

**SEC ADOPTS AND REPROPOSES AMENDMENTS TO REGULATION SHO**

On August 7, 2007, the Securities and Exchange Commission (the “SEC” or “Commission”) published final amendments<sup>1</sup> to Regulation SHO under the Securities Exchange Act of 1934 (the “Exchange Act”). Regulation SHO substantially increased the requirements to locate and deliver securities in the settlement of short sales.<sup>2</sup> The amendments eliminate a “grandfather” exception to the “close-out” requirements contained in Regulation SHO, extend the current close-out requirement of 13 consecutive settlement days for sales of Rule 144 threshold securities to 35 settlement days and make technical changes related to New York Stock Exchange (“NYSE”) Rule 80A. The adopted amendments will be effective 60 days after publication in the Federal Register.

In a separate release, the Commission repropose for comment amendments to Regulation SHO that would eliminate the exception to the close-out requirements for options market maker hedging activities and proposed for comment a requirement that broker-dealers document the location of securities subject to a long sale.<sup>3</sup> The comment period on the repropose and proposed amendments will be 30 days from the date of their publication in the Federal Register.

**Background**

Current Rule 203(b)(3) contains 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 becomes a threshold security are not subject to the close-out requirement.<sup>4</sup> The Commission adopted this exception because it was concerned that closing out large, pre-existing fail to deliver positions would create volatility in the subject security.

The second exception, the “options market maker” exception, provides that any fail to deliver position in a threshold security<sup>5</sup> resulting from short sales by a registered options market maker effected to hedge options positions created before the underlying security becomes a threshold

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<sup>1</sup> *Amendments to Regulation SHO*, Exchange Act Release No. 56212 (Aug. 7, 2007).

<sup>2</sup> 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>3</sup> *Amendments to Regulation SHO*, Exchange Act Release No. 56213 (Aug. 7, 2007).

<sup>4</sup> Rule 203(b)(3)(i) of Regulation SHO, 17 C.F.R. § 242.203(b)(3)(i).

<sup>5</sup> Rule 203(c)(6) of Regulation SHO defines a “threshold security” as an equity security for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency, as that term is defined in Rule 203(c)(3), 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”).

security are not subject to the close-out requirement.<sup>6</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, unless the grandfather provision applies.

### **Amendments Adopted**

*Grandfather exception eliminated.* The SEC has amended Rule 203(b)(3)(i) to eliminate the grandfather provision. According to the Commission, the level of fails to deliver has declined since implementation of Regulation SHO, but SEC and self-regulatory organization examinations have indicated that persistent fails to deliver may be attributable to the grandfather and the options market maker exceptions. Elimination of the grandfather provision is intended to reduce those persistent fails to deliver. 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 required to close out within 13 consecutive settlement days, with the exception of previously grandfathered positions, as discussed below. The amendment includes a 35-day phase-in period to allow market participants time to comply with the new close-out requirements.

*Rule 144 sales.* The Commission adopted an amendment to Rule 203(b)(3)(ii) of Regulation SHO with respect to sales of securities subject to Rule 144 of the Securities Act of 1933. Sales of restricted securities made pursuant to Rule 144 often cannot be settled by delivery of the restricted securities for practical reasons and, therefore, must be settled with borrowed securities. In such cases, Regulation SHO treats the sales as short sales.<sup>7</sup> The amendment extends to 35 consecutive settlement days the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities.

*Preborrow Requirement.* The Commission also amended Rule 203(b)(3)(iii) to extend the preborrow requirement. If a fail to deliver position either in securities subject to the 35-day phase-in period or in Rule 144 securities persists for more than 35 consecutive settlement days, the participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, may not accept any short sale orders or effect further short sales in the 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 a like kind and quantity.

*Technical amendment.* Finally, the SEC adopted a technical amendment to Rule 200(e)(3) of Regulation SHO 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-

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<sup>6</sup> Rule 203(b)(3)(ii) of Regulation SHO, 17 C.F.R. § 242.203(b)(3)(ii).

<sup>7</sup> Rule 200(g)(1) does not permit a broker-dealer to mark an order to sell as “long” unless the seller is deemed to own the security and the broker-dealer either (i) has physical possession or control over the security to be delivered or (ii) reasonably expects that it will have physical possession or control of the security by no later than settlement of the transaction.

percent market decline limitation is to be calculated in accordance with NYSE Rule 80A.<sup>8</sup> The technical amendment is intended to maintain consistency with NYSE Rule 80A.

### **Reproposed and Proposed Amendments**

*Options market maker exception.* Last year, the Commission proposed an amendment (the “2006 Proposal”) to Regulation SHO that would have narrowed the options market maker exception under Rule 203(b)(3)(ii) of the Exchange Act.<sup>9</sup> The 2006 Proposal would have permitted an options market maker to keep open a fail to deliver position in a threshold security that resulted from a short sale to hedge an options position created before the underlying security became a threshold security, if the options position had not expired or been liquidated. Once the underlying security became a threshold security and the options position being hedged had expired or been liquidated, however, the 2006 Proposal would have required the fail to deliver position to be closed out within 13 consecutive settlement days from the date that the security became a threshold security or the options position expired or was liquidated, whichever was later.

According to the Commission, preliminary data indicated that Regulation SHO’s close-out requirement appears to have reduced fails to deliver without market disruptions, but that a small number of threshold securities with substantial and persistent fail to deliver positions remains.

Given the substantial and persistent fail to deliver positions, the Commission has now reproposed an amendment to Rule 203(b)(3)(ii) that would eliminate the options market maker exception entirely. Options market makers would have a 35 consecutive settlement day phase-in period under amended Rule 203(b)(3)(iii) from the effective date of the amendment to close out a previously excepted fail to deliver position in a threshold security. If a fail to deliver position in a threshold security persisted for 35 consecutive settlement days from the effective date of the amendment, the amendment would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale order or effecting further short sales in the threshold security without borrowing, or entering into a bona fide arrangement to borrow, the security until the participant closed out the entire fail position by purchasing securities of a like kind and quantity. For any security that became a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from a sale effected by an options market maker to establish or maintain a hedge on options position created before the security became a threshold security would be subject to the 13 consecutive settlement day close-out requirement of Rule 203(b)(3).

The Commission also proposed two alternatives to the elimination of the options market maker exception, each of which would be subject to a 35 consecutive settlement day phase-in period

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<sup>8</sup> NYSE Rule 80A places certain trading restrictions on index arbitrage orders to sell any component of the S&P 500 Stock Price Index.

<sup>9</sup> *Amendments to Regulation SHO*, Exchange Act Release No. 54154, 71 FR 41710 (Jul. 21 2006).

similar to the one for the proposed elimination of the options market maker exception. Under Alternative 1, a fail to deliver in a threshold security that resulted from a short sale by an options market maker to establish or maintain a hedge on any options series within a portfolio created before the security became a threshold security, and that remained open for 35 consecutive settlement days from the date the security became a threshold security, would be subject to mandatory close-out. Alternative 2 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 from the date on which the security became a threshold security, or that persisted for 13 consecutive settlement days after the expiration or liquidation of the related options position, whichever is shorter. After the expiration of the 35 or 13 consecutive settlement day period, any additional fails to deliver would be subject to the 13 consecutive settlement day close-out requirement.

*Documentation for long sales.* The Commission also is proposing to amend the long sale marking provisions of Rule 200(g) of Regulation SHO. The proposed amendment to Rule 200(g)(2) would require broker-dealers to document the location of a security related to a sale marked long and, in doing so, determine if the customer is deemed to own the security within the meaning of Rule 200(g)(1). If the broker-dealer could not document the location of a security related to an order marked long, the broker-dealer would be required to mark the sale short.

### **Practical Considerations**

Persons who engage in short selling should consider what effect elimination of Regulation SHO's grandfather provision will have on their operations. Persons who engage in short selling also should update their policies and procedures to reflect elimination of the grandfather exception. The policies and procedures should include a method to track securities that become threshold securities and the steps that should be taken to close out fails to deliver on short positions in threshold securities in a timely manner. The policies and procedures also should reflect the changes to the close-out requirements applicable to Rule 144 securities.

Options market makers should recognize that, unless they could borrow, or arrange to borrow, the securities underlying the options in which they make markets, the proposed elimination of the current options market maker exception would prevent them from selling short those securities as a hedge to their options positions if the options market makers do not close out fails to deliver on short positions in underlying securities within the requisite time frame.

Finally, broker-dealers should consider the potential operational changes necessary to document the location of securities related to a sale marked long as would be required under the proposed amendment to Rule 200(g) of Regulation SHO.

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