

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 242

[Release No. 34-56212; File No. S7-12-06]

RIN 3235-AJ57

### Amendments to Regulation SHO

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is adopting amendments to Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”). The amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the grandfather provision of Regulation SHO. In addition, we are 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.

**DATES:** *Effective Date:* October 15, 2007.

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**SUPPLEMENTARY INFORMATION:** We are amending Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

### I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.<sup>1</sup> Among other things,

<sup>1</sup> 17 CFR 242.200. See also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (“Adopting Release”), available at <http://www.sec.gov/rules/final/34-50103.htm>. For more information on Regulation SHO, see “Frequently Asked Questions” and “Key Points about Regulation SHO,” available at <http://www.sec.gov/spotlight/shortsales.htm>.

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an

equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date<sup>2</sup> and to target potentially abusive “naked” short selling<sup>3</sup> in certain equity securities.<sup>4</sup> While the majority of trades settle on time,<sup>5</sup> Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might impact the market for that security.<sup>6</sup> Although high

equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

<sup>2</sup> Generally, investors must complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or “trade date plus three days”). T+3 means that when the investor purchases a security, the purchaser’s payment must be received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. Because the Commission recognized that there are many legitimate reasons why broker-dealers may not be able to deliver securities on settlement date, it adopted Rule 15c6-1, which prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1. However, failure to deliver securities on T+3 does not violate the rule.

<sup>3</sup> We have previously noted that abusive “naked” short selling, while not defined in the federal securities laws, generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle. See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (“Proposing Release”).

<sup>4</sup> In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of Sedona Corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with Sedona stock, and depressed its price. See *Rhino Advisors, Inc. & Thomas Badian*, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, *SEC v. Rhino Advisors, Inc. & Thomas Badian*, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y.). See also, Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (“2003 Proposing Release”) (describing the alleged activity in the case involving stock of Sedona Corporation); Adopting Release, 69 FR at 48016, n.76.

<sup>5</sup> According to the National Securities Clearing Corporation (“NSCC”), 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3.

<sup>6</sup> These fails to deliver may result from either short or long sales of stock. There may be many

fails levels exist only for a small percentage of issuers,<sup>7</sup> we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.

In addition, many issuers and investors continue to express concerns about extended fails to deliver in connection with “naked” short selling.<sup>8</sup>

reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. Also, broker-dealers that make a market in a security (“market makers”) and who sell short thinly-traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

<sup>7</sup> The average daily number of securities on the threshold list in March 2007 was approximately 311 securities, which comprised 0.39% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO’s current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act. NASD Rule 3210, which became effective on July 3, 2006, applies the Regulation SHO close-out framework to non-reporting equity securities with aggregate fails to deliver equal to, or greater than, 10,000 shares and that have a last reported sale price during normal trading hours that would value the aggregate fail to deliver position at \$50,000 or greater for five consecutive settlement days. See Exchange Act Release No. 53596 (April 4, 2006), 71 FR 18392 (April 11, 2006) (SR-NASD-2004-044). Consistent with the amendment to eliminate the grandfather provision of Regulation SHO, we anticipate the NASD would propose similar amendments to NASD Rule 3210.

<sup>8</sup> See, e.g., comment letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 (“Overstock”); comment letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, Taser International, dated Sept. 18, 2006 (“Taser”); comment letter from John Royce, dated April 30, 2007; comment letter from Michael Read, dated April 29, 2007; comment letter from Robert DeVivo, dated April 26, 2007; comment letter from Ahmed Akhtar, dated April 26, 2007.

To the extent that large and persistent fails to deliver might be indicative of manipulative “naked” short selling, which could be used as a tool to drive down a company’s stock price, fails to deliver may undermine the confidence of investors.<sup>9</sup> These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.<sup>10</sup> In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors’ negative perceptions regarding large and persistent fails to deliver.<sup>11</sup> Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security’s price.<sup>12</sup>

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to securities in which a substantial amount of fails to deliver have occurred (also known as “threshold securities”).<sup>13</sup> As

<sup>9</sup> See, e.g., comment letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (“NCANS”); comment letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (“State of Connecticut”) (discussing the impact of fails to deliver on investor confidence).

<sup>10</sup> See, e.g., comment letter from Congressman Tom Feeney, Florida, U.S. House of Representatives, dated Sept. 25, 2006 (“Feeney”) (expressing concern about potential “naked” short selling on capital formation, claiming that “naked” short selling causes a drop in an issuer’s stock price and may limit the issuer’s ability to access the capital markets); comment letter from Zix Corporation, dated Sept. 19, 2006 (“Zix”) (stating that “[m]any investors attribute the Company’s frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company “do something” about the perceived manipulative short selling. This perception that manipulative short selling of the Company’s securities is continually occurring has undermined the confidence of many of the Company’s investors in the integrity of the market for the Company’s securities”).

<sup>11</sup> Due, in part, to such concerns, issuers have taken actions to attempt to make transfer of their securities “custody only,” thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (“DTC”) or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

<sup>12</sup> See also, Proposing Release, 71 FR at 41712 (discussing the potential impact of large and persistent fails to deliver on the market). See also, 2003 Proposing Release, 68 FR at 62975 (discussing the potential impact of “naked” short selling on the market).

<sup>13</sup> A threshold security is defined in Rule 203(c)(6) of Regulation SHO as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78b) or for which the issuer is required to file reports pursuant to section

adopted in August 2004, Rule 203(b)(3) of Regulation SHO included two exceptions to the mandatory close-out requirement. The first was the “grandfather” provision, which excepted fails to deliver established prior to a security becoming a threshold security;<sup>14</sup> and the second was 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.<sup>15</sup>

At the time of Regulation SHO’s adoption, the Commission stated that it would monitor the operation of Regulation SHO, particularly whether grandfathered fail to deliver positions were being cleared up under the existing delivery and settlement requirements or whether any further regulatory action with respect to the close-out provisions of Regulation SHO was warranted.<sup>16</sup> In addition, with respect to the options market maker exception, the Commission noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission’s original expectations.<sup>17</sup>

Since Regulation SHO’s effective date in January 2005, the Commission’s staff (“Staff”) and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.<sup>18</sup>

15(d) of the Exchange Act (15 U.S.C. 78o(d)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue’s total shares outstanding; and is included on a list (“threshold securities list”) disseminated to its members by a self-regulatory organization (“SRO”). See 17 CFR 242.203(c)(6). Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

<sup>14</sup> The “grandfathered” status applied in two situations: (1) to fail positions occurring before January 3, 2005, Regulation SHO’s effective date; and (2) to fail positions that were established on or after January 3, 2005 but prior to the security appearing on a threshold securities list. See 17 CFR 242.203(b)(3)(i).

<sup>15</sup> 17 CFR 242.203(b)(3)(ii).

<sup>16</sup> See Adopting Release, 69 FR at 48018.

<sup>17</sup> See *id.* at 48019.

<sup>18</sup> For example, in comparing a period prior to the effective date of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to March 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

However, despite this positive impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements. Allowing these persistent fails to deliver to continue indefinitely may lead to greater uncertainty about the fulfillment of the settlement obligation.<sup>19</sup> While some delays in closing out may be understandable and necessary, a seller should deliver shares to close out its sale within a reasonable time period.

Based, in part, on the results of examinations conducted by the Staff and SROs, as well as our desire to reduce large and persistent fails to deliver, on July 14, 2006, we proposed revisions to Regulation SHO that would modify Rule 203(b)(3) by eliminating the grandfather provision and narrowing the options market maker exception.<sup>20</sup> The proposed amendments were intended to reduce the number of persistent fails to deliver attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception.

The proposals were based, in part, on data collected by the National Association of Securities Dealers, Inc. (“NASD”), as well as concerns about the persistence of certain securities on the threshold securities lists.<sup>21</sup> However, in response to commenters’ concerns regarding the public availability of data relied on by the Commission, on March 26, 2007 we re-opened the comment period to the Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the NASD’s findings that the NASD had submitted to the public file on March 12, 2007. In addition, the notice regarding the re-opening of the

- The average daily aggregate fails to deliver declined by 29.5%;
- The average daily number of securities with aggregate fails to deliver of at least 10,000 shares declined by 5.8%;
- The average daily number of fails to deliver declined by 15.1%;
- The average age of a fail to deliver position declined by 25.5%;
- The average daily number of threshold securities declined by 39.0%; and
- The average daily fails to deliver of threshold securities declined by 52.9%.

See also, *supra* n. 7.

<sup>19</sup> See Adopting Release, 69 FR at 48016–48017; see also, 2003 Proposing Release, 68 FR at 62977–62978 (discussing the Commission’s belief that the delivery requirements of proposed Regulation SHO would protect and enhance the operation, integrity and stability of the markets and the clearance and settlement system, and protect buyers of securities by curtailing “naked” short selling).

<sup>20</sup> See Proposing Release, 71 FR 41710.

<sup>21</sup> See Proposing Release, 71 FR at 41712.

comment period directed the public's attention to brief summaries of data collected by the Commission's Office of Compliance Inspections and Examinations and the New York Stock Exchange LLC ("NYSE").<sup>22</sup>

The proposals included a 35 settlement day phase-in period following the effective date of the amendment intended to provide additional time to begin closing out certain previously-excepted fails to deliver. In addition, the proposals included an amendment to update the market decline limitation referenced in Rule 200(e)(3) of Regulation SHO.<sup>23</sup> The Commission also included in the Proposing Release a number of requests for comment, including whether the Commission should amend Regulation SHO to extend the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act of 1933 (the "Securities Act").<sup>24</sup>

We received over 1,000 comment letters in response to the Proposing Release.<sup>25</sup> As discussed below, after considering the comments received and the purposes underlying Regulation SHO, we are adopting the amendments to the grandfather provision and the market decline limitation, with some modifications to refine provisions and address commenters' concerns. However, in a separate companion release, we are re-proposing amendments to the options market maker exception.<sup>26</sup> In addition, we are adopting amendments to the close-out requirement of Regulation SHO for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

<sup>22</sup> See Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007) ("Regulation SHO Re-Opening Release"). We received a number of comment letters in response to the Regulation SHO Re-Opening Release, most of which urged the Commission to take action on the proposed amendments to eliminate the grandfather provision and narrow the options market maker exception. Comment letters, including the comments of the NASD, are available on the Commission's Internet Web Site at <http://www.sec.gov/comments/s7-12-06/s71206.shtml>. See also, Memorandum from the Commission's Office of Economic Analysis regarding Fails to Deliver Pre- and Post-Regulation SHO (dated August 21, 2006), which is available on the Commission's Internet Web Site at <http://www.sec.gov/spotlight/failstodeliver082106.pdf>.

<sup>23</sup> 17 CFR 242.200(e)(3).

<sup>24</sup> 17 CFR 230.144.

<sup>25</sup> The comment letters are available on the Commission's Internet Web Site at <http://www.sec.gov/comments/s7-12-06/s71206.shtml>.

<sup>26</sup> See Exchange Act Release No. 56213 (Aug. 7, 2007)

## II. Overview of Regulation SHO

### A. Rule 203(b)(3)'s Close-out Requirement

One of Regulation SHO's primary goals is to reduce fails to deliver in those securities with a substantial amount of fails to deliver by imposing additional delivery requirements on those securities.<sup>27</sup> We believe that additional delivery requirements help protect and enhance the operation, integrity and stability of the markets, as well as reduce short selling abuses.

Regulation SHO requires certain persistent fail to deliver positions to be closed out. Specifically, Rule 203(b)(3)'s close-out requirement provides that a participant of a clearing agency registered with the Commission<sup>28</sup> must take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement ("CNS")<sup>29</sup> system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.<sup>30</sup> In addition, if the

<sup>27</sup> See Adopting Release, 69 FR at 48009.

<sup>28</sup> For purposes of Regulation SHO, the term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24). The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A), 78q-1 and 15 U.S.C. 78q-1(b), respectively. See also, Adopting Release, 69 FR at 48031. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

<sup>29</sup> The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The NSCC clears and settles the majority of equity securities trades conducted on the exchanges and over the counter. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the counterparty to both sides of the transaction. While NSCC's rules do not authorize it to require member firms to close out or otherwise resolve fails to deliver, NSCC reports to the SROs those securities with fails to deliver of 10,000 shares or more. The SROs use NSCC fails data to determine which securities are threshold securities for purposes of Regulation SHO.

<sup>30</sup> 17 CFR 242.203(b)(3).

failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, prohibits the 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 borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.<sup>31</sup>

### B. Grandfathering Under Regulation SHO

As originally adopted, Rule 203(b)(3)'s close-out requirement did not apply to positions that were established prior to the security becoming a threshold security.<sup>32</sup> This is known as grandfathering. Grandfathered positions included those that existed prior to the January 3, 2005 effective date of Regulation SHO, and to positions established prior to a security becoming a threshold security.<sup>33</sup> Regulation SHO's grandfathering provision was adopted because the Commission was concerned about creating volatility through short squeezes<sup>34</sup> if large pre-existing fail to deliver positions had to be closed out

<sup>31</sup> 17 CFR 242.203(b)(3)(iii). It is possible under Regulation SHO that the close out by the participant of a registered clearing agency may result in a failure to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. However, Regulation SHO prohibits a participant of a registered clearing agency from engaging in "sham close outs" by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a failure to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, which thus creates another fail to deliver position. 17 CFR 242.203(b)(3)(v); see also, Adopting Release, 69 FR at 48018 n.96. In addition, we note that borrowing securities, or otherwise entering into an agreement 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 paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement.

<sup>32</sup> 17 CFR 242.203(b)(3)(i).

<sup>33</sup> See Adopting Release, 69 FR at 48018. However, any new fails to deliver in a security on a threshold securities list are subject to the mandatory close-out provisions of Rule 203(b)(3) of Regulation SHO.

<sup>34</sup> The term short squeeze refers to the pressure on short sellers to cover their positions as a result of sharp price increases or difficulty in borrowing the security the sellers are short. The rush by short sellers to cover produces additional upward pressure on the price of the stock, which then can cause an even greater squeeze. Although some short squeezes may occur naturally in the market, a scheme to manipulate the price or availability of stock in order to cause a short squeeze is illegal.

quickly after a security became a threshold security.

### C. Regulation SHO's Options Market Maker Exception

In addition, Regulation SHO's options market maker exception excepts from the close-out requirement of Rule 203(b)(3) any fail to deliver position in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security.<sup>35</sup> The options market maker exception was created to address concerns regarding liquidity and the pricing of options. The exception does not require that such fails be closed out.

## III. Discussion of Amendments to Regulation SHO

### A. Grandfather Provision

#### 1. Proposal

To further Regulation SHO's goal of reducing persistent fails to deliver, the Commission proposed to eliminate the grandfather provision in Rule 203(b)(3)(i) of Regulation SHO.<sup>36</sup> In particular, the proposed amendment would require that any previously-grandfathered fails to deliver in a security that is on a threshold list on the effective date of the amendment be closed out within 35 consecutive settlement days<sup>37</sup> of the effective date of the amendment. In addition, similar to the pre-borrow requirement in Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position has persisted for 35 consecutive settlement days from the effective date of the amendment, the proposal 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 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.

<sup>35</sup> 17 CFR 242.203(b)(3)(ii).

<sup>36</sup> See Proposing Release, 71 FR 41710.

<sup>37</sup> The Commission chose 35 settlement days because 35 days is used in the current rule (although for a different purpose) and to allow participants additional time to close out their previously-grandfathered fails to deliver, given that some participants may have large previously-exceptioned fails to deliver with respect to a number of securities.

However, if a security becomes a threshold security after the effective date of the amendment, any fails to deliver in that security that occurred prior to the security becoming 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.

#### 2. Comments

We received a large number of comment letters regarding the proposal to eliminate the grandfather provision. The comments were from numerous entities, including issuers, retail investors, broker-dealers, SROs, associations, members of Congress, and other elected officials. Commenters expressed both support<sup>38</sup> and opposition<sup>39</sup> to the proposal to eliminate the grandfather provision.

<sup>38</sup> See, e.g., comment letter from Overstock, *supra* note 8; comment letter from Taser, *supra* note 8; comment letter from Barry McCarthy, Chief Financial Officer, Netflix, Inc., dated Sept. 19, 2006; comment letter from Glenn W. Rollins, President, Orkin, Inc., dated Aug. 29, 2006; comment letter from Zix, *supra* note 10; comment letter from Joseph P. Borg, Esq., President, North American Securities Administrators Association, Inc., dated Oct. 4, 2006 ("NASAA"); comment letter from Paul Rivett, Vice President, Fairfax Financial Holdings, Ltd., Sept. 19, 2006; comment letter from State of Connecticut, *supra* note 9; comment letter from John G. Gaine, President, MFA, dated Sept. 19, 2006 ("MFA"); comment letter from James J. Angel, Ph.D., Associate Professor of Finance, McDonough School of Business, Georgetown University, dated July 18, 2006 ("Angel"); comment letter from NCANS, *supra* note 9; comment letter from Simon Lorne, Chief Legal Officer, and Martin Schwartz, Chief Compliance Officer, Millennium Partners, LP, dated Oct. 10, 2006; comment letter from David C. Chavern, Capital Markets Program, U.S. Chamber of Commerce, dated Sept. 13, 2006; comment letter from Jeffrey D. Stacey, Managing Director, Jeffrey D. Stacey Associates, Ltd., dated Sept. 19, 2006; comment letter from Congressman Rodney Alexander—Louisiana, U.S. House of Representatives, dated July 28, 2006; comment letter from Senator Orin Hatch—Utah, U.S. Senate, dated Sept. 19, 2006; comment letter from Feeney, *supra* note 10; comment letter from Congressman Virgil Goode, Jr.—Virginia, U.S. House of Representatives, dated Sept. 13, 2006; comment letter from Congresswoman Sue Kelly—New York, U.S. House of Representatives, dated Sept. 19, 2006; letter from Congressman Jim Ryun—Kansas, U.S. House of Representatives, dated Sept. 18, 2006; comment letter from Congressman Jim Matheson—Utah, U.S. House of Representatives, dated Sept. 19, 2006; comment letter from Governor Jon M. Huntsman, Governor of Utah, dated Sept. 8, 2006; comment letter from Mark L. Shurtleff, Attorney General for the State of Utah, dated Sept. 18, 2006; and comment letter from Wayne Klein, Director, Division of Securities, State of Utah, dated Sept. 13, 2006 ("Utah Division of Securities").

<sup>39</sup> See, e.g., comment letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated Sept. 19, 2006 ("SIA"); comment letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association Section of Business Law, dated Sept. 27, 2006 ("ABA"); comment letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options

Some of the commenters that supported eliminating the grandfather provision stated that the proposal would restore investor confidence and that it would not cause excessive volatility.<sup>40</sup> For example, one commenter stated that elimination of the grandfather provision should not cause excessive volatility because, according to the commenter, the Depository Trust & Clearing Corporation ("DTCC") and market participants have said that fails to deliver are a small problem.<sup>41</sup> Another commenter stated that the Commission's concern over potential short squeezes is "misplaced," as this is a risk short sellers assume when they sell short.<sup>42</sup> Many commenters supported the proposed 35-day phase-in period for certain previously-grandfathered fails to deliver;<sup>43</sup> although some commenters stated their belief that a phase-in period was unnecessary.<sup>44</sup>

Commenters opposing the elimination of the grandfather provision did so for various reasons. For example, one commenter stated that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.<sup>45</sup> Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempt to close out positions.<sup>46</sup> This commenter also stated that eliminating the grandfather provision would negatively impact bona fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.<sup>47</sup> According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.<sup>48</sup> Another commenter maintained that eliminating the grandfather provision

Exchange, dated Oct. 11, 2006 ("CBOE"); comment letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS Securities LLC, dated Sept. 22, 2006 ("UBS"); comment letter from Leonard J. Amoroso, Senior Managing Director and Chief Compliance Officer, Knight Capital Group, Inc., dated Sept. 20, 2006 ("Knight").

<sup>40</sup> See comment letters from MFA, *supra* note 38; NCANS, *supra* note 9; State of Connecticut, *supra* note 9.

<sup>41</sup> See comment letter from NCANS, *supra* note 9.

<sup>42</sup> See comment letter from H. Glenn Bagwell, Jr., Esq., Sept. 19, 2006.

<sup>43</sup> See, e.g., comment letters from NCANS, *supra* note 9; Taser, *supra* note 8; Overstock, *supra* note 8.

<sup>44</sup> See, e.g., comment letters from NASAA, *supra* note 38; Utah Division of Securities, *supra* note 38; Zix, *supra* note 10.

<sup>45</sup> See comment letter from CBOE, *supra* note 39.

<sup>46</sup> See comment letter from Knight, *supra* note 39.

<sup>47</sup> See *id.*

<sup>48</sup> See *id.*

would cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive “naked” short sellers.<sup>49</sup>

Some commenters stated that the proposal is an overly broad means of addressing the issue of substantial, persistent fails to deliver that may occur in only a small subset of threshold securities and that, in fact, the available data shows that the proposal is not necessary.<sup>50</sup> These commenters also stated their belief that a more targeted approach, such as tracking actual “naked” short sales, would be a more appropriate method of addressing the issue of fails to deliver. Another commenter stated that the Commission had not explained the need for the proposal and had not provided substantial evidence showing that persistent fails to deliver are primarily attributable to the grandfather provision.<sup>51</sup> However, as discussed in more detail below, even those commenters opposing the elimination of the grandfather provision suggested alternative proposals to elimination for the Commission to consider. For example, one commenter suggested allowing for a period longer than 13 consecutive settlement days within which to close out all fails to deliver currently excepted from the close-out requirement due to the grandfather provision.<sup>52</sup>

### 3. Adoption

After careful consideration of the comments, we are adopting the amendment to eliminate the grandfather provision as proposed. As adopted, the amendment eliminates the grandfather provision from Regulation SHO and amends Rule 203 to 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 amendment.<sup>53</sup>

For the reasons discussed above and in the Proposing Release, we believe that no fail to deliver position should be left open indefinitely. While some delays in closing out may be understandable and necessary, a seller should deliver shares to close out a sale within a reasonable time period. Thus, we believe the adoption of the amendment as proposed is warranted and strikes the appropriate balance between reducing large and persistent fails to deliver in threshold securities and still providing participants flexibility and advance notice to close out the originally grandfathered fails to deliver. While the amendments may have some potential impact on liquidity, we believe the advance notice and flexibility provided by the amendments will limit any impact on liquidity of requiring market participants to close out such previously-grandfathered fails to deliver.

Commenters opposing the elimination of the grandfather provision contended that elimination of the grandfather provision could lead to increased volatility, a reduction in liquidity, and short squeezes in these securities as individuals attempt to close out positions. Although we recognize that elimination of the grandfather provision could have these potential effects, we believe the benefits of requiring that fails to deliver not be allowed to continue indefinitely justify these potential effects. In addition, we believe that such effects, if any, would be minimal.

First, we believe that the potential effects, if any, of eliminating the grandfather provision will be minimal because the number of securities that will be impacted by elimination of the grandfather provision will be relatively small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).<sup>54</sup> Requiring close out only for securities

with large and persistent fails to deliver limits the overall market impact. Moreover, the amendment only impacts those fails to deliver in threshold securities that were created before the security became a threshold security. Because the current grandfather provision has a limited application, the overall impact of its removal on liquidity, volatility, and short squeezes, is expected to be minimal, if any.

Second, to the extent that the amendment could result in a decrease in liquidity, increased volatility, or short squeezes, we believe that any such potential effects will likely be mitigated by the fact that even though fails to deliver that were previously-grandfathered from the close-out requirement of Regulation SHO will no longer be permitted to continue indefinitely, such fails to deliver will not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)'s mandatory close-out requirement, both new and previously-grandfathered fails to deliver in threshold securities will have 13 consecutive settlement days within which to be closed out.

Third, as noted above, the grandfather provision excepts from Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement only those fails to deliver created before the security became a threshold security. Thus, it does not apply to fails to deliver created after the security became a threshold security. In examining the application of the current mandatory close-out requirement of Regulation SHO for all non-grandfathered fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-grandfathered fails to deliver in threshold securities has negatively impacted liquidity or volatility in these securities, or resulted in short squeezes.

Fourth, to the extent that elimination of the grandfather provision results in decreased liquidity, or increased volatility in certain securities, or results in short squeezes, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive “naked” short selling. The deprivation of the benefits of ownership, as well as the perception that abusive “naked” short selling is

amendment will 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 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. For those fails to deliver not subject to the 35 consecutive settlement day phase-in period, Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, will apply to fail to deliver positions in threshold securities that persist beyond the 13 consecutive settlement day mandatory close-out requirement.

<sup>54</sup> See *supra* note 7 (discussing the number of threshold securities as of March 31, 2007).

<sup>49</sup> See comment letter from UBS, *supra* note 39.

<sup>50</sup> See, e.g., comment letter from Knight, *supra* note 39.

<sup>51</sup> See comment letter from ABA, *supra* note 39; see also, *supra* note 22 (discussing the Regulation SHO Re-Opening Release).

<sup>52</sup> See, e.g., comment letters from CBOE, *supra* note 39; SIA, *supra* note 39; Knight, *supra* note 39; UBS, *supra* note 39. See also, Section III.A.3., discussing these alternative proposals.

<sup>53</sup> In addition, similar to the proposed amendment and Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, the

occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Some commenters expressed concern about "naked" short selling causing a drop in an issuer's stock price, which may limit an issuer's ability to access the capital markets.<sup>55</sup> We believe that by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing some to continue indefinitely, there will likely be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the amendments are expected to improve investor confidence about the security. We also believe that the amendments will lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

#### Alternative Proposals

Some commenters suggested alternative close-out requirements to the proposed amendment to eliminate the grandfather provision of Regulation SHO. For example, one commenter suggested that all fails to deliver in threshold securities, whether or not grandfathered, be closed out within 20 consecutive settlement days.<sup>56</sup> Although 20 consecutive settlement days would provide a uniform close-out requirement, we believe that it would be unwise to extend the close-out requirement to 20 consecutive settlement days because the current industry practice is to close out non-grandfathered fails to deliver in threshold securities within 13 consecutive settlement days and, for the most part, firms appear to be complying with this requirement. Also, it would extend the time in which a fail to deliver position would be permitted to persist, which is contrary to our goal of further reducing fails to deliver in threshold securities within a reasonable period of time. In addition, the current close-out requirement has led to a

significant reduction in fails to deliver in threshold securities and, therefore, we do not believe it is appropriate to extend the close-out requirement beyond 13 consecutive settlement days.<sup>57</sup>

As another alternative to the proposed amendment, this commenter also recommended that the Commission require that all fails to deliver that exist prior to the security becoming a threshold security be closed out within 35 consecutive settlement days.<sup>58</sup> Under this alternative, all new fail to deliver positions in threshold securities would be subject to the current 13 consecutive settlement day close out requirement; however, it would allow all fails to deliver that occur prior to the security becoming a threshold security to be closed out within 35 consecutive settlement days. We believe that this two-track approach to the close out requirement of Regulation SHO would be difficult to apply and monitor for compliance.

Another option suggested by commenters was to modify the proposal to have it address only threshold securities that have a high level of persistent fails to deliver, rather than all threshold securities. Under this alternative, a previously-grandfathered fail to deliver position in a threshold security would only become subject to the mandatory close-out requirement if the threshold security has a substantial number of fails to deliver and consistently remains on the threshold list for an extended period of time. The number of securities that are threshold securities is already a small number of securities. For example, in March 2007, the average daily number of securities on the threshold list was approximately 311 securities, which comprised 0.39% of all equity securities, and 2.33% of those securities subject to Regulation SHO. The number of threshold securities with a high level of persistent fails to deliver would be an even smaller number. Thus, we do not believe that this alternative would effectively achieve the Commission's goal of further reducing fails to deliver in all threshold securities.

#### B. Options Market Maker Exception

The Commission proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.<sup>59</sup> Based on comments to

the proposed amendments, we have determined at this time to re-propose amendments to the options market maker exception that would eliminate the exception.<sup>60</sup> In addition, in the re-proposal we request comment regarding specific alternatives to eliminating the options market maker exception that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames. We look forward to receiving comments regarding these proposed amendments to the options market maker exception.

#### C. Amendments to Rule 200(e)

##### 1. Proposal

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.<sup>61</sup> 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.<sup>62</sup> If a market decline triggers the

<sup>60</sup> See Exchange Act Release No. 56213 (Aug. 7, 2007).

<sup>61</sup> To qualify for the exception under Rule 200(e), the liquidation of the index arbitrage position must relate to a securities index that is the subject of a financial futures contract (or options on such futures) traded on a contract market, or a standardized options contract, notwithstanding that such person may not have a net long position in that security. 17 CFR 242.200(e).

<sup>62</sup> Specifically, the exception under Rule 200(e) is limited to the following conditions: (1) The index arbitrage position involves a long basket of stock and one or more short index futures traded on a board of trade or one or more standardized options contracts; (2) such person's net short position is solely the result of one or more short positions created and maintained in the course of bona-fide arbitrage, risk arbitrage, or bona-fide hedge activities; and (3) the sale does not occur during a period commencing at the time that the DJIA has declined below its closing value on the previous day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day. *Id.*

The two percent market decline restriction was included in Rule 200(e)(3) so that the market could avoid incremental temporary order imbalances during volatile trading days. Regulation SHO

<sup>55</sup> See, e.g., comment letter from Feeney, *supra* note 10.

<sup>56</sup> See comment letter from SIA, *supra* note 39.

<sup>57</sup> See, e.g., *supra* note 18 (providing data regarding the impact of Regulation SHO since adoption).

<sup>58</sup> See comment letter from SIA, *supra* note 39.

<sup>59</sup> See Proposing Release, 71 FR 41710.

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.<sup>63</sup>

The reference to the DJIA in the Commission's rule was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions).<sup>64</sup> However, on August 24, 2005, the Commission approved an amendment to NYSE Rule 80A to use the NYSE Composite Index ("NYA") to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA.<sup>65</sup> As noted in the Commission's approval order, according to the NYSE, the NYA is a better reflection of market activity with respect to the S&P 500 and, therefore, is a better indicator as to when the restrictions on index arbitrage trading provided by NYSE Rule 80A should be triggered.<sup>66</sup>

In addition, NYSE Rule 80A provides that the two percent limitation in that rule must be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter.<sup>67</sup> As adopted, Rule 200(e)(3) of Regulation SHO did not refer to the basis for determining the two percent limitation in the rule.

Because the Commission approved the change to NYSE Rule 80A to reference the NYA rather than the DJIA and because we believe that this is an appropriate index to reference for purposes of Rule 200(e)(3) of Regulation SHO, the Commission proposed to amend Rule 200(e)(3) to: (i) Reference the NYA instead of the DJIA; and (ii) add language to clarify that the two percent limitation is to be calculated in accordance with NYSE Rule 80A. The proposed amendments are intended to maintain consistency with NYSE Rule 80A so that market participants need refer to only one index in connection

Adopting Release, 69 FR at 48011. The two percent market decline restriction limits temporary order imbalances at the close of trading on a volatile trading day and at the opening of trading on the following day, since trading activity at these times may have a substantial effect on the market's short-term direction. The two percent safeguard also provides consistency within the equities markets. *Id.*

<sup>63</sup> See 17 CFR 242.200(e)(3); Regulation SHO Adopting Release, 69 FR at 48012.

<sup>64</sup> See 2003 Proposing Release, 68 FR at 62994–62995 (discussing proposed Rule 200 regarding netting and the liquidation of index arbitrage activities and changes to the language of the rule text to keep the language consistent with the language in NYSE Rule 80A).

<sup>65</sup> See Exchange Act Release No. 52328 (Aug. 24, 2005), 70 FR 51398 (Aug. 30, 2005).

<sup>66</sup> See *id.*

<sup>67</sup> See *id.* See also, NYSE Rule 80A (Supplementary Material .10).

with restrictions regarding index arbitrage trading.

## 2. Comments

The Commission received four comment letters addressing the proposed amendment to Rule 200(e) of Regulation SHO. Three of the four commenters supported the proposed amendment. While one of these commenters supported the amendment as proposed,<sup>68</sup> the other two commenters suggested revisions that would make the provision more consistent with NYSE Rule 80A by providing that the restriction be terminated at the end of the trading day rather than upon the establishment of the closing value of the NYA on the next succeeding trading day, as provided in the current rule.<sup>69</sup> One commenter suggested that the Commission examine whether to retain Rule 200(e) at all.<sup>70</sup>

## 3. Adoption

After considering the above comments, we are amending Rule 200(e)(3) of Regulation SHO to: (i) Reference the NYA 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. As adopted, Rule 200(e) will reference the NYA instead of the DJIA. In the Proposing Release, we proposed that Rule 200(e)(3) of Regulation SHO state that the two percent be calculated pursuant to NYSE Rule 80A. We have determined, however, that it is more appropriate to describe in the rule text how the two percent must be calculated rather than referring to NYSE Rule 80A. Thus, the amendments provide that the two percent limitation is to be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter. In response to commenter concerns regarding maintaining consistency with NYSE Rule 80A, we are also amending Rule 200(e) to provide that the market decline limitation will terminate at the end of the trading day rather than upon the establishment of the closing value of the

<sup>68</sup> See, e.g., comment letter from UBS, *supra* note 39.

<sup>69</sup> See comment letters from SIA, *supra* note 39; CBOE, *supra* note 39.

<sup>70</sup> See comment letter from Angel, *supra* note 38 (stating that in today's fast markets, there are better ways of managing volatility than "kludges" like Rule 200(e) and other circuit breakers).

NYA on the next succeeding trading day.

## D. Amendments to Rule 203 for Sales of Securities Pursuant to Rule 144

### 1. Proposal

In the Proposing Release we asked whether we should amend Rule 203 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. 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).<sup>71</sup> 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.<sup>72</sup> 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.<sup>73</sup>

### 2. Comments

The majority of commenters who responded to this request for comment supported extending the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold

<sup>71</sup> Pursuant to Rule 200(g)(2) of Regulation SHO, as adopted in August 2004, generally these sales were marked "short exempt." See Adopting Release, 69 FR at 48030–48031; *but cf.* Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348 (July 3, 2007) (removing the "short exempt" marking requirement).

<sup>72</sup> See 17 CFR 242.203(b)(2)(ii). In the Adopting Release, the Commission stated that it believed that 35 calendar days is a reasonable outer limit to allow for restrictions on a security to be removed if ownership is certain. In addition, the Commission noted that Section 220.8(b)(2) of Regulation T of the Federal Reserve Board allows 35 calendar days to pay for securities delivered against payment if the delivery delay is due to the mechanics of the transactions. See Adopting Release, 69 FR at 48015, n.72.

<sup>73</sup> See 17 CFR 242.203(b)(3).

securities pursuant to Rule 144 of the Securities Act.<sup>74</sup>

Commenters that supported extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act stated that these are legitimate long sale transactions that fail to settle within the normal 3-day settlement cycle only because of the time necessary to transfer the securities.<sup>75</sup> One commenter stated that the current requirement in Regulation SHO to close out *all* fails in threshold securities that remain for 13 consecutive settlement days, including fails resulting from sales of securities which the seller owns, has imposed serious unintended consequences on clearing firms and the broker-dealer and non-broker-dealer customers for which they clear.<sup>76</sup> Another commenter noted that these types of transactions do not reflect any of the abusive short sale transactions targeted by Regulation SHO since the seller has an ownership position in the security being sold and, therefore, no incentive to depress the price of the security.<sup>77</sup> In addition, commenters noted that clearing firms may have to effect buy-ins even though the security will be available for delivery as soon as the restrictions on sale have been removed.<sup>78</sup> Another commenter stated that it believes that all sellers who actually own a security and are permitted a maximum of 35 days after trade date to deliver such securities to their broker-dealer in accordance with Rule 203(b)(2)(ii) of Regulation SHO, not just owners of securities eligible for resale under Rule 144, should be free from the risk of being bought in.<sup>79</sup>

However, some commenters opposed allowing a longer period for closing out fails to deliver in threshold securities sold pursuant to Rule 144 of the Securities Act. These commenters stated their belief that legended shares should not be sold until the legend has been

<sup>74</sup> A few commenters, namely NASAA and some retail investors, opposed allowing additional time for delivery of these types of threshold securities. See, e.g., comment letter from NASAA, *supra* note 38.

<sup>75</sup> See, e.g., comment letters from UBS, *supra* note 39; Knight, *supra* note 39.

<sup>76</sup> For example, one commenter noted that firms have discovered in numerous instances that their CNS fail positions in threshold securities are attributable to situations where sales are effected pursuant to Rule 144 of the Securities Act; however, due to delays in getting the restricted legend removed from the certificates (or other such delays outside the seller's control), such shares are not available for a period of time after settlement date. See comment letter from SIA, *supra* note 39.

<sup>77</sup> See comment letter from UBS, *supra* note 39.

<sup>78</sup> See comment letter from SIA, *supra* note 39.

<sup>79</sup> See comment letter from ABA, *supra* note 39.

removed.<sup>80</sup> Commenters also stated that, because sellers are free to borrow shares to deliver while they await receipt of their securities from the transfer agent, any additional time for delivery is unnecessary.<sup>81</sup> One commenter stated that given that "most 144 sellers are insiders who have received their stocks at very low prices," it is "both fair and in the interests of ensuring market integrity and confidence to expect them to bear the cost of borrowing shares until delivery of unrestricted stock."<sup>82</sup> Another commenter stated that the exception allows Rule 144 shares to be used as collateral for delivery failures, and stated that any errors, difficulties, inconveniences and expense in having restrictions lifted should be borne by the owner of the restricted securities.<sup>83</sup>

### 3. Adoption

While commenters raise valid concerns, we believe that adopting the amendments is justified by the benefit of permitting the orderly settlement of fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act without causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for a sizeable amount). Thus, we are 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, because we are extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144, we are also 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.

<sup>80</sup> See, e.g., comment letters from NASAA, *supra* note 38; NCANS, *supra* note 9.

<sup>81</sup> See comment letters from Utah Division of Securities, *supra* note 38; NASAA, *supra* note 38.

<sup>82</sup> Comment letter from NASAA, *supra* note 38.

<sup>83</sup> See comment letter from Thomas Vallarino, dated May 5, 2007.

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. Following our review of the comment letters, and based on our understanding of industry practices, we understand that such processing delays, which are often out of the seller's and broker-dealer's control, frequently result in delivery taking longer than 13 consecutive settlement days. We believe, however, that 35 consecutive settlement days will provide sufficient time for delivery of these securities.

We believe that extending the current close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of these securities will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market.

Although this amendment will allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act 35 rather than 13 consecutive settlement days in which to be closed out, these fails to deliver must be closed out within 35 consecutive settlement days and, therefore, these fails to deliver cannot continue indefinitely. Thus, we believe that this amendment is consistent with our goal of further reducing fails to deliver in threshold securities, while balancing the concerns associated with closing out fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act.

## IV. Paperwork Reduction Act

The amendments to Regulation SHO will not impose a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>84</sup>

<sup>84</sup> 44 U.S.C. 3501 *et seq.*



## V. Cost-Benefit Analysis

We are sensitive to the costs and benefits of our rules and we have considered the costs and the benefits of the amendments to Regulation SHO. In order to assist us in evaluating the costs and benefits, in the Proposing Release, we encouraged commenters to discuss any costs or benefits that the amendments might impose. In particular, we requested comment on the potential costs for any modifications to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants. Commenters were encouraged to provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Regulation SHO. We did not receive any comments providing specific cost or benefit estimates.

### A. Amendments to Rule 203(b)(3)'s Delivery Requirements

#### 1. Amendment to Rule 203(b)(3)(i)'s Grandfather Provision

##### a. Benefits

As adopted, the amendment eliminates the grandfather provision from Regulation SHO and amends Rule 203 to require that all fails to deliver be closed out within either 13 consecutive settlement days or, in the case of a previously-grandfathered fails to deliver in a security that is on the threshold list on the effective date of the amendment, 35 consecutive settlement days from the effective date of the amendment.<sup>85</sup>

We believe the amendment strikes the appropriate balance between reducing fails to deliver in threshold securities from persisting for extended periods of time and still providing participants flexibility and advance notice to close out the previously-grandfathered fails to deliver. While some delays in closing out may be understandable and

necessary, a seller should deliver shares to the buyer within a reasonable time period. Although high fails levels exist only for a small percentage of issuers,<sup>86</sup> we are concerned that persistent fails to deliver may have a negative effect on the market in these securities. For example, persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that may have been priced differently. Moreover, sellers that fail to deliver securities on trade settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security.

We believe the amendment will benefit investors by facilitating the receipt of shares so that more investors receive the benefits associated with share ownership. The amendment may enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities will be delivered as expected. An increase in investor confidence in the market may facilitate investment.

We believe the amendment will also benefit issuers. A high level of persistent fails to deliver in a security may be perceived by potential investors negatively and may affect their decision about making a capital commitment.<sup>87</sup> Some issuers may believe they have endured unwarranted reputational damage due to investors' negative perceptions regarding a security having a large fail to deliver position and becoming a threshold security.<sup>88</sup> Thus, issuers may believe that elimination of the grandfather provision will restore their good name. Some issuers may also believe that large and persistent fails to deliver indicate that they have been the target of potentially manipulative conduct as a result of "naked" short sales.<sup>89</sup> Thus, elimination of the grandfather provision may decrease the possibility of artificial market influences

and, therefore, may contribute to price efficiency.

We believe the 35 day phase-in period will reduce disruption to the market and foster greater market stability because it gives participants a sufficient length of time to effect purchases to close out grandfathered positions in an orderly manner, particularly since participants could have begun to close out grandfathered positions anytime before the 35 day phase-in period was adopted. Some of the commenters that supported eliminating the grandfather provision stated that the 35 day phase-in proposal would restore investor confidence and would not cause excessive volatility.<sup>90</sup>

##### b. Costs

In order to comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping, systems, and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, the infrastructure necessary to comply with the amendments is likely already in place. As such, any additional changes to the infrastructure will likely be minimal. In the Proposing Release, we requested specific comment on the system changes to computer hardware and software, or surveillance costs that might be necessary to comply with this rule. One investor, in his comment letter, stated that elimination of the grandfather provision will not increase costs for surveillance and compliance but, instead, will actually reduce costs because firms will no longer have to identify and track which fails to deliver are grandfathered and which are not.<sup>91</sup>

We also requested comment regarding the economic costs of eliminating the grandfather provision and how this would affect the liquidity of equity securities. One commenter contended that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.<sup>92</sup> Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempted to close out positions.<sup>93</sup> This commenter also stated that eliminating the grandfather provision would negatively impact bona

<sup>85</sup> In addition, similar to the pre-borrow requirement in Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted, if the fail to deliver position persists for 35 consecutive settlement days from the effective date of the amendment, 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.

<sup>86</sup> See *supra* note 7.

<sup>87</sup> See, e.g., comment letter from Feeney, *supra* note 10.

<sup>88</sup> See, e.g., comment letter from Zix, *supra* note 10.

<sup>89</sup> See, e.g., comment letters from Feeney, *supra* note 10; Zix, *supra* note 10.

<sup>90</sup> See comment letters from MFA, *supra* note 38; NCANS, *supra* note 9; State of Connecticut, *supra* note 9.

<sup>91</sup> See comment letter from David Patch, dated July 22, 2006.

<sup>92</sup> See, e.g., comment letter from CBOE, *supra* note 39.

<sup>93</sup> See comment letter from Knight, *supra* note 39.

fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.<sup>94</sup> Another commenter stated that eliminating the grandfather provision would cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive “naked” short sellers.<sup>95</sup>

There could be some risk of market disruption in requiring market participants to close out grandfathered fails to deliver. However, we believe that any market disruption, including increased volatility, reduction in liquidity and potential short squeezes are justified by the benefits of reducing the number of persistent fails to deliver. In addition, we believe that such effects, if any, will be minimal.

First, we believe that these potential effects, if any, of eliminating the grandfather provision will be minimal because the number of securities that will be impacted by elimination of the grandfather provision will be relatively small. Regulation SHO’s close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).<sup>96</sup> Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. Moreover, the amendment only impacts those fails to deliver in threshold securities that were created before the security became a threshold security. Because the current grandfather provision has a limited application, the overall impact of its removal on liquidity, volatility, and short squeezes, is expected to be relatively small.

Second, to the extent that the amendment could result in a decrease in liquidity, increased volatility, or short squeezes, we believe that any such potential effects will likely be mitigated by the fact that even though fails to deliver that were previously-grandfathered from the close-out requirement of Regulation SHO will not be permitted to continue indefinitely, such fails to deliver will not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)’s mandatory close-out requirement, both

new and previously-grandfathered fails to deliver in threshold securities will have 13 consecutive settlement days within which to be closed out.

Third, as noted above, the grandfather provision excepts from Rule 203(b)(3)’s mandatory 13 consecutive settlement day close-out requirement only those fails to deliver created before the security became a threshold security. Thus, it does not apply to fails to deliver created after the security became a threshold security. In examining the application of the current mandatory close-out requirement of Regulation SHO for all non-grandfathered fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-grandfathered fails to deliver in threshold securities has negatively impacted liquidity or volatility in these securities, or resulted in short squeezes.

Fourth, to the extent that elimination of the grandfather provision results in decreased liquidity, or increased volatility in certain securities, or results in short squeezes, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive “naked” short selling. The deprivation of the benefits of ownership, as well as the perception that abusive “naked” short selling is occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

## 2. Amendments to Rule 203 for Sales of Securities Pursuant to Rule 144

### a. Benefits

The amendments to Rule 203 will 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, because we are extending the close-out requirement for fails to deliver resulting from sales of threshold securities pursuant to Rule 144, we are also 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.

Securities sold pursuant to Securities Act Rule 144 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. We understand, however, that such processing delays, which are out of the seller’s and broker-dealer’s control, frequently result in delivery taking longer than 13 consecutive settlement days.<sup>97</sup>

We believe that extending the current close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market. Thus, the amendments will reduce costs to participants and, in turn, investors.

Although this amendment will allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act 35 rather than 13 consecutive settlement days in which to be closed out, these fails to deliver must be closed out within 35 consecutive settlement days and, therefore, these fails to deliver cannot continue indefinitely. Thus, we believe that this amendment is consistent with our goal of further reducing fails to deliver in threshold securities, while balancing the concerns associated with closing out fails to deliver in threshold securities pursuant to Securities Act Rule 144.

<sup>97</sup> See, e.g., comment letter from SIA, *supra* note 39.

<sup>94</sup> See *id.* According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.

<sup>95</sup> See comment letter from UBS, *supra* note 39.

<sup>96</sup> See *supra* note 7 (discussing the number of threshold securities as of March 31, 2007).

## b. Costs

We do not believe these amendments will impose any significant burden or cost on market participants. As discussed in more detail above, we believe that extending the current close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from the sale of a threshold security pursuant to Rule 144 of the Securities Act is expected to reduce costs by allowing participants of a registered clearing agency with a fail to deliver position additional time for delivery of these securities beyond the current 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

Participants may incur, however, some added costs for minor changes to their current systems to reflect the extended close-out requirement. We believe any added costs are justified by the benefits of extending the close-out requirement for these securities.

## 3. Amendments to Rule 200(e)(3)

### a. Benefits

The amendments to the market decline limitation in Rule 200(e) of Regulation SHO will reference the NYA rather than the DJIA. The previous reference in Rule 200(e)(3) to the DJIA was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions). However, as discussed above, because the Commission approved an amendment to NYSE Rule 80A to use the NYA to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA,<sup>98</sup> and because we believe that this is an appropriate index to reference for purposes of Rule 200(e)(3) of Regulation SHO, we are amending Rule 200(e)(3) to reference the NYA instead of the DJIA.

In addition, the amendments provide that the two percent limitation is to be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter.<sup>99</sup> In addition, Rule 200(e), as amended, will provide that the market decline limitation will terminate at the end of the trading day rather than upon the establishment of the closing value of the NYA on the next succeeding trading day. These amendments are intended to maintain consistency with NYSE Rule 80A so that market participants need refer to only one index in connection

with restrictions regarding index arbitrage trading.

### b. Costs

As discussed above, the reference in Rule 200(e)(3) of Regulation SHO to the DJIA was based, in part, on the reference in NYSE Rule 80A to the DJIA.<sup>100</sup> Following the Commission's approval of the amendment to NYSE Rule 80A to reference the NYA rather than the DJIA, market participants engaged in index arbitrage trading needed to reference the NYA for purposes of complying with NYSE Rule 80, and the DJIA for purposes of complying with Rule 200(e)(3) of Regulation SHO. By amending Rule 200(e)(3) to reference the NYA rather than the DJIA, market participants engaged in index arbitrage trading will need to reference only one index with respect to restrictions on such trading. Thus, we believe the amendments will not impose any significant costs or burdens on market participants.

## VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.<sup>101</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>102</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In the Proposing Release, we solicited comment on whether the proposed amendments are expected to promote efficiency, competition, and capital formation.

We believe the amendments will have minimal impact on the promotion of price efficiency. In the Proposing Release we sought comment on whether the proposals promote price efficiency, including whether the proposals might impact liquidity and the potential for

manipulative short squeezes. One commenter stated that the Commission's concern over potential short squeezes is "misplaced," as this is a risk short sellers assume when they sell short.<sup>103</sup> Another commenter maintained that elimination of the grandfather provision should not cause excessive volatility because, according to the commenter, DTCC and market participants have said that fails to deliver are a small problem.<sup>104</sup> However, one commenter stated its belief that elimination of the grandfather provision could adversely impact stock liquidity and borrowing, increasing costs to investors.<sup>105</sup> Another commenter stated its belief that eliminating the grandfather provision would lead to increased volatility and short squeezes as individuals attempted to close out positions.<sup>106</sup> This commenter also stated that eliminating the grandfather provision would negatively impact bona fide market making and the ability of market makers to provide liquidity, which would lead to less liquidity, greater volatility, and widening of spreads.<sup>107</sup> Another commenter stated that eliminating the grandfather provision would cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive "naked" short sellers.<sup>108</sup>

We believe 13 consecutive settlement days will be a sufficient amount of time in which to close out fail to deliver positions even in hard to borrow securities and will likely limit the potential for short squeezes, increased volatility, or reduction in liquidity. In addition, these amendments will impact only threshold securities, which comprise a small subset of all equity securities trading in the market. For example, in March 2007, the average daily number of securities on the threshold list was approximately 311 securities, which comprised 0.39% of all equity securities, and 2.33% of those securities subject to Regulation SHO. Thus, we believe that the overall market impact of the amendments will be minimal, if any.

We also believe the 35 day phase-in period for previously-grandfathered fail

<sup>103</sup> See comment letter from H. Glenn Bagwell, Jr., *supra* note 42.

<sup>104</sup> See comment letter from NCANS, *supra* note 9.

<sup>105</sup> See comment letter from CBOE, *supra* note 39.

<sup>106</sup> See comment letter from Knight, *supra* note 39.

<sup>107</sup> See *id.* According to this commenter, the proposal could also lead to upward price manipulation, causing investors to purchase shares at inflated prices.

<sup>108</sup> See comment letter from UBS, *supra* note 39.

<sup>98</sup> See 70 FR 51398.

<sup>99</sup> This amendment provides consistency with how the two percent value is calculated pursuant to NYSE Rule 80A. See NYSE Rule 80A (Supplementary Material .10).

<sup>100</sup> See 2003 Proposing Release, 68 FR at 62994–62995 (discussing proposed Rule 200 regarding netting and the liquidation of index arbitrage activities and changes to the language of the rule text to keep the language consistent with the language in NYSE Rule 80A).

<sup>101</sup> 15 U.S.C. 78c(f).

<sup>102</sup> 15 U.S.C. 78w(a)(2).

to deliver positions will not result in market disruption because it allows participants of a registered clearing agency an extended period of time in which to effect purchases to close out previously-grandfathered fail to deliver positions as of the effective date of the amendment, particularly because these participants could have begun to close out previously-grandfathered fail to deliver positions before adoption of the 35 day phase-in period.

In addition, we believe that the amendments will have minimal impact on the promotion of capital formation. Large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive "naked" short selling. The deprivation of the benefits of ownership, as well as the perception that abusive "naked" short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. In the Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about the potential impact of "naked" short selling on capital formation claiming that "naked" short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets.<sup>109</sup> Another commenter submitted a theoretical economic study concluding that "naked" short selling is economically similar to other shorting.<sup>110</sup>

By requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, we believe that there will be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on a threshold securities list leads to an unwarranted decline in investor confidence about the security, the amendments are expected to improve investor confidence about the security. We also believe that the proposed amendments will lead to greater certainty in the settlement of

securities, which should strengthen investor confidence in the settlement process.

We also believe the amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. By eliminating the grandfather provision and extending 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, we believe the amendments to Regulation SHO will promote competition by requiring similarly situated participants to close out fails to deliver in threshold securities within the same time-frame or, in the case of threshold securities sold pursuant to Rule 144 of the Securities Act, it will provide the same additional time-frame within which to close out fails to deliver resulting from sales of these securities. The amendments also will promote competition by maintaining consistency with NYSE Rule 80A so that broker-dealers can refer to the same index with respect to restrictions regarding index arbitrage trading. Thus, we believe that the amendments will improve the functioning of the capital markets and, thereby, will enhance investor confidence in the markets.

## VII. Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),<sup>111</sup> regarding the amendments to Regulation SHO, Rules 200 and 203, under the Exchange Act. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and was included in the Proposing Release. We solicited comments on the IRFA.

### A. Reasons for and Objectives of the Amendments

We are adopting revisions to Rules 200 and 203 of Regulation SHO. The amendments to Rule 203(b)(3) of Regulation SHO are designed to further reduce the number of persistent fails to deliver in threshold securities by eliminating the grandfather provision. We are concerned that persistent, large fail positions may have a negative effect on the market in these securities. For example, although high fails levels exist only for a small percentage of issuers, they may impede the orderly functioning of the market for such issuers, particularly issuers of less

liquid securities. A significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for voting and lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a seller that fails to deliver securities on trade settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that would have been priced differently.

To allow participants sufficient time to comply with the new close-out requirements, we are including a 35 settlement day phase-in period following the effective date of the amendment. The phase-in period is intended to provide participants with flexibility and advance notice to begin closing out previously-grandfathered fail to deliver positions.

The amendment 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 also is intended to provide participants with flexibility by allowing additional time for delivery of these securities, thereby also permitting the orderly settlement of such sales. The amendment to update the market decline limitation referenced in Rule 200(e)(3) is intended to maintain consistency with NYSE Rule 80A, and to provide for an appropriate and consistent protective measure.

### B. Significant Issues Raised by Public Comment

The IRFA appeared in the Proposing Release. We requested comment on any aspect of the IRFA. In particular, we requested comment on: (i) The number of small entities that would be affected by the amendments; and (ii) the existence or nature of the potential impact of the amendments on small entities. We requested that the comments specify costs of compliance with the amendments, and suggest alternatives that would accomplish the objectives of the amendments. We did not receive any comments that responded specifically to this request. One investor, in his comment letter, however, stated that elimination of the grandfather provision would not increase costs for surveillance and compliance but, instead, will actually reduce costs because firms would no longer have to identify and track which

<sup>109</sup> See, e.g., comment letter from Feeney, *supra* note 10.

<sup>110</sup> See comment letter from J.B. Heaton, Bartlit Beck Herman Palenchar & Scott LLP, dated May 1, 2007.

<sup>111</sup> 5 U.S.C. 604.

fails to deliver are grandfathered and which are not.<sup>112</sup>

### C. Small Entities Subject to the Amendments

The entities covered by these amendments will include small entities that are participants of a registered clearing agency, and small broker-dealers for which the participant clears trades or for which it is responsible for settlement. In addition, the entities covered by these amendments will include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Although it is impossible to quantify every type of small entity covered by these amendments, Paragraph (c)(1) of Rule 0–10 under the Exchange Act<sup>113</sup> states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a–5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. We estimate that as of 2006 there were approximately 894 broker-dealers that qualified as small entities as defined above.<sup>114</sup>

As noted above, the entities covered by these amendments will include small entities that are participants of a registered clearing agency. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC’s Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver

<sup>112</sup> See comment letter from David Patch, *supra* note 91.

<sup>113</sup> 17 CFR 240.0–10(c)(1).

<sup>114</sup> These numbers are based on the Commission’s Office of Economic Analysis’s review of 2006 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

and, if fails to deliver do occur, they are small in number and are usually cleaned up within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

The federal securities laws do not define what is a “small business” or “small organization” when referring to a bank. The Small Business Administration regulations define “small entities” to include banks and savings associations with total assets of \$165 million or less.<sup>115</sup> As of May, 2007 no bank that was a participant of the NSCC was a small entity because none met this criteria.

Paragraph (e) of Rule 0–10 under the Exchange Act<sup>116</sup> states that the term “small business” or “small organization,” when referring to an exchange, means any exchange that: (1) Has been exempted from the reporting requirements of Rule 11Aa3–1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0–10. No U.S. registered exchange is a small entity because none meets these criteria. There is one national securities association (NASD) that is subject to these amendments. NASD is not a small entity as defined by 13 CFR 121.201.

Paragraph (d) of Rule 0–10 under the Exchange Act<sup>117</sup> states that the term “small business” or “small organization,” when referring to a clearing agency, means a clearing agency that: (1) Compared, cleared and settled less than \$500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than \$200 million in funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined by Rule 0–10. No clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

### D. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments may impose some new or additional reporting, recordkeeping, or compliance costs on small entities that are participants of a clearing agency registered with the

<sup>115</sup> See 13 CFR 121.201.

<sup>116</sup> 17 CFR 240.0–10(e).

<sup>117</sup> 17 CFR 240.0–10(d).

Commission.<sup>118</sup> In order to comply with Regulation SHO when it became effective in January 2005, small entities needed to modify their systems and surveillance mechanisms. Thus, we believe that the infrastructure necessary to comply with the amendments regarding elimination of the grandfather provision is likely already in place. Any additional changes to the infrastructure are expected to be minimal. We do not believe, at this time, that any specialized professional skills will be necessary to comply with these new requirements.

### E. Agency Action To Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposals, the Commission considered the following alternatives: (a) Establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The primary goal of the new amendments is to reduce the number of persistent fails to deliver in threshold securities. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities will undermine the goal of reducing fails to deliver. In addition, we have concluded similarly that it is not consistent with the primary goal of the new amendments to further clarify, consolidate or simplify the new amendments for small entities. The Commission also believes that it is inconsistent with the purposes of the Exchange Act to use performance standards to specify different requirements for small entities or to exempt small entities from having to comply with the amended rules.

### VIII. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10(a), 11A, 15, 17(a), 17A, 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78i(h), 78j, 78k–1, 78o, 78q(a), 78q–1, 78w(a), the

<sup>118</sup> See discussions above in Section VII.C. and note 28, regarding participants of a registered clearing agency that are broker-dealers as opposed to non broker-dealers.

Commission is adopting amendments to §§ 242.200 and 242.203.

**Text of the Final Amendments to Regulation SHO**

**List of Subjects in 17 CFR Part 242**

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

■ For the reasons set out in the preamble, Title 17, Chapter II, Part 242, of the Code of Federal Regulations is amended as follows.

**PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES**

■ 1. The authority citation for part 242 continues to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

■ 2. Section 242.200 is amended by revising paragraph (e)(3) to read as follows:

**§ 242.200 Definition of “short sale” and marking requirements.**

\* \* \* \* \*

(e) \* \* \*

(3) The sale does not occur during a period commencing at the time that the NYSE Composite Index has declined by two percent or more from its closing value on the previous day and terminating upon the end of the trading day. The two percent shall be calculated at the beginning of each calendar quarter and shall be two percent, rounded down to the nearest 10 points,

of the average closing value of the NYSE Composite Index for the last month of the previous quarter.

\* \* \* \* \*

■ 3. Section 242.203 is amended by:

- a. Revising paragraph (b)(3)(i);
- b. Redesignating paragraphs (b)(3)(ii), (b)(3)(iii), (b)(3)(iv) and (b)(3)(v) as paragraphs (b)(3)(iii), (b)(3)(iv), (b)(3)(vi) and (b)(3)(vii), respectively; and
- c. Adding new paragraphs (b)(3)(ii) and (b)(3)(v).

The additions and revision read as follows:

**§ 242.203 Borrowing and delivery requirements.**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) *Provided, however,* that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment and which, prior to the effective date of this amendment, had been previously grandfathered from the close-out requirement in this paragraph (b)(3) (*i.e.*, because the participant of a registered clearing agency had a fail to deliver position at a registered clearing agency on the settlement day preceding the day that the security became a threshold security), shall close out that fail to deliver position within thirty-five consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

(ii) *Provided, however,* that if a participant of a registered clearing

agency has a fail to deliver position at a registered clearing agency in a threshold security that was sold pursuant to § 230.144 of this chapter for thirty-five consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position in the security by purchasing securities of like kind and quantity;

\* \* \* \* \*

(v) If a participant of a registered clearing agency entitled to rely on the thirty-five consecutive settlement day close out requirement contained in paragraphs (b)(3)(i) or (b)(3)(ii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for thirty-five consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

\* \* \* \* \*

By the Commission.

Dated: August 7, 2007.

**Nancy M. Morris,**  
*Secretary.*

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