

SECURITIES ALERT

SEC REVISES SHORT-SALE RULES WITH ADOPTION OF REGULATION SHO

SUMMARY



On July 28, 2004, the Securities and Exchange Commission (SEC) issued a final rule adopting Regulation SHO (SEC Release 34-50103) to modernize SEC and self-regulatory organization (SRO) rules governing short sales of exchange-listed and Nasdaq National Market System (NMS) securities. Although the adopted version of Regulation SHO retreats from some of the more sweeping changes initially proposed in 2003, the SEC believes that the new rules will curtail problems associated with naked short sales and that data generated in the pilot program will facilitate informed consideration of further regulatory changes consistent with the market liquidity and pricing efficiency benefits of short selling. Regulation SHO implements, among other things:

- ***Requirement that all sales of equity securities be marked “long,” “short” or “short exempt” (Rule 200).*** In addition to mandating order-marking, this rule (i) provides that the holder of a securities futures product will not be considered long in the underlying security until the futures product has stopped trading and is ready to be physically settled and (ii) affirms previously granted no-action relief permitting broker-dealers calculating net aggregate position to aggregate only within defined trading units provided that there are sufficient walls between such units and the rest of the enterprise.
- ***Pilot program exempting certain liquid securities from short-sale tests and suspending short-sale tests for after-market trading (Rule 202T).*** This temporary rule initiates a pilot program pursuant to which the SEC will (i) suspend the application of the Rule 10a-1 “tick test” and price tests of any exchange or national securities association to approximately 1,000 securities selected from the Russell 3000 index 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.

The NASD Rule 3350 short-sale bid test will continue not to apply to after-hours transactions in Nasdaq securities.

- **Locate and delivery requirements (Rule 203).** This rule (i) requires broker-dealers effecting short sales to locate securities available for borrowing to cover such sales, with an exception for market makers engaging in bona fide market-making activities, and (ii) establishes additional delivery obligations for broker-dealers with respect to short sales of certain threshold securities that have experienced substantial failures to deliver.
- **Elimination of shelf-offering exemption (amends Rule 105 of Regulation M).** Rule 105 of Regulation M prohibits the use of offering securities purchased from an underwriter or broker-dealer participating in an offering to cover short sales effected during the restricted period, which is typically the five-day period prior to the pricing of the offering. Regulation SHO eliminates a previously existing exception to Rule 105 that permitted short sellers to cover with offering shares if the shares were purchased in a shelf offering. The Regulation SHO adopting release also gives examples of “sham” transactions that violate Rule 105 by giving the appearance that a short seller will cover with open-market shares when the short seller has actually arranged to cover the short sale with offering shares.

Most of Regulation SHO will be effective 30 days after publication in the *Federal Register*. The pilot program commences on January 3, 2005, and ends December 31, 2005, and the locate and delivery requirements of Rule 203 have a compliance date of January 3, 2005.

DISCUSSION

Current short-sale regulation is confusing and applies different price tests to securities trading in different markets. Short sales of exchange-listed securities are currently regulated by Rule 10a-1 of the Securities and Exchange Act of 1934 (Exchange Act). Under the tick test of Rule 10a-1, an exchange-listed security may be sold short (i) at a price above the price at which the immediately preceding sale was effected (plus tick) or (ii) at the last sale price if it is higher than the last different price (zero-plus tick). NMS securities have their own short-sale rules that prohibit National Association of Securities Dealers (NASD) members from engaging in short sales at or below the current best (inside) bid when that bid is lower than the previous best (inside) bid (commonly referred to as the bid test). The tick test is applicable only to exchange-listed securities, and the NASD’s bid test applies only to short-sale transactions in NMS securities effected on either SuperMontage or the NASD’s Alternative Display Facility (ADF). Neither test currently applies to short sales involving Nasdaq SmallCap, OTCBB or other securities traded over the counter. Moreover, no short-sale price test applies to short sales of NMS securities executed away from SuperMontage and the ADF unless the market on which the securities are being traded has adopted its own price test. Regulators fear that this disparate treatment of short sales has led to regulatory arbitrage.

In addition, market participants have expressed growing alarm at the prevalence of naked short selling, which is the practice of selling short even though the seller has not borrowed the securities subject to the sale, the consequence of which is often a “fail to deliver” the securities to the buyer upon settlement of the transaction. In some instances, settlement failures can exceed the entire public float of a company. Naked short selling has deleterious effects on the clearance and settlement system, on buyers who do not receive the securities to which they are entitled upon settlement of short sales, and on issuers whose stock prices naked short selling depresses. Some issuers have responded to naked short selling by withdrawing their securities from the Depository Trust Company or by attempting to make transfers in their securities “certificate only” or “custody only.”

RULE 200 — ORDER-MARKING, SECURITIES FUTURES PRODUCTS AND AGGREGATION

Order-Marking. Rule 200(g) requires market participants to differentiate among “long,” “short” and “short exempt” orders for all equity securities. Orders may be marked “long” only when the seller owns the security being sold (as determined under Rule 200(b), which replaces the ownership standards previously set forth in Rule 3b-3 of the Exchange Act) and the security either is in the physical possession or control of the broker-dealer or if it reasonably expected that the security will be in such physical possession or control no later than the settlement of the transaction. A short-sale order may be marked “short exempt” if it is effected under the Rule 202T pilot program or pursuant to an exception from the tick test of Rule 10a-1 or from a short-sale price test of an exchange or national securities association. All trades not eligible to be marked “long” or “short exempt” will be marked “short.” These order-marking requirements will aid market surveillance and provide information about the utilization of short-sale exemptions.

Securities Futures Products. Rule 200(b)(6) provides that the holder of a long security futures position will not be deemed to own the underlying security until the security terminates trading and the future is physically settled. The SEC believes that a long securities position entails a high degree of certainty that the holder will presently possess the underlying security. Because futures products involve a distant time element, the SEC analogizes them to other derivatives products that do not create long positions until they are exercised, such as options, rights, warrants and convertibles, rather than to unconditional contracts, which will continue to create long positions under Rule 200(b)(2).

Aggregation. Under Rule 200(f), short sellers must still aggregate their positions in each security to determine whether the seller has a “net long position” in such security. The rule continues relief from such aggregation rules for large broker-dealers divided into trading units or “desks” that pursue separate trading strategies. These trading units, under certain conditions, need only aggregate within each trading unit rather than aggregating together all of the trading units in the enterprise. Broker-dealers may aggregate by independent trading units if (i) the broker-dealer has a written organizational plan that identifies each aggregation unit, specifies its trading objectives and supports its independent identity, (ii) each aggregation unit determines at the time of each sale its net position for every secu-

rity that such unit trades, (iii) all traders in an aggregation unit pursue only the trading objectives or strategies of that unit and (iv) individual traders are assigned to only one aggregation unit at any time.

RULE 202T — PILOT PROGRAM SUSPENDING SHORT SALE TESTS

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 program¹ and (ii) suspend the application of the tick test to transactions in (a) Russell 1000 index securities effected between 4:15 p.m. Eastern Time and the open of the consolidated tape the following day and (b) all other exchange-listed securities effected between the close of the consolidated tape and the open of the consolidated tape the following day. Short sales of Nasdaq securities in the after-hours market still will not be subject to the NASD Rule 3350 short-sale bid test.

The pilot program will permit the SEC to study the effects of relatively unrestricted short selling on trading behavior in selected securities. Pending the results of the pilot program, the SEC has deferred action on proposed Rule 201, which would have replaced short-sale price tests with a uniform bid test mandating that all short sales in covered securities be effected at a price at least one cent above the consolidated best bid for a security at the time of execution of any short sale. Upon the evaluation of pilot program data, the SEC might (i) eliminate all SEC-imposed price tests for some or all securities, (ii) implement a uniform bid test such as that proposed in Rule 201 or (iii) take no action to alter existing price tests.

RULE 203 — LOCATE AND DELIVERY RULES

Rule 203 contains locate and delivery requirements that the SEC hopes will mitigate some of the perceived harms associated with naked short selling. Rule 203 prohibits a broker-dealer from executing a short-sale order for its own account or the account of another person unless the broker-dealer:

- (i) has borrowed the security or entered into an arrangement to borrow the security, or
- (ii) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.

Rule 203 requires that the short seller locate securities available for borrowing and record such securities in writing prior to effecting any short sale even though the seller's short position could be closed out by purchasing securities on the settlement date. The rule provides exceptions to the locate requirement for market makers and for registered broker-dealers that receive short-sale orders from other registered broker-dealers also subject to the locate requirements. The rule also provides an exception to the locate requirement if a broker-dealer effects a sale for a customer

¹ SEC Release No. 34-50104 contains a list of the securities that the SEC has selected for inclusion in the pilot program.

that is deemed to own the security pursuant to Rule 200 even if, through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by the settlement date (e.g., where a convertible security, option or warrant has been tendered for conversion or exchange but the underlying security is not reasonably expected to be received by the settlement date). In such cases, delivery must be made on the sale as soon as all restrictions on delivery have been removed and in no event later than 35 days after the trade date.

Rule 203 especially targets securities that have experienced significant settlement failures to deliver (“threshold securities”). Any registered clearing agency must take action on all failures to deliver that exist in threshold securities 10 days after the normal settlement date (i.e., 13 consecutive settlement days) by purchasing the necessary securities to close out the fail-to-deliver position. Until the position is closed out, the registered clearing agency and any broker-dealer for which it clears transactions are prohibited from engaging in further short sales in the subject threshold security without borrowing or entering into a bona fide arrangement to borrow the security. The close-out requirement will not apply to fail-to-deliver positions established prior to the subject security becoming a threshold security.

A security will constitute a threshold security if (i) it is registered under Section 12 of the Exchange Act or if its issuer is required to file reports under Section 15(d) of the Exchange Act and (ii) for five consecutive settlement days (a) the security experiences aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security, (b) such amount is equal to at least one-half of one percent of the issuer’s total shares outstanding and (c) the security is included on a list published by an SRO. The SEC estimates that approximately 4 percent of all securities will be classified as threshold securities. In order to be removed from the list of threshold securities, a security must not exceed the specified level of fails for at least five consecutive settlement days.

Rule 203 also supplants Rule 10a-2 of the Exchange Act and requires that, in the absence of specified circumstances, a broker-dealer that knows or should know that the sale of an equity security is marked “long” must make delivery of such security when due and cannot use borrowed securities to do so.

AMENDMENTS TO RULE 105 OF REGULATION M — SHORT SALES IN CONNECTION WITH A PUBLIC OFFERING

To prevent artificial forces from distorting offering prices, Rule 105 of Regulation M prohibits a short seller from covering short sales with offering securities purchased from an underwriter or broker-dealer participating in an offering if the short sale occurs during the restricted period, which is typically the five-day period prior to the pricing of the offering. Regulation SHO eliminates a previously existing exception to Rule 105 that permitted short sellers to cover with offering shares if the shares were purchased in a shelf offering. The SEC has observed that shelf offerings are relatively common in the market today and that, if an individual with notice of a shelf offering effects short sales during the five days prior to pricing and covers his short sale with shelf offering securities, his conduct creates the

downward price pressure and potential for manipulation that Rule 105 is designed to prevent. The Regulation SHO adopting release also discusses sham transactions that violate Rule 105 by using offering shares to cover short sales effected during the pre-pricing restricted period even though such transactions give the misleading appearance of covering the short sale with open market shares.

CONTACT INFORMATION

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

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