

MEMORANDUM

TO: Members and Member Organizations

FROM: Legal Department

DATE: August 15, 2007

RE: Regulation SHO - Proposed and Final Rules Regarding
Exceptions to the Close-Out Requirement for Threshold Securities

On August 7, 2007 the Securities and Exchange Commission ("SEC" or "Commission") issued two releases concerning exceptions to the close-out requirement for threshold securities of Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act"). The releases propose certain changes to Regulation SHO and adopt others as final rules.

Regulation SHO is the SEC's regulatory framework governing short sales. It imposes a close-out requirement contained in Rule 203(b)(3) which is intended to address persistent failures to deliver securities in which a substantial amount of fails to deliver have occurred (also known as "threshold securities") on trade settlement date.

The close-out requirement was originally subject to two exceptions: the "grandfather" provision, which excepted fails to deliver established prior to a security becoming a threshold security, and 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.

On July 14, 2006 the SEC issued a release proposing to eliminate the grandfather provision and to narrow the options market maker exception.¹ The two more recent releases issued on August 7, 2007 also relate to these two proposals and are available on the Commission's website at www.sec.gov.²

¹ See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (the "Proposing Release").

² See Exchange Act Release Nos. 56212 and 56213 (August 7, 2007), 72 FR 45544 and 45558 (August 14, 2007). The two releases also make a number of other proposed and final changes relating to short sales, which will be discussed in a separate memorandum

I. Release No. 34-56212: Elimination of the “Grandfather” Exception to the Close-Out Requirement

In Release No. 34-56212, the Commission is adopting amendments to Regulation SHO to eliminate the “grandfather” exception to the close-out requirement. As amended, Rule 203 will require that all fails to deliver in threshold securities be closed out within either 13 consecutive settlement days or, in the case of a previously-grandfathered fail to deliver position in a security that is a threshold security on the effective date of the amendment, 35 consecutive settlement days from the effective date of the amendments.

The effective date of these amendments is October 15, 2007. The entire release, including the actual text of the amendments, is available on the SEC’s website at <http://www.sec.gov/rules/final.shtml>.

II. Proposed Elimination of the Options Market Maker Exception to the Close-Out Requirement

Proposed Elimination of Options Market Maker Exception

As noted above, in the July 14, 2006 Proposing Release the SEC proposed amendments to the Regulation SHO options market maker exception which would have limited the duration of the exception. In the August 7, 2007 release the SEC has re-proposed amendments to the options market maker exception that would eliminate the exception. Any previously excepted fail to deliver position in a threshold security on the effective date of the amendment, including any adjustments to that fail to deliver position, would be required to be closed out within 35 consecutive settlement days of the effective date of the amendment pursuant to a one-time phase-in period. After 35 consecutive settlement days from the effective date of the amendment the phase-in period would expire. Any additional fails to deliver in the threshold security would be subject to the current mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3). If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) , if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the proposed amendment would prohibit a 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

to Members and Member Organizations. This memorandum is limited to a summary of certain highlights of the releases.

borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. Any fails to deliver that were not previously-expected from the close-out requirement of Rule 203(b)(3) as of the effective date of the amendment and, therefore, not subject to the one-time 35 consecutive settlement day phase-in period, would be subject to the pre-borrow requirement of Rule 203(b)(3)(iv).

Potential Alternatives to Elimination of the Options Market Maker Exception

In the release the Commission stated that it anticipates that, in response to its request for comment on the proposed elimination of the options market maker exception, it will receive comment that an options market maker exception, similar to the current exception in Regulation SHO, is necessary. The release therefore also requests comments concerning two potential alternatives that, rather than eliminating the exception altogether, would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames.

Both of the potential alternatives would provide for a 35 consecutive settlement day phase-in period similar to the phase-in period discussed above for securities that are threshold securities on the effective date of the amendment and that have previously excepted fail to deliver positions. Thereafter, the first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second alternative, certain fails to deliver would be required to be closed out within the earlier of: (i) 35 consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated.

The potential alternatives would also require that participants of a registered clearing agency and options market makers document that any fails to deliver in threshold securities that have not been closed out in accordance with the 13 consecutive settlement days close-out requirement of Rule 203(b)(3) of Regulation SHO are eligible for the options market maker exception. The release states that such documentation could indicate, among other things, when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out.

Due Date for Comments

Comments on the proposed amendments, including the two potential alternatives to the proposed elimination of the options market maker exception, should be received by the Commission on or before September 13, 2007. The entire release, including the actual text of the amendments, is available on the SEC's website at <http://www.sec.gov/rules/proposed.shtml>. Any comments regarding the proposed amendments that may have been submitted electronically may also be viewed on the Commission's website at <http://www.sec.gov/comments/s7-19-07/s71907.shtml>.

Questions concerning this memorandum should be directed to Carla Behnfeldt, Director and Counsel, at (215) 496-5208.