

MEMORANDUM

TO: All Members and Member Organizations

FROM: John Dayton

DATE: October 11, 2007

RE: Amendments to Regulation SHO

Recently, the Securities and Exchange Commission (“SEC” or “Commission”) issued a release¹ 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. These amendments become effective on October 15, 2007.

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.

Close out requirements for certain securities that a seller is “deemed to own”

Currently, Regulation SHO provides for an exception from the locate requirement of Rule 203(b)(1) for situations where a broker-dealer effects a short sale on behalf of a customer that is deemed to own the security pursuant to Rule 200, although, through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date and, therefore, is a “short” sale under the marking requirements of Rule 200(g). Rule 203(b)(2)(ii) of Regulation SHO provides that in such circumstances, delivery must be made on the sale as soon as all restrictions on delivery have been removed, and in any event no later than 35 days after trade date, at which time the broker-dealer that sold on behalf of the person must either borrow securities or close out the open position by purchasing securities of like kind and quantity. If the security is a threshold security, however, any fails to deliver in the security must be closed out in accordance with the requirements of Rule 203(b)(3) of Regulation SHO, i.e., within 13 consecutive settlement days.

¹ The release is located at: <http://www.sec.gov/rules/final/2007/34-56212.pdf>.

Securities sold pursuant to Rule 144 of the Securities Act are formerly restricted securities that a seller is “deemed to own,” as defined by Rule 200(a) of Regulation SHO. The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend and, therefore, sales of these securities frequently result in fails to deliver. The Commission is amending Rule 203 of Regulation SHO to extend the close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act. In addition, the Commission is extending the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, for these fails to deliver. Thus, if the fail to deliver position persists for 35 consecutive settlement days, the amendment will prohibit a participant of a registered clearing agency, 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, 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.

The Market Decline Limitation

Regulation SHO currently provides a limited exception from the requirement that a person selling a security aggregate all of the person's positions in that security to determine whether the seller has a net long position. This provision, which is contained in Rule 200(e) of Regulation SHO, allows broker-dealers to liquidate (or unwind) certain existing index arbitrage positions involving long baskets of stocks and short index futures or options without aggregating short stock positions in other proprietary accounts if, and to the extent that, those short stock positions are fully hedged. The current exception, however, does not apply if the sale occurs during a period commencing at a time when the Dow Jones Industrial Average (“DJIA”) has declined below its closing value on the previous trading day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day. If a market decline triggers the application of Rule 200(e)(3), a broker-dealer must aggregate all of its positions in that security to determine whether the seller has a net long position.

The Commission is amending Rule 200(e)(3) of Regulation SHO to: (i) reference the NYSE Composite Index instead of the DJIA; (ii) add language to clarify how the two percent limitation is to be calculated for purposes of the market decline limitation; and (iii) provide that the market decline limitation will remain in effect for the remainder of the trading day.

The text of the rules may be found at <http://www.sec.gov/rules/final/2007/34-56212.pdf>. Questions about this memorandum may be directed to John Dayton, at (435) 783-6415.