

**SEC ADOPTS REGULATION SHO GOVERNING SHORT SALES**

The Securities and Exchange Commission (the “Commission”) has adopted Regulation SHO (“Reg SHO”) providing a new framework for the regulation of short sales in securities. Reg SHO includes new “locate” and delivery requirements, modifications to the definitions of ownership for short sale purposes, clarification of the requirements for determining a seller’s net aggregate position, new ticket-marking requirements and elimination of the shelf offering exception from Rule 105 of Regulation M. The text and interpretation of Reg SHO have been published in Securities Exchange Act Release No. 50103 (July 28, 2004).<sup>1</sup>

Together with Reg SHO, the Commission has published an order in Securities Exchange Act Release No. 50104 (July 28, 2004) establishing a one-year pilot that suspends the operation of the current price (“tick”) test in Rule 10a-1 under the Securities Exchange Act of 1934 (the “Exchange Act”), as well any short sale price test of any exchange or national securities association, including NASD Rule 3350, for one third of the stocks in the Russell 3000 index (the “Order”). The one-year pilot also extends to short sales executed in any security in the Russell 1000 index after 4:15 p.m. and to all other securities after the close of the consolidated tape until it reopens the next day.<sup>2</sup>

Rules 200-203 of Reg SHO will become effective 30 days after publication in the Federal Register, with a compliance date of January 3, 2005. The amendment to Rule 105 of Regulation M will be effective 30 days after publication in the Federal Register.

**The one-year pilot program**

The Commission notes in the Order that, in suspending the pricing test for 1000 stocks in the Russell 3000 index, the pilot program is intended to permit the Commission to gather data that will help it determine whether short sale regulation should be removed, in part or in whole, for actively traded securities or, if the regulation is retained, whether it should be applied to additional securities. The Commission also stated that, together with the SROs, it would monitor trading activity during the pilot and conduct surveillance to detect possible manipulative short selling.

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<sup>1</sup> Exchange Act Release No. 50103 is available at <http://www.sec.gov/rules/final/34-50103.pdf>.

<sup>2</sup> Exchange Act Release No. 50104 is available at <http://www.sec.gov/rules/other/34-50104.htm>.

### **Deferral of a uniform bid test**

As originally proposed, Rule 201 of Reg SHO would have replaced the current tick test in Rule 10a-1 with a new uniform bid test. That test would have restricted short sales in exchange-listed and Nasdaq NMS securities to a price at least one cent above the consolidated best bid. The Commission did not adopt that test but stated it will reconsider the uniform bid test after completion of the Rule 202T pilot program.

Following a review of the data it gathers from the pilot program, the Commission will consider whether a short sale price test should be removed, in part or in whole, for some or all securities, or, if retained, whether it should be applied to additional securities, for example, to Nasdaq SmallCap or other OTC securities. In the meantime, the price test in Rule 10a-1, as well as all SRO price tests, will be maintained in their present form for securities not included in the pilot program. All existing exceptions to and exemptions from Rule 10a-1 also will remain in effect.

### **The definition of ownership**

*Unconditional Contracts.* Rule 200 of Regulation SHO incorporates Exchange Act Rule 3b-3 with some amendments. Rule 200(b)(2) retains the current definition of “unconditional contract” contained in Rule 3b-3(b), but the Commission notes that it may revisit the definition following its assessment of the results of the pilot program. With respect to futures contracts, the Commission notes the distant time element of a futures contract and the need to borrow securities for delivery are inconsistent with the concept of ownership. Concluding that a futures contract is more like other derivatives products than an unconditional contract, the Commission has adopted Rule 200(b)(6), which provides that a person holding a long security futures position is not considered to own the underlying security until the security future stops trading and the future will be physically settled.

*Aggregation Units.* Rule 200(f) governs aggregation unit netting. Since Rule 200 incorporates the short sale definition in Rule 3b-3, it also includes the standard for determining whether the seller has a “net long position”, and thus ownership, in a security. The seller of an equity security must still aggregate all its positions in the security across all accounts, but the Commission incorporated into Rule 200(f) its no-action position allowing registered broker-dealers to calculate their “net long” or “net short” positions within defined “aggregation” units instead of on a firm-wide basis.<sup>3</sup> A broker-dealer must meet the following requirements to qualify for use of aggregation units:

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<sup>3</sup> See letter from Dr. Richard Lindsey, SEC, to Roger D. Blanc of Willkie Farr & Gallagher re: Bear, Stearns & Co. Inc.; Credit Suisse First Boston Corporation; Deutsche Bank Securities Inc.; Donaldson, Lufkin & Jenrette Securities Corporation; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.;

*(Footnote continued)*

1. the broker-dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity;
2. each aggregation unit within the firm determines at the time of each sale its net position for every security it trades;
3. all traders in an aggregation unit pursue only the trading objectives or strateg(ies) of that aggregation unit; and
4. individual traders are assigned to only one aggregation unit at any time.

The Commission has decided not to extend aggregation unit netting to non-broker-dealers, noting that such entities are subject neither to regulatory oversight nor to examination by the Commission. The Commission also notes that firms not using the aggregation-unit exception should either aggregate firm-wide positions on a real-time basis, or be able to demonstrate why such aggregation is impracticable and that the alternative method employed (*e.g.*, on a daily basis) accurately reflects firm ownership positions.

*Block Positioners and Liquidation of Index Arbitrage Positions.* In Rule 200(d), the Commission has incorporated the block positioner exception in subsection (e)(13) of Rule 10a-1, which permits a broker-dealer who engages in block positioning to disregard economically neutral bona fide arbitrage, risk arbitrage, and bona fide hedge positions involving short stock components in determining its net position in the block positioned security.

Rule 200(e) incorporates the position the Commission took in a 1986 Merrill Lynch no-action letter, granting relief for sales effected in connection with the unwinding of an index arbitrage position,<sup>4</sup> but provides a limited relaxation of the requirement that a person selling a security aggregate all his positions in that security to determine whether he has a net long position. Similar to the Rule 200(d) block positioner exception, Rule 200(e) allows market participants to liquidate (or unwind) certain existing index arbitrage positions involving long baskets of stock and short index futures (traded on a contract market) or options without aggregating short stock positions in other proprietary accounts if and to the extent that those stocks are fully hedged. The Rule 200(e) exception is subject to a market decline restriction.

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*(Continued footnote)*

Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated; PaineWebber Incorporated; Prudential Securities Incorporated; Salomon Smith Barney Inc.; SG Cowen Securities Corporation; and Warburg Dillon Read LLC (November 23, 1998), 1998 SEC No-Act, LEXIS 1038.

<sup>4</sup> See letter re: Merrill Lynch, Pierce, Fenner, & Smith Inc. (December 17, 1986); Securities Exchange Act Release No. 27938 (April 23, 1990).

## **Order marking requirements**

The marking requirements under subsections (c) and (d) of current Rule 10a-1 apply only to exchange-listed securities. Reg SHO adopts marking requirements that apply to short sales in all equity securities. Under Rule 200(g), all sell orders in all equity securities must be marked either “long”, “short”, or “short exempt” (e.g., short sales permitted under any of the exceptions in the short sale rules as well as short sales of pilot securities effected during the pilot period). Certain types of sales that could previously be marked “long” will now be treated as short sales, and thus be subject to any applicable price test, as well as the new locate and delivery requirements.

In particular, Rule 200(g) directs that an order can be marked long only when the seller owns the security being sold and either the security is in the physical possession or control of the broker-dealer or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than settlement.

## **Locate and delivery requirements**

Rule 203(b) of Reg SHO replaces existing SRO “locate” rules (NASD Rule 3370 and NYSE Rule 440C) and creates a uniform Commission rule requiring a broker-dealer, before effecting a short sale in any equity security, to “locate” securities available for borrowing. Specifically, the rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer’s own account, unless the broker-dealer (1) has borrowed the security or entered into an arrangement to borrow the security or (2) has “reasonable grounds” to believe that the security can be borrowed so that it can be delivered on the date delivery is due. The broker-dealer must make and document the locate before effecting a short sale, regardless of whether the seller’s short position may be closed out by purchasing securities the same day.

The Commission details in the Release how broker-dealers may satisfy the “reasonable grounds” requirement of Rule 203(b)(1)(ii). Notably, absent countervailing factors, broker-dealers can rely on “easy to borrow” lists rather than contacting the source of the borrowed securities, provided the information used to generate such lists is less than 24 hours old and the securities included on the list are so readily available that it is unlikely the seller will fail to deliver securities on settlement date. Unlike the current provisions of NASD Rule 3370, however, the fact that a security does not appear on a “hard to borrow” list will not satisfy the “reasonable grounds” test of Rule 203(b)(1)(ii). In addition, a broker-dealer may rely in some cases on a customer’s assurance that the customer received a locate from another source.

The Commission has carved out several exceptions to the locate requirement. First, where a broker-dealer accepts a short sale order from another broker-dealer, only the first broker-dealer will be required to perform the locate. Also, the locate requirement is extended to 35 days when a broker-dealer effects a sale on behalf of a customer who owns a security that, through no fault of the customer or broker-dealer, is not reasonably expected to be available for delivery on settlement date. Examples might include a security tendered for conversion, or a resale of a

restricted security pursuant to Rule 144 under the Securities Act of 1933. Finally, as in the current SRO rules, Rule 203(b)(2)(iii) includes an exception for short sales by registered market makers in connection with bona fide market making activities. Trading activity that does not constitute bona fide market making includes:

1. activity that is related to speculative selling strategies of the broker-dealer and is disproportionate to the broker-dealer's usual market making patterns or practices;
2. activity whereby the market maker posts continually at or near the best offer but does not also post at or near the best bid; and
3. transactions whereby the market maker enters into an arrangement with another broker-dealer or customer to use the market maker's exception to avoid compliance with the locate requirement.

The Commission has decided not to include the current exception in NASD Rule 3370 for short sales that result in bona fide hedged or arbitrated positions, or to create an exception for transactions in exchange-traded funds. Instead of an express exception for either situation, the Commission notes that it would deal with these activities through the exemptive process.

#### **Requirements for short sales in “threshold securities”**

Rule 203 of Reg SHO includes additional requirements aimed at designated “threshold securities” that have a substantial amount of fails to deliver. A list of such threshold securities will be published daily by the SRO on which the security is listed or for which the SRO bears primary surveillance responsibility. The SRO will include on the list of threshold securities any equity security of a reporting issuer where, for five consecutive settlement days, there are aggregate fails to deliver at a registered clearing agency of at least 10,000 shares and the aggregate fails to deliver are also equal to at least 0.5% of the issuer's total shares outstanding. A security will be removed from the list if it does not exceed the specified level of fails for five consecutive settlement days. The Commission estimates that approximately 4% of all equity securities would meet this threshold.

The SEC noted that such threshold securities should generally not be included on “easy to borrow” lists. In addition, Rule 203(b)(3) requires a participant of a registered clearing agency, such as a broker-dealer, to close out any fail-to-deliver position in a threshold security that has remained open for 13 consecutive settlement days by purchasing securities of like kind and quantity. To meet this close-out requirement, the participant must not know or have reason to know that the counterparty from whom the participant purchases securities will not deliver the securities. The close-out requirement does not apply to any fail-to-deliver position that was established before the particular security became a threshold security.

If the participant does not take action to close out the open fail-to-deliver position, certain self-executing restrictions are triggered. Specifically, Rule 203(b)(3)(iii) states that any such participant, and any broker-dealer for which it clears transactions, including any market maker that would otherwise rely on the bona fide market maker exception, is prohibited from effecting

further short sales in the particular threshold security without first borrowing, or arranging to borrow, the security until the fail-to-deliver position is closed out. The Commission noted, however, that if a participant is able to identify the specific broker-dealer(s) or account(s) for which it clears that contributed to the fail-to-deliver position, the Rule 203(b)(3)(iii) restrictions should apply only to those particular broker-dealer(s) or account(s). Rule 203(b)(3)(iv) also allows the participant to reasonably allocate its close-out responsibility to another broker-dealer for which the participant is responsible for settlement.

Although the Commission has provided an exception from the locate requirement for short sales effected in connection with bona fide market making, it has chosen not to provide a similar exception from the close-out requirement.

### **Delivery requirements for “long” sales**

Rule 203(a) of Reg SHO incorporates the provisions of current Rule 10a-2 and extends these requirements to all equity securities. If a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. The restriction does not apply in several circumstances, including where the broker-dealer knows or has been reasonably informed that the seller owns the security and will deliver the security prior to settlement, but the seller fails to make such delivery. The Commission notes, however, that it may be unreasonable for a broker-dealer to treat a sale as “long” where the same customer has repeatedly failed to deliver the security by settlement date.

### **Elimination of the shelf offering exception**

Rule 105 of Regulation M prohibits a short seller from covering short sales effected within a five-day period prior to pricing of an offering with offering securities. The Commission has amended Rule 105 to eliminate the current exception for shelf offerings because the Commission believes that the underlying reasons for the exception are no longer true; shelf offerings are now commonplace, and investors often have notice of a shelf offering before it occurs.

The Commission also has issued interpretive guidance to address “sham” transactions that the Commission believes violate Rule 105. The Commission is targeting transactions structured to create the appearance that the short sale was covered by shares purchased in the open market when in fact it was covered by offering shares. The Commission offers two examples of what it believes are “sham transactions”:

1. covering short sales effected in the pre-pricing restricted period with securities obtained via an arrangement with a third party who actually acquires the securities in the primary offering; and
2. covering short sales effected in the pre-pricing period through a series of wash sales, such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and little or no market risk.

The examples provided by the SEC may raise complex questions about what market transactions would be legitimate for a market participant that is simultaneously long and short and closes out the short position at or near the same time as an offering.

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If you have any questions regarding this memorandum, please contact Roger D. Blanc at (212) 728-8206, Edward J. Ferraro at (212) 728-8766, or the partner with whom you normally work.\*

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August 5, 2004

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\* We wish to acknowledge and thank Ms. Carla Rothenberg, a summer law clerk with our firm, for her substantial and valuable work in the drafting of this memorandum.