Division of Market Regulation:

Responses to Frequently Asked Questions Concerning Regulation SHO

The following answers to frequently asked questions were prepared by and represent the views of the staff of the Securities and Exchange Commission's ("Commission") Division of Trading and Markets ("staff"). They are not rules, regulations, or statements of the Commission, and do not have the approval or disapproval of the Commission.

The staff may update these questions and answers periodically. In each update, the questions added after publication of the last version will be marked with **"UPDATED!"** or **"NEW!"** and may be marked **"MOVED!"**

For Further Information Contact: Any of the following attorneys in the Office of Trading Practices, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, N. E., Washington, D.C. 20549-1001, at (202) 551-5777: Josephine Tao, Assistant Director, Valerie Dahiya, Branch Chief, Andrea Orr, Timothy (Mick) Riley, and Thankam Varghese, Special Counsels.

I. Introduction

A short sale is the sale of a security that the seller does not own and any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller will borrow the security, usually from a broker-dealer or an institutional investor. Typically, the short seller later closes out the position by purchasing equivalent securities on the open market and returning the borrowed 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 an economic long position in the same security or in a related security.

The Commission has plenary authority under Section 10(a) of the Securities Exchange Act of 1934 to regulate short sales of securities registered on a national securities exchange, as necessary or appropriate in the public interest or for the protection of investors. Current regulatory requirements applicable to short sales of equity securities are generally found in Regulation SHO, which the Commission adopted to address its concerns regarding persistent fails to deliver and potentially abusive "naked" short selling. A "naked" short sale generally refers to selling short without having borrowed the securities to make delivery. All sellers of securities should promptly deliver, or arrange for delivery of, securities and all buyers of securities have a right to expect prompt delivery of securities purchased. The Commission was concerned about the negative effect that fails to deliver may have on the markets and shareholders. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending, and sellers that fail to deliver securities on settlement date may attempt to use this additional freedom to engage in trading activities to improperly depress the price of a security.

Regulation SHO imposes four general requirements with respect to short sales of equity securities: a marking requirement, a short sale price test circuit breaker, a locate requirement, and a close-out requirement. Due to continued concerns about fails to deliver, and to promote market stability and preserve investor confidence, the Commission has amended Regulation SHO several times to eliminate certain exceptions, strengthen certain requirements and reintroduce a price test restriction.

As initially adopted, Regulation SHO included two major exceptions to the close-out requirement: the ''grandfather'' provision and the ''options market maker'' exception. Due to continued concerns about fails to deliver, and the fact that the Commission continued to observe certain securities with fail to deliver positions that were not being closed out under then existing requirements, in 2007 the Commission eliminated the ''grandfather'' provision and in 2008 the Commission eliminated the options market maker exception.

In 2008, the Commission adopted temporary Rule 204T, and in 2009 adopted final Rule 204, which strengthened further the close-out requirements of Regulation SHO by applying close-out requirements to fails to deliver resulting from sales of all equity securities and reducing the time-frame within which fails to deliver must be closed out.

The Commission adopted Rule 201 of Regulation SHO in 2010. Rule 201 restricts the price at which short sales may be effected when a stock has experienced significant downward price pressure. Rule 201 is designed to prevent short selling, including potentially manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline, and to facilitate the ability of long sellers to sell first upon such a decline.

Regulation SHO's four general requirements are summarized below:

- *Rule 200 — Marking Requirements.* Rule 200(g) requires that a broker-dealer must mark all sell orders of any equity security as "long," "short" or "short exempt." A sell order may only be marked "long" if the seller is "deemed to own" the security being sold and either: (i) the security to be delivered is in the physical possession or control of the broker or dealer; or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. The "short exempt" marking requirement applies only with respect to the short sale price test restriction.
- *Rule 201 — Short Sale Price Test Circuit Breaker.* Rule 201 generally requires trading centers to have policies and procedures in place to restrict short selling when a covered security has triggered a circuit breaker by experiencing a price decline of at least 10 percent