

SEC Proposes Amendments to Regulation SHO

On August 7, 2007, the Securities and Exchange Commission (the "Commission" or "SEC") issued a release¹ (the "Proposing Release"), proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 to eliminate the "options market maker" exception to the "close out" requirement and to require broker-dealers marking a sale as "long" to document the present location of the securities being sold.

Elimination of Options Market Maker Exception to Regulation SHO's "Close out" Requirement

One of the SEC's primary goals in adopting Regulation SHO was to address failures to deliver stocks on trade settlement dates and to target abusive "naked" short selling in certain equity securities.² As one way to achieve that goal, 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 a 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 whose issuer is required to file reports with the Commission, where for five consecutive settlement days:

- there are aggregate fails to deliver 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 self-regulatory organization publishes.

Current Rule's Exception

Rule 203(b)(3)(ii) currently provides that Regulation SHO's close out requirement does not apply to:

the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security.

¹ Amendments to Regulation SHO, Rel. No. 34-56213 (Aug. 7, 2007), available at www.sec.gov/rules/proposed/2007/34-56213.pdf. See *Dechert OnPoint FS #21-07-07* for earlier adoption and proposal.

² Proposing Release at 3.

The SEC created the options market maker exception to address liquidity and options pricing concerns.³

2006 Proposal

In July 2006, the SEC proposed to limit the duration of this exception.⁴ Under the proposal:

- If the security became a threshold security after the effective date of the amendment, all fail to deliver positions in the security that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on an options position that existed before the security became a threshold security would have to be closed out within 13 consecutive settlement days of the security becoming a threshold security or of the expiration or liquidation of the options position, whichever was later.
- In addition, if the fail to deliver position persisted for 13 consecutive settlement days from the date on which the security became a threshold security or the options position had expired or was liquidated, whichever was later, the proposal would have prohibited a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, 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 closed out the entire fail to deliver position by purchasing securities of like kind and quantity.

Accordingly, under the 2006 proposal, a registered options market makers still would have been able to keep open fail to deliver positions in threshold securities resulting from short sales to hedge an options position created prior to the time the underlying security became a threshold security, but only as long as the options position had not expired or been liquidated. After the related options position has expired or been liquidated, the fail to deliver position would

³ Id. at 10.

⁴ Amendments to Regulation SHO, Rel. No. 34-54154 (July 14, 2006), available at www.sec.gov/rules/proposed/2006/34-54154.pdf.

have been subject to the 13 consecutive settlement day close out requirement under Rule 203(b)(3).

The SEC received a number of comment letters on the proposal to limit the options market maker exception's duration, some in favor, some opposed. In particular, the comment letters opposing the proposal expressed concerns that a mandatory close out requirement for fails to deliver in threshold securities underlying options position could harm the liquidity in threshold securities and would make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth.⁵ The SEC responded, in the Proposing Release, by stating that based on the evidence "such an impact, if any, would be minimal."⁶

2007 Re-Proposal

In the Proposing Release, the SEC re-proposed for comment the complete elimination of the options market maker exemption, after a 35 consecutive settlement day phase-in period. The phase-in-period would reduce any potential market disruption from having to close out fails to deliver excepted previously under the options market maker exception. It would expire after 35 consecutive settlement days from the effective date of the amendment, and all fails to deliver from hedging activities by options market makers would be subject to the thirteen day close out requirement of Rule 203(b)(3).

In addition, the Commission proposed to impose a pre-borrow requirement on options market makers that is similar to the current rule. As with the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO:

If the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the proposed amendment would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, 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 bor-

⁵ Proposing Release at 16.

⁶ The Proposing Release at 16–19 outlines the Commission's reasons for dismissing such concerns.

row, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. Any fails to deliver that were not previously-expected from the close-out requirement of Rule 203(b)(3) of Regulation SHO as of the effective date of the amendment and, therefore, not subject to the one-time 35 consecutive settlement day phase-in period, would be subject to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.⁷

In addition, the SEC proposed two specific alternatives to applying the 13-day close out requirement to option market maker positions.

Alternative One

The first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days. It would provide that:

[A] participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series within a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within 35 consecutive settlement days of the security becoming a threshold security. After the 35 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.⁸

Alternative One also would include a pre-borrow requirement:

[I]f the fail to deliver position persists for 35 consecutive settlement days, the proposed alternative would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from ac-

cepting 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 entire fail to deliver position by purchasing securities of like kind and quantity.⁹

Alternative Two

The second alternative would require a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within the earlier of:

- thirty-five consecutive settlement days from the date on which the security became a threshold security; or
- thirteen consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated.

After the 35 or 13 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.¹⁰

Alternative Two also includes a pre-borrow requirement:

[T]he proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, 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 entire excepted fail to deliver posi-

⁷ *Id.* at 25.

⁸ *Id.* at 37–39.

⁹ *Id.* at 38.

¹⁰ *Id.* at 39.

tion by purchasing securities of like kind and quantity.¹¹

Amendments to the Long Locate Requirement

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. In the Proposing Release, the Commission proposed amendments to Rule 200(g)(1) to require broker-dealers to document the location of the “long” marked security to be sold.

Conclusion

The practice of short selling engenders both spirited critics and defenders. The Commission continues to try to strike a balance between some who claim that

current rules do not effectively prevent manipulation by market participants who allegedly read current restrictions too narrowly or seek to circumvent them altogether, and others who claim that proposed restrictions are overly broad and will impair the operations of the options markets. The Commission, for example, stated that: “[W]e believe that the proposed amendment would be warranted because it strikes the appropriate balance between reducing large and persistent fails to delivery in threshold securities while still allowing participants some flexibility in conducting their hedging activities.”¹² It will be interesting to see if the re-proposal or the alternatives engender any more of a consensus.



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¹¹ *Id.* at 39–42.

¹² *Id.* at 27.

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