

MEMO# 16938

January 5, 2004

INSTITUTE LETTER ON PROPOSED SEC REGULATION SHO RELATING TO SHORT SALES

[16938] January 5, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 1-04 SEC RULES MEMBERS No. 2-04 RE: INSTITUTE LETTER ON PROPOSED SEC REGULATION SHO RELATING TO SHORT SALES The Institute has filed a comment letter with the Securities and Exchange Commission on proposed Regulation SHO, which would modernize and replace existing Commission and self-regulatory organization ("SRO") rules governing short sales.¹ The most significant aspects of the comment letter are summarized below and a copy of the letter is attached. I. Proposed Uniform Bid Test The Institute's 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 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 letter, however, recommends that the uniform bid test be extended to other less liquid securities not currently subject to short sale pricing restrictions (e.g., OTC Bulletin Board, Pink Sheet, and Nasdaq SmallCap securities). The letter states that extending the protections of short sale regulation to these securities would ensure that investors in smaller, less liquid securities are safeguarded from manipulation that the short sale rule was designed to address. The letter also supports the implementation of a pilot program suspending the proposed bid test for a select group of highly liquid securities. Finally, the 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, the price is not determined until after the close of trading when the VWAP value is calculated, and other conditions are met. The 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 1 Memorandum to Equity Markets Advisory Committee No. 35-03 and SEC Rules Members No. 176-03, dated December 5, 2003 [16847]. 2 sufficient to prevent the VWAP trade from being used to place downward pressure on a stock (e.g., two hours). The letter states that this exemption would enhance the ability of institutional investors to effectuate transactions based on partial-day VWAP prices. 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 and would impose additional requirements on securities that have failures to deliver in

excess of a specified amount and on persons that, in connection with short sales, have failed to deliver securities for settlement within a specified time frame. The letter strongly supports the proposed uniform locate requirement. In particular, the letter states that naked short selling, particularly in thinly-capitalized securities, can have a number of negative effects on the market, the most significant of which is the ability to deliberately depress the price of a security. The letter states that the proposed uniform locate requirement should help prevent such manipulative short selling activity.

III. Definition of Short Sale Currently, under Securities Exchange Act Rule 3b-3, a person is considered "long" if he has purchased a security, or has 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 that person to have a "long" position with respect to the shares that are subject to the contract. The 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 and could act as a disincentive for broker-dealers to provide liquidity in handling block orders from institutional investors. The 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.

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