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Short Sales; Final Rule and Notice

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 241 and 242

[Release No. 34–50103; File No. S7–23–03]

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Short Sales

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; interpretation.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting new Regulation SHO, under the Securities Exchange Act of 1934 (''Exchange Act''). Regulation SHO defines ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities ''long,'' ''short,'' or ''short exempt.'' Regulation SHO also includes a temporary rule that establishes procedures for the Commission to suspend temporarily the operation of the current ''tick'' test and any short sale price test of any exchange or national securities association, for specified securities. Regulation SHO also requires short sellers in all equity securities to locate securities to borrow before selling, and also imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred. The Commission is also adopting amendments that remove the shelf offering exception, and issuing interpretive guidance addressing sham transactions designed to evade Regulation M.

The Commission is deferring consideration of the proposal to replace the current ''tick'' test with a new uniform bid test restricting short sales to a price above the consolidated best bid, and also deferring consideration of the proposed exceptions to the uniform bid test. The Commission will reconsider any further action on these proposals after the completion of the pilot established by Regulation SHO.

DATES: *Effective Date:* September 7, 2004 except part 241 will be effective August 6, 2004 and § 242.202T will be effective from September 7, 2004 to August 6, 2007.

Compliance Date: The compliance date for §§ 242.200 and 203 is January 3, 2005. The compliance date for § 242.202T is the same as its effective date, September 7, 2004.

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SUPPLEMENTARY INFORMATION: The Commission is adopting Rules 200, 202T, and 203 of Regulation SHO [1] and amending Rule 105 of Regulation M,[2] and Rule 10a–1[3] under the Exchange Act.

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I. Introduction

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 will 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 owned, 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.

On October 28, 2003, the Commission proposed Regulation SHO, which would replace Rules 3b–3, 10a–1, and 10a–2 under the Exchange Act.[4] As proposed, Regulation SHO contained the following rules:

- Rule 200, which would replace Rule 3b–3 and: (1) Define the term ''short sale'' to allow multi-service broker-dealers to aggregate their positions by separate trading units; and (2) define ownership of a security to address security futures products and unconditional contracts to purchase securities;
- Rule 201, which would replace Rule 10a–1 and apply a uniform price test for exchange-listed and Nasdaq NMS securities based upon the consolidated best bid instead of the current tick test based upon the last reported sale;
- Rule 202T, which would establish a procedure for the Commission to suspend on a temporary basis the operation of Rule 10a–1 and any short sale price test of any exchange or national securities association for specified securities; and
- Rule 203, which would replace current Rule 10a–2, incorporate provisions of the existing self-regulatory organization (''SRO'') ''locate'' rules into a uniform Commission rule applicable to all equity securities, wherever they are traded, and impose additional delivery requirements on broker-dealers for securities in which a substantial amount of failures to deliver have occurred.

We also proposed revisions to Rule 105 of Regulation M (short selling in connection with a public offering) to eliminate the current shelf offering exception, and provide interpretive guidance addressing sham transactions designed to evade the rule.

We received letters from 462 commenters in response to proposed Regulation SHO.[5] The responses varied widely, with some commenters arguing for more stringent short sale regulation and others advocating the elimination of many or all short sale restrictions.

After considering the comments received, and upon further examination of current market practices and the purposes underlying short sale

[1] 17 CFR 242.200 through 242.203.

[2] 17 CFR 242.105.

[3] 17 CFR 240.10a–1.

[4] Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) (''Proposing Release'').

[5] The comment letters and a comprehensive summary of the comments are available for inspection in the Commission's Public Reference Room in File No. S7–23–03, or may be viewed at *http://www.sec.gov/rules/proposed/s72303.shtml*. The 438 different letters from 462 commenters reflect the number of different letters received; thus form letters, referred to as ''letter types'' on the Commission's Web site (*www.sec.gov*), counted as one letter. For example, 18 individuals sent Letter Type A, 21 individuals sent Letter Type B, 18 individuals sent Letter Type C, 19 individuals sent Letter Type D, two individuals sent Letter Type E, two individuals sent Letter Type F, 15 individuals sent Letter Type G, two individuals sent Letter Type H, 15 individuals sent Letter Type I, and four individuals sent Letter Type J. In addition, although submitted under Regulation SHO, Letter Types H, I, and J substantively refer to amendments to NASD Rule 3370. *See* Securities Exchange Act Release No. 49285 (February 19, 2004), 69 FR 8717 (February 25, 2004). They are included in the total here because commenters indicated that they were submitted in response to proposed Regulation SHO.

regulation,[6] we have decided to adopt certain provisions of proposed Regulation SHO and to defer consideration of other provisions. We are adopting proposed Rule 200, with some minor modifications. Rule 200, which incorporates Rule 3b–3, defines ownership for short sale purposes, and clarifies the requirement to determine a seller's net aggregate position. We have also decided to incorporate into Rule 200 the proposed requirements to mark sales in all equity securities ''long,'' ''short,'' or ''short exempt.'' [7] We believe that the ownership, aggregation, and marking requirements are important for all short sale regulations.

We are also adopting Rule 202T, which creates a procedure for the Commission to establish, through a separate order, a pilot program pursuant to which the Commission may exclude designated securities from the operation of the tick test of Rule 10a–1 and any short sale price test rule of any exchange or national securities association (''pilot''). Concurrently with this release, we are issuing an order establishing a pilot program employing the procedures of Rule 202T.[8] We have determined not to proceed with the uniform bid test of proposed Rule 201 until we have obtained the results of the pilot. Rule 10a–1, as well as all SRO price tests, will be maintained in present form for securities not included in the pilot.

We believe that conducting a pilot pursuant to Rule 202T is an important component of evaluating the overall effectiveness of price test restrictions on short sales. The pilot will allow us to obtain data on the impact of short selling in the absence of a price test to assist in determining, among other things, the extent to which a price test is necessary to further the objectives of short sale regulation, to study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity, and to obtain empirical data to help assess whether a short sale price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities.

The Commission's Office of Economic Analysis (''OEA'') will gather and analyze data during the pilot period to assess trading behavior in the absence of short sale price restrictions. Additionally, researchers are encouraged to provide the Commission with their own empirical analyses of the pilot.[9]

We are adopting additional proposals in Regulation SHO, which we believe are necessary and appropriate regardless of whether short sales are subject to a price test, to clarify provisions and to address commenters' concerns. As adopted, Rule 203 creates a uniform Commission rule requiring broker-dealers, prior to effecting short sales in all equity securities, to ''locate'' securities available for borrowing, and imposes additional delivery requirements on broker-dealers for securities in which a substantial amount of failures to deliver have occurred (''threshold securities''). We believe that strong and uniform requirements in this area will reduce short selling abuses. The locate and delivery requirements will act as a restriction on so-called ''naked'' short selling.[10]

We are also adopting amendments to Rule 105 of Regulation M in order to eliminate the shelf exception. In the Proposing Release we sought comment on how to address ''sham'' transactions that are structured to give the false appearance that short sales are being covered with open market shares, when in fact, the short seller has arranged to cover the short sale with offering shares, thereby violating Rule 105. We are issuing interpretive guidance relating to ''sham'' transactions that violate Rule 105.

II. Price Test—Proposed Rule 201

We proposed Rule 201 of Regulation SHO to replace Rule 10a–1's tick test with a price test using the consolidated best bid as the reference point for permissible short sales. Specifically, subparagraph (b) of proposed Rule 201 would have required that all short sales in covered securities be effected at a price at least one cent above the consolidated best bid at the time of execution.[11]

The comments we received on the proposed price test varied widely. Some commenters (including the Investment Company Institute (''ICI''), North American Securities Administrators Association (''NASAA''), and many smaller investors) advocated more stringent short sale regulation. These commenters, favored extending the proposed bid test to smaller issuers and urged imposition of stricter locate and delivery requirements. Other commenters, despite supporting many of the initiatives, argued for maintaining the current ''tick'' test. The New York Stock Exchange (''NYSE''), a proponent of retaining the tick test, also contended that the NYSE should be allowed to maintain a tick test for short sales on the exchange even if the Commission determines to eliminate price restrictions on short sales.[12] Additionally, the NYSE letter stated that it was representing the views of its issuers. None of these issuers submitted comments separately.[13]

A number of commenters, including some of the largest broker-dealers (*e.g.*, J.P. Morgan, UBS Securities, Lehman Brothers), the Securities Industry Association (''SIA''), and one regional exchange, Chicago Stock Exchange (''CHX''), advocated that the Commission consider further the necessity of any price test (either the current tick test or the proposed bid test). Generally, these commenters supported the pilot as a good first step, but argued that the pilot should be shortened from the proposed two-year duration to one year to expedite this process. These commenters, and other broker-dealers (*e.g.*, Goldman Sachs, Citigroup, Merrill Lynch, and Morgan Stanley), raised various concerns about the proposed price test, and opposed the Commission requiring market

[6] In adopting the tick test, the Commission sought to achieve three objectives: (i) allowing relatively unrestricted short selling in an advancing market; (ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and (iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers. *See* Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976). As we stated in the Proposing Release, short selling provides the market with at least two important benefits: market liquidity and pricing efficiency. Proposing Release, 68 FR at 62974.

[7] This marking requirement had been proposed in Rule 201(c). The marking requirements as adopted in Rule 200 apply to short sales in all equity securities, in contrast to paragraphs (c) and (d) of current Rule 10a–1, which only apply to exchange-listed securities.

[8] Securities Exchange Act Release No. 50104 (July 28, 2004).

[9] The Commission expects to make information obtained during the pilot publicly available.

[10] ''Naked'' short selling, while not defined in the federal securities laws or SRO rules, generally refers to selling short without having borrowed the securities to make delivery.

[11] Additionally, the Commission sought comment on an alternative price test that would allow short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (*i.e.*, an upbid). Under this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid if the current best bid is below the previous bid (*i.e.*, a downbid).

[12] The Specialist Association also argued for maintaining the current tick test on exchange-listed securities, and also opposed the proposed pilot program, arguing that it is likely to have unwarranted and unintended adverse effects on the securities included in the pilot, and could disadvantage these issuers compared to peer issuers that remain subject to the tick test.

[13] The letter from the American Society of Corporate Secretaries (''ASCS''), an organization of corporate issuers, did not opine on the pilot or the proposed bid test, but rather focused exclusively on the effects of short selling on proxy voting. The Commission expects to determine at a future date whether to take action with regard to that issue.

participants to expend time and resources to re-program systems for the proposed bid test prior to the completion of a pilot, especially if a possible outcome following the completion of the pilot is the removal of a price test altogether based on the results of the pilot.[14]

We have decided that the prudent course of action is to defer consideration of the proposed uniform bid test until after the conclusion of any pilot established pursuant to Rule 202T. As noted, the purpose of the pilot is to assist the Commission in considering alternatives, such as: (1) Eliminating a Commission-mandated price test for an appropriate group of securities, which may be all securities; (2) adopting a uniform bid test, and any exceptions, with the possibility of extending a uniform bid test to securities for which there is currently no price test; or (3) leaving in place the current price tests.[15]

III. Rule 200—Definitions and Marking Requirements

We are adopting Rule 200 to incorporate Rule 3b–3 of the Exchange Act,[16] with some amendments to the rule's current text. One of the key changes in Rule 200 is the requirement to mark sell orders in all equity securities ''long,'' ''short,'' or ''short exempt.'' Additionally, Rule 200 allows broker-dealers to calculate net positions in a particular security within defined trading units; incorporates the block-positioner exception from current Rule 10a–1(e)(13); and codifies prior interpretations related to the ownership of security futures products, and the unwinding of certain index arbitrage positions.[17]

A. Ownership

1. Unconditional Contracts To Purchase Securities—Rule 200(b)(2)

As proposed, paragraph (b) of Rule 200 would have amended the definition of unconditional contract to require the specification of a fixed price and amount of securities to be purchased in order for a person to claim ownership of the securities underlying the contract. Given our decision to maintain the status quo on the short sale price test in Rule 10a–1, we have determined not to amend the current definition of ''unconditional contract'' found in Rule 3b–3(b). Our decision primarily relates to our intent to preserve the operation of the current price test during the application of Rule 202T's pilot program. Amending qualifications for ownership of securities would affect net long positions, and thus have an impact on various trading strategies. However, we will continue to consider whether any future changes to the unconditional contract provision are appropriate, and may revisit our decision upon termination of any pilot that will be implemented pursuant to Rule 202T.

2. Ownership of Securities Underlying Securities Futures Products—Rule 200(b)(6)

We proposed Rule 200(b)(6) to achieve consistency with existing Commission guidance that defines when a person shall be deemed to own a security underlying a security futures contract.[18] The proposed amendment provided that a person holding a long security futures position is not considered to own the underlying security, for Rule 200 purposes, until the security future stops trading and the future will be physically settled. In the Proposing Release, we stated that termination of trading is the moment at which an open position in a security future, either a long or short position, can no longer be closed or liquidated either by buying or selling an opposite position. At that point, the person obligated to deliver would be considered short, and a person entitled to acquire the securities would be considered long.[19]

One commenter addressed the Rule 200 proposal and asserted that a person who holds a security future, which obligates the person to take delivery of the underlying securities by physical settlement, should be considered long the securities.[20] Additionally, the commenter argued that securities futures products are ''materially different'' from options, rights, warrants, and convertibles, which merely give the holder the right, but not the obligation, to acquire the securities.

We believe that the ownership language in Rule 3b–3 implicitly contemplates that there is a high degree of certainty that the person presently will obtain possession of the security. The distant time element of a futures product is inconsistent with this position. Moreover, the sale of securities related to a future-dated delivery contract necessitates borrowing for delivery, thus rendering the sale of the related securities a short sale. Therefore, a futures contract is more analogous to other derivative products than to an unconditional contract.

Therefore, we are adopting the proposed language relating to ownership of securities underlying a security futures contract. This interpretation is consistent with existing Commission guidance concerning the manner in which Rule 3b–3 addresses instances where a person owns a derivative instrument that entitles the person to acquire securities underlying the instrument, *e.g.*, options, rights, warrants, convertibles, and security futures.[21]

3. Aggregation Units—Rule 200(f)

We are adopting aggregation unit netting in Rule 200(f). Historically, a multi-service broker-dealer was considered one entity, so all of its positions were aggregated to determine the firm's net position.[22] However, firm-wide aggregation often interfered with the trading of independent units within the broker-dealer. The staff of the Division of Market Regulation therefore issued a no-action letter allowing multi-service broker-dealers to aggregate their positions within defined trading units.[23] We proposed to incorporate trading unit aggregation, for purposes of determining the trading unit's net position, into Regulation SHO.[24]

[14] *See e.g.*, letter from The American Stock Exchange (''Amex''); letter from CHX. Amex estimated that it would take the exchange three and a half months to make the necessary surveillance changes and would cost roughly $125,000. CHX represented that the aggregate cost to the exchange and its floor members would amount to at least $500,000.

[15] As a result, all existing exceptions and exemptions from Rule 10a–1 remain in effect. In addition, at this time, because we are not adopting the proposed uniform bid test, we have deferred a decision on our proposal to codify prior exemptive relief. *See* Proposing Release, Section VII.

[16] Rule 3b–3 sets forth the definition of ''short sale'' and identifies the specific instances for determining a long position. 17 CFR 240.3b–3.

[17] *See* Proposing Release, Section X.

[18] *See Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products,* Securities Exchange Act Release No. 46101 (June 21, 2002), 67 FR 43234 (June 27, 2002) (''Guidance Release'').

[19] Guidance Release at II.B.2.; Proposing Release at n. 179.

[20] *See* letter from LEK Securities.

[21] *See* Guidance Release.

[22] Under Rule 3b–3, a seller of an equity security subject to Rule 10a–1 must aggregate all of its positions in that security in order to determine whether the seller has a ''net long position'' in the security. 17 CFR 240.3b–3. *See also* Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120 (October 3, 1983) (to determine whether a person has a ''net long position'' in a security, all accounts must be aggregated); Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949, 17950 (aggregation must be based on a listing of securities positions in all proprietary accounts as determined at least once each trading day).

[23] 1998 SEC No-Act LEXIS 1038 (November 23, 1998) (aggregation unit netting no-action letter).

[24] For firms not relying on the aggregation unit exception, we understand that available technology allows firms to aggregate their firm-wide positions on a real-time basis. To the extent that a firm is unable to accomplish real-time aggregation on a firm-wide basis, it should be able to demonstrate

As proposed and adopted, Rule 200(f) permits trading unit aggregation if a registered broker-dealer meets the following requirements: (1) The broker-dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity; [25] (2) each aggregation unit within the firm determines at the time of each sale its net position for every security that it trades; (3) all traders in an aggregation unit pursue only the trading objectives or strategy(ies) of that aggregation unit; and (4) individual traders are assigned to only one aggregation unit at any time.[26]

We believe that these conditions are necessary to prevent potential abuses associated with establishing aggregation units within multi-service broker-dealers. Specifically, we require a written plan of organization as a means to demonstrate that each unit is independent and engaged in separate trading strategies without regard to other trading units. Aggregation of the unit's net position prior to each sale limits the potential for abuse associated with coordination among units. The final two conditions, limiting traders to the pursuit of the trading strategies or objectives of the particular aggregation unit and the assignment to only one aggregation unit at a time, are both designed to maintain the independence of the units. Thus, if two or more traders or groups of traders (*i.e.*, desks) within the same firm coordinate their trading activities, those traders or groups must be in the same aggregation unit.[27]

4. Block Positioners and Liquidation of Index Arbitrage Positions—Rule 200(d) and (e)

As proposed, we are incorporating the block positioner exception (currently found in subsection (e)(13) of Rule 10a–1) into Rule 200(d) because this provision directly relates to the calculation of a broker-dealer's net position. Block positioning occurs when a broker-dealer acts as principal in taking all or part of a block order placed by a customer in order to facilitate a transaction that might otherwise be difficult to effect in the ordinary course of trading.[28] The block positioner may then seek to sell the securities so acquired. The exemption for block positioners addresses the interaction between the price test under Rule 10a–1 and the determination of the seller's net position under Rule 3b–3.[29] A broker-dealer that engages in block-positioning will continue to be able to disregard economically neutral bona-fide arbitrage, risk arbitrage, and bona-fide hedge positions involving short stock components in determining its net position in the block-positioned security.

Under subparagraph (e) of Rule 200, we are adopting relief for sales effected in connection with the unwinding of an index arbitrage position. Rule 200(e) provides a limited relaxation of the requirement that a person selling a security aggregate all of the person's positions in that security to determine whether he or she has a net long position. In a manner similar to that permitted under the block positioner exception in Rule 200(d), this provision allows market participants 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. To qualify for the relief, 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,[30] notwithstanding that such person may not have a net long position in that security.[31]

Aggregation relief for index arbitrage positions was originally granted in a staff no-action letter.[32] Proposed Rule 200(d) contained additional provisions that were not contained in the prior no-action letter. Three commenters supported the relief, but stated that the relief was too limited.[33] Generally, these commenters preferred the relief as provided by the Merrill Lynch letter. We have carefully reviewed the comments and have determined to include the additional provisions in connection with the liquidation of an index arbitrage position. The Commission still believes that a market decline restriction is appropriate and in the public interest, and will avoid incremental selling pressure 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.

As proposed and adopted, the exception for unwinding index arbitrage positions provided in 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 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 during which the DJIA has not declined by two percent or more from its closing value on the previous day. If a market decline triggers the application of subparagraph (e)(2), a broker-dealer must aggregate all of its other positions in that security to

why such aggregation is impracticable and that the alternative method employed (*e.g.*, on a daily basis) accurately reflects firm ownership positions.

[25] As noted in the Proposing Release, the independence of the units would be evidenced by a variety of factors, such as separate management structures, location, business purpose, and profit and loss treatment.

[26] Two commenters focused on expanding aggregation unit netting to non-broker-dealers. *See* letters from LEK Securities; MFA. The Commission has determined not to extend aggregation unit netting to entities that lack self-regulatory oversight and are not subject to Commission examination. The lack of regulatory oversight may facilitate the creation of units that are not truly independent or separate.

[27] As with any rule, broker-dealers relying on this exception should be prepared to monitor for compliance with its conditions, and maintain records documenting such compliance.

[28] Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (noting that the Commission has long recognized the important role that block positioning plays in providing liquidity for large securities transactions and in maintaining fair and orderly markets).

[29] *See* Securities Exchange Act Release No. 20230 (September 27, 1983) 48 FR 45119 (October 3, 1983) (proposing the block positioner exception); *see also* Securities Exchange Act Release No. 20715 (March 6, 1984), 49 FR 9414 (March 13, 1984) (adopting the block positioner exception).

[30] ''Standardized options contract'' is defined in Rule 9b–1(a)(4) under the Exchange Act. 17 CFR 240.9b–1(a)(4).

[31] The Commission proposed to codify this relief in 1992, but the proposal was not adopted. *See* Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992).

[32] *See* letter re: Merrill Lynch, Pierce, Fenner & Smith, Inc. (December 17, 1986); Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (April 30, 1990) (clarifying and emphasizing certain aspects of the limited relief granted in the Merrill Lynch letter). The Merrill Lynch letter provided no-action relief if: (i) The firm has a long stock position as part of an index arbitrage position; (ii) the stock is being sold in the course of ''unwinding'' an index arbitrage position; and (iii) the sale would be a short sale, as defined in Rule 3b–3, solely as a result of the netting of the index arbitrage long position with one or more short positions created in the course of bona-fide hedge activities.

[33] *See* letters from LEK Securities; Willkie Farr & Gallagher, LLP (''Willkie Farr'') (sent on behalf of J.P. Morgan Securities and UBS Securities).

determine whether the seller has a net long position.[34]

B. Order-Marking Requirements—Rule 200(g)

We are adopting the new order-marking requirements proposed in Rule 201(c) and incorporating them into Rule 200(g). Since the new marking requirements apply to all equity securities, not just exchange-listed securities, we are removing them from current Rule 10a–1. The new order-marking requirements differentiate between ''long,'' ''short,'' and ''short exempt'' orders for all exchange-listed and over-the-counter equity securities.

Under the former marking requirements in Rule 10a–1(d), a broker-dealer could only mark an order to sell a security ''long'' if the security was carried in the account for which the sale is to be effected, or the broker-dealer is informed that the seller owns the security to be sold, and will deliver the security to the account for which the sale is effected as soon as possible without undue inconvenience or expense.[35] We had proposed changing the marking requirement so that a sale could only be marked ''long'' if the seller owns the security being sold and either the security to be delivered is in the physical possession or control of the broker-dealer, or will be in the physical possession or control of the broker-dealer prior to settlement of the transaction.

As adopted, an order can be marked ''long'' when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than settlement. We added the language ''reasonably expected'' because we acknowledge that it may be difficult for a person to know with certainty at the time of sale that a security will be in the possession or control of the broker-dealer prior to settlement. However, if a person owns the security sold and does not reasonably believe that the security will be in the possession or control of the broker-dealer prior to settlement, the sale should be marked ''short.'' The sale could be marked ''short exempt'' if the seller is entitled to rely on an exception from the tick test of Rule 10a–1, or the price test of an exchange or national securities association.[36] Short sales of pilot securities effected during any pilot period should be marked ''short exempt.''

The new marking requirements will eliminate the prior discrepancy between how Rule 3b–3 defined a short sale and the marking provisions previously found in Rule 10a–1. In addition, the new marking requirements should facilitate the surveillance and monitoring of compliance with Rule 10a–1. The change to the marking requirements will provide information that shows when exceptions from Rule 10a–1 are used.

IV. Rule 202T—Pilot Program

A. General

We proposed Rule 202T to provide a procedure for the Commission to suspend, on a pilot basis, the trading restrictions of the Commission's short sale price test, as well as any short sale price test of any exchange or national securities association, for short sales in such securities as the Commission designates by order as necessary or appropriate in the public interest and consistent with the protection of investors, after giving due consideration to the security's liquidity, volatility, market depth and trading market.[37] We stated our belief that temporary suspension of Commission and SRO price tests is an essential component of evaluating the overall effectiveness of such restrictions, and would permit the collection of data on the impact of short selling in the absence of a price test.

Overall, thirty-eight commenters expressed support for a pilot program.[38] Some commenters opposed any suspension of a price test for short sales, and expressed concern about possible pricing anomalies and disparate trading activity in securities within the same industry where one security is subject to a price test and another is not.[39] We considered these suggestions together with other comments that not only supported the pilot, but recommended that the pilot criteria be expanded to include, among other things, less liquid securities; securities with position limit tiers for listed options; and stocks that currently qualify for the Regulation M exception for actively-traded securities.[40]

A number of commenters stated that the proposed two-year time span for the pilot would be too long.[41] For example, Nasdaq asserted that the pilot should only last as long as absolutely necessary, to minimize the impact on issuers and the market, and suggested a six-month or twelve-month pilot. The NYSE expressed concern that a two-year pilot is ''an exceptionally long time,'' especially if there were no quick mechanism to shorten or end the pilot if it proves to dislocate market prices. The STA favored a six-month pilot.

After careful consideration of the comments received, we are adopting a modified version of proposed Rule 202T. As adopted, Rule 202T provides procedures for the Commission to suspend any short sale price test for such securities and for such time periods as the Commission deems

[34] We have adopted language that closely resembles the block positioner exception in Rule 200(d) since we believe that the economic rationale for and the operation of both exceptions are analogous. Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992) at n. 60 (*citing* Securities Exchange Act Release No. 20230, 48 FR at 45119); Securities Exchange Act Release No. 20715 (March 6, 1984), 49 FR 9414 (March 13, 1984)).

[35] 17 CFR 240.10a–1(d).

[36] In this situation, the seller may be entitled to rely on an exception if the seller ''owns the security sold and intends to deliver such security as soon as possible without undue inconvenience or expense.'' 17 CFR 240.10a–1(e)(1). Additionally, the seller may be entitled to rely on an exception from Rule 203(b)(2)(ii), as adopted, if the seller owns the security sold pursuant to Rule 200, and the seller intends to deliver the security as soon as all restrictions on delivery have been removed, and no later than 35 days after trade date. *See* Rule 203(b)(2)(ii), discussed further in Part V.A.1.c., *infra*. However, without an exception to the price test, this sale should be marked ''short.''

[37] *See* Proposing Release, Section V.

[38] *See* letters from James Angel; Archipelago Holdings (''ARCA''); Yuseff J. Burgess; Chicago Board Options Exchange (''CBOE''); Dario Cosic; Davis Polk; Timothy K. Dolnier; Tolga Erman; Chris Freddo; Kristopher Goldhair; Chris Gregg; Marc Griffin; Charles W. Hansford; Zachary Hepner; ICI; Mike Ianni; Brian Ingram; Kevin Karlberg; Gregory Kleiman; LEK Securities; Michael Lucarello; Hal Lux and Leon M. Metzger; Managed Funds Association (''MFA''); Raymond J. Murphy; Nasdaq Stock Market (''Nasdaq''); Osmar92@optonline.net; Tal Plotkin; David Schwarz; Sinan Selcuk; Theodore J. Siegel; Todd Sherman; SIA; Dan Solomon; The Securities Traders Association (''STA''); Securities Traders Association of New York (''STANY''); Jimmie E. Williams; Willkie Farr.

[39] *See, e.g.*, letters from Anthony Gentile; Robert Morrow; NYSE; The Specialists Association. The NYSE asserted that a pilot will create a confusing system that will ''slow trading, lead to errors and baffle market participants'' as well as create ''artificially anomalous price situations, particularly for securities within the same industry where some are subject to a 'tick' or 'bid' test and others are not.''

[40] Some commenters suggested expanding the scope of stocks that may be included in a pilot. *See* letters from CBOE; Coreina Chan; Timothy K. Dolnier; Charles W. Hansford; Zachary Hepner; Gregory Kleiman; Michael Lucarello; Nasdaq; Osmar92@optonline.net; Tal Plotkin; David Schwarz; Dan Solomon; STA; STANY; Hiro Shinohara; Daniel C. Sweeney. Additionally, some advocated including less liquid Nasdaq NMS and listed securities, while others argued for including groups of stocks with the two highest position limit tiers for listed options. *See* letters from STA; STANY; CBOE. SIA's letter suggested using stocks that currently qualify for the Regulation M exception for actively-traded securities because they are less susceptible to market manipulation and because programming costs may be less as many broker-dealers already have systems in place to identify such stocks.

[41] *See* letters from James Angel; Charles Schwab Capital Markets (''Charles Schwab''); Nasdaq; NYSE; STA; STANY.

necessary or appropriate, in the public interest and consistent with the protection of investors after giving due consideration to the securities' liquidity, volatility, market depth and trading market. Any such pilot would commence by separate order of the Commission, which would allow the Commission to act quickly should adverse findings result from any pilot. As part of that process, we would consider the concerns expressed by some commenters that any pilot last only as long as absolutely necessary to allow the Commission to gather sufficient data. The order establishing any such pilot would identify the pilot stocks and set forth the methodology we would use in selecting pilot and control group stocks. Any such order would also indicate the factors we plan to analyze in the pilot, such as the impact on market quality, price changes caused by short selling, costs imposed by the tick test, and the use of alternative means to establish short positions.

By separate order, the Commission is establishing a pilot that includes a subset of securities from a broad-based index. The order identifies the pilot stocks and sets forth the methodology we used in selecting pilot and control group stocks.[42] We believe that a pilot established under Rule 202T using a subset of securities from a broad-based index will provide a balanced and targeted approach to assessing the efficacy of a price test for short sales. There is the potential that prices and trading activity may vary between securities included in a pilot and similar securities subject to the price test.[43] However, to the extent there are price and trading activity variations, this is precisely the empirical data that the Commission seeks to obtain and analyze as part of our assessment as to whether the price test should be removed or modified, in part or whole, for actively-traded securities or other securities.[44]

We appreciate the concerns expressed by some commenters that issuers subject to a pilot could be unfairly disadvantaged because of potentially abusive or manipulative behavior. We note, however, that most of the more liquid securities that will be appropriate for a pilot are traded on exchanges or other organized markets with high levels of transparency and surveillance. This would enhance the ability of the Commission and SROs to monitor trading behavior during the operation of any pilot and to surveil for manipulative short selling. Moreover, the general anti-fraud and anti-manipulation provisions of the federal securities laws will continue to apply to trading activity in these securities, thus prohibiting trading activity designed to improperly influence the price of a security.[45] In addition, a pilot would suspend only the operation of the price test, while the other requirements of Regulation SHO, including the order-marking, locate and delivery requirements, would remain in effect.[46]

Further, as adopted, Rule 202T makes explicit that no SRO ''shall have a rule that is not in conformity with or conflicts with'' the suspension of a price test for the securities selected for the pilot. Although a few commenters asserted that SRO price tests should remain in effect even if the Commission determined to eliminate price restrictions on short sales,[47] as we noted in the Proposing Release, we believe it would be inconsistent with, and detrimental to the goals of, Rule 202T and any pilot to allow SRO price tests to continue to apply to securities subject to the pilot. A pilot would be intended to allow the Commission to, among other things, study the effects of relatively unrestricted short selling on trading behavior for a select group of stocks. If pilot stocks remained subject to SRO price tests, the empirical data would be compromised and the value of the study undermined. As a result, Rule 202T, as adopted, prohibits the SROs from applying a price test for short sales in securities selected for a pilot during the operation of any pilot.

B. After-Hours Trading

We included in the Proposing Release our interpretation that the tick test applies to all trades in listed securities, whenever they occur, including in the after-hours market and after the consolidated transaction reporting system ceases to operate.[48] A significant number of commenters objected to this position, arguing that there is limited liquidity after regular trading hours, and that the trades do not generate price effects associated with the abusive practices that the short sale rule is designed to prevent.[49] These commenters further argued that many short sales that are executed after-hours are facilitating trades that are provisionally agreed to during regular trading hours, and accordingly provide liquidity to investors.[50]

Moreover, some commenters asserted that many after-hours trades are currently executed overseas due to the operation of Rule 10a–1.[51] Excepting short sales executed after-hours on a pilot basis may result in these trades being executed in the United States, thus allowing for increased surveillance of these trades and providing increased liquidity to potential U.S. buyers.

In response to the comments received, Rule 202T, as adopted, establishes a procedure by which we may suspend on a pilot basis the tick test of Rule 10a–1(a) and any SRO short sale price test during such time periods as the Commission finds necessary or appropriate and consistent with the protection of investors. Any such pilot would commence by order of the Commission.[52] The order described above establishes a pilot removing any price test for short sales of certain securities effected during certain after-hours periods.

V. Rule 203—Locate and Delivery Requirements for Short Sales

A. ''Locate'' Requirement

We are adopting proposed Rule 203, with some modifications, after considering the comments received.[53]

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[42] The Commission may in the future issue other orders adopting other pilot programs.

[43] *See, e.g.*, letter from SONECON, LLC.

[44] No individual issuers submitted comment letters opposing a pilot or expressing concern about the possible disparate trading of securities subject to a pilot or about the possible adverse impact on their securities should the price test be removed from short selling in their stock on a temporary basis. However, the NYSE submitted a letter expressing concern ''on behalf of its members and its listed companies'' that strongly supported continuing price restrictions and expressed concern about unscrupulous market participants forcing prices lower in stocks not subject to a price test.

[45] *See, e.g.*, Securities Act of 1933 (''Securities Act'') Section 17(a), and Exchange Act Sections 9(a), 10(b), and 15(c) and Rules 10b–5 and 15c1–2 thereunder.

[46] Also, the order permits the Commission to act quickly to modify the pilot to address any adverse results, should we determine that continued operation of an established pilot would not be necessary or appropriate in the public interest or inconsistent with the protection of investors.

[47] The NYSE asserted that it should be allowed to maintain a tick test for short sales on the NYSE even if the Commission determines to eliminate price restrictions on short sales. The Specialist Association also argued for maintaining the current tick test on exchange-listed securities.

[48] Proposing Release, Section XIV.A. After the consolidated tape ceases to operate, the tick test rule prevents any person from effecting a short sale at a price that is lower than the last sale reported to the tape.

[49] *See, e.g.*, letters from James Angel; Charles Schwab; Davis Polk; Goldman; Citigroup; Merrill Lynch; Morgan Stanley; LEK Securities; MFA; SIA; Susquehanna International Group, LLP; Willkie Farr.

[50] *See, e.g.*, letters from Goldman, Citigroup, Merrill Lynch, Morgan Stanley.

[51] *See, e.g.*, letter from SIA.

[52] The order that is being issued concurrently with this release includes a pilot for short sales occurring after hours. *See*, n. 8, *supra.*

[53] Most commenters welcomed the Commission's proposal as a means to address potential manipulation through so called ''naked'' short selling, and additionally welcomed replacing the

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As adopted, Rule 203(b) creates a uniform Commission rule requiring a broker-dealer, prior to effecting a short sale in any equity security, to ''locate'' securities available for borrowing. For covered securities, Rule 203 supplants current overlapping SRO rules. Specifically, the rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.[54] The locate must be made and documented prior to effecting a short sale, regardless of whether the seller's short position may be closed out by purchasing securities the same day.[55] The rule provides for some limited exceptions, including for short sales effected in connection with bona-fide market making, as discussed in further detail below.

As proposed, Rule 203(b) would have allowed the ''person for whose account the short sale is executed'' to perform a locate.[56] We agree with commenters that the locate requirement should apply to a regulated entity—the broker-dealer effecting the sale—and have modified the adopted rule accordingly.[57] Therefore, the rule as adopted makes clear that the broker-dealer effecting the short sale has the responsibility to perform the locate.[58]

We requested comment in the Proposing Release on the manner in which persons could satisfy the ''reasonable grounds'' determination in the proposed rule. In particular, we asked whether blanket assurances that stock is available for borrowing, *i.e.*, ''Easy to Borrow'' or ''Hard to Borrow'' lists, provide an accurate assessment of the current lending market in a manner that would not impede liquidity and the ability of market participants to establish short positions, while at the same time guarding against potential problems inherent with large extended settlement failures.[59] After considering the comments received, we believe that, absent countervailing factors, ''Easy to Borrow'' lists may provide ''reasonable grounds'' for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities.[60] In order for it to be reasonable that a broker-dealer rely on such lists, the information used to generate the ''Easy to Borrow'' list must be less than 24 hours old, and securities on the list must be readily available such that it would be unlikely that a failure to deliver would occur.[61] Therefore, absent adequately documented mitigating circumstances, repeated failures to deliver in securities included on an ''Easy to Borrow'' list would indicate that the broker-dealer's reliance on such a list did not satisfy the ''reasonable grounds'' standard of Rule 203.[62]

Broker-dealers create ''Hard to Borrow'' lists to identify securities that are in limited supply. Thus, locates for securities on ''Hard to Borrow'' lists are likely to be difficult. However, the fact that a particular lender placed certain securities on a ''Hard to Borrow'' list cannot be taken to mean that the lender represents that securities that are *not* on the ''Hard to Borrow'' list are easy to borrow. Commenters viewed ''Hard to Borrow'' lists with circumspection,[63] and we understand that such lists are not widely used by broker-dealers. Therefore, the fact that a security is not on a hard to borrow list cannot satisfy the ''reasonable grounds'' test of Rule 203(b)(1)(ii).

current disparate SRO requirements with a uniform Commission rule. *See, e.g.*, letters from NYSE; Nasdaq; SIA.

[54] Any broker-dealer using the United States jurisdictional means to effect short sales in securities traded in the United States would be subject to Regulation SHO, regardless of whether the broker-dealer is registered with the Commission or relying on an exemption from registration. In addition, Commission staff members have engaged in discussions with staff of The Investment Dealers Association of Canada (''IDA''), who have confirmed that the IDA intends to issue an interpretation that failure of IDA members to comply with the requirements of Regulation SHO may be considered a breach of IDA rules. This would be consistent with an interpretation that the IDA recently issued regarding an amendment to NASD Rule 3370, noting that IDA members would be required to make an affirmative determination that the member will receive delivery of the security from its customer or that the member can borrow the security on behalf of the customer by settlement date. It was stated that failure of IDA members to make such an affirmative determination may be considered a breach of IDA rules. Investment Dealers Association of Canada Member Regulation Notice MR0282 (April 13, 2004). The NASD amendment had extended the affirmative determination requirements to short sale orders that NASD members receive from non-member broker-dealers. Securities Exchange Act Release No. 48788 (November 14, 2003), 68 FR 65978 (November 24, 2003); NASD Notice to Members 04–03 (January, 2004); NASD Notice to Members 04–21.

[55] This is consistent with the current practice under NASD Rule 3370. *See, e.g., Ko Securities, Inc.* and *Terrance Y. Yoshikawa*, Securities Exchange Act Release No. 48550 (September 26, 2003) (holding that an affirmative determination, *i.e.*, a ''locate,'' must be made before the securities are sold short regardless of whether the short seller repurchases securities on the same day).

[56] Several commenters addressed this issue. *See, e.g.*, letters from NYSE; SIA.

[57] *See, e.g.*, letter from NYSE.

[58] A broker-dealer may obtain an assurance from a customer that such party can obtain securities from another identified source in time to settle the trade. This may provide the ''reasonable grounds'' required by Rule 203(b)(1)(ii). However, where a broker-dealer knows or has reason to know that a customer's prior assurances resulted in failures to deliver, assurances from such customer would not provide the ''reasonable grounds'' required by 203(b)(1)(ii). The documentation required by Rule 203(b)(1)(iii) should include the source of securities cited by the customer. The broker-dealer also should be able to demonstrate that there are ''reasonable grounds'' to rely on the customer's assurances, *e.g.*, through documentation showing that previous borrowings arranged by the customer resulted in timely deliveries in settlement of the customer's transactions.

[59] According to the current NASD ''affirmative determination'' rule, the manner by which a member or person associated with a member annotates compliance with the affirmative determination requirement is to be decided by each member. Members may rely on ''blanket'' or standing assurances (*i.e.*, ''Easy to Borrow'' lists) that securities will be available for borrowing on settlement date. For short sales executed in Nasdaq National Market (''NNM'') or exchange-listed securities, members also may rely on ''Hard to Borrow'' lists identifying NNM or listed securities that are difficult to borrow or unavailable for borrowing on settlement date provided that: (i) Any securities restricted pursuant to NASD Rule 11830 must be included on such a list; and (ii) the creator of the list attests in writing (on the document or otherwise) that any NNM or listed securities not included on the list are easy to borrow or are available for borrowing. Members are permitted to use Easy to Borrow or Hard to Borrow lists provided that: (i) The information used to generate the list, is no more than 24 hours old; and (ii) the member delivers the security on settlement date. Should a member relying on an Easy to Borrow or Hard to Borrow list fail to deliver the security on settlement date, the NASD deems such conduct inconsistent with the terms of Rule 3370, absent mitigating circumstances adequately documented by the member. See NASD Rule 3370(b)(4)(C).

[60] In its comment letter, the SIA noted that in developing ''Easy to Borrow'' lists, broker-dealer stock loan desks use information from a number of sources, including institutional lenders that have sophisticated systems for estimating borrow supply. Broker-dealer stock loan desks also consider the availability of inventory at their own firms and potential availability from other broker-dealers that act as conduit lenders. Much of this information is available through electronic feeds and is updated frequently. *See* letter from SIA.

[61] A broker-dealer could look to a lender's statement to the broker-dealer regarding the amount of securities available to lend on an ''Easy to Borrow'' list.

[62] Of course, securities that are ''threshold securities'' pursuant to Rule 203(c) should generally not be included on ''Easy to Borrow'' lists.

[63] *See, e.g.*, letter from NYSE. In particular, the NYSE stated that, ''We believe that the use of 'easy to borrow' lists, together with an industry-wide list of securities where there is evidence of significant settlement failures (*i.e.*, those for which there are fails to deliver at a clearing agency of 10,000 shares or more and that is equal to at least one-half of one percent of the issue's total shares outstanding) prepared daily by the National Securities Clearing Corporation ('NSCC') as proposed, would be a more appropriate means of determining whether a security sold short could be borrowed. Consequently, the Exchange believes that broker-dealers should be required to make an affirmative determination for those securities that are not on the 'easy to borrow' list.''

1. Exceptions From the Locate Requirement

a. Broker-Dealer Accepting Short Sale Order From Another Broker-Dealer—Rule 203(b)(2)(i)

Rule 203(b)(2)(i) provides a new exception from the uniform locate requirement of Rule 203(b)(1) for a registered broker or dealer that receives a short sale order from another registered broker or dealer that is required to comply with 203(b)(1). For example, where an introducing broker-dealer submits a short sale order for execution, either on a principal or agency basis, to another broker-dealer,[64] the introducing broker-dealer has the responsibility of complying with the locate requirement. The broker-dealer that received the order from the introducing broker-dealer would not be required to perform the locate. However, a broker or dealer would be required to perform a locate where it contractually undertook to do so or the short sale order came from a person that is not a registered broker-dealer.[65]

b. Bona-Fide Market Making

We are adopting the proposed exception from the uniform ''locate'' requirement, as Rule 203(b)(2)(iii), for short sales executed by market makers, as defined in Section 3(a)(38) of the Exchange Act,[66] including specialists and options market makers, but only in connection with bona-fide market making activities.[67] Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception.[68] Further, bona-fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with Rule 203(b)(1) by the other broker-dealer or customer.[69]

c. Additional Exception From the Locate Requirement—Rule 203(b)(2)(ii)

Pursuant to the suggestions of other commenters, we are including an additional exception from the uniform locate requirement of Rule 203(b)(1) for situations where a broker-dealer effects a 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 the 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 is thus a ''short'' sale under the marking requirements of Rule 200(g) as adopted.[70] Such circumstances could include the situation where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date.[71] Rule 203(b)(2)(ii) as adopted provides that in all situations, delivery should 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.[72]

Two commenters advocated maintaining the current exception from the ''affirmative determination'' requirements of NASD Rule 3370 for short sales that result in fully hedged or arbitraged positions.[73] One comment letter requested an exception from the proposed locate and delivery requirements of Rule 203 in a situation where a market participant has a long position in warrants or rights which are exercisable within 90 days and are subject to a fixed price per share conversion ratio.[74] The other comment letter requested an exception from the proposed locate and delivery requirements in the situation where a market participant is long in-the-money call options.[75] The commenter argued

[64] This could include an electronic communications network (ECN).

[65] Of course, an executing broker-dealer who executes a short sale pursuant to an order from an introducing broker as part of a scheme to manipulate the security, or where, for example, it knows that the introducing broker did not perform the locate, could be liable under the securities laws, for, among other violations, committing or aiding and abetting a violation of Rule 203(b)(1). *See, e.g.*, Sections 15(b)(4)(e) and 20(e) of the Exchange Act. 15 U.S.C. 78t.

[66] Section 3(a)(38) states: ''The term 'market maker' means any specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer quotation system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.'' 15 U.S.C. 78c(a)(38).

[67] As noted in the Proposing Release, we believe that a narrow exception for market makers engaged in bona-fide market making activities is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the ''locate'' requirement.

[68] Moreover, a market maker that continually executed short sales away from its posted quotes would generally be unable to rely on the bona-fide market making exception.

[69] *See also* NASD IM–3350(c)(2) (''A market maker would be deemed in violation of the Rule if it entered into an arrangement with a member or a customer whereby it used its exemption from the rule to sell short at the bid at successively lower prices, accumulating a short position, and subsequently offsetting those sales through a transaction at a prearranged price, for the purpose of avoiding compliance with the Rule, and with the understanding that the market maker would be guaranteed by the member or customer against losses on the trades.''). Although the IM–3350 interpretation applies expressly to the bid test in NASD Rule 3350, the NASD previously found that the standards set forth are equally applicable to the market maker exemption in NASD Rule 3370. *See* NASD Hearing Panel Decision as to Respondents John Fiero and Fiero Brothers, Inc. (December 6, 2000); *See also* Section 20(b) of the Exchange Act, 15 U.S.C. 78t.

[70] Pursuant to Rule 200(g), a broker or dealer shall mark an order to sell a security ''long'' only if the seller is deemed to own the security being sold pursuant to 17 CFR 242.200 and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. *See, supra* Part III.B. for a further discussion of the order marking requirements.

[71] Another situation could be where a customer owns stock that was formerly restricted, but pursuant to Rule 144 under the Securities Act of 1933, the securities may be sold without restriction. In connection with a sale of such security, the security may not be capable of being delivered on settlement date, due to processing to remove the restricted legend. *See, e.g.*, letter from Feldman Weinstein, LLP (''Feldman'').

[72] We believe that 35 days is a reasonable outer limit to allow for restrictions on a security to be removed if ownership is certain. We note that Section 220.8(b)(2) of Regulation T of the Federal Reserve Board allows 35 days to pay for securities delivered against payment if the delivery delay is due to the mechanics of the transaction. 12 CFR 220.8(b)(2).

[73] *See* NASD Rule 3370(b)(2)(B), which states in pertinent part that, ''[n]o member shall effect a 'short' sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date. This requirement will not apply to * * * transactions that result in fully hedged or arbitraged positions.'' Rule 3370(b) provides guidelines in determining the availability of the exception.

[74] *See* first and fourth letters from Saul Ewing, LLP., on behalf of Greenwood Partners. The commenter noted the situation where a market participant views the issuer's warrants as being overly rich in comparison to the pricing of the warrants, and will thus sell the underlying stock short and purchase the warrants. It also stated that, because the stock borrow programs for many smaller issuers are virtually non-existent, the market participant engaging in this activity may be required to sell short naked. In order to guard against potential ''death spiral'' activity, it was requested that the exception be limited to warrants with a fixed price per share conversion ratio.

[75] *See* third letter from Saul Ewing, LLP. Specifically, the commenter, writing on behalf of an unnamed private equity fund, argued that the fund

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that excepting short sales in such situations promotes the ability of smaller issuers to acquire financing.

We have decided not to incorporate an exception from the locate and delivery requirements of Rule 203 for short sales that result in bona-fide fully hedged or arbitraged positions. Because ''bona-fide'' hedging and arbitrage can be difficult to ascertain, we are concerned about including a blanket exception for some activity that may have the potential to harm issuers and shareholders.[76] During the period of the pilot, we prefer instead to address the situations noted by the commenters, and other similarly situated entities, through the exemptive process, to the extent warranted.[77] This will allow us to consider the particular facts and circumstances relevant to each request, as well as any potentially negative ramifications, and, should we gain comfort with the described transaction(s), fashion appropriate relief.

Additionally, we have declined at this time to include an express exception from the locate requirements of Rule 203(b)(1) for transactions in exchange traded funds (''ETFs'').[78] We have observed high levels of fails in some ETFs. Rather than providing a blanket exception from the requirements of Rule 203, we would prefer instead to address the treatment of ETFs through the exemptive process, which would be consistent with the prior treatment of ETFs.[79] In considering any exemptive request, the Commission would evaluate the causes of large fails in certain ETFs, as well as potential remedies to resolve such fails, if necessary.

B. Short Sales in Threshold Securities—Rule 203(b)(3)

1. Threshold Securities

The Commission has decided to adopt, with certain modifications from what was proposed, additional requirements targeted at stocks that have a substantial amount of failures to deliver. As adopted, Rule 203(b)(3) requires any participant of a registered clearing agency (''participant'')[80] to take action on all failures to deliver that exist in such securities ten days after the normal settlement date, *i.e.*, 13 consecutive settlement days.[81] Specifically, the participant is required to close out the fail to deliver position by purchasing securities of like kind and quantity.

With slight modification from the proposal, a ''threshold security'' is defined in Rule 203(c)(6) as any equity security of an issuer that is registered under Section 12, or that is required to file reports pursuant to Section 15(d) of the Exchange Act[82] where, for five consecutive settlement days: there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security; that the level of fails is equal to at least one-half of one percent of the issuer's total shares outstanding; and the security is included on a list published by an SRO.[83] We believe this threshold characterizes situations where the ratio of unfulfilled delivery obligations at the clearing agency at which trades are settled represents a significant number of shares relative to the company's total shares outstanding. We believe that such circumstances warrant action designed to address potential negative effects.[84] This narrowly targeted threshold will not burden the vast majority of securities where there are not similar concerns regarding settlement.[85] Our OEA analyzed recent data from NSCC on fails to deliver and calculated that approximately 3.9% of all exchange-listed and Nasdaq securities, and 4.0%

provides financing to smaller issuers, with a typical transaction generally involving a private placement of restricted stock in a company at a fixed price in exchange for an agreement to provide cash for such shares upon the closing of the transaction. In order to hedge the risk of market price changes in the restricted shares, the fund would buy over-the-counter put options from a counterparty. It was argued, however, that the counterparty would want to hedge its risk by purchasing an in-the-money call option, and shorting the underlying stock. It was similarly argued that due to the dearth of borrowable shares in some smaller issuers, the sales could be naked short sales.

[76] In a recent matter, the Commission accepted offers of settlement from Rhino Advisors and Thomas Badian, Rhino's president, in connection with trading in the common stock of Sedona Corporation by Rhino on behalf of certain foreign entities. The Commission alleged that Rhino and Badian, acting in their capacities as investment advisors, manipulated Sedona's stock price downward by engaging in naked short selling of Sedona's stock in accounts maintained in the names of others. In the complaint filed in the action, the Commission alleged that Rhino manipulated Sedona's stock price to enhance an offshore entity's economic interests in a $3 million convertible debenture issued by Sedona and that, by depressing Sedona's stock price, Rhino increased the number of shares that the offshore entity received when it exercised its conversion rights under the debenture. *See Rhino Advisors, Inc. and Thomas Badian*, Litigation Release No. 18003 (February 27, 2003); *see also SEC* v. *Rhino Advisors, Inc. and Thomas Badian*, Civ. Action No. 03 Civ 1310 (SDNY March 5, 2003).

[77] *See* Section 203(d) of Regulation SHO, 17 CFR 242.203(d), and Section 36 of the Exchange Act. 15 U.S.C. 78mm.

[78] Two commenters requested an exception to the locate and delivery requirements for ETFs. The commenters maintain that ETFs should not be subject to the requirements of Rule 203 because ETFs have the ability to continuously create and redeem shares. *See* letters from Amex; Nasdaq.

[79] Prior exemptions from Rule 10a–1 have been granted for transactions in certain ETFs. *See, e.g.*, Letter re: SPDRs (January 27, 1993); Letter re: MidCap SPDRs (April 21, 1995); Letter re: Select Sector SPDRs (December 14, 1998); Letter re: Units of the Nasdaq-100 Trust (March 3, 1999); Letter re: ETFs (August 17, 2001) (class letter).

[80] ''Participant'' is defined in Section 3(a)(24) of the Exchange Act. 15 U.S.C. 78c(a)(24). A ''registered clearing agency'' is a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, (15 U.S.C. 78c(a)(23)(A)), that is registered with the Commission pursuant to Section 17A of the Exchange Act, 15 U.S.C. 78q–1.

[81] Rule 203(c)(5) defines ''settlement day'' to mean any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.

[82] As proposed, the restrictions of Rule 203 would have covered equity securities registered under Section 12 of the Exchange Act. We are also extending the delivery restrictions to equity securities of issuers subject to Exchange Act reporting pursuant to Section 15(d). This would thus mandate coverage of those companies that are required to provide ongoing public disclosure about the company, its actions, and its performance. As the calculation of the threshold that would trigger the delivery requirements of Rule 203 depends on identifying the aggregate fails to deliver as a percentage of the issuer's total shares outstanding, it is necessary to limit the requirement to companies that are subject to the reporting requirements of the Exchange Act.

[83] For example, if an issuer had 1,000,000 shares outstanding, one-half of one percent (.005) would be 5,000 shares. An aggregate fail to deliver position at a clearing agency of 10,000 shares or more would thus exceed the specified level of fails. If an issuer had 10,000,000 shares outstanding, one-half of one percent would be 50,000 shares. An aggregate fail to deliver position at a clearing agency of 50,000 shares or greater would exceed the specified level of fails.

[84] We are incorporating the same threshold that is currently used in NASD Rule 11830. Because of this, it is our belief that implementation will not impose excessive programming costs on the industry, although we note that some programming modifications will be necessary to extend the current calculation beyond the current universe of Nasdaq securities.

[85] As noted by some commenters, there may be many different causes of fails to deliver that could be unrelated to a market participant engaging in naked short selling. Thus, imposing a lower threshold or, as suggested by some commenters, prohibiting all fails, might be impracticable or an overly-broad method of addressing any potential abuses, and could also disrupt the efficient functioning of the Continuous Net Settlement system (''CNS'') operated by the National Securities Clearing Corporation (''NSCC''). For example, one commenter noted that some fails are caused by custodian banks failing to deliver on behalf of their customers for a number of reasons, such as where a foreign domiciled customer engages in arbitrage involving American Depositary Receipts (''ADRs'') and operates under the international arbitrage exemption provided in Rule 10a–1(e)(8). *See* letter from LEK Securities.

Additionally, some commenters addressed NSCC's securities lending program. *See, e.g.*, letter from NASAA at 3. In responding to comments on the stock borrow program, NSCC noted that the program can reduce fails and give purchasers an increased chance of receiving those securities on settlement date. *See* letter from NSCC at 6–7. The Commission notes that NSCC's stock borrow program, as approved by the Commission, permits NSCC to borrow securities for the purpose of completing settlements only if participants have made those securities available to NSCC for this purpose and those securities are on deposit in the participant's account at The Depository Trust Company (''DTC''). *See* Securities Exchange Act Release No. 17422 (December 29, 1980), 46 FR 3104 (January 13, 1981).

of all securities, would meet this threshold.[86]

In order to be deemed a threshold security, and thus subject to the restrictions of Rule 203(b)(3), a security must exceed the specified fail level for a period of five consecutive settlement days. Similarly, in order to be removed from the list of threshold securities, a security must not exceed the specified level of fails for a period of five consecutive settlement days.[87] This five-day requirement will address the potential situation where a security exceeds the fails level on one day, based on an aberrant fail to deliver that may not be indicative of the usual pattern of that particular security, and thus would prevent potential ''flickering'' of securities in and out of the list of threshold securities.[88] Rule 203(b)(3) is intended to address potential abuses that may occur with large, extended fails to deliver.[89] We believe that the five-day requirement will facilitate the identification of securities with extended fails.

As is currently the practice for Nasdaq securities that exceed the threshold designated in NASD Rule 11830, the pertinent SRO will be responsible for publishing a daily list of the threshold securities that are listed on their markets, or for which the SRO bears the primary surveillance responsibility.[90] The SROs derive the information necessary to calculate the list of threshold securities from data on fails to deliver currently received from NSCC.[91]

2. Close-out Requirement

As proposed, the rule would have specified that, for short sales of any security meeting this threshold, the selling broker-dealer must deliver the security no later than two days after the settlement date. If for any reason such security were not delivered within two days after the settlement date, the rule would have restricted the broker-dealer, including market makers, from executing additional short sales for the next 90 days in such security for the person for whose account the failure to deliver occurred, unless the broker-dealer or the person for whose account the short sale is executed, borrowed the security or entered into a bona-fide arrangement to borrow the security, prior to executing the short sale. In addition, the rule would have required the registered clearing agency that processed the transaction to refer the party failing to deliver to the NASD and the designated examining authority for such broker-dealer for appropriate action; and to withhold a benefit of any mark-to-market amounts or payments that otherwise would be made to the party failing to deliver.

Some commenters argued that under the confines of current settlement practices and procedures, it is not practical to assign delivery failures to a particular clearing firm customer account. It was noted that because NSCC's continuous net settlement (''CNS'') system nets all buys and sells in each security for each NSCC participant, broker-dealers cannot determine which customer's transaction or account gave rise to a failure to deliver.[92] We note that while this may be the current situation in the industry, if the Commission believes that the rules as adopted are not having the intended effects of reducing potentially manipulative behavior, we may consider additional rulemaking that could require broker-dealers to identify individual accounts that are causing fails to deliver.

We have considered the comments received, and have adopted a rule that differs in the mechanics from the proposed rule, but continues to preserve the goal of limiting failures to deliver in threshold securities. As adopted, Rule 203(b)(3) requires action if a fail in a threshold security remains open ten days after the settlement date, *i.e.*, for thirteen consecutive settlement days.[93] Specifically, Rule 203(b)(3) requires a participant of a clearing agency registered with the Commission [94] to take action to close out the fail to deliver that has remained for thirteen consecutive settlement days by purchasing securities of like kind and quantity.[95] In addition, Rule

[86] Some stocks that are quoted in the Pink Sheets are not reporting issuers, and thus there is not a readily available means to determine the total shares outstanding in such securities. If, however, we incorporate non-reporting issuers that have aggregate fails in excess of 10,000 shares, only an additional 1% of all securities would be added. These securities will not be subject to the additional requirements imposed upon threshold securities, although broker-dealers effecting short sales in these securities are subject to the locate requirements of Rule 203(b)(1).

[87] For example, an issuer that had 10,000,000 shares outstanding and an aggregate fail to deliver position greater than 50,000 shares for at least five consecutive settlement days, would be a threshold security, and would no longer be a threshold security after the aggregate fail to deliver position was less than 50,000 shares for at least five consecutive settlement days.

[88] For example, we note the situation involving ADR arbitrage as described in n. 85, *supra*.

[89] A person that sells a security and fails to deliver, with the intent of triggering the close-out requirement of Rule 203(b)(3) and creating a short squeeze that could benefit a person's long position, could be deemed to be engaging in manipulative behavior.

[90] It is expected that the NYSE will calculate and disseminate a list of NYSE-listed securities that exceed the specified fails level for at least five consecutive settlement days. Amex will calculate and disseminate a list of Amex-listed securities that exceed the specified fails level for at least five consecutive settlement days, in addition, the NASD will calculate and disseminate a list of all over-the-counter securities, including Nasdaq, OTCBB, and Pink Sheet securities that exceed the specified fails level for at least five consecutive settlement days. It is expected that the lists of threshold securities will be disseminated prior to the commencement of each trading day.

[91] As NSCC noted in its comment letter, it is providing the Commission, the NYSE, the NASD, and Amex with a daily report listing information on all participant short obligations for all equity securities with aggregate clearing short positions greater than 10,000 shares. The SROs will calculate whether the aggregate fails at NSCC exceed 0.5% of the issuer's total shares outstanding.

[92] *See, e.g.*, letter from SIA. The SIA, as well as several other commenters, stated the belief that buy-ins were more practical since it is possible to allocate the costs of a buy-in among multiple short sellers, whereas application of the proposed account trading restriction is not feasible. Other commenters stated that the fear of a mandatory buy-in and threat of a market loss would be a greater deterrent than the proposed restriction and withholding of the mark. *See, e.g.*, letter from H. Glenn Bagwell, Jr.

[93] We note that some commenters believed that imposing the delivery requirements two days after settlement, *i.e.*, after five settlement days, would capture many instances of ordinary course settlement delays, rather than address potentially abusive activity. *See, e.g.*, letters from CBOE; SIA; Willkie Farr. OEA took a snapshot of fails data received from NSCC from April 19 through April 30, 2004, which confirmed a rate of decline over a course of settlement days. Similar rates of decline were found using data obtained from NSCC for other periods during the past six months. In addition, because Rule 203(b)(3) would require a participant to close out all fails to deliver in threshold securities, whether resulting from short sales or long sales, extending the time period to ten days after settlement would make the close-out requirement consistent with 17 CFR 240.15c–3–3(m). Ten days after settlement is also the timeframe currently identified in NASD Rule 11830.

[94] A participant of a registered clearing agency includes registered broker-dealers, and entities that may not be registered broker-dealers, but are responsible for the settlement of transactions at a registered clearing agency, such as the Canadian Depository for Securities (''CDS'').

[95] The following examples illustrate potential scenarios involving threshold security XYZ: (i) If a participant has a 100 share fail to deliver position in XYZ for 13 consecutive settlement days, the participant is required to purchase 100 shares; (ii) If a participant has a 100 share fail to deliver position in XYZ, and the fail to deliver position increases by 100 shares each day for 13 consecutive settlement days, yielding a 1300 share fail to deliver position, then the participant is required to purchase 100 shares at the end of the 13th day, 100 shares the next day, etc., until the entire fail to deliver position is closed out; (iii) If a participant has a 100 share fail to deliver position in XYZ, which is then reduced to a 50 share fail to deliver position during the following 13 consecutive settlement days, then the participant is required to close out 50 shares; or (iv) If a participant has a 100 share fail to deliver position in XYZ, which is netted to zero five settlement days later, and then a new 100 share position is established the following day, the participant would not be required to close out the initial 100 shares, but would be required to close out the subsequent 100 share fail to deliver position if it remained for 13 consecutive settlement days.

203(b)(3)(iii) states that the participant, and any broker-dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the bona-fide market making exception, is prohibited from effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the fail to deliver position is closed out. To the extent that the participant can identify the broker-dealer(s) or account(s) that have contributed to the fail to deliver position, the requirement to borrow or arrange to borrow prior to effecting further short sales should apply to only those particular broker-dealer(s) or account(s). Rule 203(b)(3)(v) states that where a participant enters into an arrangement with a counterparty to purchase securities as required by Rule 203(b)(3), and the broker or dealer knows or has reason to know that the counterparty will not deliver the securities, the broker or dealer will not have fulfilled the requirements of the rule.[96]

The requirement to close out fail to deliver positions in threshold securities that remain for thirteen consecutive settlement days does not apply to any positions that were established prior to the security becoming a threshold security.[97] However, if a participant's fail to deliver position is subsequently reduced below the pre-existing position, then the fail to deliver position excepted by this subparagraph shall be the lesser amount.[98] Rule 203(b)(3)(iv) also provides that a participant may reasonably allocate its responsibility to close out open fail positions in threshold securities to another broker-dealer for which the participant is responsible for settlement. Thus, participants that are able to identify the accounts of broker-dealers for which they clear may allocate the responsibility to close out open fail to deliver positions to the particular account(s) whose trading activities have caused the fail to deliver position. Absent such identification, however, the participant would remain subject to the close out requirement.

3. Other Proposed Requirements

We are not adopting the additional requirements of proposed Rule 203(b)(3)(ii), which would have required a registered clearing agency that processed the transaction to refer the party failing to deliver to the NASD and the designated examining authority for such broker-dealer for appropriate action; and withhold a benefit of any mark-to-market amounts or payments that otherwise would be made to the party failing to deliver. Since the Proposing Release was issued, Commission staff and the SROs have developed new procedures to identify and inquire regarding failures to deliver that achieve the goals of the proposed notification requirement. This includes the daily dissemination by NSCC to the Commission and the SROs of a report listing information on all participant short obligations for all equity securities with aggregate clearing short positions greater than 10,000 shares, which is being used by the SROs to initiate inquiries with members concerning the cause of the fails and whether there was compliance with regulatory requirements.

In addition, NSCC and other commenters noted that, due to the manner in which the CNS system currently calculates each participant net position in a security, it is not possible to distinguish between obligations to deliver that are the result of short sales as opposed to long sales.[99] As such, it is not possible to determine whether a mark paid to a participant is a ''benefit'' received in connection with a fail to deliver position resulting from a short sale.

We are not adopting at this time the proposal that would require NSCC to withhold mark-to-market amounts paid to individuals. However, the Commission intends to pay close attention to the operation and efficacy of the provisions we are adopting in Rule 203, and will consider whether any further action is warranted.

4. Market Makers

We received a number of comments from market makers, including options market makers, on the proposal not to provide an exception for market makers from the special delivery requirements applicable to securities that meet the designated threshold.[100] Some of these commenters stated that the effect of not including such an exception would be to cease altogether options trading in securities that are difficult to borrow, as it was argued that no options market maker would make markets without the ability to hedge by selling short the underlying security.[101] In addition, another commenter stated that the heightened delivery requirements for threshold securities could drain liquidity in other securities where there is no current indication of significant settlement failures.[102] The commenter believed that, while a blanket exception from the heightened delivery requirements would be preferable, at a minimum the implementation of any such provision should not apply to market maker positions acquired prior to the effective date of the rule, and likewise should not apply to any short position acquired prior to the time that the subject security meets the designated threshold.

We note that the close out requirements of Rule 203(b)(3) will only apply to fail to deliver positions in threshold securities, and will not apply to any fail to deliver positions established prior to the security meeting the threshold.[103] As such, we believe that this addresses in part the commenters' concerns that market makers would need to assess the probability of a security meeting the threshold at some point in the future. Moreover, we expect that a small percentage of securities for which there are associated options will exceed the threshold.[104] In light of this, we believe that the effects of not including a market

[96] This includes the situation where a broker-dealer that was required to close out a fail to deliver in a security exceeding the threshold entered into an arrangement to buy from a counterparty, and thus net out the broker-dealer's position at CNS, but the broker-dealer knew or had reason to know that the counterparty did not intend to deliver the security, which thus created another fail in the CNS system.

[97] Rule 203(b)(3)(i). This is consistent with the current operation of NASD Rule 11830.

[98] For example, if a participant had a 100 share fail to deliver position in XYZ security prior to XYZ becoming a threshold security, and if XYZ subsequently became a threshold security, the participant would not be required to close out the 100 share fail, even if it remained for 13 consecutive settlement days. Therefore, if after becoming a threshold security the fail to deliver position in XYZ increased to 200 shares, and remained for 13 consecutive settlement days, the participant would be required to close out 100 shares. If, after becoming a threshold security, the participant's total fail to deliver position in XYZ fell to 50 shares, and then rose to 150 shares and remained for 13 consecutive settlement days, the participant would be required to close out 100 shares, rather than only 50 shares.

[99] *See* letter from NSCC at p. 5 for further discussion regarding the operation of the CNS system.

[100] *See, e.g.*, letters from Knight; Susquehanna; Pacific Exchange (''PCX''); Amex; and joint letter from Amex, CBOE, International Securities Exchange (''ISE''); The Options Clearing Corporation (''OCC''), PCX, Philadelphia Stock Exchange (''PHLX'') (''Joint Options Letter'').

[101] *See* Joint Options Letter.

[102] *See* letter from Susquehanna. In particular, this commenter believed that market makers would need to assess for each assigned security the probability that it would become a threshold security at some point in the future, and in circumstances in which this is thought to be a realistic possibility, the market maker would need to decide whether to incorporate the added risks into pricing or relinquish market maker status in the particular security.

[103] *See* Rule 203(b)(3)(i).

[104] OEA has estimated that approximately 4.1% of all securities that have options traded on them would meet the threshold.

maker exception from the heightened delivery requirement will not be as severe as some of the commenters have described. Moreover, while some of these commenters have opined that options market makers are not responsible for significant failures to deliver,[105] other commenters and academics have questioned this assertion.[106]

Therefore, while market makers (including options market makers) engaged in bona-fide market making will continue to be excepted from the locate requirement of Rule 203(b)(1), even when effecting short sales in threshold securities, we have decided at this time not to extend an exception to market makers from the requirements to close out fails to deliver in such securities that remain for thirteen consecutive settlement days. Moreover, as discussed previously, Rule 203(b)(3)(iii) provides that until the market maker, or the participant that clears for the market maker, takes action to close out any such fails to deliver that remain ten days after the normal settlement date, the market maker shall be unable to rely on the exception in Rule 203(b)(2)(iii) from the requirement to ''borrow or arrange to borrow'' for further short sales in such security.

We have, however, included a limited exception from the close out requirement to allow registered options market makers to sell short threshold securities in order to hedge options positions, or to adjust such hedges, if the options positions were created prior to the time that the underlying security became a threshold security. Any fails to deliver from short sales that are not effected to hedge pre-existing options positions, and that remain for thirteen consecutive settlement days, are subject to the mandatory close out requirement. We will, however, take into consideration information that shows that this provision operates significantly differently from our expectations.

VI. Rule 203(a)—Long Sales

We are adopting subparagraph (a) of Rule 203, which covers delivery requirements applicable to long sales of securities, largely as proposed. Rule 203(a) incorporates current Rule 10a–2.

As proposed, Rule 203(a) would have provided that if a broker-dealer knows or should know that a sale was marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. The proposed rule would have provided that the delivery requirements would not apply in three situations: to the loan of a security through the medium of a loan to another broker or dealer; where the broker or dealer knows or has been reasonably informed by the seller that the seller owns the security and will deliver it to the broker or dealer prior to the scheduled settlement of the transaction; or where an exchange or securities association finds, prior to the loan or fail, that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price. The proposed requirements would have extended to all securities, not just to those registered on an exchange.

Three commenters supported the proposed changes, believing that they would ensure greater consistency across markets and securities.[107] One commenter requested that the rule except long sales that fail, through no fault of the seller, because of processing delays.[108] In addition, two commenters suggested that the proposed Rule did not adequately address long sale delivery fails.[109]

After considering comments received, we are adopting the changes proposed, with one modification. Pursuant to proposed Rule 203(a), one of the circumstances in which a fail or delivery of borrowed shares would have been permitted was where, prior to the sale, the broker or dealer knew that the seller owned the securities and the seller had represented that he or she would deliver them to the broker in time for settlement. Although we believe it was implicit in the proposed rule text (and in current Rule 10a–2), we are including in the rule text the predicate that the seller fails to make such delivery after advising the broker-dealer that he or she would deliver the securities in time for settlement.[110]

As adopted, Rule 203(a) requires that if a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. This delivery obligation does not apply in three circumstances: (1) The loan of a security through the medium of a loan to another broker or dealer; (2) where the broker or dealer knows or has been reasonably informed by the seller that the seller owns the security and will deliver it to the broker or dealer prior to the scheduled settlement of the transaction and the seller fails to make such delivery;[111] or (3) where an exchange or securities association finds, prior to the loan or arrangement to loan any security for delivery, or failure to deliver, that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price.[112]

The new rule is consistent with the Commission's view that delivery requirements are important for all securities, particularly those with a lower market capitalization that may be more susceptible to abuse. Moreover, Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. This requirement is consistent with changes being made to the order marking requirements, which require that for an order to be marked

[105] *See* Joint Options Letter.

[106] *See* letter from SIA (which noted in pertinent part, ''[t]he SEC and SROs may also want to consider whether to utilize their existing authority to determine to what extent non-bona-fide market making trading activities by market makers does or does not contribute to extended fails.''); *see also* Evans, Geczy, Musto & Reed, *Failure Is an Option: Impediments to Short Selling and Options Prices*, Working Paper, The Wharton School at the University of Pennsylvania and the University of North Carolina (March 1, 2003) (finding that the options market maker exemption from the requirement to locate stock to borrow on short sales may create significant profits for the market makers).

[107] *See* letters from H. Glenn Bagwell, Jr.; Feldman; LEK Securities.

[108] *See* letter from Feldman. We have addressed this situation by providing an exception in Rule 203(b)(2)(ii) for situations where a broker effects a 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 the 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 is thus a ''short'' sale under the marking requirements of Rule 200(g) as adopted.

[109] *See* Letter Type A; SIA. The Commission disagrees with these comments. We believe that the provisions of Rule 203(a) are appropriate to guard against fails to deliver on long sales, in that a broker may fail to deliver borrowed shares on long sale fails only in the limited circumstances set forth in the rule. In addition, Rule 203(b)(3) requires a participant to close out all fails to deliver that remain in threshold securities for 13 consecutive settlement days. 17 CFR 240.15c–3–3(m) also addresses fails to deliver on long sales.

[110] *See* Rule 203(a)(2)(ii).

[111] It may be unreasonable for a broker-dealer to treat a sale as long where orders marked ''long'' from the same customer repeatedly require borrowed shares for delivery or result in ''fails to deliver.'' A broker-dealer also may not treat a sale as long if the broker-dealer knows or has reason to know that the customer borrowed the shares being sold.

[112] As with other provisions of Regulation SHO, this provision requires good faith conduct by the broker-dealer. Therefore, where the broker-dealer did not in good faith believe that the customer would deliver the securities in time for settlement, the broker-dealer cannot borrow or lend securities to deliver when the customer fails.

long, the seller must own the security.[113]

VII. Rule 105 of Regulation M—Short Sales in Connection with a Public Offering

A. Generally

Rule 105 of Regulation M prohibits a short seller from covering short sales with offering securities purchased from an underwriter or broker or dealer participating in the offering, if the short sale occurred during the Rule's restricted period, typically the five-day period prior to pricing.[114] The reason for the prohibition is that pre-pricing short sales that are covered with offering shares artificially distort the market price for the security, preventing the market from functioning as an independent pricing mechanism and eroding the integrity of the offering price.[115] Prices of ''follow-on offerings''[116] are typically based on a stock's closing price prior to the time of pricing, and thus short sales during the period immediately preceding pricing that reduce the market price can result in a lower offering price. The goal of Rule 105 is to promote offering prices that are based upon open market prices determined by supply and demand rather than artificial forces.

Rule 105 does not prohibit pre-pricing short sales, in recognition of the fact that if such sales are motivated by a short seller's evaluation of the stock's future performance, they can contribute to pricing efficiency and the creation of a correct market price. Rule 105 does, however, prohibit using offering shares to cover any such pre-pricing short sales. A trader who sells short pre-pricing and knows or has a high degree of assurance that he will be able to obtain covering shares in the offering does not assume the same market risk as a short seller who intends to cover using open market shares, and may not be contributing to pricing efficiency and true price discovery. Therefore, the rule prohibits pre-pricing short sales, effected within five days of pricing of an offering, from being covered with offering securities acquired from an underwriter or other broker-dealer participating in the offering. Moreover, this manipulative conduct can negatively affect the issuer, which receives reduced offering proceeds as a result of the lower offering price, and harms the market by inhibiting the capital raising process. In addition, the presence of such shorting activity can lead other investors, who believe that the short selling is the result of an evaluation of the stock's value, to sell short as well. By prohibiting such artificial selling activity, the Rule contributes to the integrity of the capital raising process.

B. Shelf Offerings

In the Proposing Release, we proposed to amend Rule 105 to eliminate the shelf offering exception.[117] We are adopting the amendment as proposed.

When the Commission initially adopted the shelf exception in Rule 105, it stated that it might be necessary for the Commission to reevaluate the exception in the event such offerings became more common.[118] One of the reasons for the adoption of the shelf offering exception was the generally accepted view that shelf offerings were not as susceptible to manipulation as non-shelf offerings.[119] At the time Regulation M was adopted, it was our understanding that potential investors generally were not aware of a takedown from a shelf registration until immediately prior to its occurrence, and thus pre-pricing short sales were arguably not focused on the prospective offering. Today, however, shelf offerings can have many characteristics of non-shelf offerings. They are likely to utilize the same marketing efforts—road shows and other special selling efforts—that are used with non-shelf offerings, and thus investors often have notice of a shelf offering before it occurs. Moreover, since the initial adoption of Rule 105, equity shelf offerings have become commonplace.

We believe that using offering shares to cover short sales effected prior to pricing of a shelf offering has the same negative effect as in non-shelf offerings. In light of the increased use of shelf offerings, we believe that the shelf exception presents an increased potential for the type of manipulative conduct that Regulation M is designed to prevent.

We received three comment letters on Rule 105. [120] One commenter argued that the exception should be retained because allowing offerees to act on their conviction that the proposed offering is overpriced by shorting in advance of pricing, leads to the creation of a ''true'' market price.[121] As noted above, Rule 105 does not prevent short sellers from contributing to pricing efficiency by short selling in advance of an offering. Another commenter urged the Commission to retain the exception for shelf offerings that occur on an ''overnight'' or ''bought deal basis'' where no red herring or preliminary prospectus is distributed.[122] The Commission believes that even though no preliminary prospectus is issued in these takedowns, manipulative pre-pricing short sales could take place if other marketing efforts prior to the offering put investors on notice of the offering. We therefore believe that granting a blanket exception for these offerings is not appropriate.

By providing that shelf offering prices will be based upon market prices that are not artificially influenced, the amendment will benefit both issuers and investors. It will promote the integrity of the capital raising process, enhance investor confidence in our markets, and help protect issuers conducting shelf offerings from receiving reduced offering proceeds as a result of manipulative conduct.[123]

C. Sham Transactions

In the Proposing Release, the Commission noted its concern with sham transactions that are structured to appear to comply with Rule 105, but which in fact violate the Rule. Such transactions are undertaken to give the appearance that pre-pricing short sales are not covered with offering shares, but instead are covered with shares purchased in the open market. We sought comment on how to address

[113] *See, supra* part III.B. for a discussion of the order marking requirements.

[114] 17 CFR 242.105.

[115] As noted in the Proposing Release, Rule 105 of Regulation M applies to offerings of securities for cash pursuant to a registration statement or a notification on Form 1–A filed under the Securities Act.

[116] A ''follow-on offering'' is an issuance of additional securities by an issuer that is subject to the reporting requirements pursuant to Sections 13 or 15(d) of the Exchange Act. 15 U.S.C. 78m, 78o(d).

[117] *See* Proposing Release, Section XVI.

[118] *See Anti-Manipulation Rules Concerning Securities Offerings; Final Rule,* Securities Exchange Act Release No. 38067, 62 FR 520, 538 (January 3, 1997) (''Regulation M Release''), where the Commission stated ''it may be necessary for the Commission to reevaluate this exclusion if the availability of shelf registration is further expanded or offerings of shelf-registered equity become more common-place.''

[119] *See Short Sales in Connection With a Public Offering,* Securities Exchange Act Release No. 26028, 53 FR 33455, 33458 (August 25, 1988) (''Rule 10b–21(T) Release''), adopting Rule 10b-21(T).

[120] *See* letters from The Bond Market Association (''TBMA''); Feldman; SIA.

[121] *See* letter from Feldman, at 5.

[122] *See* letter from SIA.

[123] One commenter asked the Commission to consider excluding non-equity securities offerings from the scope of Rule 105, claiming that the type of manipulative activity with which Rule 105 is concerned is less likely to occur in debt offerings than in equity offerings. *See* TBMA letter. We continue to believe that bond offerings present a potential for manipulation, and we have therefore determined that non-equity offerings will continue to be subject to the prohibitions of Rule 105. The Commission will consider granting exemptive relief on a case-by-case basis where warranted.

these transactions. We did not receive any comments on this issue. We have decided to issue interpretive guidance to address transactions that violate Rule 105 by utilizing offering-shares to cover short sales made in the pre-pricing restricted period, while structuring the transactions so as to falsely give the appearance that the short sale has been covered using shares purchased in the open market. Transactions structured in this way violate Rule 105. Some examples of sham transactions that would violate Rule 105 follow. These examples are illustrative, and are not meant to be exhaustive.

1. Arrangements To Purchase

In the first example of a sham transaction, short sales are effected during the pre-pricing restricted period and are covered using offering securities obtained through an arrangement with a third party who acquires the securities in the primary offering.[124] In this transaction, the trader is attempting to accomplish indirectly what he or she cannot do directly, *i.e.*, a type of short sale transaction prohibited by Rule 105.[125]

2. Sell/Buy and Buy/Sell

In the second example of a sham transaction, a trader effects pre-pricing short sales during the Rule 105 restricted period, receives offering shares, sells the offering shares into the open market, and then contemporaneously or nearly contemporaneously purchases an equivalent number of the same class of shares as the offering shares, which are then used to cover the short sales. Where the transaction is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership,[126] and/or little or no market risk, that transaction may be a sham transaction that violates Rule 105.

We do not believe it necessary or desirable to add rule language to address these kinds of trading, as this activity violates the current rule and can vary in its details. The Commission will continue to enforce Rule 105 in the face of sham transactions designed to evade the Rule. In addition, if such sham transactions are used as part of a fraudulent or manipulative scheme, the conduct may also violate the Commission's anti-fraud and anti-manipulation provisions, including but not limited to, Sections 9(a) and 10(b) of the Exchange Act.[127]

VIII. Paperwork Reduction Act

The adopted amendments to Regulation SHO contain collection of information requirements within the meaning of the Paperwork Reduction Act of 1995.[128] We published a notice requesting comment on the collection of information requirements in the Proposing Release, and submitted these requirements to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has approved these requests. We did not receive comments on the proposed collection of information requirements.

Compliance with the adopted amendments to Regulation SHO and Rule 105 of Regulation M will be mandatory. The Commission will not keep the information required by the amendments confidential. An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number. The title of the affected collection is ''Regulation SHO'' under OMB control number 3235–0589.

A. Summary of Collections of Information

Rule 200(g) contains a requirement that all sell orders in equity securities be marked ''long,'' ''short,'' and ''short exempt.'' Currently, Rule 10a–1(c) prohibits the execution of a sell order for a security covered by Rule 10a–1 unless the order is marked either ''long'' or ''short.'' Regulation SHO contains a new collection of information because the collection would cover a much larger number of securities. Rule 200(g) of Regulation SHO adds two elements to the existing marking requirement. First, a new category for ''short exempt'' orders is being added. Second, the marking requirement is being extended to apply to all equity securities, including exchange-listed securities, Nasdaq NMS, Nasdaq SmallCap, OTCBB, and Pink Sheet securities. By adopting Rule 200(g) of Regulation SHO, Rule 10a–1(c) is being repealed and any collection of information under Rule 10a–1 is being eliminated.

Sell orders of exchange-listed and Nasdaq securities are already marked ''long,'' ''short,'' or ''short exempt'' pursuant to Rule 10a–1, NYSE Rule 440B.20, and the ITS Plan. Nasdaq NMS and Nasdaq SmallCap securities are also currently subject to a marking requirement pursuant to NASD Rule 4991. Rule 200(g) of Regulation SHO simply codifies current industry practice for exchange-listed and Nasdaq securities into a uniform marking requirement.

Rule 203(b)(1) contains a requirement that broker-dealer must locate securities available for borrowing prior to effecting a short sale transaction. Subparagraph (iii) of Rule 203(b)(1) requires documentation of compliance with Rule 203(b)'s locate requirement. We note, however, that current SRO rules already require a written record documenting compliance with their locate rules.[129]

B. Use of Information

The information required by Regulation SHO is necessary for the execution of the Commission's mandate under the Exchange Act to prevent fraudulent, manipulative and deceptive acts and practices by broker-dealers. The purpose of the information collected is to enable the Commission, a national securities exchange or national securities association to monitor whether a person effecting a short sale covered by proposed Regulation SHO is acting in accordance with Regulation SHO. In particular, requiring each order to be marked either ''long,'' ''short,'' or ''short exempt'' would aid in ensuring compliance with Rule 203 and current Rule 10a–1. Moreover, the ''short exempt'' category will aid in surveillance for compliance with the exceptions from these rules.

C. Respondents

The marking provision in Rule 200(g) will apply to all 6,553 active brokers or dealers that are registered with the Commission. The Commission has considered each of these respondents for the purposes of calculating the reporting burden under proposed Regulation SHO.

D. Total Annual Reporting and Recordkeeping Burdens

Rule 200(g) of Regulation SHO requires all brokers or dealers to mark

[124] The Commission has previously stated its concern with transactions where an intermediary is used to purchase covering-shares from the offering. *See* Rule 10b–21(T) Release, 53 FR at 33460.

[125] *See also* Exchange Act Section 20(b), 15 U.S.C. 78t.

[126] *See also* Exchange Act Section 9(a)(1), 15 U.S.C. 78i(a)(1). For example, an individual places limit orders to sell and buy the same amount of shares, and the transaction is crossed in the individual's brokerage account. There is no change in beneficial ownership and no market risk associated with the transaction, *i.e.*, these are ''wash sales.'' Although the individual has attempted to disguise the fact that the offering shares are being used to cover the short sale, in fact, he is covering his pre-pricing short sale with shares obtained in the offering. *See, e.g.*, Ascend Capital, LLC, Securities Exchange Act Release No. 48188 (July 17, 2003).

[127] 15 U.S.C. 78i(a), 78j(b).

[128] 44 U.S.C. 3501.

[129] NASD Rule 3370(b)(4)(B).

all sell orders appropriately as ''long,'' ''short,'' or ''short exempt'' for all equity securities. We estimate that all of the approximately 6,553 active registered broker-dealers [130] effect sell orders in securities covered by proposed Regulation SHO. For purposes of the Paperwork Reduction Act, the Commission staff has estimated that a total of 1,465,563,860 trades are executed annually.[131]

Currently, under both Commission and SRO rules, broker-dealers are obligated to document certain order information. Rule 10a–1 requires sell orders of exchange-listed and Nasdaq securities to be marked ''long,'' ''short,'' or ''short exempt.'' NYSE Rule 440B.20, the ITS Plan, and NASD Rule 4991 [132] additionally impose a marking requirement. Rule 200(g) of Regulation SHO simply codifies the current practice for exchange-listed and Nasdaq securities into a uniform marking requirement.

Based on the number of annual trades and number of active registered broker-dealers, the average annual responses by each respondent is approximately 223,647. Each response of marking orders ''long,'' ''short,'' or ''short exempt'' takes approximately .000139 hours (.5 seconds) to complete.[133] Thus, the total estimated annual hour burden per year is 203,713 burden hours (1,465,563,860 responses @ 0.000139 hours/response). A reasonable estimate for the paperwork compliance for the proposed rules for each broker-dealer is approximately 31 burden hours (223,647 responses @ .000139 hours/response) or a total of 203,713 burden hours/6,553 respondents.

IX. Cost-Benefit Analysis

We are sensitive to the costs and benefits of our rules and we have considered the costs and benefits of our adopted rules. To assist us in evaluating the costs and benefits, in the Proposing Release, we encouraged commenters to discuss any costs or benefits that the rules might impose. In particular, we requested comment on the potential costs for any modification 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 others. Commenters were requested to provide analysis and data to support their views on the costs and benefits associated with proposed Regulation SHO and proposed amendments to Rule 105 of Regulation M. We received very few comments providing cost or benefit estimates.

A. Costs and Benefits of the Adopted Amendments in Regulation SHO

We believe that Regulation SHO simplifies and updates short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938. First, Rule 200 incorporates current Rule 3b–3 to provide ownership definitions for short sale purposes, clarifies the requirement to determine a seller's net aggregate position, and requires sales in all equity securities to be marked ''long,'' ''short,'' or ''short exempt.'' Second, Rule 202T establishes procedures for the Commission to exclude designated securities from the operation of the tick test of Rule 10a–1 and any short sale price test rule of any exchange or national securities association. Third, Rule 203 incorporates current provisions applicable to long sales under current Rule 10a–2. Rule 203 additionally creates a uniform Commission rule requiring broker-dealers to ''locate'' securities available for borrowing prior to effecting short sales in all equity securities, and imposes additional requirements on securities that have a substantial amount of failures to deliver. Finally, the amendments to Rule 105 of Regulation M, eliminate the current shelf offering exception, such that short sales may not be covered with offering securities purchased from an underwriter or other broker-dealer participating in the shelf offering.

1. Rule 200: Definitions

a. Ownership of Securities Underlying Securities Futures Products

i. Benefits

The codification of existing Commission guidance regarding when a person is deemed to own a security underlying a securities futures contract provides important compliance benefits. The interpretation is designed to ensure consistency with the way current Rule 3b–3 addresses several instances where a person owns a security that entitles a person to acquire securities underlying the instrument, *e.g.,* options, rights, warrants, and convertibles. Additionally, by codifying existing guidance, Regulation SHO clarifies and facilitates compliance with the short sale rule for persons trading in securities futures.

ii. Costs

We do not believe that codifying existing guidance will impose costs or result in lost business opportunities. Although the Commission did not receive comments quantifying the costs related to the codification, we note that the guidance is well established and has been adhered to by the industry.[134]

b. Aggregation Units

i. Benefits

Permitting aggregation unit netting provides enhanced flexibility and liquidity to both broker-dealers and the market as a whole. Subject to four expressed conditions, Rule 200(f) permits multi-service broker-dealers to calculate net positions in a particular security within defined trading units apart from the positions held by other aggregation units within the firm. This allows multi-service firms to pursue different trading strategies, within certain parameters, without being restricted by limitations associated with firm-wide aggregation. The greater trading flexibility, through use of aggregation unit netting, should improve the liquidity provided by these firms.

ii. Costs

We believe that there are no costs associated with aggregation unit netting since firms are not required to use aggregation units. Aggregation of net positions within defined trading units is entirely optional and will likely be used by firms that believe it is cost effective to do so. However, firms that choose to make use of aggregation unit netting must comply with requirements set forth in Rule 200(f).[135] Compliance with aggregation unit netting requirements may impose fewer costs to broker-dealers than if the firms use alternative means, such as establishing separate broker-dealers for each trading desk's strategy to ensure the independence of each trading desk. Industry sources maintain that the costs associated with aggregation unit netting are nominal. Furthermore, the technology to facilitate

[130] This number is based on 2003 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[131] In calendar year 2003, there were approximately 722,753,000 trades on the NYSE, 733,410,000 on Nasdaq NMS and Nasdaq SmallCap, and over 9,400,860 in OTCBB, Pink Sheet, and other (gray market) securities.

[132] For Nasdaq NMS and Nasdaq SmallCap securities.

[133] As stated in the Proposing Release, we believe it is reasonable that it would take 0.5 seconds (or .000139 hours) to mark an order ''long,'' ''short,'' or ''short exempt.''

[134] *See* Guidance Release, at n. 18, *supra.*

[135] Firms that find difficulty in complying with the aggregation unit netting conditions in Rule 200(f) may submit requests for exemptive relief.

aggregation unit netting is widely available.

c. Liquidation of Index Arbitrage Position

i. Benefits

Codifying the liquidation index arbitrage relief, in Rule 200(e), facilitates pricing efficiency while preserving the fundamental objectives of short sale price regulation. By focusing on the timing of the liquidation of all the index arbitrage positions, rather than on the timing of the establishment of individual index arbitrage positions,[136] Rule 200(e) relieves firms from the compliance burdens of tracking different positions of fungible securities according to the timing or circumstances related to their acquisition. Additionally, it reduces the possibility of unintended effects that may penalize buy-side index arbitrage strategies involving the purchase of stocks during times of market stress.

Subparagraph (e)(3) of Rule 200 provides a 2% market decline restriction [137] so that markets can avoid incremental selling pressure during volatile trading days. The safeguard benefits all market participants by limiting selling pressure 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. Lastly, inclusion of the 2% safeguard provides consistency within the equities markets. In 1999, the NYSE amended its rules on index arbitrage restrictions to include the 2% trigger.[138] The Commission's adoption of the same trigger provides a uniform protective measure.

ii. Costs

If the unwinding of the index arbitrage position occurs during a period when the DJIA has declined by 2%, short sellers will not be permitted to use the price test exemption, and thus will incur additional costs.[139] Therefore, Rule 200(e)(3) may increase costs for short sellers during certain times of market decline. We estimate that any costs incurred will be limited to compliance with Rule 10a–1's tick test. The safeguard simply limits the relief from the price test for short sales of securities held in an index arbitrage position. The Commission did not adopt a blanket prohibition of short sales during a market decline; rather, the effect of subparagraph (e)(2) is to require such sales to comply with the short sale price test.

d. Order Marking Requirement

i. Benefits

The new order marking requirements provide important benefits for investors and the market as a whole. First, because the new order-marking requirements extend beyond exchange-listed equity securities to include over-the-counter equity securities, *i.e.,* OTCBB and Pink Sheet securities, they provide a uniform practice designed to ensure consistency within the equity markets. Second, the marking requirement will generate information identifying when and under what circumstances certain exceptions to the price test are used. Third, the new marking requirements benefit the surveillance of previously undetected violations of Rule 10a–1. Under the prior requirements, orders marked ''long,'' despite having to borrow shares to consummate delivery, were handled and executed as long sales.

Furthermore, the requirement of physical possession or control, or the reasonable expectation that the security will be in the possession or control of the broker-dealer no later than settlement, in order to mark an order ''long,'' benefits the clearance and settlement process. Clearance and settlement systems are designed to preserve financial integrity and minimize the likelihood of systematic disturbances by instituting risk-management systems. Requiring a broker-dealer to have possession or control of the securities before it can mark an order long, assists in mitigating settlement and credit risks that can affect the stability and integrity of the financial system as a whole.

ii. Costs

The addition of the classification of ''short exempt'' to the marking requirements will impose certain nominal costs on broker-dealers. According to industry sources, some broker-dealers already use the short exempt classification when marking certain sell orders. Additionally, SRO rules already either require or advise members to utilize the ''short exempt'' designation on such sell orders. However, broker-dealers not already using the ''short exempt'' classification will incur a one-time cost associated with programming. Industry sources estimated that implementation costs would be approximately $100,000 to $125,000.

The Commission recognizes that there is an ongoing paperwork burden cost associated with adding the ''short exempt'' category and extending the marking requirement to all equity securities. The paperwork burden is estimated to be approximately 31 burden hours for each active broker-dealer registered with the Commission.[140]

We do not believe the new order marking requirements will impose additional monitoring or surveillance costs for registered broker-dealers. Registered broker-dealers already have established systems in place to comply with current SRO rules.

The Commission estimates that little to no costs will arise from the requirement that sell orders be marked long only in cases where the securities to be sold are owned by the customer and either are presently, or reasonably expected to be, in the customer's account prior to settlement. Most customer securities are not held by investors in physical form, but rather are held indirectly through their broker-dealer in ''street name.'' Furthermore, commenters did not indicate any significant burden associated with the requirement.

2. Rule 202T: Pilot

Rule 202T establishes procedures for the Commission to temporarily suspend the trading restrictions of the Commission's short sale price test, as well as any short sale price test of any exchange or national securities association, for short sales in such securities as the Commission designates

[136] As provided in the Merrill Lynch Letter. *See* Securities Exchange Act Release No. 27938, n. *supra.*

[137] For Rule 200(e)(3) relief, the sale does not occur during a period commencing at the time that 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 during which the DJIA has not declined by two percent or more from its closing value on the previous day.

[138] Securities Exchange Act Release No. 41041 (February 11, 1999) 64 FR 8424 (February 19, 1999) (approval of amendments to NYSE Rule 80A). We note that NYSE 80A removes the stabilizing requirement if the DJIA moves within 2% of the previous day's close.

[139] Short sellers would have to aggregate in the usual way, with all of the seller's other positions in that security, to determine whether the seller has a net long position.

[140] This is an average of approximately 223,647 annual responses by each respondent. Each response of marking orders ''long,'' ''short,'' or ''short exempt'' takes approximately .000139 hours (.5 seconds) to complete. Thus, the total approximate estimated annual hour burden per year is 203,713 burden hours (1,465,563,860 responses at 0.000139 hours per response). A reasonable estimate for the paperwork compliance for the proposed rules for each broker-dealer is approximately 31 burden hours (223,647 responses at .000139 hours per response) or a total of 203,713 burden hours between 6,553 respondents.

by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving due consideration to the security's liquidity, volatility, market depth and trading market.

a. Benefits

We believe establishing procedures for the Commission to adopt a pilot pursuant to Rule 202T is an essential component of evaluating the overall effectiveness of price test restrictions on short sales. Any such pilot would be intended to: provide data on the impact of short selling in the absence of a price test; study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity; and obtain empirical data to help us assess whether a price test is necessary to further the objectives of short sale regulation and whether short sale price tests should be removed, in part or in whole, for actively traded securities or for all securities, or if retained, whether it should be extended to securities for which there currently is no price test.

We believe that there will be both short-term and long-term benefits from any such pilot. In the short-term, the removal of the price test for a specified period would immediately ease restrictions on short sales and might benefit investors and the markets without necessarily compromising the policy goals that a prophylactic price test is designed to address. Removing such restrictions could facilitate market participants' hedging activities in the securities included in the pilot, and might facilitate short selling that increases market liquidity and pricing efficiency. Short selling in the absence of a price test might increase the number of shares available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of selling interest due to short sale price restrictions.

In the long-term, a pilot would allow the Commission to obtain empirical data necessary to consider alternatives, such as eliminating a Commission mandated price test for an appropriate group of securities, which may be all securities; adopting a uniform bid test, possibly extended to securities for which there is currently no price test; or leaving in place the current price tests. Historically, the possibility of considering such alternatives has been hampered by a lack of data concerning short selling, particularly with regard to listed-securities. Without empirical data relating to short selling in the absence of a price test in today's market, we believe that only broad conclusions could be derived with respect to the general impact of such short selling. Consequently, we believe that it is beneficial to establish a pilot to obtain empirical data in order to assist us in ascertaining whether to implement a price test, in whole or in part, for short sales in some or all securities, including securities not currently subject to any price test.

b. Costs

As an aid in evaluating costs, we sought comment in the Proposing Release concerning the public's views as well as any supporting information. Specifically, we sought detailed comment on the extent of required system changes and costs associated with implementation of a pilot program. Many industry commenters favored the creation of a pilot.[141] Operation of the pilot could cause additional costs to brokers, dealers, SROs, and potentially to issuers and investors. SROs and broker-dealers might need to make system changes in order to exclude the selected securities from the Commission's tick test as well as any SRO price test.

Based on comments from the industry, we estimate that a pilot established under Rule 202T could require broker-dealer firms to reconfigure systems that currently set price test restrictions on short sales, which could impose modest costs. We anticipate that firms would have to remove existing price test restrictions for short sales of specified securities. The implementation of these modifications would require a readily identifiable, one-time adjustment. Market participants already remove the NASD's short sale rule, Rule 3350, after traditional market hours, as it is not applicable during that time,[142] so application of any pilot to Nasdaq securities would not likely require the development of any new programs or surveillance systems.

Some commenters expressed a concern about pilot-related costs borne by issuers. According to these commenters, these costs could arise from possible manipulative short selling in the absence of price restrictions or pricing anomalies between securities in the same industry subject to a pilot and similar securities not subject to the price test. These commenters also asserted that a pilot might create a confusing system that will slow trading, lead to errors and confound market participants.

Most of the more liquid securities that would be appropriate for a pilot are traded on exchanges or other organized markets with high levels of transparency and surveillance. This would enhance the ability of the Commission and SROs to monitor trading behavior during the operation of any pilot and to surveil for manipulative short selling.[143] Moreover, the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to apply to trading activity in these securities, thus prohibiting trading activity designed to improperly influence the price of a security.[144] To the extent there are price and trading activity variations, this is precisely the empirical data that the Commission seeks to obtain and analyze as part of our assessment as to whether the price test should be removed, in part or whole, for pilot securities or other securities. In addition, a pilot would suspend only the operation of the price test, while the other requirements of Regulation SHO, including the order marking, locate and delivery requirements, would remain in effect.

The Commission, by further order, can terminate or extend the period of a pilot, remove or add some or all securities selected for a pilot as it determines necessary or appropriate in the public interest or to protect investors. Thus, costs associated with any manipulative short selling or price variations may be ameliorated through the termination of the pilot or removal of affected securities.

3. Rule 203: Locate and Delivery Requirements for Short Sales

a. Benefits

As adopted, Rule 203(b) creates a uniform Commission rule requiring

[141] *See* letters from James Angel; ARCA; Yuseff J. Burgess; CBOE; Dario Cosic; Davis Polk; Timothy K. Dolnier; Tolga Erman; Chris Freddo; Kristopher Goldhair; Chris Gregg; Marc Griffin; Charles W. Hansford; Zachary Hepner; ICI; Mike Ianni; Brian Ingram; Kevin Karlberg; Gregory Kleiman; LEK Securities; Michael Lucarello; Lux & Metzger; MFA; Raymond J. Murphy; Nasdaq; Osmar92@optonline.net; Tal Plotkin; David Schwarz; Sinan Selcuk; Theodore J. Siegel; Todd Sherman; SIA; Dan Solomon; STA; STANY; Jimmie E. Williams; Willkie Farr.

[142] *See* NASD Head Trader Alert #2000–55 (August 7, 2000).

[143] No individual issuers submitted comment letters opposing the pilot or expressing concern about the possible disparate trading of securities subject to the pilot or about the possible adverse impact on their securities should the price test be removed from short selling in their stock on a temporary basis. The NYSE submitted a letter expressing concern, ''on behalf of its members and its listed companies'' strongly supporting continued price restrictions and expressing concern about unscrupulous market participants forcing prices lower in stocks not subject to a price test.

[144] *See, e.g.*, Securities Act Section 17(a), and Exchange Act Sections 9(a), 10(b), and 15(c) and Rules 10b–5 and 15c1–2 thereunder.

broker-dealers to follow specified procedures for short sellers in all equity securities, wherever traded. Rule 203(b) requires that, prior to effecting short sales in all equity securities, broker-dealers must ''locate'' securities available for borrowing. This uniform rule furthers the goals of regulatory simplification and avoidance of regulatory arbitrage. Specifically, Rule 203(b) prohibits a broker-dealer from executing a short sale in any equity security, for the broker-dealer's own account or the account of another person, unless the broker-dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. Rule 203 requires that the locate be made and documented prior to effecting any short sale, regardless of whether the seller's short position may be closed out by purchasing securities the same day. The Commission has also adopted additional requirements targeted at ''threshold securities'' that have a substantial amount of failures to deliver, *i.e.*, any equity security of an issuer registered under Section 12 or required to file reports under Section 15 of the Exchange Act where there are fails to deliver at a registered clearing agency of 10,000 shares or more per security; that the level of fails is equal to at least one-half of one percent of the issue's total shares outstanding; and the security is included on a list published by an SRO. In order to be subject to the restrictions of Rule 203, a security must exceed the designated level of fails for a period of five consecutive settlement days. Similarly, in order to be removed from the list of threshold securities, a security must not exceed the threshold for a period of five consecutive settlement days.

A broker-dealer is required to take additional steps should a fail in a threshold security remain 10 days after the normal settlement date, *i.e.*, for 13 consecutive settlement days. Specifically, Rule 203(b)(3) requires the participant of a registered clearing agency to take action to close out the fail to deliver by purchasing securities of like kind and quantity.

The new locate and delivery requirements will protect and enhance the operation, integrity, and stability of the markets. For example, the requirements of Rule 203 include securities with lower market capitalization that may be more susceptible to abuse. Also, adopting uniform rules will further the goals of regulatory simplification and avoidance of regulatory arbitrage, as well as assist the Commission in its enforcement efforts regarding naked short selling activity. Certain issuers have taken steps to make their securities either ''certificate only,'' which require physical certification of company ownership for all share transfers, or ''custody only,'' which restricts ownership of their securities by depositories or financial intermediaries, which they assert has been done to avoid the effects of naked short selling of their securities. These custody arrangements are highly costly to the clearing agencies, depositories and financial intermediaries. Imposing a requirement to close-out large fails at the clearing level may decrease costs on the clearing agency by reducing the requests for ''certificate only'' issues.[145]

b. Costs

The Commission recognizes that locate and delivery requirements may increase costs for some market participants who engage in short selling. The Commission is, however, including an exception from the locate requirements of Rule 203(b)(1) for short sales executed by market makers in connection with bona-fide market making activities. In addition, any costs that initially may be incurred should be mitigated over time because the uniform rule should lead to regulatory simplification with regard to training and surveillance.

The rule includes certain exceptions from the locate requirement, which mitigate many associated cost burdens. The rule provides an exception for bona-fide market making. This exception covers short sales executed by market makers, including specialists and options market makers, in connection with bona-fide market making activities. Excepting bona-fide market making activity from the locate requirement will benefit investors and the market by preserving necessary market liquidity.

A second exception is for broker-dealers that receive a short sale order from another registered broker-dealer that is required to have already complied with Rule 203(b)(1). This exception relieves the executing broker-dealer from engaging in a second locate for the transaction. This exception limits the possibility of over borrowing as well as any delay in execution.

A third exception to the locate requirement covers situations where a broker effects a sale on behalf of a customer who owns the security pursuant to Rule 200, but through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the possession or control of the broker-dealer by settlement date. Under the newly adopted marking requirement, this sale would be marked ''short.'' Such situations could include where a convertible security, option, or warrant has been tendered for conversion, but the underlying security is not reasonably expected to be received by settlement date.

There may be costs associated with implementing these locate requirements for OTCBB and Pink Sheet securities. For example, a number of commenters noted that there might not be a broad pool of lendable securities in such issuers, due to the inability of firms to hypothecate shares bought on margin, and due to the absence of institutional lenders in these securities. This could affect the ability of these small issuers to obtain financing through the issuance of convertible debentures, in that market participants that buy these convertible debentures may not be able to sell short for hedging purposes if they are unable to locate the issuer's securities.

In addition, other commenters also noted that, due to the absence of stock available for borrowing in these issuers, requiring short sellers to locate such securities could essentially remove the ability to take short positions in these stocks, and would help to facilitate issuers, promoters, or other shareholders that may be attempting to manipulatively push up the company's stock price. These commenters noted their belief that some issuers and their associated stock promoters may also be using the recent controversy over naked short selling to engage in fraud, or otherwise distract investors from fundamental problems with the company.

It is the Commission's belief that removing all restrictions on the ability to effect naked short sales is not the proper recourse against potential issuer fraud, as it may simply encourage another type of manipulation or exacerbate other potentially negative consequences associated with large failures to deliver. Nevertheless, the

[145] The Commission approved a rule change filed by DTC that clarified that DTC's rules permit only its participants to withdraw securities from the depository. See Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003). In addition, the Commission recently proposed a rule, ''Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries,'' which would prohibit a registered transfer agent from transferring any equity security registered pursuant to Section 12 of the Exchange Act, or any equity security that subjects an issuer to reporting under Section 15(d) of the Exchange Act, if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary. See Securities Exchange Release No. 49804 (June 4, 2004), 69 FR 32783 (June 10, 2004).

Commission is cognizant of these concerns and is taking action to combat such activities. For example, the Commission continues to bring enforcement actions for issuer fraud, including actions against some of the companies that have claimed to be ''victims'' of naked short selling.[146] In addition, the Commission recently proposed other steps to protect investors by deterring fraud and abuse in the securities markets through the use of ''shell companies.''[147]

The greatest costs associated with Rule 203's requirements relate to controlling failures in threshold securities.[148] Participants of a registered clearing agency, broker-dealers, market makers, and SROs may incur costs in making initial system changes necessary to implement these new requirements, as well as maintaining ongoing compliance and surveillance mechanisms. Comments from the industry maintained that any one-time programming costs would be ''manageable'' or ''nominal.''[149] Since NSCC already provides to the SROs information on all issuers that have failed to deliver in excess of 10,000 shares, this will mitigate any cost burdens on accessing the information. Furthermore, this information can be matched with the readily available information on an issuer's total shares outstanding to determine whether the security meets the definition of a threshold security under Regulation SHO.

However, some industry sources argued that the ongoing cost of requiring broker-dealers, including market makers,[150] to borrow or arrange to borrow for future short sales if there was not compliance with the requirement to close-out fails to deliver in threshold securities would decrease liquidity, impose large borrowing costs and execution delay. Also, some commenters, including options market makers and options exchanges, noted that if we do not include such an exception would be to cease altogether options trading in securities that are difficult to borrow, as it was argued that no options market maker would make markets without the ability to hedge.

We note that the close out requirements of Rule 203(b)(3) will only apply to short sales in securities that meet the designated threshold level of fails, and similar to the current operation of NASD Rule 11830, will not apply to any short sales effected prior to the security meeting the threshold. We have noted the above concerns, but believe that they may be exaggerated, especially considering that OEA has estimated that threshold securities represent approximately 4% of the equities markets.[151] Also, any cost estimates related to the narrowly applied borrowing requirement appear extremely speculative.[152] In light of this, we do not expect that excluding a market maker exception from the close out requirement of Rule 203(b)(3) would have such adverse consequences.

4. Rule 203: Requirements for Long Sales

Rule 203(a) incorporates Rule 10a–2, which covered delivery requirements applicable to long sales of securities registered or admitted to unlisted trading privileges on a national securities exchange. As adopted, Rule 203(a) generally provides that if a broker-dealer knows or should know that a sale is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so.[153] Rule 203(a) extends these delivery requirements to all securities, including those not registered on an exchange. In addition, Rule 203(a) makes clear that a broker or dealer may not fail to deliver, nor may it loan securities for delivery on a sale marked ''long,'' unless, prior to the sale, the broker or dealer knew that the seller owned the securities and the seller represented that he would deliver them to the broker in time for settlement but failed to do so.

a. Benefits

Extending the long sale delivery requirements to all securities will benefit investors and the markets, because as with short sales, delivery requirements are important in securities with lower market capitalization that may be more susceptible to abuse. Moreover, Rule 203(a) states that a broker-dealer cannot fail or loan shares on a long sale unless, in advance of the sale, the broker-dealer ascertains that the customer owned the shares. This change, together with changes being made to the long sale order marking requirements, provide an important benefit to the market by making clear a broker's obligation to confirm the long seller's ownership of the shares prior to executing the sale.

b. Costs

Although we sought public comment on costs, we did not receive any comments relating to Rule 203(a). We recognize that there may be some costs associated with extending the delivery requirements to all securities, including costs related to system changes and surveillance. However, since market participants already must comply with the current language of Rule 10a–2, we expect any costs will be nominal. The benefit of a uniform delivery scheme for long sales justifies any costs that will be incurred by market participants.

5. Rule 105 of Regulation M

Rule 105 of Regulation M prohibits a short seller from covering short sales with offering securities purchased from an underwriter, broker or dealer participating in the offering if the short sale occurred during the Rule's restricted period, typically the five-day period prior to pricing. The reason for the prohibition is that pre-pricing short sales that are covered with offering shares artificially distorts the market price for the security, preventing the market from functioning as an independent pricing mechanism and eroding the integrity of the offering

[146] *See, e.g.*, SEC vs. Universal Express, Inc., *et. al.*, Litigation Release No. 18636 (March 24, 2004). Securities Exchange Act Release No. 49566 (April 15, 2004).

[147] Securities Exchange Act Release No. 49566 (April 15, 2004). The proposal would prohibit the use of Form S–8, under the Securities Act, by a shell company. In addition, the release proposes amendments to Form 8–K, under the Exchange Act, to require a shell company, when reporting an event that causes it to cease being a shell company, to file with the Commission the same type of information that it would be required to file to register a class of securities under the Exchange Act. The provisions in this release target regulatory problems that the Commission has identified where shell companies have been used as vehicles to commit fraud and abuse the regulatory processes.

[148] The general locate requirement for short sales will not impose additional costs on broker-dealers, since current SRO rules require broker-dealers to effect such a locate.

[149] Industry participants appeared more concerned with having enough time to make the necessary programming and systems upgrades than the actual costs related to such upgrades.

[150] We have decided at this time not to extend to market makers an exception from the additional requirements to close out fails to deliver in securities exceeding the threshold that remain ten days after settlement date.

[151] OEA has also estimated that approximately 4% of all securities that have options traded on them would be threshold securities.

[152] Industry participants could not produce a quantifiable estimate for the cost related to the ''borrow or arrange to borrow'' requirement for failing to close-out deliveries in threshold securities that remain open for ten days past the settlement date. Additionally, some industry participants provided inconsistent statements regarding the amount of securities for which a locate is given, compared to whether a short sale execution actually occurs. The estimated range is anywhere from 10% to 80%.

[153] As in former Rule 10a–2, these prohibitions do not apply to the loan of a security that occurs by way of a loan to another broker or dealer, or where an exchange or securities association finds, prior to the loan or fail, that the sale resulted from a good faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price.

price. The goal of Rule 105 is to promote offering prices that are based upon open market prices determined by supply and demand rather than artificial forces. The Rule is prophylactic, and prohibits the conduct irrespective of the short seller's intent in effecting the short sale.

Typically, follow-on offering prices are based on a stock's closing price prior to pricing, and thus short sales during the period immediately preceding pricing that reduce the market price can result in a lower offering price. Rule 105 does not prohibit pre-pricing short sales, but it does prevent short sellers from covering the short sales with offering shares. A trader who sells short pre-pricing because the trader knows or has a high degree of certainty that he or she will be able to obtain covering shares in the offering at a lower price does not assume the same market risk as a short seller who intends to cover with open market shares and is not engaged in an evaluation of the stock's ''true value.'' This manipulative conduct can negatively impact the issuer, which receives reduced offering proceeds as a result of the lower offering price, and harms the market by inhibiting the capital raising process.

The adopted amendments to Rule 105 eliminate the shelf offering exception. At the time of adoption of the exception, the Commission viewed shelf offerings as uncommon and generally less susceptible to manipulation than non-shelf offerings.[154] Today, shelf offerings are common, and investors generally have notice of them before they occur because they are likely to utilize the same marketing efforts—road shows and other selling efforts—that are used with non-shelf offerings.

a. Benefits

Eliminating the shelf exception from Rule 105 will provide a number of important benefits to issuers, investors, and the market as a whole. The amendment updates Rule 105 by adopting a uniform standard for shelf and non-shelf offerings, which are much more similar today than when the exception was adopted because of changes in the way most shelf offerings are sold. Both shelf and non-shelf offerings are susceptible to the manipulation that Rule 105 is intended to prevent. In both cases, pre-pricing short sales that are covered with offering shares exert downward pressure on pricing that is not connected to any evaluation of the stock's future performance.

Elimination of the shelf exception will benefit issuers and investors by promoting shelf-offering prices that are based upon market prices that are not artificially influenced. This will safeguard the integrity of the capital raising process with respect to shelf offerings and enhance investor confidence in our markets. The amended rule will also protect issuers conducting shelf offerings from receiving reduced offering proceeds as a result of manipulative conduct.

b. Costs

We recognize that the amendments to Rule 105 may result in some costs to certain market participants. Eliminating the shelf exception may impair a short seller's ability to effect a covering transaction because there are fewer shares available with which one may cover. It may also impact traders and firms that derive significant revenue from covering pre-pricing shorts with shelf offering shares.

We anticipate these changes to Rule 105 may impose compliance costs, in the form of increased surveillance, on broker-dealers. However, we do not expect the change to result in a major increase in costs or prices for consumers or individual industries. Rather, the change will curtail the potential for manipulative activity that might otherwise create a temporary mispricing of securities and reduce offering proceeds. The change will provide a protective measure against abusive conduct that hampers the capital raising process and negatively impacts issuers.

Any costs associated with restricting a short sellers' ability to cover with offering shares is balanced by the benefits derived from preventing the manipulative activity of effecting pre-pricing short sales and covering with offering shares. Moreover, although the Commission recognizes that the amendments may diminish a short seller's ability to effect a covering transaction by restricting the sources from which he may cover, Rule 105 will continue to allow the beneficial effects of short selling to reach the market. Short selling in advance of a shelf offering will remain available to enhance pricing efficiency.

Lastly, the amendments to Rule 105 of Regulation M do not impose a ban on pre-pricing short sales. Rather, the amendments prohibit short sellers from covering the short sales with offering shares. The amendments will prevent a trader who sells short pre-pricing because the trader knows he or she will obtain offering shares to cover the short position at a lower price in order to generate a risk-free profit.

X. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[155] requires us, when engaging in rulemaking and where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[156] requires the Commission in adopting rules under the Exchange Act, to consider the anticompetitive effects of any rules it adopts under the Exchange Act. Section 23(a)(2) prohibits us 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 the proposals' effects on efficiency, competition, and capital formation. Additionally we requested, but did not receive, comments regarding the impact of the proposed amendments on the economy generally pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996.[157]

We have considered the proposed amendments in Regulation SHO in light of the standards of Section 23(a)(2) of the Exchange Act and believe the adopted amendments should not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. We note, however, that there are several areas in Regulation SHO where issuers may be treated differently.

First, in any pilot created pursuant to Rule 202T, the price test could be suspended for issuers selected, while the price test would continue to apply to issuers in the same industry that are not selected for the pilot. Some commenters expressed a concern about the pilot imposing costs on issuers selected, relative to possible manipulative short selling in the absence of price restrictions or pricing anomalies. These commenters also asserted that the pilot would create a confusing system that would slow trading, lead to errors, and confound market participants.

We believe that most of the more liquid securities that would be appropriate for a pilot are traded on exchanges or other organized markets

[154] Potential investors generally were not aware of a takedown until immediately prior to its occurrence, and thus their pre-pricing short sales were arguably non-manipulative.

[155] 15 U.S.C. 78c(f).

[156] 15 U.S.C. 78w(a)(2).

[157] Pub. L. 104–121, tit. II, 110 Stat. 857 (1996).

with high level of transparency and surveillance. The Commission and SROs would monitor trading behavior during the operation of any pilot and surveil for manipulative short selling activity. Furthermore, the general anti-fraud and anti-manipulation provisions of the federal securities laws will continue to apply to trading activity in these securities, thus prohibiting trading activity designed to improperly influence the price of a security.[158] Moreover, to the extent there are price and trading activity variations, this is precisely the empirical data that the Commission seeks to obtain and analyze as part of our assessment as to whether the price test should be removed, in part or whole, for the pilot securities or other securities.

By further order, the Commission can terminate or extend the period of the pilot as it determines necessary or appropriate in the public interest or to protect investors or to remove or add some or all securities selected for the pilot, any costs associated with manipulative short selling or price variations may be ameliorated through the termination of the pilot or removal of affected securities.

Secondly, the additional requirements of Rule 203(b)(3) will apply to any equity security of an issuer registered under Section 12 or required to file reports pursuant to Section 15 of the Exchange Act where, for five consecutive settlement days, there are fails to deliver at a registered clearing agency of 10,000 shares or more per security, and that is equal to at least one-half of one percent of the issue's total shares outstanding. The additional requirements will not apply to any issuers that are not registered under Section 12 or required to file reports pursuant to Section 15 of the Exchange Act, and are thus not required to provide ongoing public disclosure about the company, its actions, and its performance. As the calculation of the threshold that would trigger the requirements of Rule 203(b)(3) depends on identifying the aggregate fails to deliver as a percentage of the issuer's total shares outstanding, it is necessary to limit the requirement to companies that are subject to the reporting requirements of the Exchange Act.

XI. Final Regulatory Flexibility Analysis

The Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with the Regulatory Flexibility Act.[159] This FRFA relates to new Regulation SHO, adopted under the Exchange Act, which replaces Rules 3b–3 and 10a–2, and amends Rule 105 of Regulation M.

Rule 200 of Regulation SHO defines ownership of securities, specifies aggregation of long and short positions, and also includes the requirement that sales in all equity securities be marked ''long,'' ''short,'' or ''short exempt.'' Regulation SHO includes a temporary rule, Rule 202T, that establishes procedures to allow the Commission to suspend the operation of the current ''tick'' test in Rule 10a–1, and any short sale price test for any exchange or national securities association, for specified securities. Rule 203 of Regulation SHO requires short sellers in all equity securities to locate securities to borrow before selling, and also imposes heightened delivery requirements on securities that have fails to deliver at a registered clearing agency of 10,000 shares or more per security, and that is equal to at least one-half of one percent of the issues total shares outstanding. The Commission is also adopting amendments to Rule 105 of Regulation M to remove the shelf offering exception.

A. Need for and Objectives of the Amendments

Regulation SHO and the amendments to Rule 105 of Regulation M are designed, in part, to fulfill several objectives, including: (1) Establish uniform locate and delivery requirements in order to address potentially abusive naked short selling and other problems associated with failures to deliver; (2) clarify marking requirements for short sales in all equity securities; (3) establish a procedure to temporarily suspend Commission and SRO short sale price tests in order to evaluate the overall effectiveness and necessity of such restrictions; and (4) prohibit certain short sales from being covered with securities obtained from shelf offerings.

Moreover, the rules are consistent with the objective of simplifying and modernizing short sale regulation, providing controls where they are most needed, and temporarily removing restrictions where they may be unnecessary. Rule 203(b) of Regulation SHO provides stronger locate and delivery requirements designed to address abusive naked short selling, *i.e.*, a security could only be sold short to the extent that there was stock available to borrow. Rule 203 is a targeted approach that incorporates the provisions of existing SRO rules while imposing additional restrictions where we believe appropriate to address naked short selling while protecting and enhancing the operation, integrity, and stability of the markets. As a part of this effort to improve locate and delivery requirements, Rule 200 clarifies marking requirements and thus clarifies when a participant must locate stocks for delivery. Rule 202T establishes procedures for the Commission to temporarily remove price restrictions for short sales from certain securities so that we can obtain empirical data on the impact of short selling in the absence of a price test and to assess whether a short sale price test should be removed, in part or in whole, for some or all securities.

The amendments to Rule 105 of Regulation M prohibit covering certain short sales with securities acquired in a shelf offering. The amendments are in response to the recognition that shelf offerings are much more common in today's markets and with increased transparency they are susceptible to the same potential for manipulation and abuse as non-shelf offerings. The elimination of the shelf offering exception in Rule 105 is designed to reduce the potential that pre-pricing short sales will exert downward price pressure on the market price of a shelf offering.

B. Significant Issues Raised by Public Comments

The Initial Regulatory Flexibility Analysis (''IRFA'') appeared in the Proposing Release.[160] We requested comment in the IRFA on the impact the proposals would have on small entities and how to quantify the impact. We did not receive any comment letters addressing the IRFA; however, a few commenters discussed certain costs that would be incurred by small broker-dealers and issuers if some or all of the proposals in Regulation SHO were adopted.[161]

[158] *See, e.g.*, Securities Act Section 17(a), and Exchange Act Sections 9(a), 10(b), and 15(c) and Rules 10b–5 and 15c1–2 thereunder.

[159] 5 U.S.C. 603.

[160] *See* Proposing Release, Section XXII.

[161] For example, one commenter expressed concern about the Commission's proposal for firms to aggregate their positions in securities on a contemporaneous basis throughout the day. The commenter claimed such a requirement would require system changes for those broker-dealers who have not implemented the aggregation units, *i.e.*, smaller broker-dealers, and would be significantly expensive without the attenuating benefits. *See* letter from SIA. Also, other commenters were concerned about the impact of Regulation SHO on small issuers, claiming it would increase the cost of capital to them by imposing locate and delivery requirements in the absence of a hedging exemption. *See* letters from Saul Ewing and Feldman.

C. Small Entities Subject to the Amendments

Paragraph (c)(1) of Rule 0–10[162] 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 that is not affiliated with any person (other than a natural person) that is not a small business or small organization. In the IRFA of the Proposing Release, we estimated that as of 2002 there were approximately 880 broker dealers that qualified as small entities, as defined above. Presently, we estimate that as of 2003 there are approximately 906 broker-dealers that qualify as small entities, as defined above.

In the Proposing Release, we sought comment on the costs on small entities to modify, and in some cases install, systems and surveillance mechanisms to ensure compliance with the new rules, including implementing the pilot, marking, and locate and delivery requirements. No commenters responded with cost estimates pertaining to the requested data listed above. Nevertheless, we estimate the costs related to upgrades of systems and surveillance mechanisms will be minimal. Industry sources stated that most broker-dealers, including small broker-dealers, already have the necessary systems in place. Therefore, such entities will only be required to modify their systems for compliance.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Regulation SHO may impose some new compliance and marking requirements on broker-dealers that are small entities. Some small entities that trade securities that may be subject to the pilot program will have to make changes to exclude these securities from Commission and SRO price test restrictions. Moreover, small entities may have to make systems changes for additional marking requirements for short sales in listed securities, *i.e.*, adding a ''short exempt'' designation.[163]

We sought comment on the reporting, recordkeeping, and compliance costs on small entities with regard to, among other things, implementing the pilot and the marking requirements. We estimate that the greatest cost associated with such requirements is related to implementation time and training.

E. Agency Action To Minimize the Effect on Small Entities

As required by the Regulatory Flexibility Act, we have considered alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Several alternatives were considered but rejected, while other alternatives were taken into account in the adoption of Regulation SHO and the amendments to Rule 105 of Regulation M. The final rules and rule amendments meet the Commission's stated goals by applying short sale restrictions where they are most needed and easing them, on a temporary basis to obtain greater empirical data, where they may be unnecessary.

Regulation SHO and the amendments to Rule 105 of Regulation M should not adversely affect small entities because they impose minimal new reporting, record keeping or compliance requirements. Moreover, it is not appropriate to develop separate requirements for small entities with respect to Regulation SHO and the adopted amendments to Rule 105 of Regulation M, because we think all issuers, including issuers that are small entities, should be subject to short sale locate and delivery requirements, marking requirements, and the easing of restrictions on short sales subject of the pilot. As stated in the Proposing Release, we believe that it is beneficial to establish uniform standards specifying procedures for all short selling.

XII. Statutory Basis and Text of Adopted Amendments

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78i(h), 78j, 78k–1, 78o, 78q(a), 78q–1, 78w(a), and 78mm, the Commission is adopting §§ 242.200, 242.202T, 242.203, along with amendments to Regulation M, Rule 105, and interpretative guidance set forth in part 241.

List of Subjects

17 CFR Parts 240 and 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

17 CFR Part 241

Securities.

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

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

§ 240.3b–3 [Removed]

§ 240.10a–2 [Removed]

■ 2. Sections 240.3b–3 and 240.10a–2 are removed and reserved.

§ 240.10a–1 [Amended]

■ 3. Section 240.10a–1 is amended by:

■ a. Removing the authority citations following the section;

■ b. Removing and reserving paragraphs (c) and (d); and

■ c. Removing paragraph (e)(13).

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ 4. Part 241 is amended by adding Release No. 34–50103 and the release date of July 28, 2004 to the list of interpretive releases.

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

■ 5. 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), 78*l*, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78g(h), 78w(a), 78dd–1, 80a–23, 80a–29, and 80a–37.

■ 6. The part heading for part 242 is revised as set forth above.

§ 242.105 [Amended]

■ 7. Section 242.105, paragraph (b) is amended by removing the phrase ''offerings filed under § 230.415 of this chapter or to''.

■ 8. Part 242 is amended by adding a new subject heading and §§ 242.200 through 242.203 to read as follows:

[162] 17 CFR 240.0–10(c)(1).

[163] We believe this cost should be minimal because some self-regulatory organizations already either require or advise members to utilize the ''short exempt'' designation.

Regulation SHO—Regulation of Short Sales

Regulation SHO—Regulation of Short Sales

§ 242.200 Definition of ''short sale'' and marking requirements.

(a) The term *short sale* shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

(b) A person shall be deemed to own a security if:

(1) The person or his agent has title to it; or

(2) The person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or

(3) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or

(4) The person has an option to purchase or acquire it and has exercised such option; or

(5) The person has rights or warrants to subscribe to it and has exercised such rights or warrants; or

(6) The person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.

(c) A person shall be deemed to own securities only to the extent that he has a net long position in such securities.

(d) A broker or dealer shall be deemed to own a security, even if it is not net long, if:

(1) The broker or dealer acquired that security while acting in the capacity of a block positioner; and

(2) If and to the extent that the broker or dealer's short position in the security is the subject of offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

(e) A broker-dealer shall be deemed to own a security even if it is not net long, if:

(1) The broker-dealer is unwinding index arbitrage position involving 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 as defined in 17 CFR 240.9b√1(a)(4); and

(2) If and to the extent that the broker-dealer's short position in the security is the subject of offsetting 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 Dow Jones Industrial Average has declined by two percent or more from its closing value on the previous day and terminating upon the establishment of the closing value of the Dow Jones Industrial Average on the next succeeding trading day.

(f) In order to determine its net position, a broker or dealer shall aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position. Independent trading unit aggregation is available only if:

(1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity;

(2) Each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades;

(3) All traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; and

(4) Individual traders are assigned to only one aggregation unit at any time.

(g) A broker or dealer must mark all sell orders of any equity security as ''long,'' ''short,'' or ''short exempt.''

(1) An order to sell shall be marked ''long'' only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section and either:

(i) The security to be delivered is in the physical possession or control of the broker or dealer; or

(ii) It is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.

(2) A short sale order shall be marked ''short exempt'' if the seller is relying on an exception from the tick test of 17 CFR 240.10a–1, or any short sale price test of any exchange or national securities association.

(h) Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.

§ 242.201 Price test [Reserved].

§ 242.202T Temporary short sale rule suspension.

(a) The provisions of 17 CFR 240.10a–1(a) and any short sale price test for any exchange or national securities association shall not apply to short sales in such securities, or during such time periods, as the Commission designates by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving due consideration to the security's liquidity, volatility, market depth and trading market. All other provisions of 17 CFR 240.10a–1, § 242.200, and § 242.203 shall remain in effect.

(b) No self-regulatory organization shall have a rule that is not in conformity with or conflicts with any order issued pursuant to paragraph (a) of this section.

(c) This temporary section will expire on August 6, 2007.

§ 242.203 Borrowing and delivery requirements.

(a) *Long sales.* (1) If a broker or dealer knows or has reasonable grounds to believe that the sale of an equity security was or will be effected pursuant to an order marked ''long,'' such broker or dealer shall not lend or arrange for the loan of any security for delivery to the purchaser's broker after the sale, or fail to deliver a security on the date delivery is due.

(2) The provisions of paragraph (a)(1) of this section shall not apply:

(i) To the loan of any security by a broker or dealer through the medium of a loan to another broker or dealer;

(ii) If the broker or dealer knows, or has been reasonably informed by the seller, that the seller owns the security, and that the seller would deliver the security to the broker or dealer prior to the scheduled settlement of the transaction, but the seller failed to do so; or

(iii) If, prior to any loan or arrangement to loan any security for delivery, or failure to deliver, a national securities exchange, in the case of a sale effected thereon, or a national securities association, in the case of a sale not effected on an exchange, finds:

(A) That such sale resulted from a mistake made in good faith;

(B) That due diligence was used to ascertain that the circumstances specified in § 242.200(g) existed; and

(C) Either that the condition of the market at the time the mistake was discovered was such that undue hardship would result from covering the transaction by a ''purchase for cash'' or that the mistake was made by the seller's broker and the sale was at a permissible price under any applicable short sale price test.

(b) *Short sales.* (1) A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has:

(i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or

(ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and

(iii) Documented compliance with this paragraph (b)(1).

(2) The provisions of paragraph (b)(1) of this section shall not apply to:

(i) A broker or dealer that has accepted a short sale order from another registered broker or dealer that is required to comply with paragraph (b)(1) of this section, unless the broker or dealer relying on this exception contractually undertook responsibility for compliance with paragraph (b)(1) of this section;

(ii) Any sale of a security that a person is deemed to own pursuant to § 242.200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. If the person has not delivered such security within 35 days after the trade date, the broker-dealer that effected the sale must borrow securities or close out the short position by purchasing securities of like kind and quantity;

(iii) Short sales effected by a market maker in connection with bona-fide market making activities in the security for which this exception is claimed; and

(iv) Transactions in security futures.

(3) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity:

(i) The provisions of this paragraph (b)(3) shall not apply to the amount of the fail to deliver position that the participant of a registered clearing agency had at a registered clearing agency on the settlement day immediately preceding the day that the security became a threshold security; provided, however, that if the fail to deliver position at the clearing agency is subsequently reduced below the fail to deliver position on the settlement day immediately preceding the day that the security became a threshold security, then the fail to deliver position excepted by this paragraph (b)(3)(i) shall be the lesser amount;

(ii) The provisions of this paragraph (b)(3) shall not apply to the amount of the fail to deliver position in the 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;

(iii) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen 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;

(iv) If a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant; and

(v) A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this paragraph (b)(3) where the participant enters into an arrangement with another person to purchase securities as required by this paragraph (b)(3), and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase.

(c) *Definitions.* (1) For purposes of this section, the term *market maker* has the same meaning as in section 3(a)(38) of the Securities Exchange Act of 1934 (''Exchange Act'') (15 U.S.C. 78c(a)(38)).

(2) For purposes of this section, the term *participant* has the same meaning as in section 3(a)(24) of the Exchange Act (15 U.S.C. 78c(a)(24)).

(3) For purposes of this section, the term *registered clearing agency* means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act (15 U.S.C. 78c(a)(23)(A)), that is registered with the Commission pursuant to section 17A of the Exchange Act (15 U.S.C. 78q–1).

(4) For purposes of this section, the term *security future* has the same meaning as in section 3(a)(55) of the Exchange Act (15 U.S.C. 78c(a)(55)).

(5) For purposes of this section, the term *settlement day* means any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.

(6) For purposes of this section, the term *threshold security* means any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)):

(i) 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;

(ii) Is included on a list disseminated to its members by a self-regulatory organization; and

(iii) *Provided, however*, that a security shall cease to be a threshold security if the aggregate fail to deliver position at a registered clearing agency does not exceed the level specified in paragraph (c)(6)(i) of this section for five consecutive settlement days.

(d) *Exemptive authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.

By the Commission.

Dated: July 28, 2004.

Jill M. Peterson,

Assistant Secretary.

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