

SEC Publishes New Regulation SHO



To: Head of NASDAQ Trading; Technical Contacts; Compliance Officers
From: Chris Concannon, Executive Vice President
The NASDAQ Stock Market
Date: August 17, 2004
Re: **SEC Publishes New Regulation SHO**
(Head Trader Alert #2004-108)

Summary

- The SEC published new Regulation SHO, significantly changing short sale regulation
 - Compliance effective January 3, 2005
- The SEC deferred adoption of uniform price test
- One-year pilot program to be implemented in approximately 1,000 securities
 - Pilot securities to be exempt from price tests: no tick test or short sale price test
- Other amendments to short sale rules:
 - Firms required to locate securities available for borrowing
 - Requirements in threshold securities
- NASDAQ Market CenterSM system changes
- Extension of Transition Period for Conversion to NASDAQ Bid Tick Indicator
- Additional information

Reg SHO Overview

On Wednesday, July 28, 2004, the Securities and Exchange Commission (SEC) published Regulation SHO for short sales. The new Regulation SHO:

- Eases some current restrictions on effecting short sales, including:
 - removal of price test restrictions for a subset of actively-traded securities, and
 - Creates new restrictions, including:
 - a uniform "locate" requirement for short sales in all equity securities, and
 - additional requirements on securities with significant settlement failures.

The new provisions will become effective 30 days after publication in the [Federal Register](#), although they will have a compliance date of **Monday, January 3, 2005**.

Deferred Adoption of Uniform Price Test/Pilot Exemption Program

The SEC has deferred adoption of a uniform price test that would have established a uniform short sale rule in all securities across all markets.

Instead, the Commission will implement a one-year pilot program that will exempt approximately 1,000 securities from any price test (Pilot). The 1,000 Pilot securities are comprised of 47.8% NASDAQ National Market[®] (NM) securities, 50% NYSE-listed securities, and 2.2% Amex-listed securities. During the Pilot, the SEC will suspend the "tick test" of SEC Rule 10a-1 as well as any short sale price test of any national securities association or national securities exchange (i.e., the bid test of NASD Rule 3350 and the tick test of NYSE Rule 440B).

During the Pilot, the SEC also will suspend the tick test for short sales in exchange-listed securities in the Russell 1000 index that are effected after 4:15 p.m., Eastern Time (ET) and for short sales in all other exchange-listed securities effected after the close of the consolidated tape (i.e., after 8:00 p.m., ET).

The SEC will review data collected during the Pilot to determine whether to: (1) eliminate a price test for some or all securities; (2) adopt a uniform bid test for all securities, which could include NASDAQ SmallCap MarketSM and other over-the-counter securities, not currently covered by a price test; or (3) maintain the current price tests. The Pilot, currently scheduled to launch on January 3, 2005, and run until December 31, 2005, will apply to a [subset](#) of Russell 3000 Index stocks.

Securities not included in the Pilot will still be covered by the existing bid test (for NASDAQ NM securities) or tick test (for exchange-listed securities).

Uniform "Locate" Requirement

Regulation SHO includes a new uniform requirement for broker-dealers to locate securities available for borrowing prior to effecting a short sale. Regardless of whether the seller's short position may be closed out by purchasing securities the same day, firms will need to document that (a) they have borrowed or arranged to borrow the stock, or (b) they have reasonable grounds to believe they can borrow the stock and deliver on delivery date.

Broker-dealers can rely on "easy-to-borrow" lists to satisfy the "reasonable grounds" requirement, provided the information used to generate such lists is less than 24 hours old and the securities included on the list are so readily available that it is unlikely the seller will fail to deliver securities on settlement date, but may not rely on the fact that a security is not on a "hard-to-borrow" list to satisfy the test.

There are several exceptions to the locate requirement, including one for short sales by market makers in connection with bona fide market making activities.

Additional Requirements For Short Sales in "Threshold Securities"

Regulation SHO includes additional requirements targeted at designated "threshold securities" that have substantial settlement failures. A list of such threshold securities will be calculated and disseminated daily by the Self Regulatory Organization (SRO) on which the security is listed or for which the SRO bears primary surveillance responsibility.

Such threshold securities should generally not be included on "easy-to-borrow" lists. Additionally, clearing brokers must close out any fail-to-deliver position that has remained for 13 consecutive settlement days.

Other Amendments to Short Sale Regulation

Additional changes under Regulation SHO include:

- A rule prohibiting a broker-dealer from failing-to-deliver, or lending securities to prevent a fail to deliver, on a sale that is marked "long".
- New order marking requirements.
- Codification of the definition of ownership of securities for short sale purposes and clarification of requirement to determine a seller's net aggregate position.
- Amendments to Rule 105 of Regulation M addressing short sales in connection with a public offering. The amendments to Regulation M take effect on September 7, 2004.

NASDAQ Market Center System Changes

In preparation for these changes, effective Monday, January 3, 2005, NASDAQ® will update the NASDAQ Market Center Execution System for NASDAQ and exchange-listed securities so that no short sale validation is performed for the pilot securities.

Extension of Transition Period for Conversion to the NASDAQ Bid Tick Indicator

[Head Trader Alert 2003-157](#) announced the extension of the date by which market participants must convert their systems to the NASDAQ bid tick indicator until the date when the SEC makes a final determination on Regulation SHO. Because the SEC has not yet made a final determination on a uniform price test, pending completion of the pilot program described above, NASDAQ will further extend the transition period until the conclusion of the SEC pilot program. At that time, NASDAQ will issue a Head Trader Alert notifying market participants of their Short Sale Rule obligations.

Additional Information

For more information:

- Visit www.sec.gov/rules, or,
- Contact NASDAQ Market Sales at 800.846.0477 or sales@nasdaq.com.