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Legal Update

SEC Enforcement Turns Attention to Reg. SHO Aggregation Unit

On September 30, 2020, the U.S. Securities and Exchange Commission ("SEC") issued a settlement order imposing a $5 million civil monetary penalty in connection with violations of Rule 200(g) under Regulation SHO,[1] which requires a broker-dealer to mark sales of securities as "long" only if it is deemed to own the security being sold, among other requirements.[2] The SEC's findings were predicated upon the failure to maintain independence between two trading units in connection with the firm's synthetic prime brokerage swaps business. Because these trading units could not be considered independent, their net securities positions would be required to be aggregated, leading to the order marking failures at issue in the SEC order.

Regulation SHO and Aggregation Units

Regulation SHO was first adopted in 2004 to address concerns regarding persistent failures to deliver and potentially manipulative or abusive "naked" short selling.[3] Regulation SHO formalized previously existing SEC relief from the requirement that a seller's position as "long" or "short" be determined on an enterprise-wide basis by permitting certain broker-dealers to determine whether they are selling "long" or "short" on a profit-center or unit-by-unit basis.

Rule 200(f) under Regulation SHO requires a broker-dealer to aggregate all of its positions in a security to determine whether it is net "long" or net "short" unless it qualifies for independent trading unit aggregation. Independent trading unit aggregation is available to a broker-dealer only if:

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

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

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

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

Broker-dealers are further required to mark sell orders as "long," "short" or "short exempt," and may only mark an order as "long" where (i) the security to be delivered is in the physical possession or control of the broker-dealer, or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker-dealer no later than the settlement of the transaction.[5] "Short" sales are subject to a number of conditions that do not impact "long" sales; this designation also allows "long" sellers to take priority over "short" sellers when a security experiences a significant intra-day price decline.[6]

Recent SEC Enforcement

The findings in the SEC order indicate that the trading units in question, which were structured as part of the firm's synthetic prime brokerage swaps business, were not independent trading units and were therefore not eligible for independent trading unit aggregation. Because of this incorrect designation, the firm had been incorrectly marking "short" sale orders as "long" sales for a number of years in violation of Regulation SHO.

The findings identified in the SEC order indicated that the two trading units had identical management structures, with the same front-line supervisor overseeing both units, and traders from both units sat side-by-side, with traders from one unit routinely substituting for traders in the other unit during absences.

Furthermore, the units had the same business purpose of hedging the firm's synthetic exposure to equity securities created by swaps transactions, differentiated only in that the one unit held long hedges while the other unit held short hedges. In the "long" unit, the firm marked all sell orders of equity securities executed upon unwind or expiration of the related swap as "long" sales. In the "short" unit, the firm marked all sell orders of equity securities executed to establish its hedge to its newly-created synthetic exposure as "short" sales.

As such, the units had the same trading strategy or objective: to hedge synthetic exposure established through the swap business. The bifurcation of hedging activity into separate units allowed the equity sales of one unit to be uniformly marked "short" and those of the other unit to be uniformly marked "long." This practice was found to be in contravention of Regulation SHO because the units were not sufficiently independent.

The SEC order affirmed that the firm should have, at a minimum, netted the "long" and "short" positions of both units together or netted the "long" and "short" positions of both units across the entire broker-dealer.

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In the press release accompanying the SEC's settlement order, Daniel Michael, Chief of the Complex Financial Instruments Unit of the SEC's Division of Enforcement, cautioned firms who are not fully complying with their obligations under Regulation SHO, noting that: "Market participants cannot disregard the rules of the road established by Reg SHO for all short sales." As a result of this enforcement activity, we encourage firms to review the structure of their trading units and their order marking practices to ensure that they are operating in compliance with Regulation SHO.

If you or your firm have questions about this Legal Update or about compliance with your regulatory obligations under Regulation SHO, please contact the authors or any member of our Broker-Dealer Regulation & Compliance practice.

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Endnotes

[1] 17 C.F.R. § 242.200(g).

[2] https://www.sec.gov/news/press-release/2020-238; https://www.sec.gov/litigation/admin/2020/34-90046.pdf.

[3] U.S. Sec. & Exch. Comm'n, Final Rule and Interpretation, Short Sales, 69 Fed. Reg. 48007, Exch. Act Rel. No. 34-50103 (Aug. 6, 2004), https://www.sec.gov/rules/final/34-50103.htm.

[4] 17 C.F.R. § 242.200(f).

[5] 17 C.F.R. § 242.200(g)(1).

[6] See 17 C.F.R. §§ 242.201 (circuit breaker treatment); 203 (locate requirement); 204 (close-out requirement).