

**MEMO# 16844**

December 5, 2003

## **SEC PROPOSES REGULATION SHO RELATING TO SHORT SALES**

[16844] December 5, 2003 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 35-03 SEC RULES COMMITTEE No. 99-03 RE: SEC PROPOSES REGULATION SHO RELATING TO SHORT SALES The Securities and Exchange Commission has published for comment proposed Regulation SHO relating to short sales.<sup>1</sup> Proposed Regulation SHO would, among other things, institute a uniform bid test allowing short sales to be effected at a price one cent above the consolidated best bid; implement a uniform "locate" requirement to address the problem of "naked" short selling; and amend the definition of a "short sale." The proposal also requests comment on a temporary rule that would suspend the operation of the proposed bid test for specified liquid securities during a two-year pilot period. Proposed Regulation SHO would replace the current rules relating to short sales, specifically Rules 3b-3, 10a-1, and 10a-2 under the Securities Exchange Act of 1934. The most significant aspects of the SEC's proposal are summarized below. Comments on the proposal must be received by the SEC no later than January 5, 2004. We have scheduled a conference call to discuss proposed Regulation SHO and the Institute's comment letter for December 9 at 12 pm Eastern. The dial-in number for the call will be 888- 673-9781 and the passcode for the call will be 56223. If you, or someone else at your firm, would like to participate in the conference call, please contact Monica Carter-Johnson by phone at 202-326-5823 or by e-mail at [mcarter@ici.org](mailto:mcarter@ici.org). I. Proposed Uniform Bid Test Currently, short sale regulation applies different price tests to securities trading in different markets. In particular, Rule 10a-1's tick test applies only to short sale transactions in securities listed on a national securities exchange, whether the transaction is effected on an exchange or otherwise. The NASD's bid test applies to short sale transactions in Nasdaq NMS securities effected on either Nasdaq's SuperMontage or the NASD's Alternative Display Facility ("ADF") (but not to Nasdaq SmallCap, OTCBB, and other securities traded over-the-counter). In addition, no short sale price test applies to short sales of Nasdaq NMS securities executed 1 Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) ("Release"). The Release can be found on the SEC's website at <http://www.sec.gov/rules/proposed/34-48709.htm>. 2 away from SuperMontage and the ADF, unless the market on which the securities are being traded has adopted its own price test. In order to create uniformity in the application of short sale regulation, the SEC is proposing Rule 201 of Regulation SHO, which would replace Rule 10a-1's tick test with a test using the consolidated best bid as the reference point for permissible short sales. Specifically, proposed Rule 201 would require that all short sales in exchange-listed and Nasdaq NMS securities, wherever traded, be effected at a price at least one cent above the consolidated best bid at the time of execution. The SEC is not proposing to extend the uniform bid test to securities not currently covered by a short sale price test (i.e., Nasdaq SmallCap, OTCBB, and Pink Sheet securities).<sup>2</sup> The SEC also requests comment on an alternative to the

proposed bid test, in particular, allowing short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (i.e., an upbid). However, in this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid (not equal to the best bid) if the current best bid is below the previous bid (i.e., a downbid). This alternative test would apply to the same securities as the uniform bid test.<sup>3</sup>

**II. Application of Proposed Uniform Bid Test Rule 10a-1** currently contains thirteen exceptions to the tick test designed to permit certain types of trading activities that were intended to benefit the markets or that were believed to carry little risk of the kind of manipulative or destabilizing trading that the rule was designed to address. The SEC has proposed modifying some exceptions for inclusion in proposed Rule 201 and excluding other exceptions from the rule. Exceptions proposed to be retained include, among other things, exceptions relating to a long seller's delay in delivery; an error in marking a short sale; odd lot transactions; domestic and international arbitrage; distribution over-allotment; equalizing short sales and trade-throughs. In addition, NASD Rule 3350 currently exempts from operation of the NASD's bid test short sales executed by qualified market makers in connection with bona fide market making. There is no similar exception in Rule 10a-1 for the bona fide market making activities of specialists and third market makers in exchange-listed securities. The Release states that because the proposed rule permits unrestricted short sales at the offer or at any other price that is one cent or more above the bid, the need for an exception to allow market makers to sell at or below the best bid seems limited. The SEC is seeking comment, however, on the importance of a market maker exception in the context of a market maker's role in providing liquidity and on the extent to which market makers might need to be able to short at the bid in order to facilitate

**2** The SEC requests comment on whether the proposed uniform bid test should be extended to these securities and whether these securities need the protection of the proposed uniform bid test.

**3** The SEC requests comment on several aspects of the proposed bid test, including whether there would be any benefits in eliminating a short sale price test; whether there ever would be a circumstance where there would not be a consolidated bid in an exchange-listed or Nasdaq NMS security; whether a one-cent increment is an appropriate standard for allowing short sales above the best consolidated bid; and whether the proposed bid test would operate effectively in the current decimal environment, i.e., would bid flickering inhibit the operation of the test.

**3 a** customer buy order, and whether an exception limited to those situations would be necessary or appropriate. The proposed uniform short sale rule also would apply to after hours trades in all covered securities. In particular, after the time the consolidated best bid ceases to be calculated and disseminated, the proposed rule would prevent short selling at a price at or below the last published consolidated best bid.<sup>4</sup>

Finally, the Release states that short sale regulation applies to trades in reported securities when the trade is agreed to in the United States, even if the trades are "booked" overseas.

**III. Pilot Program Suspending Proposed Bid Test**

The SEC is proposing temporary Rule 202 of Regulation SHO that would suspend, on a pilot basis, the operation of the proposed bid test for specified liquid securities. The Release states that the pilot would enable the SEC to study the effects of relatively unrestricted short selling on, among other things, market volatility, price efficiency, and liquidity and to assess whether short sale regulation should be removed, in part or in whole, for actively traded securities.<sup>5</sup>

The Release states that the securities included in the pilot could be comprised of a subset of the Russell 1000 index (e.g., one-third of the securities in the index), or such other securities as the SEC designates after giving due consideration to the security's liquidity, volatility, market depth and trading market. The proposed temporary rule would remain in effect for two years.<sup>6</sup>

**IV. Uniform Locate Requirement**

The Release states that many issuers and investors have complained about alleged "naked short selling," which occurs when someone is selling short without borrowing the necessary

securities to make delivery. The SEC believes that current SRO requirements have not fully addressed the problems of naked short selling and that it would be beneficial to establish a uniform standard specifying the procedures that all short sellers would follow to locate securities for borrowing. The SEC is therefore proposing to incorporate in proposed Regulation SHO a uniform “locate” rule applicable to all equity securities, wherever they are traded. In particular, proposed Rule 203 would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale is executed: (1) borrowed the security, or entered into 4 The SEC requests comment on whether the consolidated quote information that is collected and published after hours provides sufficient information to allow short selling or whether the rule should impose a fixed reference point above which all short sales must be effected, such as the consolidated best bid at the close of the regular session. 5 The pilot would only suspend the operation of the proposed bid test. All other provisions of proposed Regulation SHO would continue in effect. 6 The SEC requests comment on several aspects of the pilot program including, among other things, if temporarily suspending the short sale price test for liquid stocks is appropriate and whether liquid stocks are more difficult to manipulate through short selling; whether a two-year temporary suspension of the short sale price test is a sufficient period to fully study its impact; whether one market could benefit over another market depending on the selection of stocks for the pilot; and whether the short sale price test should be automatically reinstituted in extraordinary market conditions. 4 an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due. V. Definition of “Short Sale” Rule 3b-3 defines the term “short sale” as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Rule 3b-3 also defines specific instances when a person shall be deemed to own a security for the purposes of Rule 10a-1. The SEC is proposing new Rule 200 to replace Rule 3b-3. In particular, proposed Rule 200 would require that a person not only have entered into an unconditional contract, binding on both parties, to purchase the security, but also that the contract specify the irrevocable price and amount of securities purchased and provide for present delivery. The Release states that a fixed price and quantity, as well as present delivery, are essential elements in determining whether a contract to purchase securities conveys ownership for purposes of short sale regulation, and requiring these elements would restrict certain activities designed to manipulate the market. In addition, without an express requirement that the contract contemplate present delivery, there is a danger that contracts would be formed solely for the purposes of creating a long position to evade the short sale rule, in cases where there is no real intention to actually acquire the securities pursuant to the contract.<sup>7</sup> Ari Burstein Associate Counsel 7 The SEC specifically requests comment on whether proposed Rule 200 should require a definite timeframe that limits when the buyer can consider itself long (e.g., a buyer would be deemed to own the securities only if the contract contemplates the buyer will receive the securities within 30 days), and, if so, what the timeframe should be.