

MEMO# 16923

December 29, 2003

DRAFT INSTITUTE LETTER ON SEC PROPOSED REGULATION SHO RELATING TO SHORT SALES

[16923] December 29, 2003 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 42-03 SEC RULES COMMITTEE No. 108-03 RE: DRAFT INSTITUTE LETTER ON SEC PROPOSED REGULATION SHO RELATING TO SHORT SALES As we previously informed you, the Securities and Exchange Commission published for comment proposed Regulation SHO, which would modernize and replace existing Commission and self-regulatory organization ("SRO") rules governing short sales.¹ The Institute has prepared a draft comment letter (a copy of which is attached) on the proposal. The most significant aspects of the draft comment letter are summarized below. Comments on the proposal are due to the SEC no later than January 5, 2004. If you have any comments on the draft Institute letter, please contact the undersigned by phone at 202-371-5408, by fax at 202-326-5839, or by e-mail at aburstein@ici.org no later than January 2.

I. Proposed Uniform Bid Test The draft letter supports the Commission's proposal to create uniformity in the application of short sale regulation by implementing a uniform test, based on the consolidated best bid in a security, for measuring the permissibility of short sales. The draft letter states that a uniform test would simplify the regulation and utilization of short sales and should lead to better regulatory market oversight. A uniform bid test also would resolve the issue of having different markets applying different types of short sale rules (or none at all) to the same security. The draft letter, however, recommends that the uniform bid test be extended to other securities not currently subject to short sale pricing restrictions (e.g., OTC Bulletin Board, Pink Sheet, and Nasdaq SmallCap securities). The draft letter states that extending the protections of the short sale rule to these securities would ensure that investors in smaller, less liquid securities also are safeguarded from the type of manipulation that the short sale rule was designed to address. The draft letter also supports the implementation of a pilot program suspending the proposed bid test for a select group of highly liquid securities. The draft letter recommends, 1 Memorandum to Equity Markets Advisory Committee No. 35-03 and SEC Rules Committee No. 99-03, dated December 5, 2003 [16844]. 2 however, that the Commission use the stocks included in the S&P 500 Index and the Nasdaq 100 Index as the pilot program stocks instead of, as proposed, a subset of securities in the Russell 1000 Index. The draft letter states that these stocks are more familiar and recognizable to market participants and may simplify compliance with the pilot program. Finally, the draft letter recommends that the Commission expand its limited exemptive relief for VWAP transactions from the short sale rule. Currently, VWAP sale transactions are not subject to the short sale rule provided that the VWAP transaction is arranged before the market opens and the price is not determined until after the close of trading when the VWAP value is calculated. The draft letter recommends that the

Commission broaden this exemption to include intra-day VWAP transactions, specifically, transactions based on a VWAP price over a minimum period of time sufficient to prevent the VWAP trade from being used to place downward pressure on a stock (e.g., two hours).

II. Uniform Locate Requirement In order to address problems associated with, among other things, “naked short selling,” proposed Rule 203 of Regulation SHO would incorporate existing SRO affirmative determination or “locate” requirements into a uniform rule. The draft letter strongly supports the proposed uniform locate requirement. In particular, the draft letter states that naked short selling, particularly in thinly-capitalized securities, can have a number of negative effects on the market, most significantly, the ability of naked short sellers to engage in trading activities that deliberately depress the price of a security, and that the proposed uniform locate requirement should help prevent such manipulative activity.

III. Definition of Short Sale Currently, under Securities Exchange Act Rule 3b-3, a person is considered “long” if he has purchased, or entered into an unconditional contract to purchase a security but has not yet received the security. Proposed Rule 200 of Regulation SHO would replace Rule 3b-3 and would require that a person not only have entered into an unconditional contract to purchase a security, but also that the contract specify the irrevocable price and amount of securities purchased and provide for present delivery in order for a person to have a “long” position with respect to the shares that are subject to the contract. The draft letter supports the additional requirements of proposed Rule 200, in so far as they restrict certain activities designed to manipulate the market, but states that the adoption of these requirements could significantly affect the ability of broker-dealers to effect sales to facilitate an investor’s order to sell based on a VWAP or closing price. The draft letter therefore recommends that the Commission modify proposed Rule 200 to permit persons to consider themselves “long” for purposes of Regulation SHO if they have entered into an unconditional contract to purchase securities on a VWAP or closing price basis, provided that the contract specifies the amount of securities to be purchased, even though the specific price of the securities sold will not be known when the contract is entered into. Ari Burstein Associate Counsel Attachment