

## SECURITIES ALERT

### SEC POSTPONES REGULATION SHO PILOT PERIOD AND PROHIBITS TRANSFER AGENTS FROM EFFECTING TRANSFERS IN SECURITIES SUBJECT TO SECURITIES INTERMEDIARY RESTRICTIONS



#### DELAY OF REGULATION SHO PILOT PROGRAM

Regulation SHO, which the Securities and Exchange Commission (SEC) adopted on July 28, 2004, to modernize the rules governing short-sale transactions, provides for a one-year pilot program exempting certain liquid securities from short-sale tests and suspending short-sale tests for after-market trading (Rule 202T). Specifically, during the pilot program, the SEC will —

- (i) suspend the application of the tick test of Rule 10a-1 and any short-sale price test of an exchange or national securities association with respect to short sales in securities contained in a subset of approximately 1,000 stocks that the SEC has selected from the Russell 3000 index for inclusion in the pilot program<sup>1</sup> and
- (ii) suspend the application of the tick test (a) to short sales in Russell 1000 index securities effected between 4:15 p.m. Eastern Time and the open of the consolidated tape the following day and (b) to short sales in all other exchange-listed securities effected between the close of the consolidated tape and the open of the consolidated tape the following day.

As is currently the case, the NASD Rule 3350 short-sale bid test will not apply to after-hours transactions in NASDAQ securities during the pilot program.

The pilot program, which was originally scheduled to commence on January 3, 2005, and to end on December 31, 2005, will permit the SEC to study the effects of relatively unrestricted short selling on trading behavior in selected securities. The SEC will only be able to obtain meaningful data to conduct such an evaluation if market participants comprehensively participate in the pilot program. In light of concerns about the practicality of such participation, on November 29, 2004, the SEC issued an order (SEC Release 34-50747) changing the pilot program's commencement date to May 2, 2005, and its ending date to April 28, 2006.

<sup>1</sup>Securities Exchange Act Release No. 50104 (July 28, 2004), 69 *Federal Register* 48032 (August 6, 2004), contains a list of the securities the SEC has selected for inclusion in the pilot program.

In the course of its communications with market participants since the adoption of Regulation SHO, the SEC found that it would not be possible prior to January 3, 2005, for broker-dealers to update their order processing systems to mark short-sale orders for pilot program stocks as “short exempt” as required under Regulation SHO (Rule 200). In fact, many broker-dealers indicated to the SEC that it would not be cost-effective to make costly and perhaps temporary modifications to their order processing systems to participate in a pilot program with a one-year duration. In place of such modifications, market centers have offered to help their broker-dealer members comply with Regulation SHO during the pilot period by “masking” short instructions on pilot program stocks so that such orders will be processed without any short-sale price test even if such orders are not marked “short-exempt” by the broker-dealers. The SEC understands that market centers will have systems in place to accomplish such masking by the new pilot program commencement date of May 2, 2005.

January 3, 2005, remains the compliance date for all other provisions of Regulation SHO.

### **TRANSFER AGENT RESTRICTIONS**

One impetus for the adoption of Regulation SHO was heightened concern over naked short selling, which takes place when a seller sells a security short even though the seller has not borrowed the security subject to the sale, the consequence of which is often a “fail to deliver” the security to the buyer upon settlement of the transaction. Some issuers have responded to naked short selling by requiring their shares to be represented in certificated form and/or restricting ownership of their securities by prohibiting transfer agents from acknowledging ownership of shares registered in the name of the Depository Trust Company (DTC) or by prohibiting transfer of shares to DTC or other securities intermediaries.

The SEC believes that such “certificate-only” or “custody-only” requirements thwart efficient clearance and settlement of securities transactions. Accordingly, on November 30, 2004, the SEC issued a final rule (SEC Release 34-50758) prohibiting transfer agents from effecting transfers of equity securities registered or subject to reporting requirements under the Securities Exchange Act of 1934 if such securities are subject to any restrictions or prohibitions on transfer to or from a securities intermediary.

### **CONTACT INFORMATION**

If you have any questions or would like to learn more about this topic, please contact the partner who represents you, or:

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