

## SEC Adopts Amendments to Regulation SHO

### Summary

In June 2007, the Securities and Exchange Commission (the "Commission" or "SEC") adopted and proposed amendments to the short sales rules under the Securities Exchange Act of 1934 (the "Exchange Act").<sup>1</sup> The SEC:

- adopted amendments to Rules 200 and 203 of Regulation SHO to
  - the eliminate the "grandfather" exception to the "close out" requirement,
  - extend the current close out requirement of thirteen consecutive settlement days for securities sales pursuant to Rule 144 under the Exchange Act to thirty-five settlement days, and
  - update the market decline limitation relating to index arbitrage trading activity;
- proposed and re-proposed amendments to Regulation SHO to eliminate the "option market maker" exception to the close out requirement, and to require broker-dealers making a sale as "long" to document the present location of the securities being sold; and
- adopted amendments to Rule 10a-1 and Regulation SHO to repeal all price tests, including the "tick" test, and to provide that no price test, including any price tests of any self-regulatory organization ("SRO"), shall apply to short sales of any securities.

The adopted amendments to Rule 10a-1 and Regulation SHO to repeal all price tests took effect on July 3, 2007. The other adopted amendments to Regulation SHO will take effect 60 days after publication in the Federal Register.

### The Adopted Amendments to Rules 200 and 203 of Regulation SHO

#### Elimination of the "Grandfather" Exception to Regulation SHO's "Close Out" Requirement

Rule 203(b)(3) of Regulation SHO requires a participant in a registered clearing agency to "close out" a fail to deliver position if a "threshold security" remains open ten days after the settlement date, i.e., for 13 consecutive settlement days. Specifically, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iii) prohibits the participant from accepting any short sale orders or effecting further short sales in the particular "threshold security" without borrowing, or entering into a *bona fide* arrangement to borrow, the security until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.

Rule 203(c)(6) of Regulation SHO defines a "threshold security" as an equity security of an issuer that is registered under Section 12, or

<sup>1</sup> SEC Press Release, SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate "Tick" Test (June 13, 2007) ("Press Release"), available at <http://www.sec.gov/news/press/2007/2007-114.htm>. The Press Release summarizes the Commission's actions taken at an open Commission Meeting on June 13, 2007 (the "Open Meeting").

whose issuer is required to file reports with the Commission, where for five consecutive settlement days:

- there are aggregate fails to delivery at a registered clearing agency of at least 10,000 shares;
- the level of fails is at least 0.5% of the issuer's total outstanding shares; and
- the security is included on a list that a SRO publishes.

Under Rule 203(b)(3)(i), the "close out" requirement currently does not apply to positions that were established prior to the security becoming a threshold security. This is known as the "grandfather" provision. At the Open Meeting, the Commission voted to eliminate the grandfather provision and apply the close out requirement regardless of whether the fails to deliver occurred before or after the security became a threshold security. Participants in registered clearing agencies that previously have "grandfathered" fail to deliver positions on the date the amendment becomes effective will be allowed thirty-five settlement days to close-out such positions.

#### **Extension of Grace Period for Fails Resulting from Sales Pursuant to Rule 144**

The SEC also voted to amend Rule 203 of Regulation SHO to extend the close out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act of 1934. The Commission adopted the longer time period because doing so would be more consistent with Rule 203(b)(2)(ii) of Regulation SHO and the process of cleaning the certificates and settling the transactions may take more than thirteen settlement days.

#### **Technical Amendments**

The Commission also voted to make some technical amendments to Rule 200(e)(3) by changing the market decline condition in the index arbitrage provision to refer to the NYSE Composite Index, rather than the Dow Jones Industrial Average. The SEC also added language to clarify that that the two-percent market decline limitation is to be calculated in accordance with NYSE Rule 80A. The SEC also adopted a change

stating that the market decline limitation will remain in effect for the remainder of the trading day.

## **The Proposed Amendments to Amend the Options Market Maker Exception and Long Locate Requirement**

### **Re-Proposal of Amending the Options Market Maker Exception to Regulation SHO's "Close out" Requirement**

Rule 203(b)(3)(ii) currently provides that Regulation SHO's "close out" requirement does not apply to options market makers to sell short threshold securities to hedge options positions or to adjust such hedges, if the options positions were created prior to the time that the underlying security became a threshold security.

In July 2006, the SEC proposed to limit the duration of this exception by requiring close out of such fail to deliver positions after the related options position has expired or been liquidated.<sup>2</sup> At the Open Meeting, the SEC re-proposed for comment the complete elimination of the options market maker exemption, after a 35-settlement-day period. Alternatively, the SEC proposed two different methods of applying the 13-day-close-out requirement to option market maker positions. The first alternative would provide for a grace period of 35 settlement days. The second alternative would provide for a grace period of the shorter of 35 settlement days after the settlement date and 13 settlement days after all preexisting hedged options positions had expired.

### **Amendments to the Long Locate Requirement**

Finally, Rule 200(g) of Regulation SHO allows a broker-dealer to mark a sale "long" only if the seller is deemed to own the security, and either 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 no later than the settlement date. At the Open Meeting, the Commission voted to propose to

<sup>2</sup> Amendments to Regulation SHO, Rel. No. 34-54154 (July 14, 2006), available at <http://www.sec.gov/rules/proposed/2006/34-54154.pdf>.

require broker-dealers also to document the location of the “long” marked security to be sold.<sup>3</sup>

## The Adopted Amendments to Rule 10a-1 and Regulation SHO<sup>4</sup>

### Elimination of All Price Tests and Amendments to Regulation SHO

The SEC adopted amendments to Regulation SHO and Rule 10a-1 repealing all price tests that were designed to restrict short-selling in bear markets.<sup>5</sup> The nearly 70-year-old “tick” test under Rule 10a-1, generally applicable to securities listed on a national securities exchange, permitted short-selling only at a price above the price at which the immediately preceding sale was effected (“plus tick”), or at the last sale price if it is higher than the last different price (“zero-plus tick”). NASDAQ stocks currently are not subject to the tick test, but instead are subject to a “bid” test under NASD and NASDAQ rules, prohibiting short sales at prices below the stock’s best published bid price, when that bid price is below the previous different best published bid price.

On July 28, 2004, the SEC pursuant to Rule 202T of Regulation SHO created a “pilot program” temporarily excluding designated securities from the operation of the short sale price tests so that the Commission’s Office of Economic Analysis (the “OEA”) can evaluate the overall effectiveness of price test restrictions on short sales.<sup>6</sup> The studies by the OEA and several outside researchers revealed no support in maintaining the current price test restrictions.<sup>7</sup> Further, the SEC noted that the significant developments in the securities markets also justified eliminating price tests, such

as the increased use of matching systems that execute trade at independently derived prices during random times within specific time intervals, the spread of fully automated markets, and decimal pricing increments.<sup>8</sup>

Therefore, the SEC removed Rule 10a-1 and amended Regulation SHO by adding Rule 201 to provide that “no short sale price test, including any price test by any SRO, shall apply to short selling in any security.”<sup>9</sup> Additionally, Rule 201 will prohibit any SRO from having a price test.<sup>10</sup> Although these amendments will eliminate all existing price tests when they become effective, the SEC noted that an SRO may propose a new price test with the SEC, who may issue an exemption from Rule 201 if the SEC “determine[s] that circumstances have arisen that justify the issuance of [such] exemption.”<sup>11</sup>

Further, with the repeal of all price tests, Rule 200(g) of Regulation SHO would be amended to require that sales marked only “long” or “short,” eliminating the “short-exempt” marking requirement.<sup>12</sup> Because the “short-exempt” marking was for a seller relying on an exception to the “tick” test, the repeal of the test made the “short-exempt” marking unnecessary.

<sup>3</sup> Press Release.

<sup>4</sup> Regulation SHO and Rule 10a-1, Rel. No. 34-55970 (June 28, 2007) (“Adopting Release”), available at <http://www.sec.gov/rules/final/2007/34-55970.pdf>. The amendments in the Adopting Release affect price test and related marking requirement only. They do not relate to other provisions of Regulation SHO. The Adopting Release’s amendments do not alter the amendments to eliminate the grandfather provision, or the proposal to eliminate the options market maker exception. *Id.*

<sup>5</sup> *See id.*

<sup>6</sup> Short Sales, Rel. No. 34-50103 (July 28, 2004), available at <http://www.sec.gov/rules/final/34-50103.htm>.

<sup>7</sup> Adopting Release.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* The SEC staff has issued two no-action letters regarding the requirement to mark all short sales as short. American Stock Exchange LLC, SEC No-Action Letter (July 2, 2007); Securities Industry and Financial Markets Association, SEC No-Action Letter (July 2, 2007). The staff stated that it would not recommend that the Commission take any enforcement action against a broker-dealer marking a short sale “short exempt” for a transitional period of 90 days following the July 6, 2007 compliance date of Regulation SHO amendments, provided that (1) the broker-dealer does not mark short sales long; (2) the broker-dealer complies with the locate requirement of Regulation SHO’s Rule 203(b) for all short sales and all sales marked “short exempt,” unless such short sale order is excepted from the locate requirement; (3) the broker-dealer complies with all other requirements under Regulation SHO; and (4) the broker-dealer makes, keeps, and furnishes promptly upon request, the records as applicable rules and regulations require.

The SEC received 27 comment letters in response to the proposed amendments.<sup>13</sup> The Adopting Release states that none of them persuaded the SEC to make any modifications to the proposed amendments.<sup>14</sup>

## Conclusion

The practice of short-selling, and how the SEC should regulate it, remains one of the most controversial topics in securities regulation. The Commission's repeal of its price test rule—one of its oldest rules—demonstrates the SEC's willingness to evaluate its rules and revise them when it has new information. By implementing the pilot program to suspend the test,

<sup>13</sup> Adopting Release.

<sup>14</sup> *Id.*

the Commission obtained real data upon which it and others could assess the need for the price test rule. After evaluating the pilot, the Commission concluded that the requirement had outlived its usefulness. Both actions—conducting the pilot and repealing the rule—demonstrate the SEC's willingness to confront controversial issues and take action based on its findings, even when it means repealing a rule that, until recently, had been beyond criticism.



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