

Regulatory Circular RG04-113

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To: Members and Member Organizations

From: Division of Regulatory Services

Subject: Regulation SHO (Short Sales)

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This Regulatory Circular presents a general overview of Regulation SHO. The Exchange may issue additional Regulatory Circulars as necessary to disseminate any further compliance guidelines or interpretations issued by the Securities and Exchange Commission with respect to Regulation SHO.

KEY POINTS

1. Regulation SHO was approved by the Securities and Exchange Commission (the "Commission" or "SEC") on July 28, 2004. Regulation SHO implements significant changes to the SEC's rules governing short sales. The compliance date is January 3, 2005. A copy of the SEC's release concerning its adoption of Regulation SHO can be found at www.sec.gov/rules/final/34-50103.htm.
2. The bid test¹ that had been proposed as a replacement for the tick test of SEC Rule 10a-1 has not been adopted at this time. This bid test would have applied to all exchange and NASDAQ traded stocks. Therefore, except for pilot stocks (see paragraph 4 below), the current SEC and SRO short sale price tests remain in force.
3. Regulation SHO contains a provision that allows the Commission to temporarily suspend operation of the current tick test of SEC Rule 10a-1 and any short sale price test of any exchange or national securities association.

¹ The proposed bid test would have required short sales to be effected at least one cent above the consolidated best bid at the time of execution.

4. Under a one year pilot program, the Commission has determined to temporarily suspend the short sale price tests, including any SRO imposed price tests, for approximately one third of the stocks in the Russell 3000 Index.²
5. This pilot program begins on January 3, 2005 and ends on December 31, 2005, or sooner, if the Commission so determines. Its purpose is to give the Commission an opportunity to study the effects of short selling without a price test before making changes, if any, to the current price tests.
6. Regulation SHO requires all sell orders to be marked “long”, “short” or “short exempt.”
7. An order can be marked “short exempt” if the seller is entitled to rely on any exception from the tick test imposed under Rule 10a-1 or price test imposed by an exchange or national securities association. Short sales of securities included in the SEC’s pilot program during the pilot time frame are to be marked “short exempt”.
8. With few exceptions, a clearing firm may not borrow securities to make delivery on a sale marked “long” and must deliver the security on settlement date, even if it must purchase securities for delivery.
9. Prior to effecting a short sale, Regulation SHO requires all broker-dealers, to either borrow the security, enter into a bona-fide arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and to document compliance.
10. This “locate” requirement (paragraph 9, above) does not apply to options market-makers, provided the market-maker’s short sale is effected in connection with bona-fide market-making activity. However, when a **“threshold security”** is involved, this exception does not apply in certain circumstances (see below).
11. Regulation SHO classifies as **“threshold securities”** any security in which aggregate fails to deliver at a registered clearing agency exceed a certain level.
12. For short sales of a threshold security, Regulation SHO requires delivery of the security within 13 settlement days. If delivery is not made within 13 settlement days, the clearing firm is required to immediately close-out the failing position by purchasing securities of like kind and quantity. **This requirement also applies to options market-makers, with one exception** (see paragraph 14 below).
13. In the event that 13 settlement days have elapsed and a purchase of the security to close-out the failing position has not been executed, a clearing firm may effect

² More information, including a list of the stocks included, can be found at : www.sec.gov/rules/other/34-50104.htm

further short sales in the subject security only if the security has been borrowed, or a bona-fide arrangement to borrow has been consummated. **This requirement also applies to options market-makers, with one exception** (see paragraph 14 below).

14. In respect of an options market-maker, if the short sale of a threshold security is effected to establish or maintain a hedge on option positions that were opened before the security became a threshold security, neither the close-out requirement (paragraph 12, above) nor the pre-borrow requirement for further short sales (paragraph 13, above) are applicable.
15. Regulation SHO compels clearing firms to have a system to trace a failure to deliver in a threshold security to a specific customer account and to age that failure to deliver.
16. Absent a system to allocate and age failures to deliver in threshold securities by specific customer, the close-out requirement (paragraph 12, above) and the pre-borrow requirement (paragraph 13, above) must be imposed firm wide and customers, including market-makers, with short sales for which securities have been properly borrowed and delivered may be unfairly penalized.
17. When purchasing securities of like kind and quantity to close-out a fail to deliver, the clearing firm will have failed to comply with Regulation SHO if it knows or has reason to know that the contra-party will not deliver securities in settlement of the purchase.

DISCUSSION

On July 28, 2004, the SEC adopted new Regulation SHO – *Regulation of Short Sales*, under the Securities Exchange Act of 1934.³ Regulation SHO represents a significant change in SEC short sale rules. Regulation SHO is composed of Rules 200, 202T and 203 (Rule 201 is reserved). Regulation SHO replaces current SEC Rules 3b-3 and 10a-2, and resulted in amendments to Rule 10a-1.⁴

Rule 200 – Definition of “Short Sale” and Marking Requirements

Rule 200 replaces Rule 3b-3, which had defined ownership of securities for purposes of short sales. Rule 200 incorporates Rule 3b-3 with some modifications. Rule 200 also incorporates, with some modifications, a prior SEC no-action position allowing broker-dealers to calculate net position (long or short) within defined aggregation units rather than on a firm-wide basis.

³ Exchange Act Release No. 34-50103 (July 28, 2004), 69 FR 48008 (August 6, 2004). An online copy can be found at: www.sec.gov/rules/final/34-50103.htm.

⁴ Rule 3b-3 – Definitions of Short Sale (17 CFR §240.3b-3), Rule 10a-2 – Requirements for Covering Purchases (17 CFR §240.10a-2), Rule 10a-1 – Short Sales (17 CFR §240.10a-1)

Rule 200 requires broker-dealers to mark all sell orders in all equity securities as either “long,” “short” or “short exempt.” (Marking requirements have been moved from Rule 10a-1 and slightly altered.) According to Rule 200, a sell order can only be marked “long” when the seller owns the security being sold and the security is in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker-dealer prior to settlement. An order can be marked “short exempt” if the seller is entitled to rely on any exception from the tick test imposed under Rule 10a-1 or price test imposed by an exchange or national securities association. Also, short sales of securities included in the SEC’s pilot program during the pilot time frame (see Rule 202T, below) should be marked “short exempt.” Short sellers and clearing firms are reminded that short sales that are eligible to be marked “short exempt” are exempt only from the tick test or self-regulatory organization (“SRO”) price test, not from the new “locate” requirement discussed below.

Rule 200 also contains provisions that essentially allow broker-dealers engaging in block positioning and index arbitrage to exclude short stock positions that are fully hedged from the calculation of their net position in the stock. The provision for block positioners has been moved from Rule 10a-1. The index arbitrage exception was previously available through a SEC staff no-action letter, but certain conditions have been added, including a restriction during market declines. Refer to Rule 200, paragraphs (d) and (e), in the SEC’s July 28, 2004, release for further details and conditions.⁵

⁵ Exchange Act Release No. 34-50103 (July 28, 2004), 69 FR 48008 (August 6, 2004). An online copy can be found at: www.sec.gov/rules/final/34-50103.htm.

Rule 202T – Temporary Short Sale Rule Suspension

Rule 202T is a temporary rule that is set to expire on August 6, 2007. It contains procedures for the SEC to temporarily suspend the tick test of SEC Rule 10a-1 and any short sale price test of any national securities exchange or national securities association for such securities as the SEC may designate. By means of Rule 202T, the SEC issued an order,⁶ concurrent with the adoption of Regulation SHO, that establishes a pilot program under which the tick test and any SRO price test is suspended for short sales in:

- 1) approximately one third of the stocks in the Russell 3000 Index,⁷
- 2) any security in the Russell 1000 Index effected between 4:15 PM EST and the open of the consolidated tape on the following day, and
- 3) any other security effected between the close of the consolidated tape (i.e., 8:00 PM EST) and the open of the tape on the following day.

Rule 202T became effective on September 7, 2004. The pilot commences on January 3, 2005 and ends no later than December 31, 2005.

Rule 203 – Borrowing and Delivery Requirements

Rule 203 implements various safeguards aimed at preventing “naked” short selling (i.e., short sales where the security sold short is not borrowed and delivered to the buyer). Rule 203, paragraph (b), imposes a uniform “locate requirement” on short sales of all equity securities, thus supplanting and expanding existing SRO requirements. Accordingly, Rule 203 requires that all broker-dealers, prior to effecting a short sale in any equity security, to locate securities available for borrowing. Specifically, Rule 203(b) prohibits a broker-dealer from accepting a short sale in any equity security from another person, or from effecting a short sale for the broker-dealer’s own account, unless the broker-dealer: 1) has borrowed the security or entered into a bona-fide arrangement to borrow the security, or 2) has “reasonable grounds” to believe that the security can be borrowed so that it can be delivered on the delivery date. Furthermore, prior to effecting a short sale, broker-dealers must document compliance with 1) and 2) above.

In its release announcing the adoption of Regulation SHO, the SEC noted that an “easy to borrow” list is acceptable for meeting the “reasonable grounds” requirement, provided that the information on which the list is based is less than 24 hours old and the securities on the list are so readily available that fails to deliver are unlikely. The SEC specifically notes that the fact that a security is not on a “hard to borrow” list is an unacceptable means of complying with the “reasonable grounds” test. Another acceptable means of satisfying the “reasonable grounds” test is a customer’s assurance that a “locate” was received from another source, provided that prior assurances from

⁶ Exchange Act Release No. 34-50104 (July 28, 2004), 69 FR 48032 (August 6, 2004).

⁷ More information, including a list of the stocks included, can be found at : www.sec.gov/rules/other/34-50104.htm

the customer did not result in fails to deliver. Also, the executing broker-dealer must document the customer's source.

Regulation SHO provides market-makers with an exception from the locate requirement. To be eligible for the exception, a market-maker's short sale must be in connection with bona-fide market-making activity. The SEC warns that "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." It is further noted that "bona-fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with Rule 203(b)(1) [the "locate" requirement] by the other broker-dealer or customer."

Regulation SHO provides a broker-dealer (e.g., a clearing firm or an executing broker) with an exception from the locate rule in the case of a short sale order received from another broker-dealer. Since Regulation SHO applies to all broker-dealers, the broker-dealer submitting the order is responsible for compliance with the locate rule. Thus, a receiving broker-dealer, such as a clearing firm, is not required to perform the locate, unless it contractually accepted responsibility on behalf of the submitting broker-dealer.

Absent a contract stipulating that the clearing or executing broker-dealer will accept responsibility for performing locates, broker-dealers (non-clearing) that utilize other broker-dealers to execute and/or clear short sales are responsible for compliance with the locate rule.

There is also an exception from the locate requirement for situations where a convertible security, option or warrant has been tendered for exchange or exercised, but the underlying security is not reasonably expected to be received by settlement date. This exception is also available in the case where processing to remove the restricted legend on formerly restricted securities may not be completed before settlement date. Rule 203 allows 35 consecutive settlement days after trade date for delivery. If delivery is not made within that time frame, the selling broker-dealer must either borrow securities for delivery or purchase the securities to close-out the failing position.

Rule 203, paragraph (a), replaces Rule 10a-2, which had prohibited a broker-dealer from failing to deliver, or lending or arranging to lend securities to prevent a fail to deliver, on a sale that is marked "long". As adopted through Rule 203 [paragraph (b)], this requirement has been expanded to cover all securities rather than just exchange-listed securities. Therefore, if a sale is marked "long," delivery must be made. If securities are not in possession to make delivery, then securities of like kind and quantity must be immediately purchased to make delivery. Certain exceptions to the prohibition against lending or arranging to lend securities to prevent a fail to deliver on a sale marked "long" are provided under Rule 203.⁸

⁸ In brief, the exceptions are: 1) loans of any security between broker-dealers, 2) cases where a broker-dealer knows or has been reasonably informed by a seller that the seller owns the security and will deliver

Under Rule 203, paragraph (b)(3), a clearing broker-dealer is required to close-out any fail to deliver position in a **“threshold security”** that has remained open for 13 consecutive settlement days (trade date plus 13 business days or settlement date plus 10 business days) by immediately purchasing securities of like kind and quantity. Each exchange and securities association is required to publish a daily list of the threshold securities listed on its respective market, or for which the SRO bears the primary surveillance responsibility.⁹ Until the close-out is executed, the clearing broker-dealer and any broker-dealer for which it clears, **including a market-maker**, is prohibited from effecting further short sales in the subject threshold security, unless, prior to a new short sale, the security is borrowed or an arrangement to borrow the security is in place. **Since Regulation SHO applies to all broker-dealers, a market-maker is responsible for compliance with this locate rule for threshold securities, unless the clearing firm has contractually accepted responsibility.**

If the clearing broker-dealer can attribute a fail to deliver in a threshold security to a particular customer, the close-out and locate requirements may be imposed only on that customer rather than firm-wide.

The close-out and locate requirements do not apply to fails to deliver of threshold securities if the short sale causing the fail was effected before the security became a threshold security.

Regulation SHO provides options market-makers with one exception to the close-out and locate requirements in respect of a fail to deliver position in a threshold security. If a short sale is effected in a threshold security by an options market-maker to establish or maintain a hedge on option positions that were created before the security became a threshold security, the close-out and locate requirements are not applicable.

New Rules 200 and 203, and amended Rule 10a-1, became effective on September 7, 2004. However, members have until January 3, 2005, to be in compliance with Rules 200 and 203.

Questions concerning Regulation SHO may be directed to Richard Lewandowski, (312) 786-7183, or Robert Gardner, (312) 786-7937, in the Exchange's Department of Financial and Sales Practice Compliance.

it to the broker-dealer prior to the scheduled settlement of the transaction, but the seller fails to do; and 3) upon a finding by an exchange or securities association that would permit an exception.

⁹ Information regarding the exact time, location and form of dissemination of “Threshold Securities” lists will be announced when such information is made available by the stock exchanges and The NASDAQ Stock Market.