

FPL eases transition to new SEC short sale regulations



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On January 3, 2005, the U.S. Securities and Exchange Commission (SEC) implemented sweeping changes to the rules that regulate short sales on US Equity Markets. Officially known as Regulation SHO, these new rules ease some of the prior price tests, while adding new restrictions that require a firm to locate securities before executing a short sale.

The FPL Americas Business Practices Subcommittee, whose role is to promote standardization of business processes and practices for the Americas region through FIX, has been working toward helping members implement these new rules and has documented the data flow required to satisfy the locate requirement for a short sale. The subcommittee, led by Greg Arnold of Lehman Brothers and Erick Valdes, has also defined the FIX fields that can be used in data transport, and some of the business issues concerning implementation of the new rules.

Description of a Short Sale

According to the SEC Website¹, "A short sale is generally the sale of a stock you do not own. Investors who sell short believe the price of the stock will fall. If the price drops, you can buy the stock at the lower price and make a profit. If the price of the stock rises and you buy it back later at the higher price, you will incur a loss.

When you sell short, your brokerage firm loans you the stock. The stock you borrow comes from either the firm's

own inventory, the margin account of another of the firm's clients, or another brokerage firm."

The SEC adds, "The current rules regarding short sales are driven by the belief that protections against abusive short selling are important for issuer and investor confidence, and has enacted rules designed to curb manipulative behavior."

The SEC website describes the current regulations, "Rule 10a-1 under the Securities Exchange Act of 1934 governs securities registered on an exchange. The core requirement of Rule 10a-1 is commonly referred to as the "tick test." The tick test provides that, subject to certain exceptions, an exchange-listed security may only be sold short: (i) at a price above the immediately preceding reported price ("plus tick"), or (ii) at the last sale price if it is higher than the last different reported price ("zero-plus tick"). Subsection (c) and (d) of Rule 10a-1 also require broker/dealers effecting sell orders for exchange-listed securities to mark such orders "long" or "short." "

¹From the SEC website, Short Sales Description: <http://www.sec.gov/answers/shortsale.htm> & <http://www.sec.gov/answers/shortrestrict.htm>

There are similar tick tests that apply to NASDAQ securities.

SEC Background

The SEC is reviewing existing regulations with the goal of modernizing them to reflect technological and competitive changes that have taken place since their inception. Some rules that are changing include Regulation NMS, which establishes the National Market System, Regulation SRO, which sets the framework for Exchanges, and Regulation SHO. When these regulations were first introduced, the markets were all floor-based, using manual quotes, and open outcry trading. As electronic marketplaces developed, they have changed the landscape, and the SEC saw the need to modernize the rules governing marketplaces to reflect these changes. Regulation SHO was approved by the SEC on September 7, 2004, and market participants were required to comply with Regulation SHO starting on January 3, 2005.²

New Rules (SEC Regulation SHO)

The SEC adopted Regulation SHO to provide a new regulatory framework governing short selling of securities.³ Its goals are to:

- Establish uniform locate and delivery requirements to address problems associated with failures to deliver
- Create uniform marking requirements for all sales
- Temporarily suspend price tests to evaluate their impact on the markets

Rule 200. Sets basic definitions and order marking requirements. It incorporates requirements to mark all sell orders as “long”, “short” or “short exempt.”

Rule 201. Will replace the current “tick test” with a new uniform bid test, but this rule is deferred until the completion of a pilot program.

Rule 202T. A temporary rule that establishes a pilot program where some of the current restrictions effecting short sales are suspended for a set period of time to analyze their impact on the markets.

Rule 203. Locate and Delivery Requirements. This rule requires broker-dealers, prior to effecting short sales, to

locate securities available for borrowing in order to be able to deliver securities on the settlement date of the transaction. This rule replaces the current locate rules which rely on Service Level Agreements (SLA) between broker-dealers and counterparties that are not specific to a given trade or customer. The new rules explicitly require a broker-dealer to verify that shares have been located before a short sale can take place. Rule 203 introduces the following definitions:

- Defines additional requirements for securities with significant delivery failures (Threshold Securities).
- Defines the requirements for the “reasonable grounds” to locate securities for delivery.

Rule 203 defines the new data elements needed to be collected and transmitted along with a short sale order. FIX provides the method to transmit this new critical information.

Challenges Presented by the New Locate Rule

Before the changes to Regulation SHO took effect, a broker-dealer could satisfy the requirement to locate shares for a short sale in one of the following ways:

1. Having a standing paper SLA with a counterparty to locate and deliver the shares sold short.
2. Locating the shares before initiating the short sale.
3. Relying on a list of “easy to locate” issues, assuming that any issue on the list could be located and delivered.

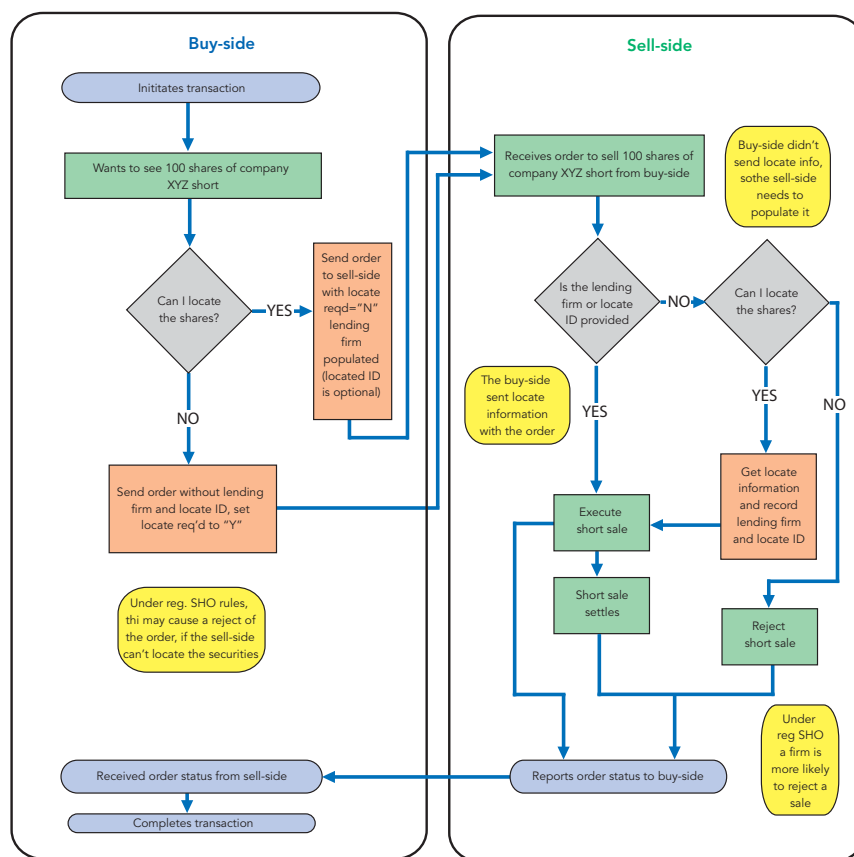
While these locate rules were widely accepted, they often resulted in delivery fails, which cause risk and expense for the parties involved.

The new locate rule (Rule 203) presents a fundamental change in the locate requirement for short sales by explicitly specifying what locate information is required. The trade originator (typically buy-side) can either locate the shares themselves, or ask that the executing broker (sell-side) locate the security on their behalf. If the buy-side firm locates the securities at trade time, they would indicate that the shares have been located by setting the Locate-Reqd indicator to “N”, and supplying the lending firm ID and optionally, the Locate ID. If the buy-side firm cannot locate the shares, they would set the Locate-Reqd indicator to “Y”, while not supplying any of the locate information. The sell-side then obtains the locate information and records

²From the SEC website: <http://www.sec.gov/about/whatwedo.shtml>

³From the SEC website, Regulation SHO Proposal, 17 CFR PARTS 240 and 242: <http://www.sec.gov/rules/proposed/34-48709.htm>

Short sale data flow



Source: FPL Program Office 2005

the lending firm ID and optionally the Locate ID, internally. The chart above illustrates the data flow.

One interesting part of Regulation SHO is the difference between obligation and enforcement. Regulation SHO states that a sell-side firm will need to locate securities available for borrowing, and document what the firm has done to locate the securities. An issue arises when the data is supplied from the buy-side, who has access to the data, but is not obligated to report. The sell-side will need to educate the buy-side regarding the importance of collecting and supplying the data needed to comply with the rule.

FPL Support of Regulation SHO Changes

The FPL Americas Business Practices Subcommittee organized two Regulation SHO meetings. The first meeting was held prior to the implementation of the rule changes, where the subcommittee defined the FIX fields that member firms needed. The second meeting, open to the industry, addressed how various segments of the industry were working toward implementing solutions for Regulation SHO challenges and issues.

During the pre-implementation meeting, two FIX fields were recommended to be used to support the information needed for Regulation SHO.

The committee reported that "FIX 4.3 and 4.4 support LocateBroker via PartyID(448) and LocateIdentifier via PartySubID(523) when used in conjunction with PartyRole(452) with a value of "8". LocateIdentifier is an optional field, while LocateBroker is required. LocateBroker will contain the MPID of the broker supplying the shares."

They added, "FIX 4.0, 4.1 and 4.2 do not provide support for these two fields, and the group recommends the use of two user-defined fields, LocateBroker(5700) and LocateIdentifier(5701) via bi-lateral agreement with one's counterparty to support Regulation SHO requirements."

Ryan Pierce of Townsend Analytics and chair of the Americas Technical Subcommittee reported that "A proposal was made to the FPL Global Technical Committee to add a new enumeration to PartySubIDType: 27 = Security

Locate ID. This allows FIX 4.4 to be used to notify the broker of the locate identifier of the stock for a short sale trade. This change has now been implemented as errata to FIX 4.4."

At the mid-January post-implementation meeting, firms discussed how they were using the FIX Protocol to address some of the implementation issues arising from Regulation SHO.

By using the new tags and workflow, efficiency can be improved by cutting down on manual processes. This can be accomplished by providing more accessible data for audits and removing duplicative efforts during the trade process.

Regulation SHO may provide some firms with the incentive to migrate from manual processes that rely on paper SLAs and phone calls to a standardized mechanism such as FIX. As written, it may be difficult to comply with the SHO rules using paper and phone calls, and as enforcement becomes more widespread, more market participants may migrate toward electronic solutions. While there are still manual processes in place, FIX provides a standardized platform to report and exchange data between the buy-side and sell-side.

According to the FPL Americas Business Practices Subcommittee, "No longer will duplicate efforts be undertaken, i.e. when the customer sends a locate at the same time the supplier is initiating a locate. Clearly knowing who is responsible for providing the locate information helps reduce the wasted effort of locating securities that the buy-side has already located."

They added, "Another benefit concerns unmanaged order flow, where in the past, locate information was collected through a phone call to the buy-side, replacing this with an electronic flow results in a more efficient process that complies with the new rules." They conclude, "Once enforcement steps up, you'll see more buy-side firms using FIX to send the required data."

Conclusion

Regulation SHO changes the rules for short sales, adding a pre-trade locate requirement that firms will be able to implement using FIX. Implementing the rules with FIX will provide efficiencies, and help firms comply with the new regulations. Support of the transmission of information, regardless of the version of FIX, was

implemented by the FPL Americas Business Practices Subcommittee by bringing together buy-side, sell-side vendors and other industry participants.

One of the challenges for the sell-side is that they are obligated to report the procedures followed to locate borrowed securities to the SEC. The sell-side has been working with vendors to have the technology in place that handles the two additional tags for FIX versions under 4.3. However, there has been no pressure to date on the buy-side to help comply with these solutions as the SEC does not regulate the customer, like it does the broker-dealer.

During the mid January call, all participating vendors reported that the necessary technologies should be in place by the close of Q1/beginning of Q2, if not in place already. It is important to note that once the technology is available, it is up to the buy-side to implement those upgrades. As enforcement of this regulation continues to evolve, the buy-side community needs to communicate to their vendors or Information Technology departments about the importance of having the right tools in place. If the buy-sides are not making demands of their vendors, the appropriate development priorities for SHO support may not happen. Open communication between the buy and sell-side in regards to complying with Regulation SHO is extremely important and should be occurring sooner rather than later.

There is a definite need to raise awareness of the importance of Regulation SHO and educate the broader community about using FIX to exchange information needed to comply with this new rule. The FPL organization will help educate the FIX community about providing the short-sale locate information required by Regulation SHO. The FPL Americas Business Practices Subcommittee is planning a follow-up meeting in April of 2005. This meeting will be held in order to get an idea of the level of growth of education regarding these new rules as well as to find out about the uptake of this new regulation. All documents and updates will be posted on the FPL website. **FIX**

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