

REGULATORY CIRCULAR (04-03)

To: BSE Member Firms
From: Maura Looney
Regulation & Enforcement
Date: December 16, 2004
Re: Regulation SHO – New provision regarding Short sales

The Securities and Exchange Commission (“SEC” or “Commission”) established new procedures for short sales (“Reg SHO”). Reg SHO Rules are to be implemented on January 3, 2005. (*See* Securities & Exchange Commission Releases No. 34-50103; 34-50104; 34-50747).

I. Rule 242.200 - Definition of Short Sale and Marking requirements:

One key change is the requirement that all orders in equity securities be marked: long, short, short exempt.¹ An order should be marked short exempt if the seller is entitled to rely on any exception from the tick test.

II. Rule 202T - Pilot Program (beginning May 2, 2005).

Certain securities will be exempt from the tick test. The pilot is only suspending the requirements of the price test, all other SHO requirements will remain in effect. In addition, the order establishes a pilot removing any price test for short sales of certain securities effected during certain after hours trading. Specifically, (1) short sales in any security included in the Russell 1000 index effected between 4:15 and the opening of the consolidated tape; and (2) short sales in any security not included in paragraphs (1) (the list) and (2) (Russell 100 index) between the close of the consolidated tape and the open of the consolidated tape the next day. As always, the Exchange will monitor trading in the Pilot securities for abusive short selling.

III. Rule 242.203 - Locate and Delivery

Pursuant to § 203(a), with limited exceptions, a broker-dealer must make delivery when due and cannot borrow if a sale is marked long. Section 203(b) requires a broker-dealer to locate securities available for borrowing prior to effecting a short sale. Exceptions to the rule, among others, include where 1) a broker-dealer accepts a short sale from another registered broker-dealer that is required to comply with (b)(1).² The

¹ At this time the Securities Industry Association is drafting letter requesting exemptive relief for the marking of ETFs as short exempt. Another SIA letter will follow requesting exemptive relief for the marking requirement for the pilot program. (See part II).

² For example, where an introducing broker-dealer submits a short sale on a principal or agency basis.

introducing broker-dealer has the responsibility of complying with the locate requirement; and 2) short sales are executed by market makers, including specialists and options market makers, but only in connection with bona fide market making activities.³

IV. Close-Out Requirement for Threshold Securities

There are additional requirements targeted at stocks that have a substantial amount of failures to deliver. A clearing broker is required to take action on all failures to deliver that exist in threshold securities ten days after the normal settlement date, or 13 consecutive settlement days. The clearing broker is required to close out the fail by purchasing securities of a like kind and quantity.

Each primary listing exchange will post a threshold securities list on its website.⁴ If a clearing broker does not close out the fail to deliver, certain trading restrictions apply. Any clearing broker and broker-dealer for which it clears, including any market maker, are prohibited from effecting short sales in that threshold securities without first borrowing or arranging to borrow, until the fail to deliver is closed. If the clearing broker can identify the account(s) which contributed to the fail to deliver the restriction will apply only to such accounts.

As stated above, market makers engaged in bona fide market making are exempt from the locate requirement. However, there is no exception from the requirement to close out fails to deliver in such securities that remain for 13 days. Accordingly, market makers must still follow this rule. The close-out requirement does not apply to a fail to deliver positions established prior to that security be placed on the threshold list.

IV. Rule 105 of Regulation M – Short Sales in Connection with Public Offering:

Rule 105 prohibits using offering shares to cover any pre-pricing short sales, effected within five days of pricing offering, from being covered with offering securities acquired from an underwriter or other broker-dealer participating in the offering. The shelf offering exception is eliminated. The Commission in its release offered some guidance on sham transactions.

V. New Exchange Rules

Finally, the given the new procedures, the Exchange has reviewed its rules regarding short sales. After the review, the Exchange filed a proposed rule change with the Commission. The text of the proposals is attached.

If there any questions, please contact me at 617-235-2073.

³ The rule specifically notes that bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns.

⁴ The Exchange will not have any securities on its list at this time, because the Exchange is not the primary listing exchange for any securities.

new language
[deleted language]

RULES OF THE BOSTON STOCK EXCHANGE

Chapter II

Short Sales

Section 16.

(a) No member or member organization shall, for his or its own account or for the account of any other person, effect on the Exchange a short sale (as defined in Section [3b-3] 17 CFR Part §242.200 of the Securities Exchange Act) of any security registered on, or admitted to unlisted trading privileges on the Exchange if trades in such security are reported pursuant to the consolidated transaction reporting system operated in accordance with a plan declared effective under Securities Exchange Act Rule 17a-15 (a "consolidated system") and information as to such trades is made available in accordance with such plan on a real time basis to vendors of market transaction information; (i) below the price at which the last sale thereof, regular way, was reported in such consolidated system, or (ii) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was reported in a consolidated system.

(b) *(No change)*

(c) *(No change)*

(d) [No member or member organization shall, by the use of any facility of the Exchange, execute any sell order unless such order is marked either "long" or "short".] (Reserved)

(e) [No member or member organization shall mark any order to sell a security registered on, or admitted to, unlisted trading privileges on the Exchange "long" unless (i) the security to be delivered after sale is carried in the account for which the sale is to be effected, or (ii) the member or member organization is informed that the seller owns the securities ordered to be sold, as soon as possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected.] (Reserved)

(f) The provisions of paragraphs a) and c) hereof shall not apply to:

(1) *(No change)*

(2) *(No change)*

(3) *(No change)*

(4) *(No change)*

(5) Any sale of a security covered by paragraph (a) of this rule (except a sale to a stabilizing bid complying with Securities Exchange Act Rule [19b-7] 242.104) by a registered dealer-specialist or market-maker registered with the Exchange in such security for his or its own account;

(a) effected at a price equal to or above the last sale reported for such security in a consolidated system, or

(b) effected at a price equal to the most recent offer communicated for the security by such registered specialist, registered exchange market maker or third market maker to an exchange or a national securities association pursuant to 240.11Ac1-1, if such offer, when communicated, was equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan.

(6) Any sale of a security covered by paragraph c) hereof on the Exchange (except a sale to a stabilizing bid complying with Securities Exchange Act Rule [10b-7] 242.104) effected with the approval of the Exchange, which is necessary to equalize the price of such security thereon with the current price of such security on another national securities exchange which is the principal exchange market for such security;

(7) *(No change)*

(8) Any sale of a security on the Exchange effected for a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on a securities market subject to the jurisdiction of the United States, provided the seller, at the time of such sale knows, or by virtue of information currently received, has reasonable grounds to believe that an offer enabling him to cover such sale is then available to him in such foreign securities market and intends to accept such offer immediately; or

(9)[Any sale of a security on the Exchange effected in accordance with a special offering plan declared effective by the Securities and Exchange Commission pursuant to paragraph (d) of Rule 10b-2; or] (Reserved)

(10) Any sale by an underwriter, or any member of a syndicate or group participating in the distribution of a security, in connection with an over-allotment of securities, or any lay-off sale by such a person in connection with a distribution of securities through rights [pursuant to Rule 10b-8] or a standby underwriting commitment;

(11) Any sale of a security covered by paragraph (a) of this section (except a sale to a stabilizing bid complying with [240.10b-7] 242.104) by any broker or dealer, for his own account or for the account of any other person, effected at a price equal to the most recent

offer communicated by such broker or dealer to an exchange or association pursuant to [240.11Ac101] 240.11Ac1-1 in an amount less than or equal to the quotation size associated with such offer, if such offer, when communicated, was (i) above the price at which the last sale, regular way, for such security was reported pursuant to an effective transaction reporting plan; or (ii) at such last sale price, if such last sale price is above the next preceding different price at which a sale of such security, regular way, was reported pursuant to an effective transaction reporting plan.

(12) This section shall not prohibit any transaction or transactions which the Commission, upon written request or upon its own motion or order, exempts, either unconditionally or on specified terms and conditions.

For the purpose of subparagraph (8) hereof a depository receipt of a security shall be deemed to be the same security as the security represented by such receipt.

*** Commentary

.01 No member or member organization shall effect on the Exchange a short sale that is not in compliance with the Securities and Exchange Commission's rules and regulations regarding short sales, including but not limited to, rules and regulations in effect and provided for in Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) ("Reg SHO").

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