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United States: SEC Staff Issues New Interpretations Of Regulation SHO

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Article by J. Craig Long, George T. Simon and Richard G. Wallace

On August 28, 2009, the SEC's Division of Trading and Markets (Division) updated its Responses to Frequently Asked Questions Concerning Regulation SHO (FAQs). The updated FAQs include new interpretations regarding the marking of sell orders (Questions 2.4 and 2.5) and the provision of locates by a foreign broker-dealer (Question 4.6).

Marking Orders

SEC Rule 200(g) requires a broker-dealer to mark sell orders for equity securities as long or short. In Question 2.4, the Division provides guidance on how to mark an order where the seller is net long for only part of the order:

For example, a seller may be net long 500 shares of a security but may wish to sell a total of 600 shares of that security. Under such circumstances, only 500 shares can be sold long, and the remaining 100 shares must be sold short. Thus, under the above-mentioned scenario, if the seller is long 500 shares, the sell order for the sale of such 500 long shares must be marked "long" and the sell order for the sale of the additional 100 shares must be marked "short."

The Division does not specify how to mark a single order that is larger than the broker-dealer's or customer's net long position (for example, a broker-dealer is long 500 shares and enters a single order to sell 600 shares). It would appear that the Division is instructing firms to break up such orders into two separate orders.

In Question 2.5, the Division "reminds" broker-dealers how to mark multiple sell orders sent simultaneously. The Division's guidance is: "Thus, we remind sellers that where a seller is net long 1,000 shares and simultaneously enters multiple orders to sell 1,000 shares owned, only one such order would constitute a long sale." The guidance implies that only one such order should be marked long. In effect, the Division's guidance calls upon broker-dealers to decrement their net position upon the entry of a sell order. Although the FAQ does not address whether to increment positions based upon buy orders, in conversations with the staff, we were advised that it was impermissible to increment positions based upon unexecuted buy orders.

As a result, there are three factors determining whether an order should be market short: the firm's opening position, less the amount of unexecuted and outstanding sell orders, plus or minus all executed buy and sell orders.

Question 2.5 raises certain conundrums for firms co-locating in more than one market center. Because inventory must be adjusted based on unexecuted sell orders, a co-located server in one market may not be aware that a server in another market has already sent a sell order to another market. It would appear that co-located servers would have to reserve shares out of the firm's or aggregation unit's position before they could enter new sell orders. This would largely eliminate any benefit derived out of co-location.

Locates

The Division's answer to Question 4.6 provides that broker-dealers "must treat an assurance from a non-U.S. registered broker-dealer that it obtained a source of securities that can be delivered in time for settlement in the same manner as an assurance originating from a non-broker-dealer customer."

The full text of the new Frequently Asked Questions is available at: http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

The Division's new interpretations of Regulation SHO are important as FINRA members have an ongoing duty to mark orders correctly. If the SEC adopts one of the price tests currently under discussion, the guidance on marking orders will impact how orders are treated under any price test that may be adopted.