What is a Regulation SHO bona-fide market maker?

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Abstract
Purpose – To summarize and analyze guidance provided by the US Securities and Exchange Commission (“SEC”) on what constitutes “bona-fide market making” for purposes of Regulation SHO’s exception to the locate requirement.

Design/methodology/approach – Explains SEC guidance on this subject, focusing on statements by the SEC and its staff related to Regulation SHO and SEC enforcement matters, including a recent SEC administrative proceeding providing concrete examples of activity that does not constitute bona-fide market making.

Findings – While there is still a lot of room for additional SEC guidance on what constitutes bona-fide market making, the SEC has provided some details on the specific type of trading that would not fall within the Regulation SHO exceptions applying to bona-fide market making activities. However, there is still a large gap between the type of activity that most likely falls within the exception and the concrete examples analyzed by the SEC.

Originality/value – Practical guidance from experienced securities lawyers that consolidates SEC guidance on the bona-fide market making exception.

Keywords Broker-dealer, US Securities and Exchange Commission (SEC), Bona-fide market making, Regulation SHO

Paper type Technical paper

Introduction
What is a Regulation SHO bona-fide market maker? As discussed below, this actually is a trick question, because Regulation SHO does not contemplate that a broker-dealer would have the status of a “bona-fide market maker,” but focuses on whether a market maker is engaged in “bona-fide market making activities.”

Regulation SHO[1] contains the principal measures that the Securities and Exchange Commission (“Commission” or “SEC”) has adopted to address “abusive naked short selling,”[2] and the concept of “bona-fide market making activities” is significant to obligations of broker-dealers subject to its requirements. In particular, Rule 203(b)(2)(iii) contains an exception to the “locate” requirement for short sales effected by a market maker in connection with bona-fide market making activities in the securities for which the exception is claimed[3], and Rule 204(a)(3) provides an extended period for a participant of a registered clearing agency to comply with the requirement to “close out” a failure-to-deliver position at the registered clearing agency in an equity security that is attributable to bona-fide market making activities[4]. Both of these exceptions were adopted by the SEC in recognition of the significant benefits that market makers provide to the securities markets, and that those benefits might be unavailable if market makers were required to follow the requirements applicable to other broker-dealers[5].
SEC guidance

According to the Commission, “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.”[6] Moreover, “[f]or purposes of qualifying for the locate exception . . ., a market maker must also be a market maker in the security being sold, and must be engaged in bona-fide market making in that security at the time of the short sale.”[7]

Therefore, a necessary condition to qualifying for these exceptions is that the person be a “market maker.” That term is defined in Section 3(a)(38) of the Securities Exchange Act of 1934 (the “Exchange Act”) as “any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.”[8] Although necessary for bona-fide market making, the status of “market maker” is not in itself sufficient[9].

When adopting the bona-fide market making exception in Rule 203(b)(2)(iii) in 2004, the Commission provided limited guidance on its application, reciting a few examples of trading patterns that would not fall within the exception. Specifically, the Commission provided the following examples as not constituting bona-fide market making[10]:

- Trading activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security;
- Posting of quotes continually at or near the best offer but not also at or near the best bid;
- Execution of short sales continually away from the market maker’s posted quotes; and
- Trading activity whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker’s exception for the purpose of avoiding compliance with the locate requirement by the other broker-dealer or customer[11].

In the adopting release for amendments to Regulation SHO in 2008, the Commission expanded upon its earlier guidance by providing examples of the types of activities that would fall within the bona-fide market making exception in Rule 203(b)(2)(iii)[12]. In particular, the Commission focused on the following activity[13]:

- Dealing on a regular basis with other broker-dealers, actively buying and selling the subject security;
- Regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market;
- Trading in which the market maker incurs economic or market risk with respect to the securities, such as by putting its own capital at risk to provide continuous two-sided quotes in markets[14];
- Providing liquidity to a security’s market, taking the other side of trades when there are short-term buy-and-sell imbalances in customer orders, or attempting to prevent excess volatility;
- A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers[15]; and
- Continuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers[16].
In all situations, “a market maker must hold itself out as being willing to buy and sell a security for its own account on a regular or continuous basis,” and “[t]hus, a market maker’s quotes must be generally accessible to the public for a market maker to be considered as holding itself out as being willing to buy and sell a security for its own account on a regular or continuous basis, and therefore, be engaged in bona-fide market making activity”[17].

The need to examine the “facts and circumstances” applies also to the label that a firm places on a trading account. Denominating an account as a “market making” account is indicative of the trading in the account, but not determinative of whether the activity is actually market making or, a fortiori, bona-fide market making[18].

On the same day that the SEC provided this guidance, it adopted an “interim final temporary rule,” Rule 204T of Regulation SHO, establishing delivery requirements and “close-out” obligations in connection with failures to deliver securities at registered clearing agencies[19]. In particular, Rule 204T(a)(3) provided an exception from the basic delivery and close-out requirement of Rule 204T(a) for bona-fide market making activities. Although the Commission did not elaborate on what constituted bona-fide market making for purposes of this rule, it narrowed the category of market makers that could take advantage of the exception to registered market makers, options market makers, and other market makers obligated to quote in the over-the-counter market. The Commission did not explain the basis for this narrower class of market makers in contrast to the exception in Rule 203(b)(2), and it retained the terms of Rule 204T(a)(3) when it adopted Rule 204 to Regulation SHO on a permanent basis in 2009[20].

In October 2015, SEC staff updated its Regulation SHO Frequently Asked Question on “What constitutes ‘bona-fide market making activities’?”[21] The staff explained:

- Reliance on and compliance with an exchange’s market making designation and quoting requirements did not per se qualify a market maker for the bona-fide market making exception in Rule 203(b)(2)(iii)[22];
- Only market makers engaged in bona-fide market making in the security at the time they effect the short sale are excepted from the “locate” requirement;
- Indicia of bona-fide market making activity include where a market maker’s quotes are generally accessible to the public and the fact that the market maker holds itself out as being willing to buy and sell a security for its own account on a regular or continuous basis; and
- A market maker whose quotes are only accessible or provided to a restricted, limited, or targeted audience would not be engaged in bona-fide market making for purposes of the exception.

Lessons from SEC enforcement cases

As is often the case, the practical application of SEC rules is revealed in enforcement proceedings. Not surprisingly, SEC enforcement actions have focused on trading activity falling outside the indicia of bona-fide market making activity discussed above. In Jeffrey A. Wolfson et al.[23], the Commission alleged that the bona-fide market making exception was unavailable because the broker-dealer’s traders “failed to maintain regular and continuous two-sided quotations and did not hold themselves out as being willing to buy and sell securities or options in the securities on a regular or continuous basis by entering quotations in an inter-dealer communications system or by any other means,” and “[r]ather, [the traders] were engaging in reverse conversions and assists for their own investment purposes.”[24]

More recently, the SEC instituted and settled administrative proceedings against a Utah broker-dealer and certain associated persons for, among other things, improperly claiming
the bona-fide market making exception to the requirement in Rule 203 of Regulation SHO
to obtain a “locate” of stock before effecting short sales[25].

The orders issued in this matter pull together many of the SEC’s extant statements on what constitutes “bona-fide market making” in the context of Rule 203(b)(2)(iii) of Regulation SHO. The SEC stated that this “narrow” exception is available only to:

- A US-registered broker-dealer[26];
- That qualifies as a “market maker” under Exchange Act Section 3(a)(38)[27];
- Is a market maker in the security being sold[28]; and
- Is engaged in bona-fide market making in that security at the time of the short sale[29].

The orders reiterated much of the Commission and SEC staff guidance outlined above to aid in determining what trading activity fell within and outside bona-fide market making activities.

The SEC alleged that a substantial portion of the firm’s trading in a variety of stocks did not constitute bona-fide market making under Regulation SHO, and therefore the firm improperly used the Regulation SHO exception to the locate requirement. According to the SEC, the firm took the position, which was reflected in its written supervisory procedures, that all of its proprietary trading was bona-fide market making activity, and therefore it did not require traders to obtain, nor did it have processes or procedures to require, locates for short sales[30]. However, the Commission alleged that the firm improperly claimed the exception because:

- It made no distinction between (a) assuming the “purported status of a market maker” and continuously posting “superficially two-sided quotations” for a security, and (b) taking steps to ensure its actual trading activity constituted bona-fide market making activity;
- Its quoting and trading did not comport with the indicia of bona-fide market making; and
- Its conduct exhibited the characteristics that the SEC has described as not qualifying as bona-fide market making[31].

In particular, the firm:

- Posted quotations that were often not at or near the market on both sides (apparently mostly in OTC stocks);
- Posted a bid quotation that was at or near the market for the security, but failed to post an offer quotation at or near the market;
- Updated its bid quotation for the security during the day, but often made few or no changes to its offer quotation throughout the entire trading day (at times not changing an offer quotation that was far away from the market despite substantial movement in the price of the security); and
- Executed numerous short sales away from its posted offer quotations[32].

In describing the firm’s deficiencies, the Commission noted that the firm did not review quotations of its proprietary traders to determine whether their activities indicated that they were engaged in bona-fide market making activities, and did not determine if the proprietary traders’ activities indicated that they were not engaged in bona-fide market making activities[33].

The Commission provided illustrations of the firm’s trading activities in five OTC securities that failed to qualify for the bona-fide market making exception[34]. For example, the firm claimed the bona-fide market making exception for its trading in Amwest Imaging Inc.
However, while the firm often posted at or near the best bid and updated that bid throughout the day, it often posted an offer that was not near the best offer and did not frequently update that offer. Specifically, with AMWI’s price ranging from $0.07 to $0.31, the firm maintained an updated bid within $0.05 of the best bid while posting a static offer of $0.52 throughout a seven-day period, which ranged from approximately $0.19 to $0.45 away from the best offer. As another example, the firm claimed the exception for its similar trading patterns in North Springs Resources Corp. (“NSRS”). With NSRS’s price ranging from $0.40 to $0.62, the firm maintained an updated bid within $0.09 of the best bid while posting a static offer of $0.72 throughout a four-day period, which ranged from approximately $0.11 to $0.32 away from the best offer. The Commission alleged that this pattern of quoting and trading did not constitute bona-fide market making under Regulation SHO. In both cases, the firm executed short sales at prices substantially away from its posted offer quotation.

Conclusion

What do we know about “bona-fide market making activities”? First, we know that the SEC’s answer is: it depends on the facts and circumstances. We also continue to know more about what it isn’t than what it is. Additionally, we know that certain factors are necessary but not sufficient in themselves to demonstrate bona-fide market making. For example, a broker-dealer must:

- Be registered with the SEC;
- Be a “market maker” in the security for which it proposes to claim the exemption (which itself requires a facts and circumstances determination)
- Post regular or continuous proprietary quotations (i.e., take risk positions) that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers; and
- Be engaged in such bona-fide market making at the time of the short sale(s) for which the exception is claimed.

As a corollary, the market maker should have written policies and procedures to assess whether its quoting and trading activity comports with these indicia. Sound policies, procedures, and documentation are critical because a firm claiming the bona-fide market making exception has the burden to demonstrate its eligibility for the exception.

Notes


3. 17 CFR § 242.203(b)(2)(iii). “Rule 203(b)(1) of Regulation SHO prohibits a broker-dealer from accepting a short sale order in an equity security for its own account, unless the broker-dealer has '(i) [b]orrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) [r]easonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) [d]ocumented compliance with this [requirement].’ This is generally referred to as the ‘locate or borrow’ requirement.” Wilson-Davis & Company, Inc., Securities Exchange Act Release No. 80533 (April 26, 2017), at 3, available at: www.sec.gov/litigation/admin/2017/34-80533.pdf. This requirement is also frequently termed the “locate” requirement, which is the form used in this article.

4. 17 CFR § 242.204(a)(3).


7. Id. (footnote omitted).

8. 15 USC § 78c(a)(38). Although it might appear that all block positioners generally would be eligible to take advantage of these exceptions as “market makers,” the SEC has narrowed the scope of this term for Regulation SHO purposes to block positioners “to the extent that they engage in bona-fide block positioning activities,” and effectively limited that concept to activities by “qualified block positioners” as defined in Exchange Act Rule 3b-8(c). 73 FR at 61698-61699.


12. See 73 FR at 61698-61699. The SEC reiterated its position that this is a “narrow exception to the locate requirement because such market makers may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the locate requirement.” Id. at 61698.

13. Id. at 61699.

14. The SEC elaborated by stating that “if the market maker does not incur any market risk with respect to a transaction or related set of transactions, the market maker may not be engaged in bona-fide market making activities,” and further provided the example that “if a market maker sells stock (short) together with a synthetic short position (e.g., a conversion) to a client and the client then sells the stock (long) retaining the synthetic short position, the effect would be as if the market maker had ‘rented’ its exception to the client. Such transactions or other transactions that have the same effect will not be considered bona-fide market making activity.” Id. at 61699, n.99.

15. See id. at 61699 (“[E]ven selling short into a declining market may be an indication that a market maker is engaged in bona-fide market making activity.”).

16. See id. ("[A] market maker must hold itself out as being willing to buy and sell a security for its own account on a regular or continuous basis. Thus, a market maker’s quotes must be generally accessible to the public for the market maker to be considered as holding itself out as being willing to buy and sell on a regular or continuous basis.”).

17. Id. This is a theme that the SEC has applied for many years. See, e.g., Securities Exchange Act Release No. 36232 (July 14, 1993), 58 FR 39072, 39074 (July 21, 1993) (“[T]he Commission believes that a bona-fide market maker is a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market.”).

18. No-Action Letter re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Certain Subsequent Trading Activity on a Close-Out Date (October 27, 2014) ("GSEC Letter") at 3 n.11, available at: www.sec.gov/divisions/marketreg/mr-noaction/2014/goldman-090613-204.pdf ("The broker-dealer cannot rely solely on its labelling of an account as a market making account, on the designation of any trader or unit as a ‘market maker,’ or in reliance on an exchange registration or eligibility for an exchange designation as a market maker, . . . but must consider whether the short sales in the market making account or within the market maker unit also qualify as bona fide market making for purposes of Regulation SHO."); see also 58 FR at 39074 (“The Commission believes that for the qualifier ‘bona fide’ to have any substance, it must mean more than the fact that the transactions in question are effected in a market making account.”).


22. The Staff has focused on the use of “peg orders” by market makers. See Regulation SHO FAQs endnote 3. The Staff noted that the NASDAQ Stock Market (“NASDAQ”) offers a peg order type to market makers registered with NASDAQ that they may use to meet their quoting obligations under NASDAQ Rule 4613(a). In the related Regulation SHO FAQ 2.5(B) (added on March 18, 2015), the SEC staff describes a market maker peg order “set at the maximum allowable price away from the inside market, such that it is significantly higher than the inside offer and will likely never, or very rarely, be executed.” The SEC staff states: “The use of market maker peg orders is not sufficient to demonstrate eligibility for bona fide market making under Regulation SHO. The use of market maker peg orders may be one indicator, among other necessary indicators, for a market maker to demonstrate that it may be engaged in bona-fide market making activities for purposes of Regulation SHO, depending on the facts and circumstances. . . .” Curiously, the endnote also cites Securities Exchange Act Release No. 67584 (August 2, 2012), 77 FR 47472 (August 8, 2012), where the Commission (by the Division of Trading and Markets acting pursuant to delegated authority) approved NASDAQ’s new “Market Maker Peg Order” and stated: “Market Maker Peg Orders with a market maker-designated [price] offset may be able to qualify as bona-fide market making for purposes of Regulation SHO, depending on the facts and circumstances.” 77 FR at 47474 n.17.


26. See 15 USC. § 78o(b).
27. See text at n.9 supra.

28. The SEC has noted that “most specialists and market makers seek a net ‘flat’ position in a security at the end of each day and often ‘offset’ short sales with purchases such that they are not required to make delivery under the security settlement system.” Jeffrey A. Wolfson et al., supra n.23, at 14 (quoting Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972, 62977 (November 6, 2003)). The SEC also has noted that, while compliance with a securities exchange’s market maker rules “is not dispositive as to whether [a broker-dealer] was conducting bona-fide market making for the purposes of Reg. SHO, it can be viewed as an additional indicia [sic] of bona-fide market making.” Id. at 16.

29. WDCO at 4.

30. Id. at 5.

31. Id. at 6.

32. Id.

33. Id. at 5-6.

34. Id. at 6-9.

35. For the Rule 204(a)(3) exception to be available, the market maker also must be registered as a market maker (e.g., as an exchange member) or be obligated to quote in the over-the-counter market. See, e.g., FINRA Rule 6272.


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