

securities that have the potential to disrupt market operations and pricing systems.

The Commission preliminarily believes that Regulation SHO's uniform price test and enhanced locate and delivery requirements would promote capital formation because the proposed rules would reduce market volatility and the opportunities for market manipulation, thereby strengthening issuer and investor confidence in the markets. Applying the locate and delivery requirements to all equity securities would promote capital formation and especially help smaller issuers, whose securities may be more susceptible to the effects of naked short selling, enter into and remain in the marketplace and would promote capital efficiency in smaller, thinly capitalized securities that are more susceptible to manipulation.

As discussed above, proposed Regulation SHO would apply a uniform bid test to covered securities and the locate and delivery requirements to all equity securities. The Commission preliminarily believes that Regulation SHO would promote competition among exchanges or other market centers in attracting issuers to list on a particular market, in that market participants would no longer be able to select a market on which to execute a short sale based on disparate regulation. In addition, the Commission preliminarily believes proposed Regulation SHO would level the playing field by applying uniform regulation.

The Commission requests comment on whether the proposed amendments are expected to promote efficiency, competition, and capital formation.

XXI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"²³⁸ we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries;
- or
- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days

pending Congressional review. We request comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

XXII. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA),²³⁹ regarding the proposed Regulation SHO, Rules 200, 201, 202(T), and 203, replacing Rule 10a-1, Rule 10a-2, and Rule 3b-3, and proposed amendments to Rule 105 under the Exchange Act.

A. Reasons for the Proposed Action

Based on recent developments, including but not limited to, increased instances of "naked" short selling, *i.e.*, selling short without borrowing the necessary securities to make delivery; decimalization; the advent of security futures trading; and an increasing amount of Nasdaq securities being traded away from the Nasdaq market, and thus not subject to any short sale price test, the Commission is proposing Regulation SHO, Rules 200, 201, 202(T), and 203, replacing Rules 10a-1, 10a-2, and 3b-3, along with amendments to Rule 105. The proposed rules, including a proposed uniform bid test Rule 201 that would apply to all exchange-listed and Nasdaq NMS securities wherever they are traded, enhanced locate and delivery requirements under proposed Rule 203, clarification of ownership under proposed Rule 200, as well as a temporary Rule 202(T) suspending the proposed bid test for certain securities during a two-year pilot, are designed to modernize short sale regulation in light of recent developments while providing simplification and uniformity to participants.

B. Objectives

The proposed amendments are designed to fulfill several objectives. First, one of the prime objectives of the proposed amendments is to provide uniform short sale regulation applicable to trades in exchange-listed and Nasdaq NMS securities occurring in multiple, dispersed, and diverse markets. Second, the proposed amendments provide greater flexibility in effecting short sales in a decimal environment as well as accommodating trading systems that utilize price improvement models that often conflict with existing short sale

regulation. Third, the proposed amendments extend locate and delivery requirements to all equity securities, including the SmallCap, OTCBB, and Pink Sheet securities that have low market capitalization and may be more susceptible to manipulation. These locate and delivery requirements are designed to help prevent large fail positions, which may help facilitate some manipulative strategies.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78j, 78k-1, 78o, 78q, 78s, 78w(a), the Commission proposed to adopt Regulation SHO, Rules § 240.200, 240.201, 240.202(T), and 240.203, replacing § 240.3b-3, 240.10a-1, and 240.10a-2.

D. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10²⁴⁰ states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2002, the Commission estimates that there were approximately 880 broker dealers that qualified as small entities as defined above. The Commission's proposed amendments would require all small entities to modify, and in some cases install, systems and surveillance mechanisms to ensure compliance with the uniform bid test, marking, and locate and delivery requirements.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments may impose some new compliance and marking requirements on broker-dealers that are small entities. Small broker dealers that only trade SmallCap, OTCBB, or Pink Sheet securities were not previously subject to marking and borrow and delivery requirements. Under the proposed amendments these broker-dealers would have an obligation to comply with the marking requirements and the borrow and delivery requirements imposed upon them by the proposals. Moreover, some small entities that trade securities that are subject to the pilot program may

²³⁸ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

²³⁹ 5 U.S.C. 603.

²⁴⁰ 17 CFR 240.0-10(c)(1).