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Regulation SHO

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A little-known provision of Regulation SHO is getting increased attention from regulators. Recently, regulators have signaled that they will be taking a close look at broker-dealers' invocation of the so-called "bona fide market-maker" exception to Regulation SHO ("Reg SHO"), and firms that rely on this exception should be wary of the potential for future enforcement actions.

The SEC adopted Reg SHO in response to potentially abusive "naked" short selling (or, the sale of securities that an investor does not own or has not borrowed). Reg SHO imposes a number of requirements on broker-dealers that execute short sales including a "locate requirement," which requires that, prior to accepting or effecting a short sale order in an equity security, the broker-dealer must borrow the security, enter into a bona fide arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed so that it can be delivered when delivery is due.[1]

Reg SHO itself provides an exception to the locate requirement for short sales effected by market makers, but only in connection with "bona fide market-making activities."[2] In the Adopting Release to the 2008 Amendments to Reg SHO, the SEC stated that determining whether or not a market maker is engaged in bona fide market making "would depend on the facts and circumstances of the particular activity," and listed as an example where a market maker provides "continuous quotations that are at or near the market on both sides and . . . represented in a way that makes them widely available to investors and other broker-dealers." The SEC also set forth examples of activities that would not be considered bona fide market-making activities, including (1) "speculative selling strategies," and (2) where a market maker routinely executes short sales away from its posted quotes.

In its 2024 Regulatory Oversight Report, FINRA noted that some firms had failed to distinguish bona fide market making from proprietary trading activity that does not qualify for the exception. As examples of the latter, FINRA cited to firms that:

- Quoted only at maximum allowable distances from the inside bid/offer (e.g., using peg orders);
- Posted quotes at or near the inside ask but not at or near the inside bid;
- Only posted bid and offer quotes near the inside market when in possession of an order; and
- Displayed quotations that are only accessible to a small set of subscribers to a firm's trading platform.

FINRA signaled that it will continue to examine firms that rely on the bona fide market-maker exception to ensure that they can satisfy the exception.

The SEC too recently weighed in on a broker-dealer's invocation of the bona fide market-maker exception in a recent review of a FINRA disciplinary action. There, a broker (who also was the firm's biggest producer) identified penny stock companies that traded in high volumes following promotional campaigns, some of which were allegedly pump-and-dump schemes.[3] The broker would accumulate a short position in the stocks in the firm's proprietary accounts, betting that the stocks' prices would later decrease. In 122 instances, the broker did not find locates for these short positions. FINRA charged the firm with violating Reg SHO for failing

to obtain the required locates. The firm countered that it was not required to do so because the trader in question allegedly was acting as a bona fide market maker.

The SEC rejected this defense. Among other things, the SEC noted that although the trader had briefly posted both bid and ask quotes for the firm, the quotes were posted so far away from the inside bid or ask that they were unlikely ever to be hit. The SEC concluded that the broker was not acting as a bona fide market maker but instead was pursuing a "speculative selling strategy." The SEC upheld FINRA's finding that the firm violated Reg SHO, and further upheld FINRA's order of disgorgement and order appointing an independent consultant. The SEC sent the case back to FINRA to further consider the appropriate fine for the firm's Reg SHO violation, which FINRA had set at $350,000.

In light of this renewed focus from FINRA and the SEC, firms that rely on the bona fide market-maker exception are well-advised to review their supervisory systems and procedures related to the exception. First, firms should make sure that they can clearly identify those transactions for which they are claiming the exception. Firms can leverage the surveillances they use to identify and report such transactions to the Consolidated Audit Trail (CAT).[4]

Second, firms should adopt written procedures that require supervisors to examine whether short sales were made in connection with bona fide market-making activity. A firm can test for this by reviewing it trade blotter and related records for the security in question to determine if the firm is continuously placing widely-accessible, competitive (i.e., at or near the market) quotes on both sides of the market for that security and actively buying and selling that security. Those procedures should include "red flags" of non-bona fide market making that supervisors should be on alert for, such as:

- Quotes that are posted only for a brief time or posted anonymously;[5]
- Quotes that are "non-competitive";[6] and
- Quotes that are posted only to one side of the market.

Finally, firms should document these supervisory reviews and any follow-up actions taken.[7] Importantly, firms should maintain these records in a readily accessible place to ensure that they can produce complete records of their oversight.

A last note of caution: Both FINRA and the SEC previously have brought enforcement actions against firms that, they alleged, improperly invoked the bona fide market-maker exception. It may be that regulators' recent focus on the issue portends similar enforcement actions in the future.

[1] Regulation SHO, 17 C.F.R. § 242.203(b) (2022).

[2] Id. § 242.203(b)(2)(iii).

[3] In the Matter of the Application of Wilson-Davis & Co., James C. Snow, and Byron B. Barkley for Review of Disciplinary Action Taken by FINRA, S.E.C. Release No. 99248 (S.E.C. Dec. 28, 2023), available at 2023 WL 9022658 and at https://www.sec.gov/files/litigation/opinions/2023/34-99248.pdf (last visited Mar. 12, 2024).

[4] In October 2023, the SEC adopted an amendment to the CAT NMS Plan requiring that CAT reporting firms include an indication for those short sales for which they claim the bona fide market-maker exception.

[5] "A firm does not hold itself out as being 'willing to buy and sell such security for [its] own account' when it posts anonymous offers.'" In the Matter of the Application of Wilson-Davis & Co., et al., available at 2023 WL 9022658, *8 (quoting Exchange Act Section 3(a)(38), 15 U.S.C. § 78c(a)(38)).

[6] In In the Matter of the Application of Wilson-Davis & Co., et al., the SEC declined to adopt a bright-line rule as to how far away from the inside bid or ask a quote needed to be to be considered "non-competitive," but noted that the non-competitive quotes at issue in that case "often far exceeded 10% away from the inside." In the Matter of the Application of Wilson-Davis & Co., et al., available at 2023 WL 9022658, *7.

[7] In In the Matter of the Application of Wilson-Davis & Co., et al., the SEC specifically noted that the firm supervisor responsible for reviewing the firm's reliance on the bona fide market-making exception "did not document any review as to whether any particular short was made in connection with bona-fide market making activities." In the Matter of the Application of Wilson-Davis & Co., et al., available at 2023 WL 9022658, *10.

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