(h)(1) to the Securities Exchange Act of 1934,[5] which provides:

> No law, rule, regulation, or order, or other administrative action of any State . . . shall establish . . . making and keeping records, . . . or financial or operational reporting requirements for brokers [or] dealers . . . that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act].

The SIA reportedly is considering taking legal action.[6]

## Implications of the Legislation

This law has numerous implications for broker-dealers and their customers:

- It imposes potentially large monetary penalties on broker-dealers who do not report failures to deliver on trades in threshold securities of companies that are domiciled or that have their principal place of business in Utah. In conjunction with the broad joint and several liability in the statute,[7] broker-dealers licensed in Utah will be obligated to identify these Utah companies and set up reporting mechanisms.

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4 See Jed Horowitz and Carol S. Remond, *Securities Industry Weighs Suit Over New Utah Short-Sale Law*, WALL ST. J., May 30, 2006, at C5. ("WSJ Article").

5 15 U.S.C. 78o(h)(1).

6 See WSJ Article.

7 See n.3 above.

- While the legislation apparently targets short sellers,[8] the reporting obligations would be triggered by a failure to deliver on any transaction, even a long sale, in Utah securities.

- A key feature of the legislation is the requirement that the broker-dealer identify the account that failed to settle, coupled with the public disclosure of that information. This appears designed to provide Utah issuers and others with information about who may be short selling their securities.[9]

- The reporting obligation applies to a "settlement failure that occurs on or after October 1, 2006."[10] Because a settlement failure is not only an event but also a status (i.e., a failure to deliver securities may extend over a period of time), it is possible that immediate reporting obligations will arise on October 1, 2006 for Utah securities that are on the threshold lists published by the self-regulatory organizations. The reason is that threshold securities by definition have outstanding failures to deliver, and the law may not be limited to failures to settle that first occur after October 1, 2006.[11]

  This uncertainty reflects a fundamental difference between the Utah law and Regulation SHO to which it is linked. While the Utah law appears to be directed at identifying individual trades and traders that are associated with failures to deliver, Regulation SHO applies to failure to deliver positions at a clearing agency, which often are the net result of numerous transactions involving multiple parties. There is not necessarily a direct link between a particular trade executed by a broker-dealer and a failure to deliver position in the broker-dealer's account at the clearing agency.[12]

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[8] See WSJ Article. Short selling is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by or for the account of the seller. Regulation SHO, Rule 200(a). The Utah law may have an even sharper focus, i.e., so-called "naked short selling," which refers to a short sale that is effected without having located a source of available securities that can be used to deliver in settlement of the trade. See Bob Mims, *Wall Street contests new stock law*, SALT LAKE TRIBUNE, May 31, 2006, *available at* http://www.sltrib.com/portlet/article/html/fragments/print_article.jsp?article=3882677.

[9] It may be noted that although the SEC has been urged to adopt rules requiring public reporting of short positions, it has not done so. See Securities Exchange Act Release No. 29278 (June 7, 1991), 56 F.R. 27280.

[10] UTAH CODE § 61-1-5(d)(1)(D).

[11] Unlike Regulation SHO, the Utah law has no explicit "grandfathering" provision. See Rule 203(b)(3)(i) of Regulation SHO.

[12] Matters become more complicated where a trade is executed by one broker-dealer (the "executing broker") and forwarded to another broker-dealer for settlement (the "clearing broker"). The executing broker-dealer may not know which customers fail to deliver securities to the clearing broker on the settlement date. It is not clear which broker-dealer would have the reporting obligation under the Utah law.

## Conclusion

The full impact of the Utah legislation on broker-dealers, Utah companies, and traders remains unclear. The reporting obligations do not go into effect until October 1, 2006, and there is the possibility of legal challenge before then. Although we are not aware that any other state is considering adopting similar rules, if other states follow Utah's example the compliance environment for broker-dealers could become very complex.

At this stage, broker-dealers licensed to operate in Utah and their customers that trade Utah securities, especially short sellers, should consider how this provision may affect their compliance operations and trading strategies.

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If you have any questions concerning the foregoing or would like additional information, please contact Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com) or the attorney with whom you regularly work.

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