

MEMO# 17860

August 6, 2004

SEC ADOPTS REGULATION SHO RELATING TO SHORT SALES

[17860] August 6, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 36-04 SEC RULES COMMITTEE No. 69-04 RE: SEC ADOPTS REGULATION SHO RELATING TO SHORT SALES The Securities and Exchange Commission has adopted Regulation SHO relating to short sales. * Regulation SHO, among other things, amends the definition of a “short sale”; implements a uniform “locate” requirement to address the problem of “naked” short selling; and includes a temporary rule that establishes procedures for the SEC to suspend the current “tick” test and any short sale price test of any exchange or national securities association for specified securities. The SEC is deferring consideration of the proposal to replace the current “tick” test with a new uniform bid test, and is also deferring consideration of the proposed exceptions to the uniform bid test. The Release states that the SEC will reconsider any further action on these proposals after the completion of a pilot program suspending the current tick test (discussed below) established by Regulation SHO. The most significant aspects of Regulation SHO are summarized below. I. Definition of “Short Sale” The SEC adopted proposed Rule 200, with some minor modifications. Rule 200, which incorporates Rule 3b-3 under the Securities Exchange Act of 1934, defines ownership for short sale purposes and clarifies the requirement to determine a seller’s net aggregate position. Rule 200 also includes a requirement to mark sell orders in all equity securities “long,” “short,” or “short exempt.” * Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/final/34-50103.htm>. For a summary of the SEC’s proposed Regulation SHO and the Institute’s comment letter on the proposal, see Memorandum to Equity Markets Advisory Committee No. 35-03 and SEC Rules Members No. 176-03, dated December 5, 2003 [16844], and Memorandum to Equity Markets Advisory Committee No. 1-04 and SEC Rules Members No. 2-04, dated January 5, 2004 [16938], respectively. 2 II. Uniform Locate Requirement In order to address problems associated with, among other things, “naked” short selling, the SEC adopted, with some modifications, proposed Rule 203 of Regulation SHO, which incorporates a uniform “locate” rule applicable to all equity securities, wherever they are traded. In particular, as adopted, Rule 203 prohibits a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer: (1) 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. III. Pilot Program Suspending Current “Tick” Test After receiving support for a pilot program from many commenters, including the Institute, the SEC adopted proposed Rule 202T, which creates a procedure for the SEC to establish, through a separate order, a pilot program pursuant to which the SEC may exclude designated securities from the operation of the tick test of Securities Exchange Act Rule 10a-1 and any short sale price test rule of any exchange or

national securities association. Concurrently with the Release, the SEC issued an order establishing a one-year pilot program commencing on January 5, 2005, employing the procedures of Rule 202T. Specifically, the pilot includes a subset of securities from the Russell 3000 index. The Release states that the pilot will 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 a short sale price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities. IV. Compliance Dates The compliance date for Rules 200 and 203 is January 5, 2005 and the compliance date for Rule 202T is September 7, 2004. Jane G. Heinrichs Assistant Counsel

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