

SEC PROPOSES AMENDMENTS TO REGULATION SHO

On July 14, 2006, the Securities and Exchange Commission (“SEC” or “Commission”) issued a release proposing amendments to Regulation SHO that are expected to have the effect of reducing the number of fail to deliver positions in certain equity securities.¹ These proposed amendments arise out of the Commission’s concern about the potential negative effect that substantial and persistent fail to deliver positions may have on the market for some securities.²

While the proposals are limited to amending two specific provisions of Regulation SHO, the release in fact requests comment on many significant features of the locate and close-out aspects of the Regulation. The release is available at <http://www.sec.gov/rules/proposed.shtml>. Written comments may be submitted to the SEC until 60 days after publication of the release in the Federal Register, so the comment period is expected to extend to mid-September 2006.

BACKGROUND

On July 28, 2004, the SEC adopted Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”) to provide a framework for the regulation of short sales in securities.³ Regulation SHO, which is comprised of SEC Rules 200, 202T, and 203, includes “locate” and “close-out” requirements, the definition of ownership for short sale purposes, requirements for determining a seller’s net aggregate position, and order-marking requirements.

Regulation SHO, which became effective on January 3, 2005, imposes close-out requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred. Rule 203(b)(3) provides that if a participant⁴ of a registered clearing agency⁵ has a fail to deliver

¹ Amendments to Regulation SHO, Securities Exchange Act Release No. 54154 (July 14, 2006) (“Release 34-54154”).

² The need for Regulation SHO grew out of longstanding problems involving failures to deliver stock by the end of the standard three-day settlement period for trades, some of which were symptoms of abusive “naked” short selling. Naked short selling is the practice of shorting a stock without the intention of borrowing the stock to cover the position.

³ Short Sales, Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (August 6, 2004) (“Adopting Release”). Regulation SHO is codified at 17 C.F.R. § 242.200-203 (2006). See Willkie Farr & Gallagher LLP Client Memorandum, “SEC Adopts Regulation SHO Governing Short Sales” (Aug. 5, 2004), available at <http://www.willkie.com/firm.pubs.aspx>, for a discussion of Regulation SHO; see also Aaron Lucchetti & Kara Scannell, *Despite SEC Rules, A Small Amount of Naked Short Selling Appears to Persist*, WALL ST. J., Apr. 13, 2006, at C1.

⁴ “Participant” is defined in Section 3(a)(24) of the Exchange Act.

⁵ “Registered clearing agency” is defined in Rule 203(c)(3) of Regulation SHO, 17 C.F.R. § 242.203(c)(3). The relevant clearing agency for purposes of Rule 203(b)(3) is the National Securities Clearing Corporation (“NSCC”).

position at a registered clearing agency in a threshold security⁶ for 13 consecutive settlement days, the participant must close out the fail to deliver position at the end of the thirteenth day or the beginning of the fourteenth day by purchasing securities of like kind and quantity. Until the participant fulfills the close-out requirement, the participant and any broker or dealer for which it clears transactions, including any market maker,⁷ are prohibited from accepting a short sale order in the threshold security from any person, or effecting a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security.⁸

Currently, there are two main exceptions to the close-out requirements under Rule 203(b)(3). Under the first exception, commonly referred to as the “grandfather” provision, any fail to deliver positions that were established *prior* to the security becoming a threshold security are not subject to the close-out requirement.⁹

The second exception, commonly referred to as the “options market maker” exception, allows registered options market makers to sell short threshold securities in order 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 (“pre-existing options positions”). Any fail to deliver positions in threshold securities resulting from short sales that were effected to hedge pre-existing options positions are not subject to the close-out requirement.¹⁰ However, fails to deliver in threshold securities not effected to hedge pre-existing positions, and that remain open for 13 consecutive settlement days, are subject to mandatory close-out.

PROPOSED AMENDMENTS

Although Release 34-54154 states that Regulation SHO has reduced the level of fails to deliver, SEC and self-regulatory organization examinations have indicated that persistent fails to deliver may be attributable to the grandfather provision and the options market maker exception. As such, the SEC is proposing the following amendments to Rule 203:

⁶ “Threshold security” is defined in Rule 203(c)(6), 17 C.F.R. § 242.203(c)(6), as any equity security of a reporting issuer for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, that equals at least 0.5% of the issuer’s total shares outstanding, and is included on a list disseminated by a self-regulatory organization (“SRO”). A list of such threshold securities is published daily by the SROs and a security will be removed from such list if it does not exceed the specified level of fails for five consecutive settlement days.

⁷ “Market maker” is defined in section 3(a)(38) of the Exchange Act.

⁸ Rule 203(b)(3)(iii) of Regulation SHO, 17 C.F.R. § 242.203(b)(3)(iii).

⁹ Rule 203(b)(3)(i) of Regulation SHO, 17 C.F.R. § 242.203(b)(3)(i).

¹⁰ Rule 203(b)(3)(ii) of Regulation SHO, 17 C.F.R. § 242.203(b)(3)(ii).

- (1) Eliminate the grandfather provision altogether; and
- (2) Narrow the duration of the options market maker exception.

By eliminating the grandfather provision, all fail to deliver positions in threshold securities, including those that existed prior to the security becoming a threshold security, will be subject to the close-out requirement under Regulation SHO.

By limiting the duration of the options market maker exception, an options market maker's fail to deliver positions in threshold securities that resulted from short sales effected to establish or maintain a hedge on a pre-existing options position that has expired or been liquidated would be subject to mandatory close-out. Such fail to deliver positions must be closed out if they persist for 13 consecutive settlement days after the security became a threshold security or the expiration or liquidation of the options position, whichever is later. However, options market makers would still be able to continue to keep open fail to deliver positions in threshold securities that are being used to hedge options positions, including adjusting such hedges, if the pre-existing options positions have not expired or been liquidated.

To allow market participants sufficient time to comply with the new close-out requirements, the proposals include a phase-in period. Any previously grandfathered fail to deliver position in a security that is on the threshold list on the effective date of the amendment must be closed out within 35 settlement days following the effective date of the amendment. Any previously excepted fail to deliver position in a threshold security that resulted from short sales effected to hedge pre-existing options positions that have expired or been liquidated on or before the effective date of the amendment would be required to be closed out within 35 settlement days of the effective date of the amendment. If any fail to deliver positions subject to these transitional requirements are not closed out within the 35-day period, the participant, and any broker-dealer for which it clears transactions, would be subject to a "pre-borrow" requirement similar to that in Rule 203(b)(3)(iii) of Regulation SHO for the relevant threshold security.¹¹

Finally, the SEC proposes a technical amendment to Rule 200(e)(3) that relates to index arbitrage trading activity. The proposed amendment would update the market decline limitation provided in the rule by referencing the NYSE Composite Index ("NYA") instead of the Dow Jones Industrial Average ("DJIA") and by adding language to clarify how the two-percent market decline limitation is to be calculated in accordance with NYSE Rule 80A. The purpose of the technical amendment is to maintain consistency with NYSE Rule 80A.

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¹¹ See text at note 8 above.

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