

## MEMORANDUM

**To: All Members, Member Organizations, Participants and Participant Organizations**

**From: William A. Bunting, Director, Examinations Department**

**Re: Applicability of Regulation SHO to Certain Market Maker Transactions**

**Date: August 24, 2007**

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This memorandum is intended to remind Philadelphia Stock Exchange (“Phlx” or the “Exchange”) Members, Member Organizations, Participants and Participant Organizations (collectively “Member Organizations”) of the requirements of Regulation SHO, primarily with respect to the trading activity of option market makers. While these requirements apply to all Member Organizations, this memorandum is specifically targeted at those Member Organizations for which the Exchange is the designated examining authority (“DEA”).

### **The “Locate” Exemption**

Option market makers are exempt from the locate requirement of Regulation SHO when selling the underlying security short, provided that such short sales hedge option positions established during the course of bona fide market making activity. SEC Rules have established that an option market maker must, among other things, maintain regular and continuous two sided quotations in order to establish that he or she is acting as a bona fide market maker in the security in question.<sup>1</sup> An analysis of whether a market maker is acting as a bona fide market maker is an analysis that is made on a security by security basis. The fact that a broker dealer is a market maker in a particular security would not automatically qualify the broker for the “locate” exception. The market maker must also be engaging in bona fide market making activity in the security at the time of the short sale for which it asserts the exception.

Further, the fact that an option market maker is a bona fide market maker in one option, and thus entitled to the “locate” exemption when selling the underlying security short, does not necessarily mean that the market maker is entitled to the “locate” exemption when selling short another option. In determining whether a market maker qualifies for the “locate” exemption, the Phlx regulatory program will review whether the short sale in question was established in a security in which the market maker satisfied his or her obligation under relevant Phlx and SEC Rules.

Regulation SHO states the following regarding bona fide market making:

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<sup>1</sup> See Section 3(a)(38) of the Exchange Act, Rules 203(b)(2)(iii) and 11a1-3(T) thereunder, and Securities Exchange Act Release No. 50103 (July 28, 2004): 69 FR 48008, 48031 (August 6, 2004) Regulation SHO Adopting Release.

“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 or practices of the broker dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not post at or near the best bid, the market maker activities would generally not qualify as bona fide market making for purposes of the exception. “

In addition, bona fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker exception for the purposes of avoiding compliance with Rule 203(b)(1) of Regulation SHO by the other broker dealer or customer.

Even if a market maker is entitled to the locate exemption, the market maker is still subject to the 13 day close out requirement for threshold securities.

Strategies including but not limited to reverse conversions, short stock/short put and short stock/ long call transactions will be reviewed by the Exchange to access whether a “locate” was required.

### **“Close-Out” Requirement**

Currently there are two exemptions to the close out requirement applicable to option market makers. First, if the fail to deliver position was established prior to the security becoming a threshold security, the fail to deliver position does not need to be closed out within 13 days because it is a “grandfathered” position. *On June 13, 2007, the SEC adopted amendments to eliminate the “grandfather provision”. This amendment to Regulation SHO has not yet become effective.*<sup>2</sup>

Second, a fail to deliver in a threshold security that results from a short sale effected by a registered options market maker to establish or maintain a hedge on options transactions, when such option positions were created before the underlying security became a threshold security, does not have to be closed out. *The SEC has proposed the elimination of this exception to the close out requirement of Regulation SHO.*<sup>3</sup>

Certain stock transactions that are intended to effect close-outs of fail to deliver positions in threshold securities are not an acceptable way of fulfilling Regulation SHO close-out requirements.

Borrowing securities or otherwise entering into an arrangement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of stock paired with one or more short-term option transactions, such as a one day FLEX option, that is designed to create the appearance of a bona fide purchase of securities, but that is nothing more than a device to improperly reset the close-out date, and would not satisfy Regulation SHO’s close-out requirement.

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<sup>2</sup> See Securities and Exchange Act Release No. 56212 (August 7, 2007), Phlx Memorandum No. 2004-07 (August 15, 2007)

<sup>3</sup> See Securities and Exchange Act Release No. 56213 (August 7, 2007), Phlx Memorandum No. 2004-07 (August 15, 2007)

Unless the close-out requirement is properly satisfied through a bona-fide purchase, it is a violation of Regulation SHO to effect further short sales (including via exercise of the long put) without first pre-borrowing the stock (Rule 203 (b)(3)(III) of Regulation SHO).

Short sale of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, including but not limited to, reverse conversions and deep in-the-money long call/short stock, and are highly indicative of transactions that may be assisting a contra-party faced with a close out obligation in creating the appearance of a bona-fide stock purchase.

The following is an example of a transaction that would violate both the “locate” and close out requirements of Regulation SHO.

**Example:**

- Options market-maker Michael Smith enters into a reverse conversion transaction in symbol ABC by selling 2,000 December 50 puts, buying 2,000 December 50 calls and selling 200,000 shares short of the underlying equity. ABC is a threshold security. Although he is an options market maker and satisfies his market maker obligations in securities to which he is assigned, Michael Smith is not assigned to ABC, and Michael Smith does not make markets in the option. He is, however, occasionally solicited by floor brokers in this security. Because he is not a bona fide market maker in ABC, Michael Smith is not entitled to the market maker locate exemption in this security.
- Michael Smith does not deliver ABC on a settlement day and, thus, he has a fail to deliver position in the threshold security. On Day 10 of the fail to deliver Michael Smith receives notice from his clearing firm that he has an obligation to satisfy the fail to deliver under Regulation SHO by day 13 or the clearing firm will buy him in on 200,000 shares.
- Michael Smith does not want the buy-in to occur since it would require an open market purchase of a threshold security with little or no control as to execution price and it would result in an unhedged synthetic long position. Instead, Michael Smith executes a one-day, deep-in-the-money FLEX buy write with another options market maker, Martha Jones, whereby Michael Smith simultaneously purchases 200,000 shares of ABC and sells 2,000 deep in-the-money call options overlying the security. Michael Smith’s clearing firm records a security entitlement with respect to the 200,000 ABC shares.
- Martha Jones is not a bona fide ABC market maker, does not own ABC shares, does not perform a locate and does not deliver the shares sold to Michael Smith.
- On the following day, Martha Jones exercises the FLEX call option. Michael Smith’s clearing firm transfers the shares he purchase the previous day to Jones in satisfaction of the exercise notice. Smith is now short 200,000 shares of ABC. Because Jones did not own or borrow the stock, no stock was ever delivered from Martha Jones’ account to Michael Smith’s account, nor is stock delivered from Smith’s account to Jones’ account in satisfaction of the exercise notice. Accordingly, as a result of purchasing the stock as part of the buy write and being assigned on the short-term deep-in-the-money FLEX option, Michael Smith gave the appearance of closing-out his fail to deliver position, but in reality all that changed was the appearance that the age of Smith’s fail position was reduced from 10 days to 1 day.

In the above example, Michael Smith was not acting as a bona fide market maker in ABC options and thus was not entitled to the use of a locate exemption when selling the underlying security short. ABC was not one of his assigned option classes and he did not make continuous two-sided markets in the option.

In addition, the one day FLEX buy write did not constitute a compliant close out of his fail to deliver position. While he nominally purchased shares of ABC, he did so in conjunction with the short term, deep in-the-money FLEX call option which was virtually certain to be exercised by Martha Jones on the following day, thereby enabling him to almost immediately re-establish his short stock position that hedged his pre-existing short put/long call position. Such an arrangement does not constitute a bona fide purchase for purpose of close-out requirement of Regulation SHO. This arrangement constitutes a stock lending arrangement with the appearance of a bona fide purchase.

Moreover, the structure of the transaction leads to the conclusion that Smith knew or had reason to know that Jones would not deliver the shares. Because the FLEX option was short term and deep in-the-money, it was clear that both parties intended for it to be exercised on the following day and that Smith would use the shares nominally purchased from Jones to satisfy the assignment. It can be imputed that Smith intended exactly this result, which was the basis for the transaction. Moreover, since ABC was a hard to borrow threshold security, if Jones had actually owned the stock, it would likely be more profitable for her to lend it through her clearing firm than to enter into the one day FLEX buy write, a fact that Smith knew or had reason to know. In sum, Michael Smith's use of a buy write with a one-day, deep-in-the-money FLEX option circumvented the Regulation SHO delivery requirements and constituted a "sham close out" which is prohibited by Rule 203(b)(3)(v) of Regulation SHO.

Martha Jones had also violated Regulation SHO because she was not entitled to the locate exemption since she was not acting as a bona fide market maker in the security. Further, by acting as counterparty to Michael Smith's "sham close out", she may have aided and abetted Smith's Regulation SHO violation and possibly engaged in fraud. Based on the facts and circumstances set forth below it would be reasonable to conclude that she knew or had reason to know that the transaction was executed in order to circumvent Smith's Regulation SHO obligations. First, Jones did not own ABC, did not perform a locate, and was unable to deliver long stock to Smith. Jones also knew, or had reason to know, that the transaction was structured such that each of their stock positions would "revert" following exercise of the FLEX call option. Immediately prior and subsequent to the FLEX buy write, Smith is short ABC stock and Jones had no position. Finally, the transaction involved no other apparent economic rationale from Smith's perspective.

Further, an executing broker who executes these transactions and knows or has reason to know that the market maker was not exempt and did not perform a locate also could be liable under Regulation SHO.<sup>4</sup> In addition, the executing broker also could be liable under federal securities laws and Phlx rules if he knew or had reason to know that the orders he was executing were intended to artificially reset the market maker's Regulation SHO obligations.

### **Written Supervisory Procedures**

While not part of the provisions of Regulation SHO, broker dealers must have updated Written Supervisory Procedures (WSPs) that encompass the broker dealer's policies on its compliance with Regulation SHO. The following is a list of the minimum or basic policies to

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<sup>4</sup> See footnote no. 65 in the Securities and Exchange Commission's Regulation SHO adopting release.

comply with Regulation SHO, that a member organization must have in place, and does not encompass all of areas of concern, which is contingent on the individual firms trading patterns:

- (1) Member Organizations policies regarding the aggregation of its trading units and whether the Firm nets long and short positions in a particular security on a firm wide basis or within defined trading units.
- (2) Member Organizations policies for order activity, distinguishing transactions as sell long, or sell short.
- (3) Member Organizations policies regarding the process for determining and documenting the “locate” prior to effecting a short sale
- (4) Member Organizations policies regarding sales that result in a Fail to Deliver for the firm, and the Firm's procedures regarding the close out of a fail to deliver within thirteen consecutive settlement days
- (5) Member Organizations policies regarding the exemption for the closing out requirements for a short sale effected to hedge, or adjust a hedge on option positions that were created prior to the time the underlying security became a threshold security.

Option market makers are urged to take appropriate steps, both in structuring complex transactions and closing out any resultant fail to deliver positions, to ensure that the transactions can be, and are, effected in a compliant manner.

This Memorandum is intended to provide an example, and an analysis of a transactions that violate Regulation SHO locate and delivery requirements, and not to provide an exhaustive list of trading activity that could be deemed violative. **The Exchange recognizes that transactions matching options with stock may be utilized as part of a legitimate hedging strategy, and we do not want to discourage their use for that purpose.** Rather we are calling attention to abusive transactions that have characteristics described above and are used in a scheme to evade Phlx or SEC Rules.

Member Organizations are encouraged to read the Decision and related Stipulation of Facts and Consent to Penalty published by the American Stock Exchange on July 31, 2007, for two disciplinary actions, each involving violations of Regulation SHO by an options market maker. These documents are available on-line at:

[http://www.amex.com/atamex/regulation/discipline/2007/SArensteinSBA\\_Decision\\_072007.pdf](http://www.amex.com/atamex/regulation/discipline/2007/SArensteinSBA_Decision_072007.pdf)  
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For questions regarding this memorandum, or other applicable matters, please contact the Department's general number at (215) 496-5188, or William Bunting, Director, Examinations Department, at (215) 496-5401.