

**SEC ADOPTS AMENDMENTS TO SHORT SALE RULES**

On June 13, 2007, the Securities and Exchange Commission (“SEC” or “Commission”) voted to adopt amendments to major rules under the Securities Exchange Act of 1934 (the “Exchange Act”) regulating short sales of securities. The Commission, however, did not consider a proposed amendment to Rule 105 of Regulation M.<sup>1</sup> The Commission did not announce the withdrawal of the proposed amendment from consideration before or at the open meeting, nor did it explain at the open meeting the reason for the withdrawal. We understand, however, that the proposed amendment was withdrawn to address certain drafting details. We also understand that the Commission will consider the proposed amendment to Rule 105 at a future open meeting.

The amendments adopted, which will be effective immediately upon publication in the Federal Register for Rule 10a-1 and 60 days after publication for Regulation SHO:

- (a) eliminate all price restrictions under Rule 10a-1 and prohibit self-regulatory organizations (“SROs”) from imposing their own price tests on short sales for any security;
- (b) eliminate the “grandfather” exception to the “close-out” requirements contained in Regulation SHO;
- (c) extend the current close-out requirement of 13 consecutive settlement days for sales of Rule 144 threshold securities to 35 settlement days; and
- (d) eliminate the “short exempt” marking requirement.

The Commission re-proposed for comment amendments to the exception to the “close-out” requirements contained in Regulation SHO for options market maker hedging activities. It also proposed for comment a requirement that broker-dealers document the location of securities subject to a long sale. The comment period on the re-proposed and proposed amendments will be 30 days from the date of their publication in the Federal Register.

**AMENDMENT ELIMINATING THE “TICK TEST” OF RULE 10a-1**

The Commission adopted an amendment to Rule 10a-1 under the Exchange Act that eliminates the “tick test.” Subject to limited exceptions, the “tick test” permitted the short sale of an exchange-listed security only (1) at a price above the price at which the immediately preceding

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<sup>1</sup> The amendment was intended to create a bright line rule prohibiting persons from purchasing securities in a firm commitment public offering, if they had sold the security short during the five trading days before such offering was priced.

sale was effected (plus tick), or (2) at the last sale price if it was higher than the last different price (zero-plus tick). To study the market impact of short selling in the absence of price regulation, the Commission conducted a pilot program to suspend all price tests for a group of securities, and collected data from May 2, 2005 to August 28, 2006.<sup>2</sup> The empirical evidence from this study showed that relatively unrestricted short selling had minimal effects on market volatility, price efficiency and liquidity.

Based on the results of the pilot program, the Commission proposed and has now adopted an amendment eliminating all price restrictions under Rule 10a-1 and prohibiting SROs from applying their respective price tests to short sales for any security. If an SRO later determines that a price test is necessary, however, it could seek Commission approval to adopt a new rule through the rule filing process.

## AMENDMENTS TO REGULATION SHO

### **Background**

On July 28, 2004, the SEC adopted Regulation SHO under the Exchange Act to provide a framework for the regulation of short sales in securities.<sup>3</sup> 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.

Rule 203 of Regulation SHO imposes “close-out” requirements on broker-dealers. Rule 203(b)(3) provides that if a participant<sup>4</sup> of a registered clearing agency<sup>5</sup> has a fail to deliver position at a registered clearing agency in a threshold security<sup>6</sup> for 13 consecutive settlement days, the participant must take immediate action to close out the fail to deliver position by

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<sup>2</sup> The suspension of short sale price tests for pilot securities remains in effect.

<sup>3</sup> 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.

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

<sup>5</sup> “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”).

<sup>6</sup> “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.

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,<sup>7</sup> 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.<sup>8</sup>

Before adoption of the amendments discussed below, Rule 203(b)(3) contained two main exceptions to the close-out requirements. Under the first exception, commonly referred to as the “grandfather” provision, any fail to deliver positions established before the security became a threshold security were not subject to the close-out requirement.<sup>9</sup>

The second exception, the “options market maker” exception, provides that any fail to deliver position in a threshold security resulting from short sales by a registered options market maker that were effected to hedge options positions created before the underlying security became a threshold security are not subject to the close-out requirement.<sup>10</sup> 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.

### **Amendments Adopted**

*Grandfather exception eliminated.* To help reduce fails to deliver, the SEC adopted an amendment to Rule 203 that eliminates the grandfather provision. The SEC stated that, although 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. Therefore, the SEC decided to eliminate the grandfather provision. Under the amended rule, all fail to deliver positions in threshold securities, including those that existed before the security became a threshold security, will be subject to the close-out requirement under Regulation SHO.

The amendment includes a 35-day phase-in period to allow market participants sufficient time to comply with the new close-out requirements. 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.

*Rule 144 sales.* The Commission also adopted an amendment extending the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities to 35 settlement days. The Division of Market Regulation explained that Rule 144 securities involve

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<sup>7</sup> “Market maker” is defined in Section 3(a)(38) of the Exchange Act.

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

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

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

processing steps that are not in the control of the short seller or its broker-dealer and that can delay delivery of the seller's securities.

*Marking requirement.* The Commission adopted an amendment to Rule 200(g) of Regulation SHO to eliminate the "short exempt" marking requirement. Rule 200(g)(2) required a short sale order to be marked "short exempt" if the seller was relying on an exception to the tick test. With the elimination of the tick test, the marking requirement became unnecessary.

*Technical amendment.* Finally, the SEC adopted a technical amendment to Rule 200(e)(3) that relates to index arbitrage trading activity. The amendment updates the market decline limitation contained in the rule by referencing the NYSE Composite Index instead of the Dow Jones Industrial Average and by adding language to clarify how the two-percent market decline limitation is to be calculated in accordance with NYSE Rule 80A. The technical amendment is intended to maintain consistency with NYSE Rule 80A.

### **Proposed Amendments**

*Options market maker exception.* The Commission re-proposed an amendment to the options market maker exception to the Regulation SHO "close out" provisions. The amendment proposes three alternatives to the current rule. One alternative would eliminate the exception entirely. Another alternative would impose a 35-day close-out requirement on options market makers. Under this second alternative, a fail to deliver in a threshold security that remained open for 35 consecutive settlement days would be subject to mandatory close-out. The third alternative would require the options market maker to close out any fail to deliver in a threshold security that remained open for 35 consecutive settlement days or persisted for 13 consecutive settlement days after the expiration or liquidation of the related options position, whichever is shorter. The SEC staff apparently was not persuaded by the options market makers' comments on the proposed amendment that they may maintain short positions in underlying securities even after an option has expired or been liquidated because they hedge their risks in a portfolio rather than on an individual security basis.

*Documentation for long sales.* The Commission proposed an amendment to Regulation SHO that would require broker-dealers to document the location of a security related to a sale marked long.

### **Observations**

The amendments to the short sale rules, including the elimination of the "tick test" under Rule 10a-1, do not diminish the importance of determining if a sale is a short sale. This determination is pertinent to a number of SEC provisions, including: Regulation SHO, to perform a locate and to mark an order properly; Rule 105 of Regulation M, to determine if a person is subject to the prohibitions of that rule; and Rules 17a-3 and 17a-4 under the Exchange Act, which require accurate recordkeeping regarding orders. Whether a sale is a short sale also is relevant to: SRO order and trade reporting rules (for example, OATS); SRO short position reporting requirements; and margin rules. Also, it was emphasized at the SEC meeting that the SEC and the SROs will

continue to monitor short selling activity for indications of market manipulation, so proper identification of short sales will continue to be required.

Moreover, the “aggregation unit” provision in Rule 200(f) of Regulation SHO will continue to be useful for broker-dealers effecting short sales.<sup>11</sup> There was no discussion at the SEC meeting, however, as to whether the provisions of Rule 200(f) will be extended to entities other than broker-dealers as many commenters on the proposed amendments had urged the Commission to do.

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If you have any questions regarding this memorandum, please contact Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com) or the attorney with whom you regularly work.

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<sup>11</sup> Rule 200(f) of Regulation SHO, 17 C.F.R. § 242.200(f).