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17 CFR Part 242

Amendments to Regulation SHO; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–54154; File No. S7–12–06]

RIN 3235–AJ57

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 (Exchange Act). The proposed amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities, by eliminating the grandfather provision and narrowing the options market maker exception. The proposals also are intended to update the market decline limitation referenced in Regulation SHO.

DATES: Comments should be received on or before September 19, 2006.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–12–06 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–12–06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549–1090. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Acting Associate Director, Josephine J. Tao, Branch Chief, Joan M. Collopy, Special Counsel, Lillian S. Hagen, Special Counsel, Elizabeth A. Sandoe, Special Counsel, Victoria L. Crane, Special Counsel, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 551–5720, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, provides a new regulatory framework governing short sales.[1] Among other things, Regulation SHO imposes a close-out requirement to address problems with failures to deliver stock on trade settlement date and to target abusive ''naked'' short selling (*e.g.*, selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement period) in certain equity securities.[2] While the majority of trades settle on time,[3] Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might harm the market for that security. These fails to deliver may result from either short sales or long sales of stock.[4]

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to broker-dealers for securities in which a substantial amount of fails to deliver have occurred (also known as ''threshold securities'').[5] As discussed more fully below, Rule 203(b)(3) of Regulation SHO includes two exceptions to the mandatory close-out requirement. The first is the ''grandfather'' provision, which excepts fails to deliver established prior to a security becoming a threshold security;[6] and the second is the ''options market

[1] *See* Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (''Adopting Release''), available at *http://www.sec.gov/rules/final/34-50103.htm.* For more information on Regulation SHO, *see* ''Frequently Asked Questions'' and ''Key Points about Regulation SHO'' (at *http://www.sec.gov/spotlight/shortsales.htm*).

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

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

[3] According to the National Securities Clearing Corporation (NSCC), on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities, fail to settle. In other words, 99% (by dollar value) of all trades settle on time. The vast majority of these fails are closed out within five days after T+3.

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

[5] A threshold security is defined in Rule 203(c)(6) as 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)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and is included on a list disseminated to its members by a self-regulatory organization (''SRO''). 17 CFR 242.203(c)(6). This is known as the ''threshold securities list.'' Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

[6] The ''grandfathered'' status applies in two situations: (1) to fail positions occurring before January 3, 2005, Regulation SHO's effective date; and (2) to fail positions that were established on or after January 3, 2005 but prior to the security appearing on the threshold securities list. 17 CFR 242.203(b)(3)(i).

maker exception,'' which excepts any fail to deliver in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.[7]

At the time of Regulation SHO's adoption in August 2004, the Commission stated that it would monitor the operation of Regulation SHO, particularly whether grandfathered fail positions were being cleared up under the existing delivery and settlement guidelines or whether any further regulatory action with respect to the close-out provisions of Regulation SHO was warranted.[8] In addition, with respect to the options market maker exception, the Commission noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission's original expectations.[9]

Based on examinations conducted by the Commission's staff and the SROs since Regulation SHO's adoption, we are proposing revisions to Regulation SHO. As discussed more fully below, our proposals would modify Rule 203(b)(3) by eliminating the grandfather provision and narrowing the options market maker exception. Regulation SHO has achieved substantial results. However, some persistent fails to deliver remain. The proposals are intended to reduce the number of persistent fails to deliver attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception. The proposals also would include a 35 settlement day phase-in period following the effective date of the amendment. The phase-in period is intended to provide additional time to begin closing out certain previously-excepted fail to deliver positions. Our proposals also would update the market decline limitation referenced in Rule 200(e)(3) of Regulation SHO. We also seek comment about other ways to modify Regulation SHO.

II. Background

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

One of Regulation SHO's primary goals is to reduce fails to deliver.[10] Currently, Regulation SHO requires certain persistent fail to deliver positions to be closed out. Specifically, Rule 203(b)(3)'s close-out requirement requires a participant of a clearing agency registered with the Commission to take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement (CNS)[11] system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.[12] In addition, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iii) prohibits the participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.[13]

B. Grandfathering Under Regulation SHO

Rule 203(b)(3)'s close-out requirement does not apply to positions that were established prior to the security becoming a threshold security.[14] This is known as grandfathering. Grandfathered positions include those that existed prior to the effective date of Regulation SHO and positions established prior to a security becoming a threshold security.[15] Regulation SHO's grandfathering provision was adopted because the Commission was concerned about creating volatility through short squeezes[16] if large pre-existing fail to deliver positions had to be closed out quickly after a security became a threshold security.

C. Regulation SHO's Options Market Maker Exception

In addition, Regulation SHO's options market maker exception excepts from the close-out requirement of Rule 203(b)(3) any fail to deliver position in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on an options position that was created before the security became a threshold security.[17] The options market maker exception was created to address concerns regarding liquidity and the pricing of options. The exception does not require that such fails be closed out within any particular timeframe.

D. Regulation SHO Examinations

Since Regulation SHO's effective date in January 2005, the Staff and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.[18] However, despite this positive

[7] 17 CFR 242.203(b)(3)(ii).

[8] *See* Adopting Release, 69 FR at 48018.

[9] *See id.* at 48019.

[10] *Id.* at 48009.

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

[12] 17 CFR 242.203(b)(3).

[13] 17 CFR 242.203(b)(3)(iii). It is possible under Regulation SHO that a close out by a broker-dealer may result in a failure to deliver position at another broker-dealer if the counterparty from which the broker-dealer purchases securities fails to deliver. However, Regulation SHO prohibits a broker-dealer from engaging in ''sham close outs'' by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a failure to deliver position and the broker-dealer knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another failure to deliver position. 17 CFR 242.203(b)(3)(v); Adopting Release, 69 FR at 48018 n. 96.

[14] 17 CFR 242.203(b)(3)(i).

[15] *See* Adopting Release, 69 FR at 48018. However, any new fails in a security on the threshold list are subject to the mandatory close-out provisions of Rule 203(b)(3).

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

[17] 17 CFR 242.203(b)(3)(ii).

[18] For example, in comparing a period prior to the effectiveness of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to May 31, 2006) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- The average daily aggregate fails to deliver declined by 34.0%;
- The average daily number of securities with aggregate fails for at least 10,000 shares declined by 6.5%;
- The average daily number of fails to deliver positions declined by 15.3%;
- The average age of a fail position declined by 13.4%;
- The average daily number of threshold securities declined by 38.2%; and
- The average daily fails of threshold securities declined by 52.4%.

Continued

impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement guidelines.

Based on these examinations and our discussions with the SROs and market participants, we believe that these persistent fail positions may be attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception. Although high fails levels exist only for a small percentage of issuers,[19] we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. First, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. Second, they can be indicative of manipulative naked short selling, which could be used as a tool to drive down a company's stock price. The perception of such manipulative conduct also may undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.

Allowing these persistent fails to deliver to continue runs counter to one of Regulation SHO's primary goals of reducing fails to deliver in threshold securities. While some delays in closing out may be understandable and necessary, a seller should deliver shares to the buyer within a reasonable time period. Thus, we believe that all fails in threshold securities should be closed out after a certain period of time and not left open indefinitely. As such, we believe that eliminating the grandfathering provision and narrowing the options market maker exception is necessary to reduce the number of fails to deliver.

Although we believe that no failure to deliver should last indefinitely, we note that requiring delivery without allowing flexibility for some failures may impede liquidity for some securities. For instance, if faced with a high probability of a mandatory close out or some other penalty for failing to deliver, market makers may find it more costly to accommodate customer buy orders, and may be less willing to provide liquidity for such securities. This may lead to wider bid-ask spreads or less depth. Allowing flexibility for some failures to deliver also may deter the likelihood of manipulative short squeezes because manipulators would be less able to require counterparties to purchase at above-market value.

Regulation SHO's close-out requirement is narrowly tailored in consideration of these concerns. For instance, Regulation SHO does not require close outs of non-threshold securities. The close-out provision only targets those securities where the level of fails is very high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days), and where a participant of a clearing agency has had a persistent fail in such threshold securities for 13 consecutive settlement days. Requiring close out only for securities with large, persistent fails limits the market impact. While some reduction in liquidity may occur as a result of requiring close out of these limited number of securities, we believe this should be balanced against the value derived from delivery of such securities within a reasonable period of time. We also seek specific comment on whether the proposed close-out periods are appropriate in light of these concerns.

III. Discussion of Proposed Amendments to Regulation SHO

A. Proposed Amendments to the Grandfather Provision

To further reduce the number of persistent fails to deliver, we propose to eliminate the grandfather provision in Rule 203(b)(3)(i). In particular, the proposal would require that any previously-grandfathered fail to deliver position in a security that is on the threshold list on the effective date of the amendment be closed out within 35 settlement days[20] of the effective date of the amendment.[21] If a security becomes a threshold security after the effective date of the amendment, any fails to deliver in that security that occurred prior to the security becoming a threshold security would become subject to Rule 203(b)(3)'s mandatory 13 settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

The amendment would help prevent fails to deliver in threshold securities from persisting for extended periods of time. At the same time, the amendment would provide participants flexibility and advance notice to close out the originally grandfathered fail to deliver positions.

Request for Comment

- The grandfather provision of Regulation SHO was adopted because the Commission was concerned about creating volatility from short squeezes where there were large pre-existing fail to deliver positions. The Commission intended to monitor whether grandfathered fail to deliver positions are being cleaned up to determine whether the grandfather provision should be amended to either eliminate the provision or limit the duration of grandfathered fail positions. Is the elimination of the grandfather provision from the close-out requirement in Rule 203(b)(3) appropriate? Should we consider instead providing a longer period of time to close out fails that occurred before January 3, 2005 (the effective date of Regulation SHO),[22] or

Fails to deliver in the six securities that persisted on the threshold list from January 10, 2005 through May 31, 2006 declined by 68.6%.

[19] The average daily number of securities on the threshold list in May 2006 was approximately 298 securities, which comprised 0.38% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO's current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act. NASD Rule 3210, which became effective on July 3, 2006, applies the Regulation SHO close-out framework to non-reporting equity securities with aggregate fails to deliver equal to, or greater than, 10,000 shares and that have a last reported sale price during normal trading hours that would value the aggregate fail to deliver position at $50,000 or greater for five consecutive settlement days. *See* Securities Exchange Act Release No. 53596 (April 4, 2006), 71 FR 18392 (April 11, 2006) (SR–NASD–2004–044). If the proposed amendments to Regulation SHO are adopted, we anticipate NASD Rule 3210 will be similarly amended.

[20] If the security is a threshold security on the effective date of the amendment, participants of a registered clearing agency must close out that position within 35 settlement days, regardless of whether the security becomes a non-threshold security after the effective date of the amendment.

We chose 35 settlement days because 35 days is used in the current rule, and to allow participants additional time to close out their previously-grandfathered fail to deliver positions, given that some participants may have large previously-excepted fails with respect to a number of securities.

Only previously-grandfathered fail to deliver positions in securities that are threshold securities on the effective date of the amendment would be subject to this 35 settlement day phase-in period. For instance, any previously-grandfathered fail position in a security that is a threshold security on the effective date of the amendment that is removed from the threshold list anytime after the effective date of the amendment but that reappears on the threshold list anytime thereafter would no longer qualify for the 35 day phase-in period and would be required to be closed out under the requirements of Rule 203(b)(3) as amended, *i.e.*, if the fail persists for 13 consecutive settlement days.

[21] In addition, similar to the pre-borrow requirement in current Rule 203(b)(3)(iii), if the fail to deliver position has persisted for 35 settlement days, the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

[22] Between the effective date of Regulation SHO and March 31, 2006, 99.2% of the fails that existed on Regulation SHO's January 3, 2005 effective date

fails that occur before a security becomes a threshold security, or both? (*e.g.*, 20 days)? Please explain in detail why a longer period should be allowed.

• Should we provide a longer (or shorter) phase-in period (*e.g.*, 60 days instead of 35), or no phase-in period? What are the economic tradeoffs associated with a longer or shorter phase-in period? How much do these tradeoffs matter?

• Is a 35 settlement day phase-in period necessary as firms will have been on notice that they will have to close out previously-grandfathered fails following the effective date of the amendment? Should we consider changing the phase-in period to 35 calendar days? If so, would this create systems problems or other costs? Would a phase-in period create examination or surveillance difficulties?

• Would the proposed amendments create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the 35 day phase-in period from fails that are not eligible for the phase-in period? If there are additional costs associated with tracking fails to deliver subject to the 35 versus 13 settlement day requirements, do these additional costs outweigh the benefits of providing firms with a 35 settlement day phase-in period?

• Please provide specific comment as to what length of implementation period is necessary to put firms on notice that positions would need to be closed out within the applicable timeframes, if adopted?

• Current Rule 203(b)(3) and the proposal to eliminate the grandfather provision are based on the premise that a high level of fails to deliver for a particular stock might harm the market for that security. In what ways do persistent grandfathered fails to deliver harm market quality for those securities, or otherwise have adverse consequences for investors?

• To what degree would the proposed amendments help reduce abusive practices by short sellers? Conversely, to what degree will eliminating the grandfather provision make it more difficult for short sellers to provide market discipline against abusive practices on the long side?

• To what extent will eliminating the grandfather provision affect the potential for manipulative activity? For instance, could it increase the potential for manipulative short squeezes?

• How much would the amendments affect the specific compliance costs for small, medium, and large clearing members (*e.g.*, personnel or system changes)?

• What are the benefits of allowing fails of a certain duration, and what is the appropriate length of time for which a fail could have such a benefit?

• Should we consider changing the period of time in which any fail is allowed to persist before a firm is required to close out that fail (*e.g.*, reduce the 13 consecutive settlement days to 10 consecutive settlement days)?

• What are the economic costs of eliminating the grandfather provision? How will eliminating the grandfather provision affect the liquidity of equity securities? Are there any other costs associated with this proposal?

• Should grandfathering be eliminated only for those threshold securities where the highest levels of fails exist? If so, how should such positions be identified? What criteria should be used? What time period, if any, would be appropriate to grandfather threshold securities with lower levels of fails? Is there a *de minimis* amount of fails that should not be subject to a mandatory close out? If so, what is that amount?

• Should the Commission consider granting relief to allow market participants to close out fails in threshold securities that occurred because of an obvious or inadvertent trading error? If so, what factors should the Commission consider before granting the request? What documentation should market participants be required to create and maintain to demonstrate eligibility for relief? Should the cost of closing out the fail be a part of the economic cost of making a trading error? How would the proposed amendments affect price efficiency for fails resulting from trading errors?

• Some market participants have suggested that delivery failures in certain structured products, such as exchange traded funds (ETFs) do not raise the same concerns as fails in securities of individual issuers. We also understand that there may be particular difficulties in complying with the close-out requirements because of the structure of these products. Are there unique challenges associated with the clearance and settlement of ETFs? If so, what are these unique challenges? Should ETFs or other types of structured products be excepted from being considered threshold securities? If so, what reasons support excepting these securities?

• We understand that deliveries on sales of Rule 144 restricted securities are sometimes delayed through no fault of the seller (*e.g.*, to process removal of the restrictive legend). Should the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities be extended, *e.g.*, to 35 settlement days? Please identify specific delivery problems related to Rule 144 restricted securities. Should the current close-out requirement of 13 consecutive settlement days be similarly extended for any other type of securities and, if so, why?

• We solicit comment on any legitimate reason why a short or long seller may be unable to deliver securities within the current 13 consecutive settlement day period of Rule 203(b)(3), or within any other alternative timeframes.

• The current definition of a ''threshold security'' is based, in part, on a security having a threshold level of fails that is ''equal to at least one-half of one percent of an issuer's total shares outstanding.'' [23] Is the current threshold level (one-half of one percent) too low or too high? If so, how should the current threshold level be changed?

• When Regulation SHO was proposed, commenters noted difficulties tracking individual accounts in determining fails to deliver.[24] However, we understand that some firms now track internally the accounts responsible for fails. Should we consider requiring customer account-level close out? Should firms be required to prohibit all short sales in that security by an account if that account becomes subject to close out in that security, rather than requiring that account to pre-borrow before effecting any further short sales in the particular threshold security?

• Should we impose a mandatory ''pre-borrow'' requirement (*i.e.*, that would prohibit a participant of a registered clearing agency, or any broker-dealer for which it clears transactions, from accepting any short sale order or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security) for all firms whenever there are extended fails in a threshold security regardless of whether that particular firm has an extended fail position in that security? If so, how should we identify such securities? What criteria should be used to identify an extended fail? Should this alternative apply to all threshold securities? What are the costs and benefits of imposing

have been closed out. This calculation is based on data, as reported by NSCC, that covers all stocks with aggregate fails to deliver of 10,000 shares or more.

[23] *See supra* note 5.

[24] *See* Adopting Release, 69 FR at 48017.

such a mandatory pre-borrow requirement? What percentage of these pre-borrowed shares would eventually be required for delivery?

• Rule 203(b)(1)'s current locate requirement generally prohibits brokers from using the same shares located from the same source for multiple short sales. However, Rule 203(b)(1) does not similarly restrict the sources that provide the locates. We understand that some sources may be providing multiple locates using the same shares to multiple broker-dealers. Thus, should we amend Rule 203(b)(1) to provide for stricter locates? For example, should we require that brokers obtain locates only from sources that agree to, and that the broker reasonably believes will, decrement shares (so that the source may not provide a locate of the same shares to multiple parties)? Would doing so reduce the potential for fails to deliver? Should we consider other amendments to the locate requirement? Would requiring stricter locate requirements reduce liquidity? If so, would the reduction in liquidity affect some types of securities more than others (*e.g.*, hard to borrow securities or securities issued by smaller companies)? Should stricter locate requirements be implemented only for securities that are hard to borrow (*e.g.*, threshold securities)?

• Some people have asked for disclosure of aggregate fail to deliver positions to provide greater transparency. Should we require the amount or level of fails to deliver in threshold securities to be publicly disclosed? Would requiring information about the amount of fails to deliver help reduce the number of persistent fails to deliver? Should such disclosure be done on an aggregate or individual stock basis? If so, who should make this disclosure (*e.g.*, should each broker be required to disclose the aggregate fails to deliver amount for each threshold security or, alternatively, should the SROs be required to post this information)? How should this information be disseminated? In what way would providing the investing public with access to aggregate fails data be useful? Would providing the investing public with access to this information on an individual stock basis increase the potential for manipulative short squeezes? If not, why not? How frequently should this information be disseminated? Should it be disseminated on a delayed basis to reduce the potential for manipulative short squeezes? If so, how much of a delay would be appropriate?

• Are there certain transactions or market practices that may cause fail to deliver positions to remain for extended periods of time that are not currently addressed by Rule 203 of Regulation SHO? If so, what are these transactions or practices? How should Rule 203 be amended to address these transactions or practices?

• Would borrowing, rather than purchasing, securities to close out a position be more effective in reducing fails to deliver, or could borrowing result in prolonging fails to deliver?

• Can the close-out provision of Rule 203(b) be easily evaded? If so, please explain.

• Does allowing some level of fails of limited duration enable market makers to create a market for less liquid securities? How long of a duration is reasonable? Does eliminating the grandfather provision mean fewer market makers will be willing to make markets in those securities, and could this increase costs and liquidity for those securities? Are there any other concerns or solutions associated with the effect of the amendment on market makers in highly illiquid stocks?

• Current Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it has demonstrated that it has 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. Former NASD Rule 3370 required that a broker making an affirmative determination that a customer was long must make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Should we consider amending Regulation SHO to include these additional documentation requirements? If so, should any modifications be made to these additional requirements? In the prior SRO rules, brokers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment (''DVP trades''). Under Regulation SHO, a broker may not lend or arrange to lend, or fail, on any security marked long unless, among other things, the broker knows or has been reasonably informed by the seller that the seller owns the security and that the seller would deliver the security prior to settlement and failed to do so. Is it generally reasonable for a broker to believe that a DVP trade will settle on time? Should we consider including or specifically excluding an exception for DVP trades or other trades on any rule requiring documentation of long sales?

B. Proposed Amendments to the ''Options Market Maker Exception''

We also propose to limit the duration of the options market maker exception in Rule 203(b)(3)(ii). Under the proposed amendment, for securities that are on the threshold list on the effective date of the amendment, any previously excepted fail to deliver position in the threshold security that resulted from short sales effected to establish or maintain a hedge on an options position that existed before the security became a threshold security, but that has expired or been liquidated on or before the effective date of the amendment, would be required to be closed out within 35 settlement days of the effective date of the amendment.[25] However, if the security appears on the threshold list after the effective date of the amendment, and if the options position has expired or been liquidated, all fail to deliver positions in the security that result or resulted from short sales effected to establish or maintain a hedge on an options position that existed before the security became a threshold security must be closed out within 13 consecutive settlement days of the security becoming a threshold security or of the expiration or liquidation of the options position, whichever is later.[26]

Thus, under the proposed amendment, registered options market makers would still be able to continue to keep open fail positions in threshold securities that are being used to hedge

[25] In addition, similar to the pre-borrow requirement of current Rule 203(b)(3)(iii), if the fail to deliver has persisted for 35 settlement days, the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

[26] Also, similar to the pre-borrow requirement of current Rule 203(b)(iii), if the options position has expired or been liquidated and the fail to deliver has persisted for 13 consecutive settlement days from the date on which the security becomes a threshold security or the option position expires or is liquidated, whichever is later, the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

options positions, including adjusting such hedges, if the options positions that were created prior to the time that the underlying security became a threshold security have not expired or been liquidated. Once the security becomes a threshold security and the specific options position has expired or been liquidated, however, such fails would be subject to a 13 consecutive settlement day close-out requirement.

We understand that, without the ability to hedge a pre-existing options position by selling short the underlying security, options market makers may be less willing to make markets in securities that are threshold securities.[27] This in turn may reduce liquidity in such securities, to the detriment of investors in options. We also understand that additional time may be needed to close out a fail to deliver position resulting from a hedge on an options position that existed before the security became a threshold security. However, once the options position expires or is liquidated, we see no reason for maintaining the fail position. We believe that the 13 consecutive settlement day period provided for in this proposal would be a sufficient amount of time to allow a fail to remain that results from a short sale by an options market maker to hedge a pre-existing options position that has expired or been liquidated. Therefore, once the options position that was being hedged by a short sale in the underlying threshold security expires or is liquidated, reliance on the options market maker exception is no longer warranted and the fail to deliver position associated with that expired options position should be subsequently closed out.[28] In addition, if the proposed amendments are adopted, we anticipate an implementation period that would put the firms on notice that positions need to be closed out within the applicable time frames.

We believe the proposed amendments foster Regulation SHO's goal of reducing fails to deliver while still permitting options market makers to hedge existing options positions until the specific options position being hedged has expired or been liquidated. The 35 settlement day phase-in period also would provide options market makers advance notice to adjust to the new requirement. At the same time, the amendments would limit the amount of time in which a fail to deliver position can persist.

Request for Comment

- The options market maker exception was created to permit options market makers flexibility in maintaining and adjusting hedges for pre-existing options positions. Is narrowing the options market maker exception appropriate? If not, why not? Will narrowing the exception reduce the willingness of options market makers to make markets in threshold securities? Will narrowing this exception reduce liquidity in threshold securities? Should we consider providing a limited amount of additional time for options market makers to close out after the expiration or liquidation of the hedge (*e.g.*, from 13 days to 20 days)? What other measures or time frames would be effective in fostering Regulation SHO's goal of reducing fails while at the same time encouraging liquidity and market making by options market makers?
- Should we narrow the options market maker exception only for threshold securities with the highest level of fails? If so, how should such positions be identified? What criteria should be used? Should we provide a limited exception for threshold securities with a lower levels of fails? If so, how much time should we provide for options market maker fails in those securities (*e.g.*, 20 days)?
- Should we eliminate the options market maker exception altogether? Would this impede liquidity, or otherwise reduce the willingness of options market makers to make markets in threshold securities? Please provide specific reasons and information to support an alternative recommendation.
- After the options position has expired or been liquidated, are there circumstances that might cause an options market maker to need to maintain an excepted fail to deliver position longer than 13 consecutive settlement days? If so, what are those circumstances?
- Is there any legitimate reason an options market maker should be permitted to never have to close out a fail position that is excepted from the close-out requirement of this proposal? If so, what are the reasons?
- Are the terms ''expiration'' and ''liquidation'' of an options position sufficiently inclusive to prevent participants from evading the proposed close-out requirements? Are these terms understandable for compliance purposes? If not, what terms would be more appropriate? Please explain.
- Under the current rule a broker-dealer asserting the options market maker exception must demonstrate eligibility for the exception. Some market participants have noted that more specific documentation requirements may make it easier to establish a broker-dealer's eligibility for the exception. Should a broker-dealer asserting the options market maker exception be required to make and keep more specific documentation regarding their eligibility for the exception? Such documentation may include tracking fail positions resulting from short sales to hedge specific pre-existing options positions and the options position. What other types of documentation would be helpful, and why?
- Should Rule 203(b)(3) of Regulation SHO be amended to permit options market makers to move excepted positions to hedge other, or new, pre-existing options positions? If so, please provide specific reasons and information to support your answer.
- Based on current experience with Regulation SHO, what have been the costs and benefits of the current options market maker exception?
- What are the costs and benefits of the proposed amendments to the options market maker exception?
- What technical or operational challenges would options market makers face in complying with the proposed amendments?
- Would the proposed amendments create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the 35 day phase-in period from fails that are not eligible for the phase-in period? If there are additional costs associated with tracking fails to deliver subject to the 35 versus 13 settlement day requirements, do these additional costs outweigh the benefits of providing firms with a 35 settlement day phase-in period? Is a 35 settlement day phase-in period necessary given that firms will have been on notice that they will have to close out these fails to deliver positions following the effective date of the amendment?
- Should we consider changing the proposed phase-in period to 35 calendar days? If so, would this create systems problems or other costs? Would a phase-in period create examination or surveillance difficulties?
- Please provide specific comment as to what length of implementation period is necessary to put firms on notice that positions would need to be closed out

[27] *See* Adopting Release, 69 FR at 48018.

[28] Consistent with the current rule, options market makers would not be permitted to move their hedge on an original options position to another pre-existing options position to avoid application of the proposed close-out requirements. Once the options position expires or is liquidated, the proposed amendment would require closing out the fail that resulted from that original hedge. To clarify this, the proposed rule would amend Rule 203(b)(3)(ii) to refer to ''an options position'' rather than ''options positions.''

within the applicable timeframes, if adopted.

IV. Proposed Amendments to Rule 200(e) Exception for Unwinding Index Arbitrage Positions

We also propose to update Rule 200(e) of Regulation SHO to reference the NYSE Composite Index (NYA), instead of the Dow Jones Industrial Average (DJIA), for purposes of the market decline limitation in subparagraph (e)(3) of Rule 200.

A. Background

Regulation SHO provides a limited exception from the requirement that a person selling a security aggregate all of the person's positions in that security to determine whether the seller has a net long position. This provision, which is contained in Rule 200(e), allows broker-dealers to liquidate (or unwind) certain existing index arbitrage positions involving long baskets of stocks and short index futures or options without aggregating short stock positions in other proprietary accounts if and to the extent that those short stock positions are fully hedged.[29] The exception, however, does not apply if the sale occurs during a period commencing at a time when the 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.[30] If a market decline triggers the application of Rule 200(e)(3), a broker-dealer must aggregate all of its positions in that security to determine whether the seller has a net long position.[31]

The reference to the DJIA was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions). As amended in 1999, NYSE Rule 80A provided for limitations on index arbitrage trading in any component stock of the S&P 500 Stock Price Index (''S&P 500'') whenever the change from the previous day's close in the DJIA was greater than or equal to two percent calculated pursuant to the rule.[32] In addition, the two-percent market decline restriction was included in Rule 200(e)(3) so that the market could avoid incremental temporary order imbalances during volatile trading days.[33] The two-percent market decline restriction limits temporary order imbalances at the close of trading on a volatile trading day and at the opening of trading on the following day, since trading activity at these times may have a substantial effect on the market's short-term direction.[34] The two-percent safeguard also provides consistency within the equities markets.[35]

On August 24, 2005, the Commission approved an amendment to NYSE Rule 80A to use the NYA to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA.[36] The effective date of the amendment was October 1, 2005. The Commission's approval order notes that, according to the NYSE, the NYA is a better reflection of market activity with respect to the S&P 500 and thus, a better indicator as to when the restrictions on index arbitrage trading provided by NYSE Rule 80A should be triggered.[37] While Rule 200(e)(3) currently does not refer to the basis for determining the two-percent limitation, NYSE Rule 80A provides that the two percent is to be calculated at the beginning of each quarter and shall be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter.[38]

B. Proposed Amendments to Rule 200(e)

In order to maintain uniformity with NYSE Rule 80A and to maintain a uniform protective measure, we propose to amend Rule 200(e)(3) of Regulation SHO to: (i) Reference the NYA instead of the DJIA; and (ii) add language to clarify how the two-percent limitation is to be calculated in accordance with NYSE Rule 80A for purposes of Rule 200(e)(3).[39]

Request for Comment

- Are the proposed changes to the market decline limitation appropriate? Would another index be a more appropriate measure for the exception than the NYA?
- Is the proposed clarification language regarding the two-percent calculation useful?
- Does this limitation affect the expected cost of entering into index arbitrage positions? Does the limitation reduce market efficiency by slowing down price discovery? Does the limitation affect only temporary order imbalances or does it also keep prices from fully adjusting to their fundamental value?
- What are the costs and benefits of the proposed amendments to Regulation SHO's exception for unwinding index arbitrage positions?

V. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Regulation SHO under the Exchange Act. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendments to Regulation SHO. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

VI. Paperwork Reduction Act

The proposed amendments to Regulation SHO would not impose a new ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995.[40] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

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

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

[31] 17 CFR 242.200(e)(3); Adopting Release, 69 FR at 48012.

[32] The restrictions were removed when the DJIA retreated to one percent or less, calculated pursuant to the rule, from the prior day's close.

[33] Adopting Release, 69 FR at 48011.

[34] *Id.*

[35] In 1999, the NYSE amended its rules on index arbitrage restrictions to include the two-percent trigger. The Commission's adoption of the same trigger provided a uniform protective measure. *See* Securities Exchange Act Release No. 41041 (February 11, 1999), 64 FR 8424 (SR–NYSE–98–45) (February 19, 1999).

[36] Securities Exchange Act Relese No. 52328 (Aug. 24, 2005), 70 FR 51398 (Aug. 30, 2005).

[37] *Id.*

[38] *Id. See also* NYSE Rule 80A (Supplementary Material .10).

[39] *Id. See also* Proposed Rule 200(e)(3). In addition, because the NYA is already posted with this calculation, the amendment would make this reference point more easily accessible to market participants.

[40] 44 U.S.C. 3501 *et seq.*

VII. Consideration of Costs and Benefits of Proposed Amendments to Regulation SHO

The Commission is considering the costs and the benefits of the proposed amendments to Regulation SHO. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the Commission requests 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 other market participants. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Regulation SHO.

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

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

a. Benefits. The proposed amendments would eliminate the grandfather provision in Rule 203(b)(3)(i) of Regulation SHO. In particular, the proposal would require that any previously-grandfathered fail to deliver position in a security that is on the threshold list on the effective date of the amendment be closed out within 35 settlement days. If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that occurred prior to the security becoming a threshold security would become subject to Rule 203(b)(3)'s mandatory 13 settlement days close-out requirement, similar to any other fail to deliver position in a threshold security. We have observed a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement guidelines. We believe that these persistent fail positions are attributable primarily to the grandfather provision. We believe that the proposal to eliminate the grandfather provision would further reduce the number of persistent fails to deliver. We believe the proposed amendments to Rule 203(b)(3)(i) will protect and enhance the operation, integrity, and stability of the market.

Consistent with the Commission's investor protection mandate, the proposed amendment will benefit investors. The proposed amendments would facilitate receipt of shares so that more investors receive the benefits associated with share ownership, such as the use of the shares for voting and lending purposes. The proposal may alleviate investor apprehension as they make investment decisions by providing them with greater assurance that securities will be delivered as expected. It should also foster the fair treatment of all investors.

The proposed amendments should also benefit issuers. A high level of persistent fails in a security may be perceived by potential investors negatively and may affect their decision about making a capital commitment. Thus, the proposal may benefit issuers by removing a potential barrier to capital investment, thereby increasing liquidity. An increase in investor confidence in the market by providing greater assurance that trades will be delivered may also facilitate investment. In addition, some issuers may believe they have endured reputational damage if there are a high level of persistent fails in their securities as a high level of fails is often viewed negatively. Eliminating the grandfather provision may be perceived by these issuers as helping to restore their good name. Some issuers may also believe that they have been the target of potential manipulative conduct as a result of failures to deliver from naked short sales. Eliminating the grandfather provision may remove a potential means of manipulation, thereby decreasing the possibility of artificial market influences and, therefore, contributing to price efficiency.

We believe the 35 day phase-in period should reduce disruption to the market and foster greater market stability because it would provide time for participants to close out grandfathered positions in an orderly manner. In addition, this proposed amendment would put market participants on notice that the Commission is considering this approach.

The proposed amendment would provide flexibility because it gives a sufficient length of time to effect purchases to close out in an orderly manner. We are seeking comment on an appropriate length of implementation period that should provide sufficient notice. Market participants may begin to close out grandfathered positions at anytime before the 35 day phase-in period may be adopted.

We solicit comment on any additional benefits that may be realized with the proposed amendment, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

b. Costs. In order to comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their systems and surveillance mechanisms. Thus, the infrastructure necessary to comply with the proposed amendments should already be in place. Any additional changes to the infrastructure should be minimal. We request specific comment on the system changes to computer hardware and software, or surveillance costs that might be necessary to comply with this rule. We solicit comment on whether the costs will be incurred on a one-time or ongoing basis, as well as cost estimates. In addition, we seek comment as to whether the proposed amendment would decrease any costs for any market participants. We seek comment about any other costs and cost reductions associated with the proposed amendment or alternative suggestion. Specifically:

- What are the economic costs of eliminating the grandfather provision? How will this affect the liquidity of equity securities? Are there any other costs associated with the proposal?
- How much would the amendments to the grandfather provision affect the compliance costs for small, medium, and large clearing members (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that may arise as a result of these proposed amendments. For instance, to comply with the proposed amendments, will broker-dealers be required to:
- Purchase new systems or implement changes to existing systems? Will changes to existing systems be significant? What are the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
- Change existing records? What changes would need to be made? What are the costs associated with any changes? How much time would be required to make any changes?
- Increase staffing and associated overhead costs? Will broker-dealers have to hire more staff? How many, and at what experience and salary level? Can existing staff be retrained? What are the costs associated with hiring new staff or retraining existing staff? If retraining is required, what other costs might be incurred, *i.e.*, would retrained staff be unable to perform existing duties in order to comply with the proposed

amendments? Will other resources need to be re-dedicated to comply with the proposed amendments?

• Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.

• Establish and implement new supervisory or compliance procedures, or modify existing procedures? What are the costs associated with such changes? Would new compliance or supervisory personnel be needed? What are the costs of obtaining such staff?

• Are there any other costs that may be incurred to comply with the proposed amendments?

• In connection with error trades, should the cost of closing out the fail be a part of the economic cost of making a trading error? What costs may be involved with trading errors under the proposed amendments? How would price efficiency be effected for fails resulting from trading errors under the proposed amendments?

• Does eliminating the grandfather provision mean fewer market makers will be willing to make markets in those securities, and could this increase transaction costs and liquidity for those securities? Would such an effect be more severe for liquid or illiquid securities?

• Are there any costs that market participants may incur as a result of the proposed 35 day phase-in period? Would the costs of a phase-in period outweigh the costs of not having one? Would a phase-in create examination or surveillance difficulties?

• What are the costs and economic tradeoffs associated with longer or shorter phase-in periods? How much do these costs and tradeoffs matter?

• Similar to the pre-borrow requirements of current Rule 203(b)(iii), we are including a pre-borrow requirement for previously grandfathered fail positions when they become subject to either the proposed 35-day phase-in period or the 13-day close-out requirement. Thus, the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. What are the costs associated with including the pre-borrow requirement for the proposed amendments to the grandfather provision? What are the costs of excluding a pre-borrow requirement for these proposals?

• We ask what length of implementation period is necessary to put firms on notice that positions would need to be closed out within the applicable timeframes, if the proposed amendments are adopted. What are the costs associated with providing a lengthy implementation period?

In addition, in Section III.A., we ask whether we should consider amendments to other provisions of Regulation SHO. We also solicit comment on the costs associated with these proposals. Specifically:

• We ask whether we should consider imposing a mandatory pre-borrow requirement in lieu of a locate requirement for threshold securities with extended fails. What are the costs and benefits of such a proposal?

• We ask whether the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities or other types of threshold securities should be extended. Are there costs associated with extending the current close-out requirement for these, or other types of threshold securities? Who would bear these costs?

• What would be the costs of excepting ETFs or other types of structured products from the definition of threshold securities? Who would bear these costs?

• We ask whether we should consider tightening the locate requirements. For instance, should we consider requiring that brokers obtain locates only from sources that agree to, and that the broker reasonably believes will, decrement shares (so that the source may not provide a locate of the same shares to multiple parties)? What are the costs associated with such a proposal? Would it hinder liquidity, or raise the cost of borrowing? What would be the costs associated with other proposals to strengthen the locate requirements?

• What are the costs associated with dissemination of aggregate fails data or fails data by individual security?

• We ask whether allowing some level of fails of limited duration enables market makers to create a market for less liquid securities, or whether eliminating the grandfather provision means fewer market makers will be willing to make markets in those securities, and could this increase costs and liquidity for those securities. Are there any other costs associated with the effect of the amendments on market makers in highly illiquid stocks?

• What are the potential costs of requiring additional specific documentation of long sales? Are there systems costs, personnel costs, recordkeeping costs, etc? What costs could be saved by specifically excluding DVP trades? What costs may be incurred by excluding DVP trades from long sale documentation requirements?

2. Amendments to Rule 203(b)(3)(ii)'s Options Market Maker Exception

a. Benefits. The proposed amendments also would limit the duration of the options market maker exception in Rule 203(b)(3)(ii) of Regulation SHO. In particular, the proposal would require firms, within specified timeframes, to close out all fail to deliver positions in threshold securities resulting from short sales that hedge options positions that have expired or been liquidated and that were established prior to the time the underlying security became a threshold security. In the Regulation SHO Adopting Release, the Commission acknowledged assertions by options market makers that, without the ability to hedge a pre-existing options position by selling short the underlying security, options market makers may be less willing to make markets in threshold securities.[41] We also understand that additional time may be needed in order to close out a previously-excepted fail to deliver position resulting from a hedge on an options position that existed before the security became a threshold security. However, once the options position expires or is liquidated, we see no reason for maintaining the fail position or for allowing continued reliance on the options market maker exception. We believe the proposal promotes Regulation SHO's goal of reducing fails to deliver without interfering with the purpose of the options market maker exception. Further, the amendments would provide participants and options market makers that have been allocated the close-out obligation flexibility and advance notice to close out the fail to deliver positions. We believe the proposed amendments to Rule 203(b)(3)(ii) will protect and enhance the operation, integrity, and stability of the market.

b. Costs. Broker-dealers asserting the options market maker exception under Regulation SHO should already have systems in place to close out non-excepted fails to deliver. Broker-dealers may, however, need to modify their systems and surveillance mechanisms to track the fails to deliver and the options positions to ensure compliance with the proposed amendments. In addition, broker-dealers may need to put in place mechanisms to facilitate

[41] *See* Adopting Release, 69 FR at 48018.

communications between participants and options market makers. We request specific comment on the systems changes to computer hardware and software, or surveillance costs necessary to implement this rule. Specifically:

• What are the costs and benefits of the proposed amendments to the options market maker exception? For instance, what are the costs associated with narrowing the exception if the amendments reduce the willingness of options market makers to make markets in threshold securities?

• We ask whether we should consider providing a limited amount of additional time for options market makers to close out after the expiration or liquidation of the hedged options position (*e.g.*, from 13 days to 20 days). What costs would be associated with such a proposal? What costs might be saved by allowing additional time?

• Similar to the pre-borrow requirements of current Rule 203(b)(iii), if the options position has expired or been liquidated and the fail to deliver has persisted for 13 consecutive settlement days from the date on which the security becomes a threshold security or the option position expires or is liquidated, whichever is later (or 35 settlement days from the effective date of the amendment if the phase-in period applies), the proposal would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity. What are the costs associated with including the pre-borrow requirement for the proposed amendments to the options market maker exception? What are the costs of excluding a pre-borrow requirement for these proposals?

• We ask whether we should eliminate the options market maker exception altogether. What costs might be associated with such a proposal?

• What costs would be associated with requiring options market makers to make and keep more specific documentation of fail positions resulting from short sales to hedge specific pre-existing options positions?

• Based on the current requirements of Regulation SHO, what have been the costs and benefits of the current options market maker exception?

• What are the specific costs associated with any technical or operational challenges that options market makers face in complying with the proposed amendments?

• Would the proposed amendments create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the 35 versus 13 settlement days requirements? If there are additional costs associated with tracking fails to deliver would these additional costs outweigh the benefits of providing firms with a 35 settlement day close-out requirement? Is a 35 settlement day close out period necessary as firms will have been on notice that they will have to close out these fails to deliver positions following the effective date of the amendment?

• How much would the amendments to the options market maker exception affect compliance costs for small, medium, and large clearing members (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that may arise. For instance, to comply with the proposed amendments regarding the options market maker exception, will broker-dealers be required to:

• Purchase new systems or implement changes to existing systems? Will changes to existing systems be significant? What are the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?

• Change existing records? What changes would need to be made? What are the costs associated with any changes? How much time would be required to make any changes?

• Increase staffing and associated overhead costs? Will broker-dealers have to hire more staff? How many, and at what experience and salary level? Can existing staff be retrained? What are the costs associated with hiring new staff or retraining existing staff? If retraining is required, what other costs might be incurred, *i.e.*, would retrained staff be unable to perform existing duties in order to comply with the proposed amendments? Will other resources need to be re-dedicated to comply with the proposed amendments?

• Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.

• Establish and implement new supervisory or compliance procedures, or modify existing procedures? What are the costs associated with such changes? Would new compliance or supervisory personnel be needed? What are the costs of obtaining such staff?

• Are there any other costs that may be incurred to comply with the proposed amendments?

• Are there any costs that market participants may incur as a result of the proposed 35 day phase-in period? Would the costs of a phase-in period outweigh the costs of not having one? Would a phase-in create examination or surveillance difficulties?

• What are the economic tradeoffs associated with longer or shorter phase-in periods? How much do these tradeoffs matter?

• We ask what length of implementation period is necessary to put firms on notice that positions would need to be closed out within the applicable timeframes, if adopted. What are the costs associated with providing a lengthy implementation period?

B. Proposed Amendments to Rule 200(e)(3)

1. Benefits

The proposed modification to Rule 200(e) of Regulation SHO would reference the NYA, instead of the DJIA, for purposes of the market decline limitation in subparagraph (e)(3) of Rule 200. The reference to the DJIA was based in part on NYSE Rule 80A, which provided for limitations on index arbitrage trading in any component stock of the S&P 500 Stock Price Index (S&P 500) whenever the change from the previous day's close in the DJIA was greater than or equal to two-percent calculated pursuant to the rule. We also propose to add language to clarify that the two-percent limitation is to be calculated in accordance with NYSE Rule 80A for purposes of Rule 200(e)(3). On August 24, 2005, the Commission approved an amendment to NYSE Rule 80A to use the NYA to calculate limitations on index arbitrage trading as provided in the rule instead of the DJIA.[42] According to the NYSE, the NYA is a better reflection of market activity with respect to the S&P 500 and thus, a better indicator as to when the restrictions on index arbitrage trading provided by NYSE Rule 80A should be triggered.[43] We believe the amendment is appropriate in order to maintain uniformity with NYSE Rule 80A and to maintain a uniform protective measure. We also believe that, because the NYA is already posted with the two-percent calculation, the proposed amendment

[42] Securities Exchange Act Release No. 52328 (Aug. 24, 2005), 70 FR 51398 (Aug. 30, 2005).

[43] *Id.*

would make this reference point more easily accessible to market participants.

2. Costs

We do not anticipate that this proposed amendment will impose any significant burden or cost on market participants. Indeed, the proposed amendment may save costs by promoting uniformity with NYSE Rule 80A so that broker-dealers will need to refer to only one index with respect to restrictions regarding index arbitrage trading.

- Does this limitation affect the expected cost of entering into index arbitrage positions? Does the limitation reduce market efficiency by slowing down price discovery? Does the limitation affect only temporary order imbalances or does it also keep prices from fully adjusting to their fundamental value?
- What are the costs and benefits of the proposed amendments to Regulation SHO's exception for unwinding index arbitrage positions?

VIII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[44] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[45] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe the proposed amendments may promote price efficiency. The proposed amendments to Regulation SHO are intended to promote efficiency by reducing persistent fails to deliver securities that have the potential to disrupt market operations and pricing systems. To the extent that the proposed amendments increase the cost of market making, the proposed amendments may impact liquidity in some threshold securities. We believe that these concerns are mitigated by the scope and flexibility of the proposed amendments. We seek comment on whether the proposals promote price efficiency, including whether the proposals might impact liquidity and the potential for manipulative short squeezes.

In addition, we believe that the proposals may promote capital formation. Large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of manipulative conduct. The deprivation of the benefits of ownership, as well as the perception that manipulative naked short selling is occurring in certain securities, may undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. We solicit comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities.

The Commission also believes the proposed amendments may not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. By eliminating the grandfather provision and narrowing the options market maker exception, the Commission believes the proposed amendments to Regulation SHO would promote competition by requiring similarly situated market participants to close out fails to deliver in threshold securities within the same timeframe. We solicit comment on whether the proposed amendments would promote competition, including whether investors are more or less likely to choose to invest in foreign markets with more relaxed short selling restrictions.

The Commission requests comment on whether the proposed amendments would promote efficiency, competition, and capital formation.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[46] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA),[47] regarding the proposed amendments to Regulation SHO, Rules 200 and 203, under the Exchange Act.

A. Reasons for the Proposed Action

Based on examinations conducted by the Commission's staff and the SROs since Regulation SHO's adoption, we are proposing revisions to Rules 200 and 203 of Regulation SHO. The proposed amendments to Rule 203(b)(3) of Regulation SHO are designed to reduce the number of persistent fails to deliver. We are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. Although high fails levels exist only for a small percentage of issuers, they could potentially impede the orderly functioning of the market for such issuers, particularly issuers of less liquid securities. The proposed amendment to update the market decline limitation referenced in Rule 200(e)(3) would maintain uniformity with NYSE Rule 80A and would promote a uniform protective measure.

B. Objectives

Our proposals are intended to further reduce the number of persistent fails to deliver in threshold securities, by eliminating the grandfather provision and narrowing the options market maker exception to the delivery requirement. The proposed amendments are designed to help reduce persistent, large fail positions, which may have a negative effect on the market in these securities and also may be used to facilitate some manipulative strategies. Although high fails levels exist only for a small percentage of issuers, they could impede the orderly functioning of the market for such issuers, particularly issuers of less liquid securities. A

[44] 15 U.S.C. 78c(f).

[45] 15 U.S.C. 78w(a)(2).

[46] Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[47] 5 U.S.C. 603.

significant level of fails to deliver in a security also may have adverse consequences for shareholders who may be relying on delivery of those shares for voting purposes, or could otherwise affect an investor's decision to invest in that particular security. To allow market participants sufficient time to comply with the new close-out requirements, the proposals include a 35 settlement day phase-in period following the effective date of the amendment. The phase-in period is intended to provide market participants flexibility and advance notice to begin closing out originally grandfathered fail to deliver positions. The proposed amendments to Rule 200(e)(3) are intended to update the market decline limitation referenced in the rule in order to maintain uniformity with the NYSE Rule 80A and to maintain uniform protective measures.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78i, 78j, 78k–1, 78o, 78q, 78s, 78w(a), the Commission is proposing amendments to Regulation SHO, Rules §§ 242.200 and 242.203.

D. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0–10 [48] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a–5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2005, the Commission estimates that there were approximately 910 broker-dealers that qualified as small entities as defined above.[49] The Commission's proposed amendments would require all small entities to modify systems and surveillance mechanisms to ensure compliance with the new close-out requirements.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments may impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. In order to comply with Regulation SHO when it became effective in January, 2005, small entities needed to modify their systems and surveillance mechanisms. Thus, the infrastructure necessary to comply with the proposed amendments regarding elimination of the grandfather provision should already be in place. Any additional changes to the infrastructure should be minimal. In addition, small entities engaging in options market making should already have systems in place to close out non-excepted fails to deliver as required by Regulation SHO. These small entities, however, may need to modify their systems and surveillance mechanisms to track the fails to deliver and the options positions to ensure compliance with the proposed amendments. These entities may also need to put in place mechanisms to facilitate communications between participants and options market makers. We solicit comment on what new recordkeeping, reporting or compliance requirements may arise as a result of these proposed amendments.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,[50] the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The primary goal of the proposed amendments is to reduce the number of persistent fails to deliver in threshold securities. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the goal of reducing fails to deliver. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposals to further clarify, consolidate or simplify the proposed amendments for small entities. The Commission also preliminarily believes that it would be inconsistent with the purposes of the Exchange Act to use performance standards to specify different requirements for small entities or to exempt broker-dealer entities from having to comply with the proposed rules. We seek comment on alternatives for small entities that conduct business in threshold securities.

H. Request for Comments

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on (i) the number of small entities that would be affected by the proposed amendments; and (ii) the existence or nature of the potential impact of the proposed amendments on small entities. Those comments should specify costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the objective of the proposed amendments.

XI. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, 23(a) thereof, 15 U.S.C. 78b, 78c, 78i, 78j, 78k–1, 78o, 78q, 78q–1, 78w(a), the Commission is proposing amendments to § 240.200 and 203.

Text of the Proposed Amendments to Regulation SHO

List of Subjects 17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, part 242, of the Code of Federal Regulations is proposed to be amended as follows.

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

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

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

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

[48] 17 CFR 240.0–10(c)(1).

[49] These numbers are based on the Commission's Office of Economic Analysis's review of 2005 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[50] 5 U.S.C. 603(c).

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

* * * * *

(e) * * *

(3) The sale does not occur during a period commencing at the time that the NYSE Composite Index has declined by two percent (as calculated pursuant to NYSE Rule 80A) or more from its closing value on the previous day and terminating upon the establishment of the closing value of the NYSE Composite Index on the next succeeding trading day.

* * * * *

3. Section 242.203(b)(3) is proposed to be amended by:

a. Revising paragraphs (b)(3)(i) and (b)(3)(ii);

b. Redesignating current paragraphs (b)(3)(iii), (b)(3)(iv), and (b)(3)(v), as (b)(3)(v), (b)(3)(vi), and (b)(3)(vii);

c. Adding new paragraphs (b)(3)(iii) and (b)(3)(iv).

The proposed revisions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

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

(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 an options position that were created before the security became a threshold security;

(A) *Provided, however,* if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on an options position that was created before the security became a threshold security, if the options position has expired or been liquidated and the participant has had such fail to deliver position in the threshold security for thirteen consecutive settlement days from the date on which the security became a threshold security or the date of expiration or liquidation of the options position, whichever is later, the participant must immediately close out the fail to deliver position by purchasing securities of like kind and quantity;

(B) *Provided, however,* that a participant that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in this paragraph (b)(3) (*i.e.*, because the participant of a registered clearing agency had a fail to deliver position 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 an options position that was created before the security became a threshold security) and where such options position has expired or been liquidated on or prior to the effective date of the amendment, shall close out that fail to deliver position within thirty-five settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

(iii) If a participant of a registered clearing agency entitled to rely on the thirty-five settlement day close out requirement contained in paragraphs (b)(3)(i) and (b)(3)(ii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for thirty-five 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)(ii) 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 entitled to rely on the thirteen consecutive settlement day close out requirement contained in paragraph (b)(3)(ii) of this section has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days following the expiration or liquidation of the options position, 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)(ii) 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;

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Dated: July 14, 2006.

By the Commission.

J. Lynn Taylor,

Assistant Secretary.

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