

PUBLICATIONS

Reg SHO Action Is a Reminder for Fund Managers on Locates for “Hard to Borrow” Securities

SRZ Private Funds Regulatory Update

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A recent Financial Industry Regulatory Authority enforcement action highlights a specific locate issue in the context of Regulation SHO (“Reg SHO”) that has implications for certain fund managers.[1]

By way of background, the SEC adopted Reg SHO in 2004 to address concerns regarding failures to deliver securities sold short and abusive naked short selling (i.e., sales in which the seller does not borrow or arrange to borrow the securities in time to make delivery). While Reg SHO’s order marking and locate rules only directly apply to broker-dealers, several provisions of Reg SHO impact fund managers due to industry practice and because broker-dealers rely on their customers’ (e.g., investment funds’) representations concerning long/short order marking and whether a short sale is supported by a third-party locate.

Fund managers frequently ask whether they may reapply a locate after effecting an intra-day buy-to-cover trade (that is, can they “recycle” a locate after repurchasing shares previously sold short earlier in the day). According to Q&A 4.4 of the SEC’s Division of Trading and Markets’ frequently asked questions concerning Reg. SHO (“Q&A 4.4”), Reg SHO generally permits the re-application of locates following intra-day buy-to-cover trades as long as the subsequent sale is for an amount no greater than the original locate and the original locate is good for the entire trading day.[2] However, for “hard to borrow” and threshold securities,

Q&A 4.4 states that locates may not be reapplied and the seller must obtain a new locate prior to the subsequent short sale.

The disparate treatment that Q&A 4.4 requires for “hard to borrow” and threshold securities has been controversial because Reg SHO’s locate provision does not distinguish between these types of securities.^[3] Further, Q&A 4.4 seems to ignore the mechanics and practicalities of the locate and settlement process.

Until recently, the SEC and self-regulatory organizations have not taken action with respect to violations of Reg SHO Rule 203(b)(1) by virtue of failing to adhere to the Q&A 4.4 guidance. However, in July 2020, FINRA charged a broker-dealer with violating Reg SHO’s locate requirement by failing to distinguish between threshold and non-threshold securities when re-applying locates following intra-day buy-to-cover trades. The broker-dealer agreed to a \$225,000 fine and a censure. Notably, FINRA’s investigation included other Reg SHO and FINRA violations that were part of the resolution, which may have influenced the firm’s decision to settle.

Because broker-dealers often rely on fund managers to represent that a short sale is supported by a third-party locate, fund managers should ensure that their representations concerning long/short order marking and third-party locates are accurate. Mistakes regarding a seller’s ability or intent to deliver securities can put a fund manager’s relationship with its broker-dealers at risk and invite regulatory scrutiny.

This article appeared in the November 2020 edition of SRZ’s Private Funds Regulatory Update. To read the full Update, click here.

[1] See FINRA Letter of Acceptance, Waiver, and Consent, No. 2016050929001.

[2] See <https://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

[3] The SEC staff acknowledges that its “frequently asked questions” do not have the force of law, cannot establish new laws, rules or standards and merely reflect the staff’s interpretations of existing rules that have neither been approved nor disapproved by the Commission.

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