



Regulatory Circular RG07- 87

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To: Members and Member Organizations

From: Division of Member and Regulatory Services

Subject: Short Sales, Regulation SHO Requirement
to Close-out Short Positions in Threshold Securities

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KEY POINTS

This Regulatory Circular is being provided to remind market participants of the requirements of Regulation SHO, particularly with respect to the trading activity of options market-makers.

- Only options market-makers that are engaged in bona-fide options market-making may utilize the exception to Regulation SHO's "locate" requirement when effecting a short sale in the underlying security as a hedge. For purposes of qualifying for Regulation SHO's options market-maker exception, an options market-maker must, among other things, hold him or herself out as being willing to buy or sell options for his/her account on a regular or continuous basis.
- Regulation SHO requires that a short, fail to deliver position in a threshold security that has existed for thirteen settlement days be immediately closed-out by purchasing securities of like kind and quantity.¹
- According to Regulation SHO, purchases to close-out fail to deliver positions in threshold securities must be bona-fide purchases. In this regard, the purchase of stock paired with one or more short-term option transactions, such as, but not limited to, a one-day FLEX option, that is designed to create the appearance of a bona fide

¹ Currently, if an options market-maker can substantiate that a fail to deliver position resulted from a short sale effected to hedge or maintain a hedge on option positions that existed before the security became a threshold security, the fail to deliver position is excepted from the Regulation SHO close-out requirement. The Securities and Exchange Commission has proposed the elimination of this exception. See Securities Exchange Act Release No. 56213 (August 7, 2007). See also Securities Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348 (July 3, 2007) at n.6.

purchase of securities, but that is nothing more than a device to improperly reset the close-out date, would not satisfy Regulation SHO's close-out requirement.

- Regulation SHO expressly states that the close-out requirement is not deemed to have been fulfilled where the party responsible for the close-out enters into an arrangement with another person to purchase securities as required by Regulation SHO, and the party responsible for close-out knows or has reason to know that the other person will not deliver securities in settlement of the purchase.
- Until a close-out is properly effected, further short sales cannot be effected without a pre-borrow.

DISCUSSION

"Locate" Exception²

The Exchange reminds options market-makers that Regulation SHO limits use of the market-maker exception to the "locate" requirement to hedging activity involving short sales in stock underlying the options in which the market-maker, among other things, holds him or herself out as being willing to buy or sell options for his/her account on a regular or continuous basis.³ Market participants that engage in strategies involving the short sale of stock must perform a "locate" prior to the short sale unless the participant is a market-maker in the stock or overlying options that holds him or herself out as being willing to buy or sell on a regular or continuous basis and the short sale is part of bona-fide market-making activity that qualifies for the market-maker exception.

The SEC's Regulation SHO adopting release notes the following regarding bona-fide market-making:

"Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception."

Furthermore, in reference to bona-fide market-making, the adopting release refers to the definition of market-maker in Section 3(a)(38) of the Securities Exchange Act of 1934, which provides that a market-maker is *"any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or*

² While the focus of this section is options market-makers, the locate exception also applies to market-makers in equities. See Rule 203(b)(2)(iii).

³ See Section 3(a)(38) and 11(a) of the Securities Exchange Act of 1934, Rules 203(b)(2)(iii) and 11a1-3(T) under the Securities Exchange Act of 1934, and the Regulation SHO adopting release.

otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."

Strategies often undertaken by Exchange members including, but not limited to, reverse conversions, short stock / short put and short stock / long call transactions will be reviewed by the Exchange to assess whether a "locate" was required.

Close-out Requirement

Certain stock purchases that are intended to effect close-outs of fail to deliver positions in threshold securities are not an acceptable way of fulfilling Regulation SHO's close-out requirement.

Exchange staff has received inquiries as to whether the following activity complies with Regulation SHO's close-out requirement:

- ❖ Options market-maker #1 has a fail to deliver position in a threshold security that does not qualify for the options market-maker exception to the close-out requirement. On or before settlement day thirteen, this market-maker must purchase securities to close-out the fail to deliver position.
- ❖ Market-maker #1 executes a trade with another options market-maker ("market-maker #2"), either directly or through the use of a floor broker, whereby market-maker #1 simultaneously purchases from market-maker #2 the subject threshold securities and a put option overlying the securities that expires in a short period of time. Market-maker #1's intention is to give the appearance of closing-out the short stock position with the purchased securities.
- ❖ Market-maker #2's sale of the threshold securities is a short sale. Market-maker #2 creates a short stock / short put option position.
- ❖ Soon after, market-maker #1 reestablishes the fail to deliver position in the subject threshold security by exercising the put option. The original fail to deliver position is thus improperly reset.

Borrowing securities, or otherwise entering into an arrangement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of stock paired with one or more short-term option transactions, such as a one-day FLEX option, that is designed to create the appearance of a bona fide purchase of securities, but that is nothing more than a device to improperly reset the close-out date, would not satisfy Regulation SHO's close-out requirement.

The Exchange strongly cautions members that, in the transaction described above, pairing the close-out with one or more short-term option positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the

Regulation SHO close-out requirement. In addition, the party responsible for the close-out can reasonably infer (i.e., know or have reason to know) that a selling party will fail to deliver the securities in settlement of the purchase.

Unless the close-out requirement is properly satisfied through a bona-fide purchase, it is a violation of Regulation SHO to effect further short sales (including via exercise of the long put) without first pre-borrowing the stock [Rule 203(b)(3)(iii) of Regulation SHO].

Facilitating Resets of Fails to Deliver

Short sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example including, but not limited to, reverse conversions and deep in-the-money long call / short stock, are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase.

Generally, it is reasonable to conclude given the way the transactions are structured that the short seller in such cases would know or have reason to know that the transactions would provide the party faced with the close-out obligation with the appearance of a bona-fide stock purchase. Therefore, a short seller in such cases could also be liable, depending on facts and circumstances, for aiding and abetting a violation of Regulation SHO by the party with the close-out obligation.

Conclusion

Entering into a stock/option combination transaction that includes a very short-term option in connection with a mandatory Regulation SHO close-out obligation, as opposed to just buying the stock in the open market, brings such transactions under greater scrutiny in respect of whether they are a device to create the appearance of a bona-fide stock purchase and whether the person responsible for close-out knows or has reason to know that the selling party will fail to deliver securities in settlement of the purchase.

Stock / option strategies involving threshold securities will be closely scrutinized by the Exchange for compliance with the locate and close-out requirements, including an assessment as to whether a person responsible for a close-out knew or had reason to know that a contra-party would not be delivering securities in settlement of the purchase.

Additionally, an executing broker who facilitates these transactions knowing that a required "locate" was not performed or that the purpose of the transaction is to circumvent the Regulation SHO close-out requirement, could also be violating Regulation SHO.⁴

Each transaction has its own set of facts and circumstances, including the transaction price and the manner in which contra-parties are sought, for purposes of assessing

⁴ See footnote No. 65 in the Securities and Exchange Commission's Regulation SHO adopting release.

compliance with Regulation SHO. Absent facts and circumstances to the contrary, transactions such as that described above have the appearance of having been conducted in order to circumvent Regulation SHO's close-out requirement.

While the above scenario involves options market-makers, the same analysis would apply to similar arrangements between any market participants. The above scenario gives an example of only one type of transaction that violates Regulation SHO. This Regulatory Circular is intended to illustrate a concept, and not to provide an exhaustive list of trading activity that could be deemed violative. In addition, transactions that would constitute a device to improperly reset the close-out date are unacceptable on any day, not just settlement day thirteen.

In addition, in publishing this Regulatory Circular we recognize that transactions matching options with stock may be used as part of a legitimate hedging strategy, and we do not want to discourage their use for that purpose. Rather, we are calling attention to abusive transactions that have characteristics described above and are used in a scheme to evade CBOE or Securities and Exchange Commission rules.

Market participants are encouraged to read the *Decision* and related *Stipulation of Facts and Consent to Penalty* published by the American Stock Exchange on July 31, 2007, for two disciplinary actions, each involving violations of Regulation SHO by an options market-maker. Those documents are available on-line at the following URLs:

www.amex.com/atamex/regulation/discipline/2007.BArensteinALA_Decision_072007.pdf
www.amex.com/atamex/regulation/discipline/2007.SArensteinSBA_Decision_072007.pdf

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