



# SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules

## I. INTRODUCTION AND EXECUTIVE SUMMARY OF REGULATION SHO

On July 28, 2004, the Securities and Exchange Commission (the "Commission") approved new Regulation SHO, implementing important changes to the manner in which short sales are regulated in the U.S. markets.<sup>1</sup> Generally speaking, short sales are sales of a security by a seller that does not itself own that security. The short seller typically borrows the security that it has sold in order to deliver it to the buyer, and then seeks to acquire the security in the market prior to the loan of the security coming due in order to return the security to its lender. Short sales can be both a speculative technique, seeking to profit from an expected decline in the value of the security sold, and a hedging technique, seeking to offset a particular market risk that exists in respect of ownership of a security. Regulation SHO took effect on January 3, 2005.

Regulation SHO implements a number of significant changes to the regulations regarding short sales. Among those rules are:

- *Delay of Implementation of a "bid" test.*  
Regulation SHO proposes to replace the "price" or "uptick" test requirement for short selling with a requirement that short sales be effected at a price at least one cent above the consolidated best bid at the time of execution. In order to evaluate the effect of the various "price" and "bid" tests, the SEC has delayed the implementation of the uniform "bid" test and has suspended all price tests for certain securities in a pilot program to commence on May 2, 2005 and to end on April 28, 2006.
- *Implementation of a "locate" requirement.*  
Regulation SHO implements a uniform requirement that short sellers locate a source from which to borrow the security that they are

selling prior to initiating the short sale, and implements a new rule requiring clearing broker-dealers to close out any fail positions in securities that are, by virtue of experiencing a fail rate above the Commission's established threshold, designated as "threshold" securities, provided that such fail position has remained open for 13 consecutive days.

- *Formalizing the relief for "aggregation units" of broker-dealers.* Regulation SHO formalizes existing Commission relief from the requirement that a seller's position as "long" or "short" be determined on an enterprise-wide basis by permitting certain broker-dealers to determine whether they are selling "long" or "short" on a profit-center or unit-by-unit basis.

Each of these issues is discussed below.

This publication is meant to serve as a general discussion of some of the changes adopted, and does not purport to be a complete discussion of Regulation SHO, or even of the specific aspects of Regulation SHO that are described herein. For more information regarding short selling generally or regarding the application of Regulation SHO, please contact any of the Shearman & Sterling LLP attorneys listed on the last page of this publication.

## II. DESCRIPTION OF CERTAIN BASIC ASPECTS OF REGULATION SHO

### 2.1 *Regulation SHO Pilot Program will suspend the "uptick" rules for certain securities*

At present, Commission Rule 10a-1, together with companion NASD Rule 3350, requires generally that short sales may only be effected in a security if the most recent price of that security is higher than the previous price quoted or displayed by the market. This requirement is known as the "uptick" or "price" test for short selling. Regulation SHO would replace the uptick requirement for short sales with a new requirement that short sales must be effected at a price at least one cent above the consolidated best bid at the time of execution.

<sup>1</sup> See Commission Release 34-50103, "Short Sales" (July 2004) (the "Adopting Release"), currently available at: <http://www.sec.gov/rules/final/34-50103.htm>.

This new requirement of Regulation SHO is known as the “bid” test for short selling.

The move from an “uptick” to a “bid” test for short selling is a substantial one, the consequences of which cannot be fully known prior to the implementation of the new “bid” test. In recognition of this fact, the Commission has ordered the temporary suspension of all price tests through a pilot program covering only certain securities.<sup>2</sup> The pilot program, originally ordered to commence on January 3, 2005, has been delayed until May 2, 2005.<sup>3</sup>

## **2.2 Regulation SHO implements a uniform “locate” requirement**

Another major change introduced by the Commission through the adoption of Regulation SHO is the implementation of a uniform “locate” requirement that will replace the various self-regulatory organizations’ existing requirements. Conceptually, a “locate” requirement is a regulation that restricts short selling until the seller has located a source from which to borrow the security in order to meet the delivery requirement that is created when the short sale is made. The principal purpose of a requirement that short sellers locate a source from which to borrow the security is to prevent the failure of trades that would occur if the short seller was unable to deliver the security at the settlement of the trade.

Regulation SHO implements a requirement that no broker-dealer may accept a short sale order from any person, or effect a short sale order for its own account, unless that broker-dealer (a) has borrowed, or entered into an agreement to borrow, the security, or (b) has reasonable grounds to believe that the security can be borrowed such that it can be delivered when due in order to settle the short sale. In addition, Rule 203(b)(1) of Regulation SHO creates a requirement that a broker-

dealer must document compliance with the locate requirement before it may accept the short sale order.

The locate requirement is subject to a number of notable exceptions. Specifically, pursuant to Rule 203(b)(2) of Regulation SHO:

- A broker-dealer does not need to satisfy the locate requirement in respect of an order from another broker-dealer that is itself subject to the locate requirement.
- A broker-dealer does not need to satisfy the locate requirement in respect of sales of securities that the seller is deemed to own for purposes of Regulation SHO, and where, through no fault of the customer or broker-dealer, the security is not expected to be available for delivery by the settlement date. This exception requires that delivery of the security should be made as soon as any restrictions on delivery have been removed, and also requires that, if the security is not delivered within 35 days after the trade date, then the broker-dealer that sold the security must either borrow securities or close out the open position by purchasing securities of like kind and quantity.
- The locate requirement does not apply to short sales executed by market makers, as that term is defined in Section 3(a)(38) of the Exchange Act, provided that the market maker, specialist, or options market maker is engaged in bona fide market making activities in respect of the transaction.

The Commission has expressly declined to include an exception to the locate requirement for exchange-traded funds, notwithstanding that such funds are able to continuously create and redeem their shares.

The Commission has provided guidance as to what constitutes reasonable grounds on which to believe that a security can be borrowed. In this regard, the Commission has noted that reasonableness for purposes of Regulation SHO must be determined on the basis of the facts and circumstances of the particular situation giving rise to the transaction. For example, the Commission has noted that a broker-dealer may rely on the statement of a lender as to the availability of securities, or to assurances from a customer that the customer has or will obtain the borrowed security from another identified source in sufficient time to settle the trade.<sup>4</sup>

<sup>2</sup> The order describing the pilot program and setting forth the time period and securities covered by the pilot program is found in Commission Release 34-50104, “Order suspending the operation of short sale price provisions for designated securities and time periods” (July 28, 2004) (“Pilot Order”), currently available at <http://www.sec.gov/rules/other/34-50104.htm>. The securities to be covered by the pilot program are: (a) a group of securities selected from the Russell 3000 Index that are enumerated in the Pilot Order, (b) short sales in any security included in the Russell 1000 Index that are effected between 4:15 p.m. EST and the open of the consolidated tape on the following day; and (c) short sales in any security not included in clauses (a) and (b) above effected in the period between the close of the consolidated tape and the open of the consolidated tape the following day.

<sup>3</sup> See SEC Release No. 34-50747, “Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions” (November 29, 2004), currently available at <http://www.sec.gov/rules/other/34-50747.htm>.

<sup>4</sup> However, the Commission cautions that if a broker-dealer has reason to know that a customer’s similar prior assurances resulted in failures to deliver, then assurances from such customer would not provide the “reasonable grounds” required by Regulation SHO.

In addition, the Commission has specified that unless “countervailing factors” are present, a broker-dealer may rely on an “Easy to Borrow” lists as grounds to believe that the security sold short is available for borrowing, provided that the information that is used to generate the “Easy to Borrow” list is less than 24 hours old. For example, an acceptable “Easy to Borrow” list may be prepared by a clearing broker through whom an introducing broker settles its trades. When relying on such lists, the broker-dealer does not need to directly contact the source of the borrowed securities.

### **2.3 Regulation SHO requires clearing brokers to close out fail positions in “threshold” securities**

Under Rule 203(b)(3) of Regulation SHO, special compliance is required in respect of “threshold” securities, which are securities that have a substantial number of fails to deliver, as measured against the aggregate outstanding volume of such securities. Specifically, clearing brokers are required to take action to close open securities positions that have been subject to fails to deliver for 10 consecutive days; i.e., they must close out such positions within 13 days after the original settlement date.

Regulation SHO defines “threshold” securities as an equity security of a reporting issuer that (a) for five consecutive settlement days, has aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security, (b) has a level of fails that is equal to at least one-half of one percent of the issue’s total shares outstanding, and (c) is enumerated on a list of threshold securities that is prepared and disseminated by a self-regulatory organization.<sup>5</sup>

Rule 203(b)(3) contains two exceptions to the requirement that fail to deliver positions in threshold securities be closed 13 days after the original settlement date. First, the close out requirement does not apply to any amount of the fail to deliver position that the clearing broker had on the settlement day immediately preceding the day that the security became a threshold security. Second, the close out requirement does not apply to any amount of fail to deliver positions in a threshold security, if such positions can be attributed to short sales by a registered options market maker, provided that the short position is held by the registered options market maker in order to establish or maintain a hedge on options positions that were created before the security became a threshold security.

In addition, clearing brokers are given an option to allocate fail to deliver positions to broker-dealers that

are responsible for such positions. Specifically, under Rule 203(b)(3)(iv), a clearing broker may allocate some or all of a fail to deliver position to a registered broker-dealer for which it clears trades, or for which it is responsible for settlement, based on the short position of that broker-dealer. If the clearing broker allocates the fail to deliver position to another broker, then the provisions of Rule 203(b)(3) relating to such fail to deliver position apply to the broker-dealer that is allocated the position.

Rule 203(b)(3)(iii) sets forth the consequence of not closing out or allocating fail to deliver positions to another broker-dealer. Under that Rule, if a clearing broker has a fail to deliver position in a threshold security for 13 consecutive settlement days, then the clearing agency participant and any broker or dealer for which it clears transactions may not accept a short sale order in the threshold security from a customer (or effect a short sale in the threshold security for its own account) without borrowing the security or entering into an agreement to borrow the security, until the clearing broker closes out the fail to deliver position by purchasing securities of like kind and quantity to satisfy the fail to deliver position.

### **2.4 Substantial effect of the “locate” and “close out” requirements on broker-dealers**

Because the “locate” requirement of Regulation SHO requires the broker-dealer to locate the security—or have a reasonable belief that the security can be borrowed—prior to accepting an order to sell a security short, and because the required “close out” action is effectively that of the clearing broker, Regulation SHO creates substantial new Commission requirements for U.S.-registered broker-dealers, and, consequently, substantial new diligence and record-keeping requirements for such broker-dealers.

For example, broker-dealers must not only comply with requirements that they form a reasonable belief that a security can be borrowed, but must also be able to demonstrate the basis for the formation of such belief. Though a broker-dealer may accept an order on the basis of a customer’s past history of delivering securities on time, that broker-dealer must be able to respond to Commission or self-regulatory organization inquiries into what evidence the broker-dealer had at the time that it accepted the order that its belief was reasonable. Similarly, a clearing broker may not be able to wait 10 days in order to close out a fail position in a threshold security, and consequently must be diligent in seeking to ascertain the cause of, and possible remedies for, any fail that occurs in any threshold security. In this way, Regulation SHO continues the regulatory trend of seeking to ensure that broker-dealers actively

<sup>5</sup> For example, the NYSE’s Threshold List currently available at <http://www.nyse.com/threshold/>.

promote—and in some cases police—compliance with securities law and regulation.

We believe that the Commission will be actively monitoring the new short sale regulations contained in Regulation SHO closely, both in order to assess the success or failure of market participants' compliance with the new regulations, and in order to ensure that broker-dealers are taking adequate and accurate steps to promote compliance with short sale regulations.

### **2.5 Regulation SHO exempts certain block positioning and index arbitrage activities from all restrictions on short selling**

Regulation SHO incorporates two important exemptions from short sale regulation that existed prior to its adoption. First, Regulation SHO incorporates the exemption from short selling regulation for block positioners found in former Rule 10a-1(e)(13). Block positioning is a transaction in which a broker-dealer acts as principal, taking some or all of its customer's block order in order to ensure the completion of a transaction that otherwise may be difficult to complete through ordinary course trading. Having acquired securities in the block positioning transaction, the block positioner will in the ordinary course seek to sell such securities. Under Rule 200(d) of Regulation SHO, a broker-dealer is deemed to own a security, even if it is not net long, (a) if the broker or dealer acquired that security while acting in the capacity of a block positioner, and (b) only to the extent that the broker-dealer's short position in the security is an offsetting position that was created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

Rule 200(e) of Regulation SHO incorporates existing Commission interpretation relating to sales that are effected in connection with the unwind of index arbitrage positions. This provision allows the liquidation of existing index arbitrage positions involving long baskets of stocks and short index futures or options without aggregating short positions in other proprietary accounts to the extent that such short positions are fully hedged. The Commission notes that, "[t]o qualify for the relief, the liquidation of the index arbitrage position must relate to a securities index that is the subject of a financial futures contract (or options on such futures) traded on a contract market, or a standardized options contract, notwithstanding that such person may not have a net long position in that security."<sup>6</sup>

With respect to the index arbitrage exemption, Regulation SHO deems a broker-dealer to own a security, even if it is not net long, if the following three

criteria are met: (1) the index arbitrage position involves a long basket of stock and one or more short index futures traded on a board of trade or one or more standardized options contracts; (2) such person's net short position is the result of one or more "offsetting" positions created and maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities; and (3) the sale does not occur during a period commencing at the time that the Dow Jones Industrial Average ("DJIA") has declined by at least two per cent below its closing value on the previous trading day and terminating at the time of the establishment of the closing value of the DJIA on the next succeeding trading day (during which time the DJIA may not have declined by two percent or more from its closing value on the previous day).<sup>7</sup>

### **2.6 Regulation SHO permits broker-dealers to engage in unit aggregation**

Although Regulation SHO makes certain changes to the manner in which sales must be marked, all sales of securities must still be marked, either as "long", "short" or "short exempt". Regulation SHO, therefore, does not alter the basic responsibility of persons wishing to sell securities to know whether they have a long or short position in that security prior to the sale. As a general matter, sellers must determine whether they have a net long or net short position on an aggregate, *i.e.*, enterprise-wide, basis.

Regulation SHO provides one exception to the requirement for enterprise-wide aggregation. Under Rule 200(f) of Regulation SHO, a broker-dealer may determine its net position on a unit-by-unit basis with respect to each "independent trading unit". Independent trading unit aggregation is available only if:

- the broker-dealer has a written plan of organization that identifies each aggregation unit, specifies the trading objective(s) of each aggregation unit, and supports the independent identity of such unit;
- each aggregation unit within the broker-dealer enterprise determines, at the time of each sale, its net position for every security that it trades;

<sup>6</sup> See the Adopting Release, at text accompanying Footnotes 30 and 31.

<sup>7</sup> See the Adopting Release, at text accompanying Footnote 31. That the exception for index arbitrage unwind transactions is not available during a period of market decline is a noteworthy component of Regulation SHO. The Commission is careful to note in the Adopting Release that, if a market decline setting prohibits the use of the exception, then a broker-dealer must aggregate all of its other positions in the applicable security in order to determine whether the seller has a net long position for purposes of compliance with Regulation SHO.

- all traders in each aggregation unit pursue only the particular trading objective(s) or strategy(ies) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; or
- individual traders are assigned to only one aggregation unit at any time.

The addition of an exception for unit-by-unit aggregation of net position codifies relief that the Commission had previously granted. It is noteworthy that, in the Adopting Release, the Commission specifically refuses to extend unit-by-unit aggregation of net position to entities other than broker-dealers, stating that “the lack of regulatory oversight may facilitate the creation of units that are not truly independent or separate.”<sup>8</sup>

### **2.7 Application of Regulation SHO to non-U.S. persons**

The Commission has provided some guidance on the application of Regulation SHO to non-U.S. persons and transactions. First, the Commission states that a broker-dealer using the jurisdictional means of the United States to effect short sales in securities traded in the United States is subject to Regulation SHO, regardless of whether that broker-dealer is registered with the Commission or relying on an exemption from registration. Furthermore, the Commission expressly notes that it has engaged in discussions with the Investment Dealers Association of Canada (“IDA”), and that the IDA intends to issue an interpretation to the effect that failure of IDA members to comply with the requirements of Regulation SHO may be considered a breach of IDA rules.<sup>9</sup>

Furthermore, the Commission has stated that short sale regulation applies to trades in securities of reporting issuers if such trades are agreed to in the United States, even if such trades are booked overseas.<sup>10</sup> The Commission notes, however, that facts and circumstances will determine whether a short sale is

either executed or agreed to in the United States for purposes of this guidance.<sup>11</sup>

Finally, the Commission has stated that, for purposes of the locate requirement, the assurances of a foreign broker-dealer, acting as agent or principal, may give a U.S. broker-dealer sufficient grounds to provide a basis for a reasonable belief that the security will be available for delivery on the settlement date (in a manner similar to assurances of a U.S. broker-dealer).

## **III. CONCLUSION**

The changes adopted as to the manner in which short sales are effected in the U.S. marketplace represent important new ground rules for market participants. For market participants that effect short sales in securities that can be readily borrowed (or that have been borrowed prior to initiating the short sale), the Commission’s actions will create few noticeable changes. In such situations, Regulation SHO as proposed may facilitate the timing of short sales by permitting sellers to initiate a short sale (through a bid above the consolidated best bid) notwithstanding a falling market. However, for broker-dealers that intermediate short sales, Regulation SHO will bring new and heightened compliance requirements that effectively heighten the role of broker-dealers in monitoring—and in some cases policing—compliance with new regulation by their customers. While some of the changes, such as the formal adoption of unit aggregation, may be welcome, the effects of many of the changes brought by Regulation SHO—and in particular the effects of the pilot program—will not be known for some time.

For more information regarding the topics covered in this client publication, please contact any of the Shearman & Sterling LLP attorneys listed below.

<sup>8</sup> See the Adopting Release at Footnote 26.

<sup>9</sup> See the Adopting Release at Footnote 54.

<sup>10</sup> See Commission Release No. 34-48709, “Short Sales” (October 28, 2003) (the “Proposing Release”), currently available at <http://www.sec.gov/rules/proposed/34-48709.htm>.

<sup>11</sup> The Commission provides the following example in the Proposing Release, at the text accompanying Footnote 220:

For example, a U.S. money manager decides to sell a block of 500,000 shares in a NYSE security. The money manager negotiates a price with a U.S. broker-dealer, who sends the order ticket to its foreign trading desk for execution. In our view, this trade occurred in the United States as much as if the trade had been executed by the broker-dealer at a U.S. trading desk. Under the proposed rule, if the sale agreed to is a short sale in an exchange-listed or Nasdaq NMS security, unless otherwise excepted, it must be effected at a price one cent above the current best bid displayed as part of the consolidated best bid and offer regardless of where it is executed.

For more information regarding any of the issues described in this client publication, please contact any of the Shearman & Sterling LLP personnel listed below. This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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