

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

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RIN 3235-AJ57

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (“Commission”) is adopting amendments to Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”). The amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the grandfather provision of Regulation SHO. In addition, we are amending the close-out requirement of Regulation SHO for certain securities that a seller is “deemed to own.” The amendments also update the market decline limitation referenced in Regulation SHO.

EFFECTIVE DATE: October 15, 2007.

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SUPPLEMENTARY INFORMATION: We are amending Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.¹ Among other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date² and to target potentially abusive “naked” short selling³ in certain equity securities.⁴ While the

¹ 17 CFR 242.200. See also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (“Adopting Release”), available at <http://www.sec.gov/rules/final/34-50103.htm>. For more information on Regulation SHO, see “Frequently Asked Questions” and “Key Points about Regulation SHO,” available at <http://www.sec.gov/spotlight/shortsales.htm>.

A short sale is the 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. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

² Generally, investors must complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or “trade date plus three days”). T+3 means that when the investor purchases a security, the purchaser’s payment must be received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. Because the Commission recognized that there are many legitimate reasons why broker-dealers may not be able to deliver securities on settlement date, it adopted Rule 15c6-1, which prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1. However, failure to deliver securities on T+3 does not violate the rule.

³ We have previously noted that abusive “naked” short selling, while not defined in the federal securities laws, generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle. See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (“Proposing Release”).

⁴ In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of Sedona Corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with Sedona stock, and depressed its price. See Rhino Advisors, Inc. & Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, SEC v. Rhino Advisors, Inc. & Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y.). See also, Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (“2003 Proposing Release”) (describing the alleged activity in the case involving stock of Sedona Corporation); Adopting Release, 69 FR at 48016, n.76.

majority of trades settle on time,⁵ Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might impact the market for that security.⁶ Although high fails levels exist only for a small percentage of issuers,⁷ we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.

In addition, many issuers and investors continue to express concerns about extended fails

⁵ According to the National Securities Clearing Corporation (“NSCC”), 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3.

⁶ These fails to deliver may result from either short or long sales of stock. There may be many reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. Also, broker-dealers that make a market in a security (“market makers”) and who sell short thinly-traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

⁷ The average daily number of securities on the threshold list in March 2007 was approximately 311 securities, which comprised 0.39% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO’s current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act. NASD Rule 3210, which became effective on July 3, 2006, applies the Regulation SHO close-out framework to non-reporting equity securities with aggregate fails to deliver equal to, or greater than, 10,000 shares and that have a last reported sale price during normal trading hours that would value the aggregate fail to deliver position at \$50,000 or greater for five consecutive settlement days. See Exchange Act Release No. 53596 (April 4, 2006), 71 FR 18392 (April 11, 2006) (SR-NASD-2004-044). Consistent with the amendment to eliminate the grandfather provision of Regulation SHO, we anticipate the NASD would propose similar amendments to NASD Rule 3210.

to deliver in connection with “naked” short selling.⁸ To the extent that large and persistent fails to deliver might be indicative of manipulative “naked” short selling, which could be used as a tool to drive down a company’s stock price, fails to deliver may undermine the confidence of investors.⁹ These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.¹⁰ In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors’ negative perceptions regarding large and persistent fails to deliver.¹¹ Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security’s price.¹²

⁸ See, e.g., comment letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 (“Overstock”); comment letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, Taser International, dated Sept. 18, 2006 (“Taser”); comment letter from John Royce, dated April 30, 2007; comment letter from Michael Read, dated April 29, 2007; comment letter from Robert DeVivo, dated April 26, 2007; comment letter from Ahmed Akhtar, dated April 26, 2007.

⁹ See, e.g., comment letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (“NCANS”); comment letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (“State of Connecticut”) (discussing the impact of fails to deliver on investor confidence).

¹⁰ See, e.g., comment letter from Congressman Tom Feeney, Florida, U.S. House of Representatives, dated Sept. 25, 2006 (“Feeney”) (expressing concern about potential “naked” short selling on capital formation, claiming that “naked” short selling causes a drop in an issuer’s stock price and may limit the issuer’s ability to access the capital markets); comment letter from Zix Corporation, dated Sept. 19, 2006 (“Zix”) (stating that “[m]any investors attribute the Company’s frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company “do something” about the perceived manipulative short selling. This perception that manipulative short selling of the Company’s securities is continually occurring has undermined the confidence of many of the Company’s investors in the integrity of the market for the Company’s securities”).

¹¹ Due, in part, to such concerns, issuers have taken actions to attempt to make transfer of their securities “custody only,” thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (“DTC”) or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

¹² See also, Proposing Release, 71 FR at 41712 (discussing the potential impact of large and persistent fails to deliver on the market). See also, 2003 Proposing Release, 68 FR at 62975 (discussing the potential impact of “naked” short selling on the market).

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to securities in which a substantial amount of fails to deliver have occurred (also known as “threshold securities”).¹³ As adopted in August 2004, Rule 203(b)(3) of Regulation SHO included two exceptions to the mandatory close-out requirement. The first was the “grandfather” provision, which excepted fails to deliver established prior to a security becoming a threshold security;¹⁴ and the second was the “options market maker exception,” which excepted fails to deliver in threshold securities resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.¹⁵

At the time of Regulation SHO’s adoption, the Commission stated that it would monitor the operation of Regulation SHO, particularly whether grandfathered fail to deliver positions were being cleared up under the existing delivery and settlement requirements or whether any further regulatory action with respect to the close-out provisions of Regulation SHO was warranted.¹⁶ In addition, with respect to the options market maker exception, the Commission

¹³ A threshold security is defined in Rule 203(c)(6) of Regulation SHO as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and is included on a list (“threshold securities list”) disseminated to its members by a self-regulatory organization (“SRO”). See 17 CFR 242.203(c)(6). Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

¹⁴ The “grandfathered” status applied in two situations: (1) to fail positions occurring before January 3, 2005, Regulation SHO’s effective date; and (2) to fail positions that were established on or after January 3, 2005 but prior to the security appearing on a threshold securities list. See 17 CFR 242.203(b)(3)(i).

¹⁵ 17 CFR 242.203(b)(3)(ii).

¹⁶ See Adopting Release, 69 FR at 48018.

noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission's original expectations.¹⁷

Since Regulation SHO's effective date in January 2005, the Commission's staff ("Staff") and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.¹⁸ However, despite this positive impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements. Allowing these persistent fails to deliver to continue indefinitely may lead to greater uncertainty about the fulfillment of the settlement obligation.¹⁹ While some delays in closing out may be understandable and necessary, a seller should deliver shares to close out its sale within a reasonable time period.

Based, in part, on the results of examinations conducted by the Staff and SROs, as well as our desire to reduce large and persistent fails to deliver, on July 14, 2006, we proposed revisions

¹⁷ See id. at 48019.

¹⁸ For example, in comparing a period prior to the effective date of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to March 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- the average daily aggregate fails to deliver declined by 29.5%;
- the average daily number of securities with aggregate fails to deliver of at least 10,000 shares declined by 5.8%;
- the average daily number of fails to deliver declined by 15.1%;
- the average age of a fail to deliver position declined by 25.5%;
- the average daily number of threshold securities declined by 39.0%; and
- the average daily fails to deliver of threshold securities declined by 52.9%.

See also, supra n. 7.

¹⁹ See Adopting Release, 69 FR at 48016-48017; see also, 2003 Proposing Release, 68 FR at 62977-62978 (discussing the Commission's belief that the delivery requirements of proposed Regulation SHO would protect and enhance the operation, integrity and stability of the markets and the clearance and settlement system, and protect buyers of securities by curtailing "naked" short selling).

to Regulation SHO that would modify Rule 203(b)(3) by eliminating the grandfather provision and narrowing the options market maker exception.²⁰ The proposed amendments were intended to reduce the number of persistent fails to deliver attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception.

The proposals were based, in part, on data collected by the National Association of Securities Dealers, Inc. (“NASD”), as well as concerns about the persistence of certain securities on the threshold securities lists.²¹ However, in response to commenters’ concerns regarding the public availability of data relied on by the Commission, on March 26, 2007 we re-opened the comment period to the Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the NASD’s findings that the NASD had submitted to the public file on March 12, 2007. In addition, the notice regarding the re-opening of the comment period directed the public’s attention to brief summaries of data collected by the Commission’s Office of Compliance Inspections and Examinations and the New York Stock Exchange LLC (“NYSE”).²²

The proposals included a 35 settlement day phase-in period following the effective date of the amendment intended to provide additional time to begin closing out certain previously-expected fails to deliver. In addition, the proposals included an amendment to update the market

²⁰ See Proposing Release, 71 FR 41710.

²¹ See Proposing Release, 71 FR at 41712.

²² See Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007) (“Regulation SHO Re-Opening Release”). We received a number of comment letters in response to the Regulation SHO Re-Opening Release, most of which urged the Commission to take action on the proposed amendments to eliminate the grandfather provision and narrow the options market maker exception. Comment letters, including the comments of the NASD, are available on the Commission’s Internet Web Site at <http://www.sec.gov/comments/s7-12-06/s71206.shtml>. See also, Memorandum from the Commission’s Office of Economic Analysis regarding Fails to Deliver Pre- and Post-Regulation SHO (dated August 21, 2006), which is available on the Commission’s Internet Web Site at <http://www.sec.gov/spotlight/failstodeliver082106.pdf>.

decline limitation referenced in Rule 200(e)(3) of Regulation SHO.²³ The Commission also included in the Proposing Release a number of requests for comment, including whether the Commission should amend Regulation SHO to extend the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act of 1933 (the “Securities Act”).²⁴

We received over 1,000 comment letters in response to the Proposing Release.²⁵ As discussed below, after considering the comments received and the purposes underlying Regulation SHO, we are adopting the amendments to the grandfather provision and the market decline limitation, with some modifications to refine provisions and address commenters’ concerns. However, in a separate companion release, we are re-proposing amendments to the options market maker exception.²⁶ In addition, we are adopting amendments to the close-out requirement of Regulation SHO for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

II. Overview of Regulation SHO

A. Rule 203(b)(3)’s Close-out Requirement

One of Regulation SHO’s primary goals is to reduce fails to deliver in those securities with a substantial amount of fails to deliver by imposing additional delivery requirements on

²³ 17 CFR 242.200(e)(3).

²⁴ 17 CFR 230.144

²⁵ The comment letters are available on the Commission’s Internet Web Site at <http://www.sec.gov/comments/s7-12-06/s71206.shtml>.

²⁶ See Exchange Act Release No. 56213 (Aug. 7, 2007)

those securities.²⁷ We believe that additional delivery requirements help protect and enhance the operation, integrity and stability of the markets, as well as reduce short selling abuses.

Regulation SHO requires certain persistent fail to deliver positions to be closed out. Specifically, Rule 203(b)(3)'s close-out requirement provides that a participant of a clearing agency registered with the Commission²⁸ must take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement ("CNS")²⁹ system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.³⁰ In addition, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, prohibits the participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing,

²⁷ See Adopting Release, 69 FR at 48009.

²⁸ For purposes of Regulation SHO, the term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24). The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A), 78q-1 and 15 U.S.C. 78q-1(b), respectively. See also, Adopting Release, 69 FR at 48031. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

²⁹ The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The NSCC clears and settles the majority of equity securities trades conducted on the exchanges and over the counter. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the counterparty to both sides of the transaction. While NSCC's rules do not authorize it to require member firms to close out or otherwise resolve fails to deliver, NSCC reports to the SROs those securities with fails to deliver of 10,000 shares or more. The SROs use NSCC fails data to determine which securities are threshold securities for purposes of Regulation SHO.

³⁰ 17 CFR 242.203(b)(3).

