

Securities Law Developments

NEWSLETTER

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Proposed Regulation SHO: A Mixed Bag for Short Sellers and Their Critics

On October 29, 2003, the Securities and Exchange Commission (“SEC” or “Commission”) published a long-awaited proposal to overhaul the existing framework for regulating short sale transactions.¹ Proposed Regulation SHO would replace Rules 3b-3, 10a-1, and 10a-2 under the Securities Exchange Act of 1934 (“Exchange Act”).² Among other things, Regulation SHO would consolidate and expand stock locate requirements and replace the existing “bid” and “tick” tests with a new “uniform price” test. Short sellers and their critics will both have reason to praise and criticize the Commission’s proposal. Moreover, irrespective of the technical aspects of the proposal, all securities market participants will find the Commission’s assertions about the extraterritorial application of these rules of interest. Comments on the proposed new rules are due by *January 5, 2004*.

I. Safeguards Against “Naked” Short Selling

A. Short Sale Locate and Delivery Requirements

Uniform Locate Rule. Proposed Rule 203 would replace and expand existing self-regulatory organization (“SRO”) locate requirements.³ 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 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. Broker-dealers would need to document the steps taken to locate stock prior to effecting a short sale, even if the seller’s short position will be closed out by purchasing securities the same day. Unlike the

1. Exchange Act Release No. 48709 (Oct. 29, 2003), 68 Fed. Reg. 62,972 (Nov. 6, 2003) (“Proposing Release”), available at <http://www.sec.gov/rules/proposed/34-48709.htm>. The Proposing Release also contains proposed amendments to Rule 105 of Regulation M under the Exchange Act. At the open meeting on October 22, 2003, the SEC stated that it would also issue an interpretive release discussing the use of so-called “married puts” to comply with short sale restrictions. As of November 14, 2003, this interpretive release has not been published.

2. 17 C.F.R. §§ 240.3b-3, 204.10a-1, and 10a-2.

3. See NASD Rule 3370; NYSE Rule 440C.10.

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current patchwork of SRO locate rules, this proposed uniform locate rule would apply to all equity securities, regardless of where they are traded.

The Commission's proposal includes an exception to the uniform locate rule that would apply to short sales executed by specialists or market makers in connection with bona-fide market making activities. The Proposing Release explains that "[t]he exemption for bona-fide market making activities would exclude activity that is related to speculative selling strategies or investment decisions of the broker-dealer or associated person and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security."⁴

Delivery Requirement for Certain Securities.

Proposed Rule 203 also includes a uniform delivery requirement for securities with a high rate of settlement failures. This delivery requirement would be triggered for a particular security where there are "fails to deliver" at a registered clearing agency of 10,000 shares or more and such fails represent at least 0.5% of total shares outstanding. This is the same threshold currently used in a comparable NASD rule.⁵

In the event that the requisite threshold for the new delivery requirement is triggered, any broker-dealer making a short sale of that security would be required to deliver the security no later than two days after the settlement date. A broker-dealer, including a market maker, that fails to meet this requirement would not be permitted to execute short sales in that security for the offending account and account owner for a period of 90 days, unless an appropriate "borrow arrangement" to deliver the security on the settlement date is in place.

B. Long Sale Delivery Requirements

Proposed Rule 203 includes a uniform delivery requirement for sales marked long that is similar

to the requirements of existing Exchange Act Rule 10a-2. Like Rule 10a-2, the proposed rule would prohibit a broker-dealer that knows or should know that a sale is marked long from lending (or arranging for the loan of) any security for delivery to the purchaser. If a broker-dealer does not have the securities to deliver, then it would need to use securities purchased for cash to make the delivery unless it knew that the seller was either in the process of forwarding the securities to the broker-dealer or would do so as soon as possible. These requirements would apply to long sales of all securities, including those traded over-the-counter, while Rule 10a-2 applies only to listed securities.

Proposed Rule 203 would incorporate the same general exceptions to the long sale delivery requirements provided in Rule 10a-2. First, sales between broker-dealers would be exempt. Second, a broker-dealer that is short despite efforts to ensure that the sale is long would be permitted to make a loan, as long as the exchange or national securities association in whose market the sale was effected found that: (1) the sale resulted from a good-faith mistake; (2) the broker-dealer used proper due diligence in determining that the sale was long; and (3) either that undue hardship would result from requiring a "buy-in" to cover the transaction or that the sale would be at a permissible price for a short sale under new Rule 201 as currently proposed.

II. The Uniform Price Test

A. Overview

Proposed Rule 201 would replace both (1) the tick test⁶ governing short sales in exchange-listed securities and (2) the bid test⁷ governing certain short sales in Nasdaq National Market System ("NMS") securities. Rule 201 would impose a new uniform price test that generally would require that short sales in exchange-listed and

4 Proposing Release at 68 Fed. Reg. 62,977 n.49.

5 See NASD Rule 11830.

6 See 17 C.F.R. 240.10a-1.

7 See NASD Rule 3350 and IM-3350.

Nasdaq NMS securities be effected at a price at least one cent above the consolidated best bid at the time of execution. This requirement would apply regardless of the location and time of execution. This requirement would *not* apply to securities that are not currently subject to any short sale price test, including Nasdaq SmallCap Securities, OTCBB securities, Pink Sheet securities, and exchange-listed bonds.⁸

The new uniform bid test would not allow any exchanges to use their own markets as a reference point for measuring the minimum shortable price.⁹ The new test would also eliminate the provision in Rule 10a-1 that allows for an adjustment to the sale price of a security when determining the minimum shortable price after a security goes ex-dividend, ex-right, or ex any other distribution.¹⁰ According to the Commission, this provision would be unnecessary under the uniform price test because the best bid would immediately reflect the impact of any corporate action.

B. Pilot Program for Certain Liquid Securities

Proposed Temporary Rule 202 would create a pilot program that would temporarily suspend the operation of the proposed uniform price test for certain liquid securities. As currently proposed, the pilot program would remain in effect for two years, and would extend to a subset of securities in the Russell 1000 index or other securities the Commission may designate after giving due consideration to each security's liquidity, volatility,

market depth, and trading market. The Proposing Release explains that the Commission may consider including approximately a third of the securities in the Russell 1000 index, but noted that the Commission also could decide to include different stocks or use a different index.

For the securities covered by the proposed pilot, only the new uniform bid test would be temporarily suspended. All other provisions of Regulation SHO (*e.g.*, the locate and delivery requirements) would continue to apply. The Commission would retain the power to terminate the operation of the pilot prior to the end of two years.¹¹ In this regard, it is important to note that the Proposing Release asks whether short selling in pilot stocks should be restricted in response to a severe market decline—*e.g.*, when circuit breakers are triggered. It is not clear how the pilot program would operate if the SEC were to limit short selling whenever the price of a covered security declines significantly during the course of a trading day.

C. Exceptions to the Uniform Price Test

Currently, there are a number of tick test exceptions and exemptions designed to permit certain types of trading activities that are viewed as either beneficial to the markets or posing little risk of abuse. Under Regulation SHO, certain of these exceptions and exemptions would be retained, while others would be eliminated. In particular, the following would be included as exceptions to proposed Rule 201:

⁸ When the Commission proposed Regulation SHO, Chairman Donaldson and Commissioner Goldschmid expressed concern that the proposed uniform price test would not apply to these securities, which are generally less liquid and therefore viewed as being prone to the abuses that Reg SHO is designed to prevent. The Proposing Release seeks comment on whether the uniform price test should be extended to all OTC markets.

⁹ This contrasts with the existing provision in Rule 10a-1(a)(2) that allows exchanges to use their own markets as a reference point for determining whether short sales are permissible.

¹⁰ See 17 C.F.R. 240.10a-1(a)(3).

¹¹ During the two-year period that the pilot would be in effect, the Commission would perform a statistical analysis that compares trading in exempt securities to trading in comparable securities that are subject to the uniform price test. Based on this analysis, the Commission would determine whether to extend the pilot or to pursue permanent elimination of the uniform bid test for some or all liquid securities.

Long Seller's Delay in Delivery. This exception would allow short sales to be effected without regard to the proposed uniform price test if the seller owns the security sold and intends to deliver such security as soon as is possible without undue inconvenience or expense.¹²

Error in Marking a Short Sale. This exception would protect broker-dealers in the event they execute a sale already marked long by another broker-dealer, but the sale turns out to be a short sale.¹³

Odd Lot Transactions. This exception would permit any sale of a covered security by a market maker to off-set customer odd-lot orders or to liquidate an odd-lot position by a single round lot sell order that changes the money maker's position by no more than a unit of trading.¹⁴

Locked or Cross Markets. This new exception would allow a responsible broker-dealer, as defined in Exchange Act Rule 11Ac1-1, to effect a short sale at a price equal to its posted offer when the market is locked or crossed, provided that the responsible broker-dealer did not initiate the locked or crossed market and that the trade is consistent with its duty of best execution.¹⁵

Domestic Arbitrage. This exception would permit short sales effected in bona fide arbitrage

transactions involving convertible, exchangeable, and other rights to acquire the securities sold short, where such rights of acquisition originally were attached to or represented by another security, or were issued to all the holders of any such class of securities (provided that the short seller subsequently acquires or purchases the security upon which the arbitrage is based).¹⁶

International Arbitrage. This exception would permit short sales effected in a special international arbitrage account to profit from a current price difference between a security on a foreign securities market and a security on a U.S. securities market (provided that the short seller has an offer to buy on a foreign market that allows him to cover immediately the short sale at the time it was made).¹⁷

Distribution Over-Allotments. This exception would permit short sales in connection with an over-allotment of securities and any lay-off sale in connection with a distribution of securities through rights or a standby underwriting commitment.¹⁸

Eligible VWAP Transactions. This exception would codify prior exemptive letters and permit short sales that qualify as pre-opening, all-day volume weighted average price transactions (provided that they meet certain other conditions set forth in the staff's prior no-action letters).¹⁹

12 Proposed Rule 201(d)(1).

13 Proposed Rule 201(d)(2).

14 Proposed Rule 201(d)(3). In contrast with the current odd-lot exception in Rule 10a-1, the proposed exception would be available to all broker-dealers acting as market-makers in odd-lots, whether or not they are registered as odd-lot dealers.

15 Proposed Rule 201(d)(4).

16 Proposed Rule 201(d)(5). The domestic arbitrage exemption in Rule 10a-1 does not require the subsequent acquisition or purchase of the securities upon which the arbitrage is based.

17 Proposed Rule 201(d)(6).

18 Proposed Rule 201(d)(7).

19 Proposed Rule 201(d)(8); Letter From Edith Hallahan re: VWAP Trading System (Mar. 24, 1999); Letter From Soo J. Yim re: Jefferies and Company, Inc. (Jefferies) (Dec. 7, 2000); Letter From Andre E. Owens re: stet. (Mar. 30, 2001); Letter From Sam Scott Miller re: Morgan, Stanley & Co., Inc. (May 11, 2001); Letter From William W. Uchimoto re: Vie Institutional Services (Feb. 12, 2003).

Riskless Principal Execution of Customer Long Sales. This new exception would allow a broker-dealer to execute customer “long” sales on a riskless principal basis, regardless of the broker-dealer’s net proprietary position.²⁰

Customer Limit Order Protection. This exception would allow broker-dealers to sell at a price equal to the consolidated best bid in order to fill customer orders as required by other SEC or SRO rules, such as the NASD Manning Interpretation,²¹ if doing so is consistent with the duty of best execution.

D. Other Areas for Potential Relief

Market Making. In addition to these exceptions, which would be codified in Regulation SHO, the Proposing Release asks whether additional regulatory relief is needed to permit certain other types of transactions. In particular, the Commission asks in the Proposing Release whether there should be a blanket exception for bona fide market making, similar to the one found in NASD Rule 3350. At present, the Commission appears to be skeptical of the need for adopting such a blanket exception, noting that “a market maker should rarely need to sell short at or below the bid in its market making capacity.”²² In this regard, note that Rule 201, as currently proposed, would *not* contain any exemption equivalent to paragraph (e)(5)(ii) of Rule 10a-1, which currently

permits registered market makers and exchange specialists to sell short to facilitate customer market and marketable limit orders at the consolidated best offer, regardless of the last trade price.

Hedging Transactions. Currently, short sales related to hedges are treated the same under Rule 10a-1 as any other short sales and that appears likely to continue. The Commission did not include an exception for hedging short sales in Regulation SHO. The Commission notes in the Proposing Release that it believes that a hedging exception is not necessary because the proposed uniform price test and pilot would provide market participants with additional flexibility in effecting short sales in order to hedge long exposure. Nevertheless, the Commission seeks comment on this issue.

ETFs and Closing Price Trades. In addition to the exceptions codified in proposed Rule 201, the Commission notes in the Proposing Release that appropriate regulatory relief would be extended to continue to permit short sales involving exchange traded funds and certain short sales executed at the closing price in after-hours crossing sessions.²³ The Proposing Release, however, fails to address exactly how the existing relief would operate in the context of the new uniform bid test, which would apply to both exchange-listed and Nasdaq NMS securities.²⁴

²⁰ Proposed Rule 201(d)(9). The Proposing Release emphasizes that this exception would be available only if: (1) that transaction is one in which a broker or dealer, after having received an order to sell a security, sells the security as principal at the same price to satisfy the order to sell; (2) the sell order is given the same per-share price at which the broker-dealer sold shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee; and (3) the broker-dealer has written policies and procedures in place to assure that (a) the customer order was received prior to the offsetting transaction; (b) the offsetting transaction is allocated to a riskless principal account or customer account within 60 seconds of execution; and (c) the broker-dealer can produce records that accurately and readily reconstruct, in a time-sequenced manner, all orders effected pursuant to this exception.

²¹ Proposed Rule 201(d)(10); NASD IM-2110-2.

²² Proposing Release at 68 Fed. Reg. 62,989 n.152.

²³ The SEC previously has granted regulatory relief under Rule 10a-1 for exchange-sponsored after-hours crossing sessions as well as other trading systems operated by broker-dealers. *See, e.g.*, Letter From Scott I. Noah re: Off-Hours Trading by the Amex (Aug. 5, 1991); Letter From Larry E. Bergmann re: Operation of Off-Hours Trading by the NYSE (June 13, 1991); Letter From Joshua J. Fox re: Burlington Capital Markets (July 1, 2003); Letter From Elliot Levine re: Bear, Stearns & Co., Inc. (January 19, 1996); Letter From R. Steven Wunsch re: AZX, Inc. (November 15, 1995); Letter From Charles R. Hood re: Instinet Corporation Crossing Network (July 1, 1992); Letter From Lloyd H. Feller re: Portfolio System for Institutional Trading (December 31, 1991).

²⁴ Note that none of SEC’s prior after-hours crossing session letters provided relief with respect to Nasdaq NMS securities because the NASD’s bid test does not apply to after-hours transactions.

E. After-Hours and Offshore Trading

1. After-Hours Trading

The Commission currently interprets the tick test to apply to all trades in listed securities, whenever they occur. By its terms, Rule 10a-1 uses as a reference point the last trade price reported to the tape. Thus, after the tape ceases to operate, the Commission takes the view that the current rule prevents any person from effecting a short sale at a price that is lower than the last sale reported to the tape. The NASD's short sale rule does not operate after hours. The Commission believes that the proposed uniform price test should apply to after hours trades in all covered securities, requiring all short sales in exchange-listed and Nasdaq NMS securities to be effected in compliance with the uniform price test.

2. Off-Shore Trading

In the Commission's view, the tick test applies to trades "booked" overseas if the trade is agreed to in the United States.²⁵ In the Proposing Release, the Commission explains that it would take the same approach under Regulation SHO. Specifically, if a short sale of an exchange-listed or Nasdaq NMS security is agreed to in the U.S., it must be effected in compliance with the uniform price test (absent an available exception), regardless of where it is executed. The Commission seeks comment regarding the factors to be used to determine whether a trade in a covered security should be deemed to have been agreed to in the U.S.

III. Order Marking Requirements

Proposed Rule 201 would combine the existing order marking requirements in Rule 10a-1 and SRO rules. In contrast to Rule 10a-1, proposed Rule 201 would differentiate "short exempt" orders from or-

ders marked "long" or "short." An order could only be marked "long" when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer or will be prior to the settlement of the transaction. A sell order would be required to be marked "short exempt" if it were a short sale effected pursuant to an exception in Rule 201. In this regard, the Proposing Release emphasizes that under the proposed exception for the riskless principal trades discussed above, a riskless principal execution of a customer long sale should be marked "short exempt" even if the broker-dealer is short. The proposed order marking requirements would apply to all securities.

IV. Determining Whether One is "Net Long" or "Net Short"

Proposed Rule 200 would replace current Rule 3b-3 in its entirety. Although Rule 200 largely tracks the language of Rule 3b-3,²⁶ the proposed rule: (1) includes key new requirements for an unconditional contract to purchase or sell securities, (2) incorporates existing guidance to allow broker-dealers to calculate net positions within defined trading units, and (3) codifies prior interpretations related to security futures products and the unwinding of certain index arbitrage positions.

Unconditional Contract to Purchase Securities. Under current Rule 3b-3(b), a person owns a security if the person has "purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it." In 1992, the Commission proposed to clarify that an "unconditional contract" must specify a fixed, currently ascertainable price, and the exact amount of securities to be obtained in order for a person to be deemed to own a security under this provision.²⁷ The Commission intended for this proposed clarification to address potentially abusive trading practices associated with contracts for future purchases of securities where the

25 See, e.g., Exchange Act Rel. Nos. 27,938 (Apr. 23, 1990), 21,958 (Apr. 18, 1985), and 28,899 (Feb. 20, 1991).

26 Generally, a short sale is and will continue to be defined 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.

27 See Exchange Act Rel. No. 30,772 (June 3, 1992) ("1992 Proposal").

price or volume was based on a formula or other contingent event. The Commission's 1992 proposal was never adopted or withdrawn.

In the Commission's view, agreement on a fixed price and quantity of securities should be an essential element of establishing a long position. Moreover, the Commission believes that requiring these elements would restrict certain activities designed to manipulate the market. Thus, proposed subparagraph (b)(2) of Rule 200 requires that an unconditional contract specify the price and amount of securities to be purchased in order for a person to claim ownership of the securities underlying the contract.

Securities Futures Products. Proposed Rule 200 includes language consistent with existing Commission guidance defining when a person will be deemed to own a security underlying a security futures contract.²⁸ Specifically, the Commission believes that a person who holds a security future obligating that person to take delivery of the underlying securities by physical settlement, would not be considered long in these securities until the security future terminates trading. This position would be codified in subparagraph (b)(6) of Rule 200.

Aggregation Units. Current Rule 3b-3 requires a seller of an equity security to aggregate all of its positions in that security in order to determine whether the seller has a "net long position" in the security. In 1998, the staff of the Division of Market Regulation issued a letter stating that they would not recommend that the Commission take enforcement action if a multi-service broker-dealer calculated its net position in a particular security within defined trading units, without regard to the positions held by the other aggregation units within the firm.²⁹ The Commission proposes to incorporate the aggregation unit concepts from that letter into proposed Rule 200.

Specifically, Rule 200(e) allows trading unit aggregation if: (1) the broker-dealer has a written plan of organization that identifies each aggregation unit, specifies the trading objective of each, and supports its independent identity; (2) each aggregation unit within the broker-dealer "continuously" determines its net position for every covered security that it trades; (3) each trader pursuing a particular trading objective or strategy is included in only one aggregation unit; and (4) individual traders are assigned to only one aggregation unit at a time.

Block-Positioner Exception. The block-positioner exception of current Rule 10a-1(e)(13) would be incorporated without modification into Rule 200 of Regulation SHO.

Liquidation of Index Arbitrage Positions. Under current Rule 3b-3, a seller of an equity security must aggregate all of the seller's positions in that security in order to determine whether the seller has a "net long position" in the security. Therefore, if a person does not have a net long position in a security, any sale of that security must be designated as a short sale and must comply with the tick or bid tests, to the extent applicable. A person liquidating an index arbitrage position involving a long basket of stocks may be unable to sell all the securities contemporaneously with closing out the derivative instrument position because of the requirement to net short security positions in other proprietary accounts. This may result in a failure to realize the expected arbitrage profit.

In the 1992 Proposal, the Commission proposed codifying prior no-action relief relating to liquidations of certain index arbitrage positions. Specifically, the Commission proposed a new exception from the tick test for any sale by a person effected in connection with the liquidation of an index arbitrage position, notwithstanding that such person may not have a net long position in that

28 See Exchange Act Rel. No. 46,101 (June 21, 2002) (providing generalized guidance regarding trading of security futures products).

29 *Bear, Stearns & Co. Inc., et al.*, SEC No-Action Letter (Nov. 23, 1998).

security. The proposed exception was limited, however, to contexts where: (1) the person's net short position is solely the result of one or more short positions created and maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedging activities; and (2) the sale does not occur during a period commencing at the time that the Dow Jones Industrial Average ("DJIA") had declined by 50 points or more from its closing value on the previous day and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day. As noted above, the amendments proposed in the 1992 Proposal were never adopted.

Proposed Rule 200(f) would include this relief with a minor change from the 1992 Proposal. Namely, Rule 200(f) would alter the second condition to specify that the relief would not be available during a period commencing at the time that the DJIA has declined below its closing value on the previous trading day by at least 2%, and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day during which the DJIA has not declined by 2% or more from its closing value on the previous day.

V. Short Sales in Connection with a Public Offering

Rule 105 of Regulation M generally prohibits a short seller from covering short sales with securities purchased from an underwriter or broker-dealer in a registered offering if the short sale occurred within five days prior to pricing of the offered securities. This rule applies to offerings of securities for cash pursuant to a registration statement or a notification on Form 1-A filed under the Securities Act of 1933, but excepts shelf offerings and offerings not conducted on a firm commitment basis. In the Proposing Release, the Commission notes the com-

mon usage of shelf offerings today and explains that short sales in advance of a shelf offering may cause the same downward price pressure that occurs with pre-pricing short sales in connection with non-shelf offerings. Accordingly, the Commission proposes to eliminate the shelf offering exception in Rule 105 of Regulation M.

VI. Conclusions

The Proposing Release represents an ambitious effort by the Commission to modernize the existing framework for regulating short sales. In particular, the proposal to subject all short sales in exchange-listed securities and Nasdaq NMS securities to a single price test seems to reflect the increased recognition that the line dividing the traditional floor-based auction market and the OTC dealer market is blurred, given the recent advances in technology and resulting changes in market structure. It is unclear, however, whether Regulation SHO, as currently proposed, would be sufficiently flexible to accommodate structural differences in certain market segments and continued market competition, while at the same time deterring abusive trading practices. Given the critical importance that the regulation of short sales plays in today's equity capital markets, the Proposing Release represents an important opportunity for both the securities industry and public investors to participate in a major rule making effort. For more information about the Proposing Release, please contact any of the following attorneys:

Brandon Becker	+1 (202) 663-6979 <i>brandon.becker@wilmer.com</i>
Soo J. Yim	+1 (202) 663-6958 <i>soo.yim@wilmer.com</i>
John C. Nagel	+1 (202) 663-6134 <i>john.nagel@wilmer.com</i>
Jerome Roche	+1 (202) 663-6870 <i>jerome.roche@wilmer.com</i>