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Part V

Securities and Exchange Commission

17 CFR Parts 240 and 242
Short Sales; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 242

[Release No. 34–48709; File No. S7–23–03]

RIN 3235–AJ00

Short Sales

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (Commission) is publishing for public comment new Regulation SHO, under the Securities Exchange Act of 1934 (Exchange Act), which would replace Rules 3b–3, 10a–1, and 10a–2. The Commission is also proposing amendments to Rule 105 of Regulation M. Proposed Regulation SHO would, among other things, require short sellers in all equity securities to locate securities to borrow before selling, and would also impose strict delivery requirements on securities where many sellers have failed to deliver the securities. In part, this action is designed to address the problem of ''naked'' short selling. Proposed Regulation SHO would also institute a new uniform bid test allowing short sales to be effected at a price one cent above the consolidated best bid. This test would apply to all exchange-listed securities and Nasdaq National Market System Securities (NMS Securities), wherever traded.

We are also seeking comment on a temporary rule that would suspend the operation of the proposed bid test for specified liquid securities during a two-year pilot period. The temporary suspension would allow the Commission to study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity.

DATES: Comments must be received on or before January 5, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following E-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–23–03. Comments submitted by E-mail should include this file number in the subject line. Comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: Any of the following attorneys in the Office of Trading Practices, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001, at (202) 942–0772: James Brigagliano, Assistant Director, or Gregory Dumark, Kevin Campion, Lillian Hagen, Elizabeth Sandoe and Marla Chidsey, Special Counsels.

SUPPLEMENTARY INFORMATION: The Commission is publishing for comment proposed Regulation SHO and a proposed temporary rule, Rule 202[2], and proposed amendments to Regulation M, Rule 105[3] under the Exchange Act.

Table of Contents

I. Introduction

Congress, in 1934, directed the Commission to ''purge the market'' of short selling abuses, and in response, the Commission adopted restrictions that have remained essentially unchanged for over 60 years. Originally adopted in 1938, the Commission's short sale rule, Rule 10a–1, is designed to restrict short sellers from effecting short sales in an exchange-traded security when the price of that security is declining.[4]

Since its adoption, the Commission has engaged in studies, investigations, and reviews of the efficacy of the Rule.[5]

[1] Personal identifying information, such as names or e-mail addresses, will not be edited from electronic submission. Submit only information that you wish to make publicly available.

[2] 17 CFR 242.202.

[3] 17 CFR 242.105.

[4] 17 CFR 240.10a–1.

[5] *See* 2 Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 247 (1963) (study to determine the relationships between changes in short positions and subsequent price trends); *see also* Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation (Part I)(House Report), H.R., Rep. No. 102–414 (1991), reprinted in CCH Federal Securities Law Reports Number 1483 Part II (1992).

Most recently, in 1999, the Commission issued a release requesting public comment on the regulation of short sales of securities (Concept Release).[6] The Concept Release examined ways to modernize our approach to short sale regulation. We received 2778 comment letters in response to the Release.[7]

Since the Concept Release was published, we have reviewed the comment letters and reexamined the structure and operation of Rule 10a–1, and related Rules 10a–2 [8] and 3b–3.[9] We also considered the status of short sale regulation in the context of requests for relief from Rule 10a–1 submitted to the Commission for a wide range of short selling activities. Finally, we considered recent market changes, including 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. As a result of this assessment, we are seeking comment on proposed Regulation SHO, which would replace Rules 3b–3, 10a–1, and 10a–2, and that would temporarily suspend the short sale price test for specified liquid stocks. We also propose to amend Rule 105 of Regulation M to eliminate the shelf offering exception. The comments we receive will assist us in determining whether to adopt the proposed changes to these rules and the nature and scope of such changes.

A. Background and Current Short Sale Regulation

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[10] In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

The following example illustrates a typical short sale transaction:

XYZ stock is currently selling at $50 per share. An investor anticipates that the price of XYZ stock will decline and wants to sell short 100 shares. The investor's broker borrows 100 shares for the investor and executes the short sale. The $5,000 proceeds from the sale (plus, usually, an additional 2%) are posted as collateral with the lender and the investor must also post margin equal to 50% of the purchase price with his broker.[11] At some point in the future the investor must purchase 100 shares to return to the lender. If the investor can purchase the XYZ shares at a price below $50, the investor can cover the short position at a profit. If the price of XYZ shares rises above $50, the investor may have to cover the short position at a loss.[12]

Section 10(a) of the Exchange Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange (listed securities), as necessary to protect investors. After conducting an inquiry into the effects of concentrated short selling during the market break of 1937, the Commission adopted Rule 10a–1 in 1938 in order to restrict short selling in a declining market.[13] The core provisions of the Rule are largely the same today as when they were adopted.

Paragraph (a) of Rule 10a–1 generally covers short sales in listed securities if trades of the security are reported pursuant to an ''effective transaction reporting plan'' and information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.[14] Paragraph (b) applies to short sales on national exchanges in securities that are not covered by paragraph (a).

Rule 10a–1(a)(1) provides that, subject to certain exceptions, a listed security may be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it is higher than the last different price (zero-plus tick).[15] Short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions, commonly described as the ''tick test,'' determines the minimum shortable price (MSP) [16] at which a security can be sold short. The following transactions illustrate the operation of the tick test: [17]

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[6] Securities Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28,1999).

[7] The comment letters and a comprehensive summary of the comments are available for inspection in the Commission's Public Reference Room in File No. S7–24–99.

[8] 17 CFR 240.10a–2.

[9] 17 CFR 240.3b–3.

[10] *See* Rule 3b–3 under the Exchange Act, 17 CFR 240.3b–3.

[11] *See, e.g.*, 12 CFR 220.12(c)(1) of Regulation T of the Board of Governors of the Federal Reserve System, which requires margin for a short sale of a nonexempted equity security of 150 percent of the current market value of the security. An investor may be required to deposit additional ''maintenance margin'' for transactions in short sales under margin requirements imposed by self regulatory organizations (SROs). *See, e.g.*, NASD Rule 2520(c) and NYSE Rule 431(c). Further, broker-dealers may institute higher short sale margin requirements than those imposed by self-regulatory organization rules. *See, e.g.*, NASD Rule 2520(d) and NYSE Rule 431(d).

[12] This simple example does not include transaction and carrying costs. For a more complete discussion of equity lending and costs of borrowing equity *see Securities Lending Transactions: Market Developments and Implications,* Technical Committee of the International Organization of Securities Commissions (IOSCO) Committee on Payment and Settlement Systems (CPSS) (July, 1999). This paper can be accessed at *www.iosco.org/pubdocs/pdf/IOSCOPD96.pdf. See also* Geczy, Musto, and Reed, 2002, *Stocks Are Special Too: An Analysis of the Equity Lending Market,* Journal of Financial Economics, 66, 241–269.

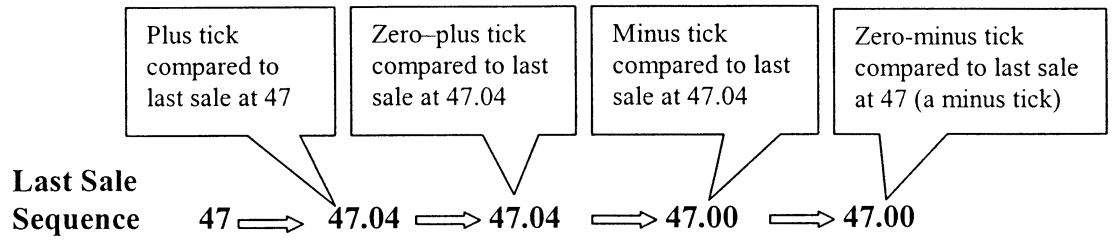
[13] Securities Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

[14] Rule 10a–1 uses the term ''effective transaction reporting plan'' as defined in Rule 11Aa3–1 (17 CFR 240.11Aa3–1) under the Exchange Act. *See* 17 CFR 240.10a–1(a)(1)(i).

[15] The last sale price is the price reported pursuant to an effective transaction reporting plan, *i.e.*, the Consolidated Tape Association, also generally referred to as the ''Tape.''

[16] The MSP is the lowest price that a stock can be sold short under current short sale regulation. If a stock is trading on a minus or zero-minus tick, a short sell order must be executed at a price higher than the last trade.

[17] The first execution at 47.04 is a plus tick since it is higher than the previous last trade price of 47.00. The next transaction at 47.04 is a zero-plus tick since there is no change in trade price but the last change was a plus tick. Short sales could be executed at 47.04 or above. The final two transactions at 47.00 are minus and zero-minus transactions, respectively. Short sales would have to be effected at the next higher increment above 47.00 in order to comply with Rule 10a–1.



In adopting the tick test, the Commission sought to achieve three objectives:

(i) allowing relatively unrestricted short selling in an advancing market;

(ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and

(iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[18]

In 1994, the Commission granted temporary approval to the NASD to apply its own short sale rule to Nasdaq NMS securities.[19] NASD Rule 3350 prohibits short sales by NASD members in Nasdaq NMS Securities [20] at or below the current best (inside) bid when that bid is lower than the previous best (inside) bid (commonly referred to as the bid test).

The operation of the bid test in NASD Rule 3350 is illustrated as follows:

Bid Sequence	47	47.04	47.04	47	47
Current Bid Compared to the previous bid.	.....	plus bid (compared to last bid at 47).	zero-plus bid (compared to last bid at 47.04).	minus bid (compared to last bid at 47.04).	zero-minus bid (compared to last bid at 47)
MSP	.....	any price	any price	47.01	47.01

B. Market Effects of Short Selling

Short selling provides the market with at least two important benefits: market liquidity and pricing efficiency.[21] Market liquidity is generally provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the buying and selling interest for securities. Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[22]

Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices.[23] One example is the ''bear raid'' where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest.[24] Further, unrestricted short selling can exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons.

Short selling was one of the central issues studied by Congress before enacting the Exchange Act, but Congress did not directly prohibit short selling.[25] Instead, Congress gave the Commission broad authority to regulate short sales in order to stop short selling abuses.[26]

C. Market Developments

Several significant developments in the securities markets, including, but not limited to, instances of abusive naked short selling, the increasing

[18] *See* Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976).

[19] *See* Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

[20] Rule 11Aa2–1 under the Act sets forth the criteria and procedures by which certain over-the-counter (OTC) securities are designated as NMS Securities. 17 CFR 240.11Aa2–1.

[21] *See* Lamont, Owen A. and Thaler, Richard H, 2003, *Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs,* University of Chicago and NBER.

[22] Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.

[23] *See, e.g., S.E.C.* v. *Gardiner,* 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); *U.S.* v. *Russo,* 74 F.3d 1383, 1392 (2nd Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b–5).

[24] Many people blamed ''bear raids'' for the 1929 stock market crash and the market's prolonged inability to recover from the crash. *See* 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203–04, note 213 (3d ed. 1989).

[25] *See* 2 Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 247 (1963) (Special Study).

[26] *Id.*

number of Nasdaq securities trading away from the Nasdaq market (and thus not subject to any price test), the advent of security futures trading, and decimalization have caused the Commission to reexamine short sale regulation. At a minimum, the Commission believes that adjustments to short sale regulation are required to keep pace with these market developments.

II. Naked Short Selling

A. Background

Many issuers and investors have complained about alleged ''naked short selling,'' especially in thinly-capitalized securities trading over-the-counter.[27] Naked short selling is selling short without borrowing the necessary securities to make delivery, thus potentially resulting in a ''fail to deliver'' securities to the buyer.

Naked short selling can have a number of negative effects on the market, particularly when the fails to deliver persist for an extended period of time and result in a significantly large unfulfilled delivery obligation at the clearing agency where trades are settled.[28] At times, the amount of fails to deliver may be greater than the total public float. In effect the naked short seller unilaterally converts a securities contract (which should settle in three days after the trade date) into an undated futures-type contract, which the buyer might not have agreed to or that would have been priced differently. The seller's failure to deliver securities may also adversely affect certain rights of the buyer, such as the right to vote. More significantly, naked short sellers enjoy greater leverage than if they were required to borrow securities and deliver within a reasonable time period, and they may use this additional leverage to engage in trading activities that deliberately depress the price of a security.[29]

The Commission recently brought an enforcement action against certain parties, alleging manipulative naked short selling, in a scheme sometimes termed as a ''death spiral.'' These schemes generally involve parties arranging financings in public companies that are unable to obtain more conventional financing in the capital markets due to their precarious financial condition. The party providing financing receives from a public company debentures that are later convertible into the stock of the issuer. The terms typically provide that the conversion ratio will be tied to a fixed value of the aggregate underlying shares (typically a discount from the market price of the security at the time of the conversion rather than a conversion price per share).[30] In some cases the parties providing financing have engaged in extensive naked short selling designed to lower the price of the issuer's stock, thus realizing profits when the debentures are converted to cover the short sales.[31]

Naked short selling has sparked defensive actions by some issuers designed to combat the potentially negative effects on shareholders, broker-dealers, and the clearance and settlement system.[32] Some issuers have taken actions to attempt to make transfer of their securities ''custody only,'' thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (DTC) or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository.[33] Withdrawing securities from DTC or requiring custody-only transfers undermine the goal of a national clearance and settlement system, designed to reduce the physical movement of certificates in the trading markets.[34]

B. Current Regulatory Requirements

The SROs have adopted rules generally requiring that, prior to effecting short sales, members must ''locate'' stock available for borrowing.[35] For example, NYSE Rule 440C.10 states that no NYSE member or member organization should ''fail to deliver'' against a short sale of a security on a national securities exchange until a diligent effort has been made by such member or member organization to borrow the necessary securities to make delivery.[36] An NYSE interpretation to the rule further states that member organizations effecting short sales for their own account or the accounts of customers must be in a position to complete the transaction. The interpretation states that no orders to sell short should be accepted or entered unless prior arrangements to borrow the stock have been made or other acceptable assurances that delivery can

[27] For example, *see* comment letters from John Henry Austin (2675), Bridget Thomas (2297), James McCaffery (492), Richard Ballard (507), and Ken Klaser (596).

[28] ''Clearing agency'' is defined in Section 3(a)(23)(A) of the Exchange Act, 15 U.S.C. 78c(a)(23)(a).

[29] The Commission issued a prior statement cautioning broker-dealers that where the broker-dealer has sold short, but did not, for a substantial period of time, effect the offsetting purchase transactions for purpose of delivery, this could generally involve violations of the anti-fraud provisions of the Federal securities laws. *See* Securities Exchange Act Release No. 6778 (April 16, 1962).

[30] For more information, *see* ''Convertible Securities'' on the Commission's Web site at *www.sec.gov/answers/convertibles.htm*

[31] The Commission recently settled a case against parties relating to allegations of manipulative short selling in the stock of Sedona Corporation, a Nasdaq Small Cap company. The action alleged that the defendants engaged in massive naked short selling that flooded the market with Sedona stock, and thus depressed its price. The defendants thereby profited by subsequently exercising the conversion rights under the debenture. *See* Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (February 27, 2003); *see also SEC* v. *Rhino Advisors, Inc. and Thomas Badian*, Civ. Action No. 03 civ 1310 (RO) (Southern District of New York).

[32] There have been press reports concerning the actions of some issuers, and questioning whether the cause of declines in their stock prices can be attributed to naked short selling, or to fundamental problems with the company. *See, e.g.*, Carol S. Remond, *Universal Blames Shorts, But What of Dilution?, Dow Jones Newswires* (October 6, 2003); Rob Wherry, *Wall Street's Next Nightmare?*, Forbes.com (October 6, 2003); *see also* Gretchen Morgenson, *If Short Sellers Take Heat, Maybe It's Time to Bail Out*, NY Times (January 26, 2003) (citing a study by Professor Owen A. Lamont that analyzed returns at companies that waged public battles with short sellers, and found that their stocks lagged the market by 2.34 percent in each of the twelve months after the battles began). As a matter of practice, the Commission does not opine on the content or accuracy of such reports.

[33] The Commission recently approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. *See* Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003) (File No. SR–DTC–2003–02).

[34] *See* Section 17A(e) of the Exchange Act. 15 U.S.C. 78q–1(e). The Commission noted in the order approving the DTC rule change that the use of certificates can result in significant delays and expenses in processing securities transactions and can raise safety concerns associated with lost, stolen, and forged certificates. *See, supra* n. 33.

[35] In 1976 the Commission proposed the adoption of Rule 10b–11. Rule 10b–11 would have prohibited any person from effecting a short sale in any equity security (*i.e.*, not just exchange-traded securities) for his own account or the account of any other person unless he, or the person for whose account the short sale is effected (i) borrowed the security, or entered into an arrangement for the borrowing of the security, or (ii) had reasonable grounds to believe that he could borrow the security so that, in either event, he would be capable of delivering the securities on the date delivery is due. Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976). In 1988, the Commission withdrew proposed Rule 10b–11, noting that since the time the rule was proposed, the NYSE and the NASD had adopted interpretations specifying that members should not accept or enter a short sale order unless prior arrangements to borrow the stock have been made, or other acceptable assurances that delivery can be made on settlement date have been obtained. The Commission also stated that it believed the general antifraud provisions of the federal securities laws were applicable to activity addressed by proposed Rule 10b–11. Securities Exchange Act Release No. 26182 (October 14, 1988), 53 FR 41206.

[36] *See* NYSE Rule 440C.10.

be made on settlement date.[37] These provisions apply to all NYSE member organizations, whether effecting transactions in exchange-listed securities on the NYSE, another national securities exchange, or in the over-the-counter market. Exceptions from the rule are provided for short sales by specialists, market makers, and odd lot dealers in fulfilling their market responsibilities.[38]

The comparable NASD Rule 3370 generally provides that no member, or person associated with a member, shall effect a short sale for a customer or for its own account unless the member makes an ''affirmative determination'' that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date.[39] The affirmative determination must be annotated in writing, evidencing that the member firm will receive delivery of the security from the customer or, if the member firm locates the stock, the identity of the individual and firm contacted who offered assurance that the shares would be delivered or were available for borrowing.[40] This requirement applies regardless of how a short sale order is received, *e.g.*, by the telephone, an electronic transmission, the Internet, or otherwise.[41] This requirement does not apply to transactions in corporate debt securities, to bona fide market making transactions by Nasdaq market makers,[42] or to transactions that result in fully hedged or arbitraged positions.[43]

The NASD has also adopted several rules addressing failures to deliver. NASD Rule 3210 prevents a member, or person associated with a member, from selling a security for his own account, or buying a security as a broker for a customer if, with respect to domestic securities,[44] he has a fail to deliver in that security that is 60 days or older. NASD Rule 11830 imposes a mandatory close-out requirement for Nasdaq securities that have a clearing short position of 10,000 shares or more per security and that are equal to at least one-half of one percent of the issue's total shares outstanding. NASD Rule 11830 generally requires that a contract involving a short sale in these securities, for the account of a customer or for an NASD member's own account, which has not resulted in delivery by the broker-dealer representing the seller within 10 business days after the normal settlement date (currently transaction date + 3 business days), must be closed by the broker-dealer representing the seller by purchasing for cash or guaranteed delivery of securities of like kind and quality. This mandatory close-out requirement does not apply to bona-fide market making transactions and transactions that result in fully hedged or arbitraged positions.

C. Proposed Amendments

1. Short Sales

The Commission believes that these SRO requirements have not fully addressed the problems of naked short selling and extended fails to deliver. We believe it would be beneficial to establish a uniform standard specifying the procedures for all short sellers to locate securities for borrowing.[45] This would further the goals of regulatory simplification and avoidance of regulatory arbitrage, as well as address some areas not currently covered. We are therefore proposing to incorporate in proposed Regulation SHO a uniform ''locate'' rule applicable to all equity securities, wherever they are traded.[46] Proposed Rule 203 would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale is executed (1) borrowed the security, or entered into an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due.[47] Consistent with the current SRO requirements, the proposed rule would require that the locate be made and annotated in writing prior to effecting any short sale, regardless of the fact that the seller's short position may

[37] Such assurances include knowledge that the security is available for borrowing, conversion privileges, rights exercise, and the like. One test of reasonableness in short sales against convertible securities, rights and merger securities is whether the security needed for delivery can be exchanged in normal transfer time. A firm that normally relies on the stock loan market without advance borrowing can demonstrate compliance by switching to prior borrowing whenever the stock borrowing market in a particular security becomes tight.'' NYSE Rule 440C.10 Interp. /01. *See also* NYSE Information Memo 91–41 (providing further information regarding compliance with Rule 440C.10).

[38] *Id.*

[39] *See* NASD Rule 3370.

[40] According to the rule, the manner by which a member or person associated with a member annotates compliance with the affirmative determination requirement is to be decided by each member. Members may rely on ''blanket'' or standing assurances (*i.e.*, ''Easy to Borrow'' lists) that securities will be available for borrowing on settlement date. For any short sales executed in Nasdaq National Market (''NNM'') or exchange-listed securities, members also may rely on ''Hard to Borrow'' lists indicating NNM or listed securities that are difficult to borrow or unavailable for borrowing on settlement date provided that: (i) Any securities restricted pursuant to NASD Rule 11830 must be included on such a list; and (ii) the creator of the list attests in writing on the document or otherwise that any NNM or listed securities not included on the list are easy to borrow or are available for borrowing. Members are permitted to use Easy to Borrow or Hard to Borrow lists provided: (i) The information used to generate the list is no less than 24 hours old; and (ii) the member delivers the security on settlement date. Should a member relying on an Easy to Borrow or Hard to Borrow fail to deliver the security on settlement date, the NASD deems such conduct inconsistent with the terms of Rule 3370, absent mitigating circumstances adequately documented by the member. *See* NASD Rule 3370(b)(4)(C).

[41] *See* NASD Notice to Members 99–98.

[42] NASD IM–3350 contains language specifying what type of activity does not constitute bona fide market making: ''Bona fide market making activity does not include activity that is unrelated to market making functions, such as index arbitrage and risk arbitrage that is independent from a member's market making functions. * * *'' IM–3350(a)(2). ''Similarly, bona fide market making would exclude activity that is related to speculative selling strategies of the member or investment decisions of the firm and is disproportionate to the usual market making patterns or practices of the member in that security. The Association does not anticipate that a firm could properly take advantage of its market maker exemption to effectuate such speculative or investment short selling decisions. Disproportionate short selling in a market making account to effectuate such strategies will be viewed by the Association as inappropriate activity that does not represent bona fide market making and would therefore be in violation of Rule 3350.'' IM–3350(a)(3).

The NASD has instituted disciplinary actions against broker-dealers that the NASD found were abusing the exemption provided for bona-fide market making transactions. *See, e.g.*, Hearing Panel Decision as to Respondents John Fiero and Fiero Brothers, Inc. (December 6, 2000) (decision affirmed by the National Adjudicatory Council on October 28, 2002); *see also* John Emshwiller, *NASD Moves to Bar Short Seller Fiero, Citing Alleged Manipulation of Stocks*, WSJ (January 9, 2001).

[43] NASD Rule 3370(b)(5) provides guidelines in determining the availability of the exemption for ''bona-fide fully hedged'' and ''bona-fide fully arbitraged'' positions.

[44] With respect to foreign securities, if the member has a fail to deliver in that security 90 days or older (except American Depositary Receipt and Canadian securities, which shall be subject to the 60 day provision).

[45] Some commenters to the Concept Release supported a single, workable approach to locating securities for borrowing before effecting short sales. *See* letter from Wilkie, Farr & Gallagher (488) (writing on behalf of Bear, Stearns & Co., Inc.; Credit Suisse First Boston Corp.; Deutsche Bank Securities, Inc.; JP Morgan Securities Inc.; PaineWebber Inc.; Prudential Securities Inc.; and Warburg Dillon Read LLC.).

[46] *See* paragraph (b), Rule 203 of proposed Regulation SHO.

[47] We are interested in receiving comment on the manner in which persons could satisfy the ''reasonable grounds'' determination in the proposed rule. As noted above, the current SRO rules generally defer to members to decide the manner of compliance, and permit members to rely on blanket assurances that stock is available for borrowing, *i.e.*, ''hard to borrow'' or ''easy to borrow'' lists. *See, supra* n. 40. We specifically request comment on whether this present method of compliance provides an accurate assessment of the current lending market in a manner that would not impede liquidity and the ability of market participants to establish short positions, while at the same time guarding against the noted problems inherent with large extended settlement failures.

be closed out by purchasing securities the same day.[48] The Commission is proposing an exception from these requirements for short sales executed by specialists or market makers but only in connection with bona-fide market making activities.[49] We believe a narrow exception for market makers and specialists engaged in bona fide market making activities is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed ''locate'' rule. Moreover, we believe 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.

As an additional safeguard against some of the problems associated with naked short selling, we are proposing a delivery requirement targeted at securities where there is evidence of significant settlement failures. We are incorporating the same threshold currently used in NASD Rule 11830,[50] *i.e.,* any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more per security, and that is equal to at least one-half of one percent of the issue's total shares outstanding.[51] We are incorporating this standard into proposed Rule 203 because we believe that the levels set in NASD Rule 11830 characterize situations where the ratio of unfulfilled delivery obligations at the clearing agency where trades are settled represents a significant number of shares relative to the company's total shares outstanding, thus requiring remedial action designed to address potential negative effects. The proposed rule would specify that for short sales of any security meeting this threshold, the selling broker-dealer must deliver the security no later than two days after the settlement date.[52] We believe a two-day grace period is appropriate to allow for transfer delays or delays due to a variety of circumstances that prevent timely delivery.[53] If for any reason such security was not delivered within two days after the settlement date, the rule would restrict the broker-dealer, including market makers, from executing future short sales in such security for the person for whose account the failure to deliver occurred unless the broker-dealer or the person for whose account the short sale is executed borrowed the security, or entered into a bona fide arrangement to borrow the security, prior to executing the short sale and delivered on settlement date. This restriction would be in effect for a period of 90 calendar days.[54] In addition, the rule would require the rules of the registered clearing agency that processed the transaction to include the following provisions: (A) A broker or dealer failing to deliver such securities shall be referred to the NASD and the designated examining authority for such broker-dealer for appropriate action; [55] and (B) The registered clearing agency shall withhold a benefit of any mark-to-market amounts or payments that otherwise would be made to the party failing to deliver,[56] and take other appropriate action, including assessing appropriate charges against the party failing to deliver. Both of these requirements should assist the Commission in preventing abuses and promote the prompt and accurate clearance and settlement of securities transactions.

These proposed requirements in Rule 203 would differ from the current SRO rules in several respects. First, the proposals require action two days after settlement, as opposed to the current ten days after settlement provided in Rule 11830.[57] Further, the mandatory close-out provision in NASD Rule 11830 currently only applies to Nasdaq securities. We believe that securities with lower market capitalization may be more susceptible to abuse, and therefore believe that these additional delivery requirements should be extended to all equity securities registered under Section 12 of the Exchange Act. Finally, although market makers engaged in bona fide market making are currently exempted from NASD Rule 11830, we believe that extended failures to deliver appear characteristic of an investment or trading strategy, rather than being related to market making. We believe it is questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is in fact engaged in providing liquidity for customers, or rather is engaged in a speculative trading strategy. Therefore, we are not proposing an exception from these additional delivery requirements for short sales in connection with market making.

In our view, these delivery requirements would protect and enhance the operation, integrity and stability of the markets and the clearance and settlement system. In

[48] *See, e.g., Ko Securities, Inc. and Terrance Y. Yoshikawa*, Securities Exchange Act Release No. 48550 (September 26, 2003) (holding that an affirmative determination must be made before the securities are sold short regardless of whether the short seller repurchases securities on the same day).

[49] The exemption for bona-fide market making activities would exclude activity that is related to speculative selling strategies or investment decisions of the broker-dealer or associated person and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.

[50] The National Securities Clearing Corporation (NSCC) currently tracks this information on fails to deliver and provides it to Nasdaq for purposes of administering NASD Rule 11830. Thus, we do not believe that the threshold proposed here would impose unduly burdensome data collection requirements.

[51] For example, if an issuer had 1,000,000 shares outstanding, one-half of one percent (.005) would be 5,000 shares. An aggregate fail to deliver position at a clearing agency of 10,000 shares or more would thus meet the threshold. If an issuer had 10,000,000 shares outstanding, one-half of one percent would be 50,000 shares. An aggregate fail to deliver position at a clearing agency of 50,000 shares or greater would meet the threshold.

[52] When the trade fails to settle on normal settlement date (*i.e.*, T+3), the broker-dealer would have to take actions, such as borrowing the security or effecting a purchase in the cash market, so that actual delivery is made by T+5.

[53] Unlike NASD Rule 11830, which provides for delivery of securities meeting this threshold to be delivered within 10 business days after the normal settlement date, we propose a two-day period because we believe it is reasonable period to allow for transfer delays or delays due to some other characteristic of the security while preventing unfulfilled delivery obligations from extending for a period that we believe is characteristic of a more significant problem.

[54] In this context, we believe that a 90-day restricted period is an appropriate consequence for a failure to deliver and a deterrent to prevent failures to deliver in the future. The Federal Reserve Board has taken this approach with respect to transactions in cash accounts where the securities are sold before they have been fully paid for. *See*, 12 CFR 220.8(c), Regulation T.

[55] Referral to the designated examining authority would allow for monitoring of broker or dealers not complying with proposed Rule 203 and allow for possible disciplinary action. In the case of any fail to deliver occurring at the Canadian Depository for Securities (CDS), the registered clearing agency would refer CDS to the Ontario Securities Commission for appropriate action.

[56] As part of its Continuous Net Settlement system (CNS) NSCC marks-to-market each day positions for which participants failed to make delivery. In situations where the value of a security that is the subject of a failure to deliver is increasing, NSCC collects the mark from the party that failed to deliver and passes it on to the party that failed to receive the securities. Conversely, in a situation where the value of the security is decreasing, NSCC collects the mark from the party that failed to receive the securities and passes it on to the party that failed to deliver. Under the CNS system, a participant does not receive the actual contract value of the securities (*i.e.*, the proceeds from their sale) until actual delivery of securities is made. *See* National Securities Clearing Corporation Rules of Procedures Rule 11. Nevertheless, we believe that withholding the benefit of mark-to-market amounts from the party failing to deliver in a security meeting the specified threshold would serve as a financial incentive to comply with the borrow and delivery requirements during the 90-day restricted period.

[57] We solicit comment on any legitimate reasons why a short seller may be unable to deliver securities by at least T+5. We may then choose to except particular types of transactions, or add a specified grace period.

particular, we believe that they will protect buyers of securities by substantially curtailing naked short selling. We request comment on the extent to which the proposed rules will achieve these objectives.

Q. What harms result from naked short selling? Conversely, what benefits accrue from naked short selling?

Q. Are there negative tax consequences associated with naked short selling, in terms of dividends paid or otherwise?

Q. What is the appropriate manner by which short sellers can comply with the requirement to have ''reasonable grounds'' to believe that securities sold short could be borrowed? Should short sellers be permitted to rely on blanket assurances that stock is available for borrowing, *i.e.*, ''hard to borrow'' or ''easy to borrow'' lists? Is the equity lending market transparent enough to allow an efficient means of creating these lists?

Q. Should short sales effected by a market maker in connection with bona fide market making be excepted from the proposed ''locate'' requirements? Should the exception be tied to certain qualifications or conditions? If so, what should these qualifications or conditions be?

Q. Should the proposed additional delivery requirements be limited to securities in which there are significant failures to deliver? If so, is the proposed threshold an accurate indication of securities with excessive fails to deliver? Should it be higher or lower? Should additional criteria be used?

Q. Are the proposed consequences for failing to deliver securities appropriate and effective measures to address the abuses in naked short selling? If not, why not? What other measures would be effective? Should broker-dealers buying on behalf of customers be obligated to effect a buy-in for aged fails?

Q. Is the restriction preventing a broker-dealer, for a period of 90 calendar days, from executing short sales in the particular security for his own account or the account of the person for whose account the failure to deliver occurred without having pre-borrowed the securities an appropriate and effective measure to address the abuses in naked short selling? Should this restriction apply to all short sales by the broker-dealer in this particular security? Should the restriction also apply to all further short sales by the person for whose account the failure to deliver occurred, effected by any broker-dealer?

Q. Should short sales effected by a market maker in connection with bona-fide market making be exempted from the proposed delivery requirements targeted at securities in which there are significant failures to deliver? If so, what reasons support such an exemption, and how should bona-fide market making be identified?

Q. Under what circumstances might a market maker need to maintain a fail to deliver on a short sale longer than two days past settlement date in the course of bona fide market making? Is two days the appropriate time period to use?

Q. Are there any circumstances in which a party not engaging in bona-fide market making might need to maintain a fail to deliver on a short sale longer than two days past settlement? If so, can such positions be identified? Should they be excepted from the proposed borrow and delivery requirements, and if so, why, and for how long?

2. Long Sales

Current Rule 10a–2 covers delivery requirements applicable to long sales of securities registered or admitted to unlisted trading privileges on a national securities exchange. We are proposing to adopt subparagraph (a) of Rule 203 in proposed Regulation SHO, which would replace and modify Rule 10a–2 to make it consistent with the new delivery requirements in the proposed short sale rule.

Generally, Rule 10a–2 provides that if a broker-dealer knows or should know that a sale is marked long, the broker-dealer must make delivery when due and cannot lend securities to do so. If the broker-dealer does not have the securities, it must make delivery with securities purchased for cash, *i.e.*, effect a ''buy in,'' unless it knows that the seller either is in the process of forwarding the securities to the broker-dealer or will do so as soon as possible without undue inconvenience or expense. Broker-dealers are excused from the buy-in requirement in two cases. In sales between broker-dealers, loans are permitted in lieu of a buy-in. The rule also allows a broker-dealer to fail to deliver, or to borrow securities in lieu of buying-in, if, despite the broker-dealer's efforts to ensure that the sale was long, it was in fact short. This exemption is available only if the exchange or national securities association in whose market the sale was effected finds that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price.

Subparagraph (a) of Rule 203 of proposed Regulation SHO preserves the substance of current Rule 10a–2 regarding delivery of securities sold pursuant to orders marked ''long.'' Only two substantive changes have been made. First, Regulation SHO would extend the delivery requirements of Rule 10a–2 to all securities, including those traded over-the-counter. As with our proposal to apply borrow and delivery requirements for short sales in all equity securities, we believe it is equally important to apply long delivery requirements to securities with lower market capitalization that may be more susceptible to abuse.

Second, proposed Regulation SHO would provide that a loan or failure to deliver is permitted if the seller has informed the broker-dealer that the seller owns the security and will deliver it to the broker-dealer prior to settlement of the transaction, but fails to do so. The proposed modification tracks the proposed amendments to the order marking requirements, which would permit an order to be marked long if the seller owns the securities and the seller's broker-dealer will have physical possession or control of the security prior to settlement.[58] The proposed rule would permit a broker-dealer to fail to deliver, or to deliver borrowed securities, if an exchange or national securities association found that the broker-dealer used due diligence in obtaining the seller's confirmation that the security would be in the broker-dealer's possession prior to settlement, and that either compelling a buy-in would result in undue hardship, or that the mistake was made by the seller's broker-dealer and the sale was at a permissible price under Proposed Rule 201(b) of Regulation SHO.[59] We believe that this change would facilitate the process of clearance and settlement, while still achieving the goals of short sale regulation.

Q. Are the delivery requirements in proposed Rule 203(a) appropriate?

III. Current Market Structure and the Tick Test

The tick test was part of short sale regulation implemented in 1938. The tick test has provided the markets with a generally effective means of regulating short sales for more than 60 years. Nonetheless, arguments have been made to allow greater flexibility in short selling. Indeed, substantial economic arguments have been made that short selling should be deregulated, at least in the case of the tick test.[60] Some

[58] *See, infra* part IX for a further discussion of the proposed order marking requirements.

[59] This exception shall not apply where a broker-dealer knows or has reason to know that an order is incorrectly marked long. Knowledge may be inferred where a broker-dealer repeatedly accepts orders marked long from the same customer that requires borrowed shares for delivery or results in a ''fail to deliver'' on several occasions.

[60] *See, e.g.*, Albert, Smaby, and Robison, 1997, *Short Selling and Trading Abuses on Nasdaq,* Financial Services Review, 6(1), 27–39; Alexander and Peterson, 1999, *Short Selling and the New York Stock Exchange and the Effects of the Uptick Rule,* Journal of Financial Intermediation, 8, 90–116; Alexander and Peterson, 2002, *Implications of a Reduction in Tick Size on Short-Sale Order Execution,* Journal of Financial Intermediation, 11, 37–60; Angel, 1997, *Short Selling on the NYSE,* working paper, Georgetown University; Jones, 2002, *Shorting Restrictions, Liquidity, and Returns,* working paper, Columbia University; Lamont, Owen A., 2003, *Go Down Fighting: Short Sellers* vs. *Firms,* working paper, University of Chicago and NBER.

commenters to the Concept Release took that position.[61] A substantial number of other commenters disagreed and expressed support for a price test.[62] We do not believe that proposing complete rescission of the short sale price test would be appropriate at this time, although we request comment about that approach. Instead, we propose a new, uniform price test that would apply to today's markets, and a pilot that would permit us to gather data about trading activity in the absence of a short sale price restriction.

IV. Proposed Bid Test

Current short sale regulation applies different price tests to securities trading in different markets. Rule 10a–1 applies only to short sale transactions in securities listed on a national securities exchange, whether the transaction is effected on an exchange or otherwise. The NASD's bid test applies to short sale transactions in Nasdaq NMS securities effected on either SuperMontage or the NASD's Alternative Display Facility (ADF), but not to Nasdaq SmallCap, OTCBB, and other securities traded over-the-counter. Moreover, no short sale price test applies to short sales of Nasdaq NMS securities executed away from SuperMontage and the ADF, unless the market on which the securities are being traded has adopted its own price test.[63] The end result is disparate short sale regulation of Nasdaq securities, depending on the market where the securities are trading. This situation may lend itself to regulatory arbitrage.[64]

We note that Nasdaq has also applied to become a national securities exchange.[65] If Nasdaq becomes an exchange, Rule 10a–1 would apply to Nasdaq securities because they would be exchange-listed securities reported pursuant to an ''effective transaction reporting plan.'' Nasdaq has applied for relief from Rule 10a–1 in conjuction with the exchange registration.[66] The Commission has not yet acted upon the application. If the Commission were to grant an exemption from Rule 10a–1 to allow Nasdaq to apply Rule 3350 to Nasdaq exchange-listed securities, the same securities quoted and traded on Nasdaq and other exchanges would be subject to two different short sale rules. This has the potential for confusion and compliance difficulties. We believe that these considerations, along with the other market developments discussed previously, make this an appropriate time to propose amendments that would provide for a more consistent approach to short sale regulation.

A. Operation of the Uniform Bid Test

The current tick test uses the last trade price in a security as a reference point for determining permissible short sale prices under Rule 10a–1. The effectiveness of this test for exchange-listed securities depends on the centralized auction nature of most exchanges and the historical concentration on exchanges of transactions in exchange-listed securities, which helps produce a consistent sequence of trade reports. In 2002, for example, the NYSE accounted for 87.9% of share volume in NYSE listed equities.[67]

The tick test, however, may not be as effective a means of regulating dealer markets. Nasdaq, in contrast to the auction markets, has no single market center that concentrates trading in Nasdaq securities. During regular trading hours, order flow in Nasdaq securities is divided among many different market makers, ECNs, and regional exchanges.[68] Trade reporting for Nasdaq securities involves multiple market makers reporting trades in the same stock from different locations using different means of reporting. Although trades are required to be reported within 90 seconds after execution, they are published in reporting sequence, not trade sequence.[69] This reporting may create upticks and downticks that may not accurately reflect price movements in the security for the purposes of the tick test. To a lesser degree, this phenomenon occurs in exchange-listed securities that are traded in multiple venues.

We are proposing Rule 201 of Regulation SHO, which would replace Rule 10a–1's tick test with a test using the consolidated best bid as the reference point for permissible short sales. Specifically, subparagraph (b) of proposed Rule 201 would require that all short sales in exchange-listed and Nasdaq NMS securities, wherever traded, be effected at a price at least one cent above the consolidated best bid at the time of execution.[70] A bid test would apply a uniform rule to trades in the same securities that occur in multiple, dispersed, and diverse markets. Moreover, a bid test would provide greater flexibility in effecting short sales in a decimals environment, as discussed below. Finally, a bid test would better accommodate increasingly popular automated trading systems that utilize passive pricing and trading systems that offer price improvement based on the consolidated best bid and offer.[71]

The proposed bid test in Rule 201 would require that a short sale be effected at a price at least one cent above the best consolidated bid at the

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[61] *See, e.g.*, letters from The Chicago Board Options Exchange (32), Cornerstone Securities Corporation (324), Electronic Traders Association (ETA) (327), Interactive Brokers; The Timber Hill Group (329), Island ECN (Island) (431), Managed Funds Association (MFA) (427), Charles Schwab (Schwab) (310), Sierra Trading Group, L.P. (39), Trimark Securities (330).

[62] *See, e.g.*, letters from the NASD (480), NYSE (467), Sherman and Sterling (424), North American Securities Administrators Association (NASAA)(321), Specialist Association (426).

[63] Transactions in these securities are not subject to short sale regulation under Rule 10a–1. *See* Securities Exchange Act Release No. 22975 (March 6, 1986), 51 FR 8801 (March 14, 1986) (the Commission adopted amendments to Exchange Act Rule 10a–1 to exclude from application of the rule transactions in NMS securities that are traded on an exchange on a listed or unlisted trading privileges basis).

[64] The Commission recently issued a Concept Release seeking comment on this and other issues presented in a petition submitted by Nasdaq. Securities Exchange Act Release No. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003).

[65] *See* Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001).

[66] *See* Letter to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and Chief Legal Officer, NASD (August 7, 2000).

[67] *See* 2002 NYSE Annual Report.

[68] For example, in May 2003, there were an average of 73 market makers per issue in the top 1% of Nasdaq stocks by trading volume, 40.5 market makers per issue in the next 9% of stocks, and an overall average of 15.4 market makers per issue. The majority of Nasdaq trading occurs primarily at dealer market centers. The agency markets operated by the seven ECNs in May 2003 accounted for 23.3% of Nasdaq share volume. In addition, the Archipelago Exchange and the Cincinnati Stock Exchange each account for 12.8% of the Nasdaq Share Volume for a total of 25.6% of Nasdaq Share Volume. *See www.marketdata.nasdaq.com*.

[69] NASD Rule 4632, Transaction Reporting, requires market makers to transmit through the Automated Confirmation Transaction Service or ''ACT'' all last sale reports of transactions in designated securities executed during normal market hours within 90 seconds after execution. *See* NASD Rule 4632 (NMS securities) and Rule 4642 (Nasdaq SmallCap securities), and Rule 6420 (exchange-listed securities).

[70] To address the problem of locked and crossed markets, we have proposed an exception from the proposed bid test allowing a responsible broker or dealer, as defined in 17 CFR 240.11Ac1–1(a)(21), to effect a short sale at a price equal to the consolidated best offer when the market for the covered security is locked or crossed, provided however, that the exception shall not apply to any broker or dealer who initiated the locked or crossed market. *See, infra* Part VI.A.7 for a further discussion of this exception.

[71] Passive pricing systems often effect trades at an independently-derived price, such as the midpoint of the bid-offer spread. Such pricing would often not satisfy the current tick test. However, midpoint pricing would generally satisfy a test requiring a short sale to be priced above the current best bid. We generally do not believe that such passive pricing systems present significant opportunities for short selling abuse. *See infra*, part IV.D, for a further discussion of passive pricing.

time of execution.[72] This would be a significant change from the current tick test, which is based on last sale prices. The bid test also would operate differently from the current rule for Nasdaq securities. NASD's Rule 3350 prohibits NASD members from effecting short sales in NMS securities at or below the best bid when the best bid displayed is below the preceding best bid in a security. However, if there is an ''upbid'' in a security, *i.e.*, the best bid displayed is above the preceding best bid, there is no restriction on the price that a NASD member can sell an NMS security short.[73]

Under the proposed uniform bid test, the price at which a short sale could be effected would move contemporaneously with the movement of the consolidated best bid.[74] In contrast, compliance with the current short sale price tests require a comparison of the previous last sale in relation to the most recent last sale in listed securities or a comparison of the current bid with the previous bid for Nasdaq securities.

We recognize that a quotation only proposes a transaction, whereas the last trade price reflects an actual trade. However, pursuant to Commission and SRO rules, quotations for all covered securities must be firm. Further, we believe that bids generally are a more accurate reflection of current prices for a security because last trade prices can be reported out-of-sequence within a 90 second window.

We believe the proposed bid test would promote the fundamental goals of short sale regulation. First, the proposed bid test would facilitate relatively unrestricted short selling in an advancing market, because the short selling reference price would move with the current interest of the market.

The proposed bid test also is designed to achieve the second and third objectives of the short sale rule, preventing short selling at successively lower prices and preventing short sellers from accelerating a decline in the market by exhausting all remaining bids at one price level. One of the negative uses of short selling is attempting to establish lower transaction prices in a security, hoping to induce others to liquidate their positions and lower prices further.[75] A short seller may attempt to accomplish this by exhausting higher priced bids in a security, thus creating the appearance of a declining market.[76] Barring short sales at prices equal to or below the consolidated best bid would prevent short sellers from exhausting the bids in a security and thus prevent short sellers from inducing a price decline. Since only long sellers could sell at the consolidated best bid, it is unlikely that short sellers could directly cause short selling at successively lower prices.[77]

While we believe the uniform bid test is the most flexible approach to modernizing the short sale rule while continuing to promote the goals of short sale regulation, we understand that some market participants may desire an even greater range of prices at which to effect short sales. One alternative would be a bid test allowing short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (*i.e.*, an upbid). However, in this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid (not equal to the best bid) if the current best bid is below the previous bid (*i.e.*, a downbid).[78] This alternative test would apply to the same securities as our uniform bid test.[79] While we are not proposing this alternative test as part of Regulation SHO, we seek comment on this test as another possible approach to regulating short sales.

We are aware that these proposals represent significant changes in the operation of Rule 10a–1. We request comment about the appropriateness of the proposed bid test and the alternative bid test.

Q. Should short sales continue to be limited by a price test? If the Commission did not adopt a price test under Regulation SHO, should it also preclude the ability of the SROs to have price tests?

Q. Would there be any benefits in eliminating a short sale price test? Would the elimination of a price test benefit the markets by allowing investors to more freely short sell potentially overvalued securities so that their price more accurately reflects their fundamental value? Are there other benefits to the removal of a price test, such as elimination of systems and surveillance costs?

Q. Would the proposed ''bid test'' in Rule 201, allowing short sales above the best consolidated bid, effectively prevent short selling being used as a tool for driving the market down?

Q. Would short sale regulation using the proposed bid test operate effectively in an auction market? If not, why not?

Q. Would short sale regulation using the proposed bid test operate effectively in a dealer market? If not, why not?

Q. Would there ever be a circumstance where there would not be a consolidated bid in an exchange-listed or Nasdaq NMS security? If so, please describe.

Q. The proposed bid test likely would inhibit short sales in a declining market because there would be few execution opportunities above the best bid. Is this appropriate?

Q. Is a one-cent increment an appropriate standard for allowing short sales above the best consolidated bid? If not, what is an appropriate increment?

Q. Would short sale regulation using the proposed bid test present any automated systems problems for market participants?

Q. Would the proposed bid test operate effectively in the current decimal environment, *i.e.*, would bid flickering inhibit the operation of the test?

[72] As stated in the Commission's approval of Nasdaq's penny short sale pilot, a $0.01 increment for a short sale price test is a reasonable increment in a decimals environment. *See* Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 8, 2001). However, the Commission may revisit this requirement upon the completion of its analysis of statistical data relating to quoting and trading activity in a decimals environment.

[73] Should the Commission adopt changes to existing short sale regulations, the SROs would need to update their rules to reflect our modifications.

[74] Under the proposed bid test, if the best bid in a security is $47.00, short selling would be allowed at $47.01 or higher, regardless of whether the immediately preceding bid was $46.99 or $47.01 (*i.e.*, it does not matter whether the current bid is an upbid or downbid from the immediately preceding bid). Also, if the best bid in a security is $47.00, and the last trade price in the security was $47.05, short selling would be allowed at $47.01 or higher (*i.e.*, the last sale price is irrelevant).

[75] *See* Securities Exchange Act Release No. 10668 (March 6, 1974), 39 FR 10604 (March 21, 1974).

[76] *Id.*

[77] The Commission would view activity by market participants to alter the consolidated best bid solely for the purpose of facilitating short sales as a violation of proposed Regulation SHO, as well as potentially the anti-fraud and anti-manipulation provisions of the federal securities laws, including Sections 9(a), 10(b), and 15(c) of the Exchange Act, and Rules 10b–5 and 15c1–2 thereunder. For example, a broker-dealer may attempt to circumvent the rule by entering into an arrangement with a customer in which the customer would sell short to the dealer one cent above the bid, and the dealer would charge a higher commission to cover the price. The dealer would then sell ''long'' at the bid. An example of this is as follows: Assume that the best bid is $20.35. A broker-dealer could arrange with a customer to execute a short sale at $20.36, and include a mark-up or commission of 6 cents. The net to the customer would thus be $20.30. The broker-dealer could then sell long into the bid at $20.35, thus earning a profit on the transaction. Not only may such activity violate reporting rules (*see* NASD Rule 6130(d)(3)), such activity could be viewed as fraudulent and/or manipulative by the Commission.

[78] The following example demonstrates the operation of this alternative uniform short sale rule: If the consolidated best bid in a security is $47.00, and the immediately preceding bid was $46.99, short selling would be allowed at $47.00 or higher. If the consolidated best bid in a security is $47.00, and the immediately preceding bid was $47.01, short selling would only be allowed at $47.01 or higher.

[79] We note that, unlike the proposed bid test, this alternative test would incorporate the preceding bid into the calculation of the price at which a short sale could be executed. This would add a layer of complexity to the rule and could impose additional programming costs.

Q. Would the proposed bid test fulfill the fundamental goals of short sale regulation?

Q. Would the alternative test allowing short selling at a price equal to or above the consolidated best bid if it is an upbid better fulfill the goals of short sale regulation?

B. Scope of the Uniform Bid Test

1. Securities Subject to the Price Test

The proposed bid test would apply to all securities currently subject to short sale price tests, *i.e.*, exchange-listed and Nasdaq NMS securities, wherever they are traded. Specifically, the proposed bid test would apply to all national market system securities as defined in § 240.11Aa2–1 of this chapter, but shall exclude Nasdaq Small Cap securities, as determined by NASD rules.

Market information for securities, including quotes, is disseminated pursuant to a variety of different national market system plans. Generally, the SROs have developed networks or systems that disseminate market information.[80] The NYSE, Amex, Nasdaq, and the regional exchanges are all required to make available to vendors the best bids in any common stock, long-term warrant, or preferred stock.[81] This information is disseminated as a part of an effective transaction reporting plan pursuant to the Consolidated Tape Association Plan (CTA Plan) and the Consolidated Quotation Plan (CQ Plan). The NYSE, Amex, Nasdaq, and the regional exchanges all participate in the CTA Plan and CQ Plan.[82] Finally, Nasdaq disseminates market information for securities in the two tiers of the Nasdaq market, *i.e.*, NMS and SmallCap stocks, as well as certain other securities traded OTC. Information for NMS securities is collected and disseminated pursuant to NASD's rules and the Nasdaq/UTP plan.[83]

These networks are designed to ensure that consolidated bids from the various market centers that trade exchange-listed and Nasdaq NMS securities are continually collected and disseminated on a real-time basis, in a single stream of information. Thus, all market participants would have access to the consolidated bids for all the securities that would be subject to the proposed uniform bid test.

2. Securities Not Subject to the Price Test

We are not proposing at this time to extend the uniform bid test to securities not currently covered by a short sale price test (*i.e.*, Nasdaq SmallCap, OTCBB, and Pink Sheet securities) in part because these markets have not been subject to the rule in the past. More significantly, we believe that the proposed locate and deliver requirements may address many of the concerns regarding abusive short selling in thinly-capitalized securities trading over-the-counter. In particular, these proposals should significantly discourage efforts to deliberately depress the price of these securities by removing the leverage abusive short sellers enjoy through short selling without incurring the costs of borrowing and delivering. We recognize, however, that issuers of less actively traded securities believe that they are particularly vulnerable to ''abusive'' short selling, and we seek specific comment on whether the proposed bid test or other price test should be extended to these securities.

Q. Should the proposed uniform bid test be extended to Nasdaq SmallCap and OTCBB Securities? Do these securities need the protection of the proposed uniform bid test?

Q. Should the proposed uniform bid test be extended to other OTC securities, *e.g.*, those quoted in the Pink Sheets? If so, are quotes in these securities disseminated in a manner that would allow for the use of the proposed uniform bid test? In addition, would the proposed bid test be workable due to the fact that the best bid in these securities could be outstanding for long periods of time? If not, could a last sale test or some other test be applied to these securities?

C. Bid Test Flexibility in a Decimals Environment

The Commission is aware of concerns about the ability to effect short sales using the tick test in a decimals environment. In particular, with the increase in the number of price points from 16 to 100 per dollar as a result of pricing in decimals, there has been an increase in price flickering, *i.e.*, an increase in the number of times the last trade price in a security changes rapidly.

As a result market participants have sought relief from the tick test provisions of Rule 10a–1. For example, some third market makers in exchange-listed securities offer trade execution for eligible customer orders at a price equal to or better than the consolidated best offer. However, if the consolidated best offer is below the previous last reported sale in a security and the third market maker or specialist has a short position, sales at the consolidated best offer would violate the tick test of Rule 10a–1. The Commission has granted an exemption from Rule 10a–1 to permit registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit orders at the consolidated best offer, regardless of the last trade price.[84] The exemption provided relief in a decimals environment to market makers and specialists in instances where they would be providing liquidity in response to customer buy orders. Such relief would not be necessary with a bid test, since such sales (by any market participant) would always be effectuated above the best bid, specifically at the consolidated best offer or better.

Permitting short sales above the best bid should alleviate other difficulties complying with the tick test in a decimals environment. The Commission's Office of Economic Analysis (OEA) conducted a study that found that the proposed bid test is considerably less restrictive than the current tick test.[85] Specifically, OEA

[80] In relevant part, these networks can be categorized as follows: (1) Network A—securities listed on the NYSE; (2) Network B—securities listed on Amex or the regional exchanges; and (3) Nasdaq system—securities qualified for inclusion in the Nasdaq system and certain other securities traded in the OTC market.

[81] *See* Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1; Exchange Act Rule 11Ac1–4, 17 CFR 240.11Ac1–4.

[82] CTA Plan, Sections I(q) and VII(a)(i) for NYSE securities (Network A), CTA Plan, Sections I(q) and VII(a) for Amex and the regional exchanges (Network B). These plans were adopted pursuant to Rule 11Aa3–1, 17 CFR 240.11Aa3–1, which governs the dissemination of transaction reports and last trade price information in national market system securities (equity securities listed on national securities exchanges or included in the national market tier of Nasdaq). In general, this rule requires an SRO to file a transaction reporting plan for such securities, and it requires SRO members to transmit information required by the plans to the SROs.

[83] See Securities Exchange Act Release No. 42208 (December 9, 1999) 64 FR 70613 (December 17, 1999) (concept release requesting comment on the regulation of market information fees and revenues).

[84] *See* Letter re: Bernard L. Madoff Investment Securities LLC (February 9, 2001) (exemption from Rule 10a–1 to allowing registered market makers and specialists to sell short to facilitate customer market and marketable limit orders at the consolidated best offer regardless of the last trade price). All such short sales effected pursuant to the exemption are required to be reported as ''sell short exempt.'' This relief is strictly limited to the facilitation of customer market and marketable limit orders and is not available as a means of soliciting customer orders. Moreover, the exemption letter notes that whether an execution at the consolidated best offer constitutes best execution of a customer's trade will depend on all the facts and circumstances.

[85] The study was conducted using stocks listed on the NYSE during the month of July, 2003. The study did not examine the proposed bid test relative to the current Nasdaq bid test. The study is available in the Commission's Public Reference Room. *See also* Alexander and Peterson, 1999, *Short Selling on the New York Stock Exchange and the Effects of the Uptick Rule,* Journal of Financial Intermediation (a study of, among other things, short selling opportunities under the current tick test in a declining market).

compared the minimum shortable price (MSP) using the proposed bid test and the current tick test. Under the proposed bid test, the MSP is always a minimum increment above the bid. Under the tick test, if the last transaction was on an uptick or zero-plus uptick, the MSP is equal to the latest transaction price. If the latest transaction price was on a minus tick or a zero-minus tick, the MSP is equal to the latest transaction price plus one tick.[86] OEA found that the tick test was more restrictive (the MSP was higher for the tick test than it was for the proposed bid test) 60.4% of the time, the proposed bid test and tick test were equally restrictive (the MSP for the tick test and the proposed bid test were the same) 15.5% of the time, and the proposed bid test was more restrictive (the MSP was at or below the bid) 24.1% of the time. As this study indicates, the proposed bid test should offer more short selling opportunities than the current tick test.

D. Bid Test Flexibility for Passive Pricing Systems

We have granted limited exemptive relief from the tick test provisions of Rule 10a–1 in connection with short sale transactions executed on a volume-weighted average price (VWAP) basis.[87] The relief is limited to VWAP transactions that are arranged or ''matched'' before the market opens at 9:30 a.m. but are not assigned a price until after the close of trading when the VWAP value is calculated.[88] We granted the exemption based, in part, on the fact that these VWAP short sale transactions appear to pose little risk of facilitating the type of market effects that Rule 10a–1 was designed to prevent. In particular, the pre-opening VWAP short sale transactions do not participate in or affect the determination of the VWAP for a particular security. Moreover, the Commission stated that all trades used to calculate the day's VWAP would continue to be subject to Rule 10a–1.[89]

There are also electronic trading systems that match and execute trades at other independently-derived prices, such as the midpoint of the consolidated best bid and offer. Limited short sale relief has been granted to certain systems that match customer orders at random times within specific time intervals.[90] These systems had requested relief from Rule 10a–1 because matches could potentially occur at a price below the last reported sale price. Due to the passive nature of pricing and the lack of price discovery, trades executed through the systems generally do not appear to involve the types of abuses that 10a–1 was designed to prevent.[91]

We believe that the proposed bid test would accommodate the recent growth of matching systems that execute trades at an independently derived price above the consolidated best bid. Such executions would generally comply with the proposed bid test, while also enabling customer orders to seek executions that would provide price, and possibly size, improvement.

We note, however, that there may be instances where the final execution price of VWAP short sale transactions could be at or below the closing best bid for that security, and thus would violate the proposed bid test. Nevertheless, we propose codifying an exception to the bid test provisions of proposed Rule 201 to permit short sales at the VWAP, subject to the same conditions included in the above exemptions.[92] These would be the following: (1) All short sale orders will be received and matched before the regular trading session opens and the execution price of VWAP matched trades will be determined after the close of the regular trading session; (2) the VWAP for the covered security is calculated by: calculating the values for every regular way trade reported in the consolidated system, or on a primary market that accounts for 75% or more of the covered security's average daily trading volume for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (3) the transactions are reported using a special VWAP trade modifier; (4) short sales used to calculate the VWAP will themselves be subject to the bid test; (5) the VWAP matched security qualifies as an ''actively-traded security'' (as defined under Rules 101(c)(1) and 102(d)(1) of Regulation M).[93] Where the subject listed security is not an ''actively-traded security'' or a S&P 500 Index security, the proposed short sale transaction would be permitted only if it is conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (6) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; (7) a broker or dealer shall be permitted to act as principal on the contra-side to fill customer short sale orders only if the broker or dealer's position in the subject security, as committed by the broker-dealer during the pre-opening period of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the subject security's relevant average daily trading volume, as defined in Regulation M.[94] Any VWAP short sale transaction that does not meet these conditions would need to comply with the bid test. In addition, all other provisions of Regulation SHO, including the marking requirements in Rule 201 and the locate and deliver requirements in Rule 203, would apply. We request comment on whether the proposed exception for VWAP executions, subject to these conditions, is appropriate.

[86] In OEA's analysis, if the tick test MSP was greater than the MSP from the proposed bid test, then the tick test was more restrictive than the proposed bid test because the bid test allows lower execution prices, and, of course, the converse conclusion would be reached if the opposite was true.

[87] *See e.g.* Letter re: VWAP Trading System (March 24, 1999); Letter re: Jeffries and Company, Inc. (Jeffco) (December 7, 2000); Letter re: POSIT (March 30, 2001); Letter re: Morgan, Stanley & Co., Inc. (May 11, 2001); Letter re: Vie Institutional Services (February 12, 2003).

[88] The VWAP for each security is generally determined by: (1) Calculating raw values for regular session trades reported by the Consolidated Tape during the regular trading day by multiplying each such price by the total number of shares traded at that price; (2) compiling an aggregate sum by adding each calculated raw value from step one above; and (3) dividing the aggregate sum by the total number of reported shares for that day in the security. *See, e.g.*, Letter re: POSIT (March 30, 2001).

[89] The relief is subject to a number of conditions, including: limiting it to only those securities which would qualify as ''actively-traded securities'' as defined in Regulation M (unless the security is part of a ''basket'') 17 CFR 242.100; that there be no pre-arranged matching sale and purchase orders; a 10% average daily volume limitation when acting as principal on the contra-side of a VWAP short sale transaction; and that no transactions are made for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security. *See, supra* n. 87.

[90] *See e.g.* Letter re: POSIT (April 23, 2003).

[91] The relief was also conditioned on the fact that none of the persons relying on the exemption would be represented in, or otherwise influence the primary market bid or offer, and that none of the transactions effected on the electronic system would be made for the purpose of depressing or manipulating the price of the security. *Id.*

[92] We believe that these conditions have worked well in restricting the exemptive relief to situations that do not appear to raise the abuses that the short sale price test is designed to prevent, and should be incorporated in the proposed exception. We also note that market participants that have been granted these exceptions have designed their programming and surveillance systems in accordance with these conditions.

[93] At this time, securities that qualify as ''actively traded securities'' under Rule 101 of Regulation M and securities that comprise the S&P 500 index would qualify as ''actively traded securities'' for purposes of this exception.

[94] 17 CFR 242.100(b).

Q. Do VWAP transactions create perverse incentives for broker-dealers, such that they should not be granted an exception? If an exception is included, are there ways to detect and limit the effects of these perverse incentives?

Q. Are the proposed conditions for the VWAP exception appropriate? If not, why not? Should there be any additional conditions?

V. Pilot Program

As a part of the Commission's review of short sale regulation, we are also proposing temporary Rule 202 of Regulation SHO that would suspend, on a pilot basis, the operation of the proposed bid test of proposed Rule 201 for specified liquid securities. We believe that the pilot is appropriate for several reasons. The pilot would enable us to study the effects of relatively unrestricted short selling on, among other things, market volatility, price efficiency, and liquidity. This would thus allow us to obtain empirical data to assess whether short sale regulation should be removed, in part or in whole, for actively traded securities. The pilot would also allow the Commission to determine the extent to which the proposed bid test achieves the three objectives of short sale regulation through the comparison of trading activity of similar stocks subject to the test and those not subject to the test.

In 1976 the Commission proposed a suspension of the tick test as a part of a comprehensive review of short sale regulation that was designed to obtain statistical data regarding short selling.[95] The pilot was never implemented due to concerns expressed by trading markets and listed companies.[96] However, there have been significant developments in market surveillance since 1976 that now make a pilot more appropriate. Further, the Commission and SROs now have access to a wide range of trading data on potentially manipulative trading behavior.[97] Access to this information greatly enhances the ability of the Commission and the SROs to monitor trading behavior during the proposed suspension of the bid test and surveil for manipulative short selling.

We also believe that a pilot may be appropriate in light of the Commodity Futures Modernization Act of 2000 (CFMA) lifting the ban on security futures.[98] Among other things, investors are now allowed to enter into futures contracts for the sale of individual securities at a fixed point in the future and at a set price. In authorizing single stock futures trading, Congress exempted transactions in security futures products from short sale regulation. Short security futures, *i.e.*, obligating a person to make a future delivery of the underlying securities, may function as a substitute for short selling the underlying stock.[99] We believe that to the extent possible, consistent with investor protection, one market should not benefit over another because of regulatory differences. Thus, we intend to include liquid securities subject to futures trading in our proposed pilot.

As a result, we believe it is appropriate to propose a rule that would establish procedures for a temporary suspension of the trading restrictions of the price test of the Commission's short sale rule, and any short sale price test of any exchange or national securities association, for a limited number of securities. The securities that could be included in the pilot could be comprised of a subset of the Russell 1000 index, or such other securities as the Commission designates by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving due consideration to the security's liquidity, volatility, market depth and trading market. The relative weight given to these factors would vary. In particular, the Commission would consider including in the pilot one-third of the securities in the Russell 1000 Index.[100] To select the stocks for the pilot if we were to use the Russell 1000, we would sort the Russell 1000 by average daily dollar volume over the calendar year prior to the start of the pilot and use an objective method that would create two samples that should be approximately similar in average market value and average volume.[101] Of course, as noted above, the Commission might include different stocks in the pilot or base the pilot on a different broad-based index if it were necessary or appropriate in the public interest and consistent with the protection of investors.

While we recognize that the price of any security can be manipulated, we believe that as trading volume increases, it becomes less likely that a trader would be able to cost-effectively

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[95] *See* Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530. We proposed three alternative temporary rules that would have suspended the tick test to varying degrees in order for critical data to be collected. The three alternative temporary rules would have: (1) Suspended the operation of the short sale rule for all securities registered, or admitted to unlisted trading privileges on a national securities exchange; (2) suspended the operation of the tick test only for equity securities (other than warrants, rights, or options) that are registered, or admitted to unlisted trading privileges, on more than one national securities exchange and for which transactions were reported in the consolidated system; and (3) suspended the operation of the tick test only for the fifty most active equity securities (other than warrants, rights, or options) during the 12 calendar months preceding the effective date of the rule. However, the Commission withdrew this and other short sale rule proposals largely because commenters did not support the changes. Securities Exchange Act Release No. 17347 (December 1, 1980), 45 FR 80834 (December 8, 1980).

[96] One commenter expressed concern that removal of the tick test might accelerate market declines and increase volatility as well as create distortions in the market for secondary or tertiary stocks. *See* Letter from James E. Buck, Secretary, NYSE, to George A. Fitzsimmons, Secretary, SEC (March 17, 1977). Another commenter stated that the tick test should be retained to prevent manipulative short selling even though some arguments could be made that short selling helps adjust markets to their proper levels more quickly. The commenter stated that it was beneficial to retain Rule 10a–1 until such time a rule could be devised that distinguished between manipulative and non-manipulative short sales. *See* Letter from Frank A. Hutson, Jr., Chairman, Securities Law Committee, American Society of Corporate Secretaries, Inc., to George A. Fitzsimmons, Secretary, SEC (May 3, 1977).

[97] For example, the NYSE has since implemented both on-line and off-line automated surveillance capability, and monitors trading on both a real-time and next day basis. Further, the NYSE also utilizes an audit trail through its Intermarket Surveillance Information System (ISIS) data base. Securities Exchange Act Release No. 22183 (June 28, 1985) 50 FR 27875 (July 8, 1985). Further, NYSE adopted a rule requiring all transactions in NYSE-listed stocks that are not reported to the Consolidated Tape to be reported to the Exchange in order to provide an accurate record of overall trading activity. In its filing with the Commission, NYSE stated that the information obtained pursuant to the rule will ''augment and enhance its ability to surveil for and investigate, among other matters, insider trading, frontrunning, and manipulative activities, * * *'' Securities Exchange Act Release No. 31358 (October 26, 1992) 57 FR 49736 (November 3, 1992) (order approving NYSE Rule 410B).

[98] Pub. L. 106–554, 114 Stat. 2763 (2000). Futures involving single stocks are generally defined as futures contracts (or options thereon) on single non-exempt securities and narrow based groups or indices of non-exempt securities.

[99] We note that the CFMA exception was a departure from traditional short sale regulation, which is security-based rather than market-based (*i.e.*, the tick test applies to a security irrespective of the market in which the short sale occurs.)

[100] The Russell 1000 Index comprises the 1,000 largest companies in the Russell 3000 Index (approximately 92% of the total market capitalization of the Russell 3000 Index). Inclusion in the Russell 1000 index is based completely on objective criteria, *i.e.*, market capitalization. A pilot containing stocks from the Russell 1000 index would allow us to analyze the effects of removing price restrictions on a broad range of liquid securities. A narrower index of liquid securities might not provide the breadth of information necessary to make an accurate determination of these effects. Conversely, broader indexes may contain certain securities that could be considered less liquid, which may not be appropriate for a pilot that focuses on short selling in liquid securities.

[101] In addition, both samples should also contain Nasdaq and NYSE stocks, optionable stocks, stocks with associated security futures, and both value and growth stocks. We hope that both samples would have similar average short interest and similar expected volatility. Even if the two samples differ slightly along these dimensions, researchers can control for the variations using regression techniques.

manipulate the price of a security.[102] Further, the high levels of transparency and surveillance for actively-traded securities on exchanges and other regulated markets make it more likely that any manipulation would be detected and pursued.[103]

The proposed temporary Rule 202 would remain in effect for two years. We anticipate that a partial, two-year suspension of the short sale rule would allow the Commission to gather and analyze the data necessary to reach conclusions regarding trading behavior in the absence of short sale price restrictions. The sample period should provide data on advancing and declining markets, high volume and low volume, and different stages of volatility so that the suspension can be studied fully.[104]

The Commission notes that the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to apply to trading activity in these securities, thus prohibiting trading activity designed to improperly influence the price of a security.[105] Further, the pilot would only suspend the operation of the proposed bid test. All other provisions of proposed Regulation SHO, including the marking requirements of Rule 201 and the locate and deliver requirements of Rule 203, would continue in effect. Finally, the Commission could terminate the operation of the pilot, in whole or in part, prior to the end of the proposed two-year period as it determines necessary or appropriate in the public interest or to protect investors by removing all securities selected for inclusion in the pilot.

Q. Is the proposed rule temporarily suspending the short sale price test for liquid stocks appropriate? Are liquid stocks more difficult to manipulate through short selling?

Q. Is a two-year temporary suspension of the short sale price test a sufficient period to fully study the impact? If not, what time period should be selected? Commenters should provide specific reasons to support their view in favor of establishing another time period.

Q. Is the proposed selection method for the pilot, including our contemplated use of the Russell 1000, appropriate? If not, what other selection method should be considered? Is it possible that one market could benefit over another market depending on the selection of stocks for the pilot?

Q. Should the short sale price test be automatically reinstituted in extraordinary market conditions, for instance, if, on an intraday basis, the price of a security falls more than a certain percentage based on the day's opening price (*e.g.*, if the price of a security falls 10% from the day's opening price short sale restrictions would be reinstituted)?

Q. The pilot, in part, would allow the Commission to obtain data to assess whether the price test should be removed for some types of securities and to study trading behavior in the absence of the proposed bid test. After analyzing the results of the pilot, the Commission may propose that the bid test be removed for certain exchange-listed and NMS securities. Should the Commission await the results of the pilot before applying the uniform bid test to exchange-listed and Nasdaq NMS securities that may later have the bid test removed?

Q. Should the pilot apply to existing short sale rules even if we do not adopt the new uniform bid test?

Q. The securities included in the pilot would still be marked and specialists and market makers can observe this mark prior to executing the short sale. How would this affect the outcome and reliability of the pilot, if at all?

VI. Rule 10a–1 Exceptions

Paragraph (e) of Rule 10a–1 currently contains 13 exceptions to the tick test designed to permit certain types of trading activities that were intended to benefit the markets or that were believed to carry little risk of the kind of manipulative or destabilizing trading that the Rule was designed to address. We have reviewed these exceptions in light of proposed Rule 201, and we propose modifying some exceptions for inclusion in Rule 201 and excluding other exceptions from the Rule.

A. Exceptions Proposed To Be Retained

1. Long Seller's Delay in Delivery

Subsection (e)(1) of Rule 10a–1 has existed since the inception of the short sale rule in 1938. This exception allows short sales to be effected without regard to the current tick test if the seller owns the security sold and intends to deliver such security as soon as is possible without undue inconvenience or expense. It was created so that sellers who actually own a security will not be penalized in the event they are unable to deliver the security to their broker prior to settlement, despite every intention of doing so, or in the event the certificate turned in by the seller is not in a form appropriate for transferring.

In the event that the seller's shares are not delivered to the broker-dealer prior to settlement, borrowed shares may be used to consummate the sale. By definition, when borrowed shares are delivered, the sale is a short sale. We believe that this exception continues to be necessary to facilitate those limited circumstances where the seller owned the securities at the time of sale, however delivery may be briefly delayed, as when an option, right or warrant has been exercised but the underlying security has not yet been received by the seller. We propose to retain this exception from the proposed bid test substantially unchanged.[106]

Q. Should this exception be retained in its current form?

Q. Is this exception outdated?

2. Error in Marking a Short Sale

Subsection (e)(2) of Rule 10a–1 has also existed since the inception of the Rule. This exception protects brokers in the event they execute a sale already marked long by another broker-dealer, but the sale turns out to be a short sale. The broker-dealer that marks the order long must abide by the provisions of the marking requirement that dictates when an order may be marked long and the executing broker-dealer may rely on this marking when executing the sell order. This exemption was created to avoid implicating a broker that has unknowingly participated in a violation of the Rule, and we believe the basis for including the exception still makes sense in the current environment.[107] We propose to retain this exception substantially unchanged.[108]

Q. Should this exception be retained in its current form?

3. Odd Lot Transactions

An exception for certain odd-lot transactions was created in an effort to reduce the burden and inconvenience that short sale restrictions would place on odd-lot transactions. In 1938, the Commission found that odd-lot transactions played a very minor role in potential manipulation by short selling. Initially, sales of odd-lots were not subject to the restrictions of Rule 10a–1.[109] However, the Commission became

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[102] *See* Securities Exchange Act Release No. 37094 (April 11, 1996), 61 FR 17108 (April 18, 1996) (proposing anti-manipulation rules including an exception to the rules for trading activity in high ADTV securities).

[103] *Id.*

[104] The Commission would study data from the pilot to determine the effect that the removal of the proposed bid test has on trading in the pilot securities. By the end of the two year period, we would consider extending the pilot in light of trading data and whether to pursue rulemaking to permanently remove the proposed bid test for a segment of securities.

[105] *See, e.g.*, Securities Act Section 17(a), Exchange Act Sections 9(a), 10(b), and 15(c) and Rules 10b–5 and 15c1–2 thereunder.

[106] *See* subparagraph (d)(1) of proposed Rule 201 of Regulation SHO.

[107] This exception does not apply where a broker-dealer knows or has reason to know that an order is incorrectly marked long. Knowledge may be inferred where a broker-dealer repeatedly accepts orders marked long from the same counterparty but requires borrowed shares for delivery or results in a ''fail to deliver'' on several occasions.

[108] *See* subparagraph (d)(2) of proposed Rule 201 of Regulation SHO.

[109] The Commission initially adopted three exceptions for odd-lot transactions. While the first

concerned over the volume of odd-lot transactions, which possibly indicated that the exception was being used to circumvent the Rule. As a result, the exception was changed to the present two exceptions.[110]

Subparagraph (e)(3) is limited to odd-lot dealers registered in the security and third-market makers. The exception allows short sales by odd-lot dealers registered in the security and by third market-makers (of covered securities) to fill customer odd-lot orders. Subparagraph (e)(4) provides relief for any sale to liquidate an odd-lot position by a single round lot sell order that changes such broker-dealer's position by no more than a unit of trading. We understand the odd lot exception to still be of utility and not in conflict with the goals of the proposed bid test. We propose combining the two exceptions into one odd-lot exception under subparagraph (d)(3) of Rule 201 of proposed Regulation SHO.

In addition, we propose extending these exceptions to all market makers acting in the capacity of an odd-lot dealer. When the Rule was adopted, odd-lot dealers dealt exclusively with odd-lot transactions, and were so registered. Today, specialists assigned to a security are typically the odd-lot dealer in that security. We propose to broaden the use of this exception to all brokers or dealers acting as ''market makers'' in odd-lots.[111]

Odd-lot transactions by market makers to facilitate customer trades are generally not of a size that could facilitate a downward movement in the market. Therefore, those acting in the capacity of a ''market maker'' should be able to off-set customer odd-lot orders and liquidate an odd-lot position by a single round lot sell order that changes such broker-dealer's position by no more than a unit of trading without regard to the restrictions of the current tick test or proposed bid test.

Q. Are these exceptions relating to odd-lots appropriate in today's markets?

Q. Should these exceptions apply to all market makers in odd-lots or should the exception be more limited?

Q. Are these odd-lot exceptions susceptible to abuse?

Q. Should all odd-lot transactions have an exception from the Rule? Would providing an exception for all odd-lot transactions pose a risk of increased short sale manipulation, *e.g.*, would traders break up trades into 99 share odd-lots in order to avoid the price test?

4. Domestic Arbitrage

Current subsection (e)(7) of Rule 10a-1 was adopted in 1938 to allow short selling associated with certain bona fide domestic arbitrage transactions.[112] In adopting this exception, we stated that it ''applies only to bona fide arbitrage transactions in a security effected, under certain circumstances described in the exception, by persons who own rights or privileges entitling them to acquire that security.'' [113] The exception has remained unchanged since its adoption.

The term ''bona fide arbitrage'' generally describes an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to lock in a gross profit or spread resulting from a current differential in pricing of two related securities.[114] The Commission continues to believe that bona fide arbitrage activities are beneficial to the markets because they tend to reduce pricing disparities between securities.[115] These activities also carry limited risk of the kind of manipulative or destabilizing trading that Rule 10a–1 was designed to address.

We therefore propose that proposed Rule 201 of Regulation SHO would retain the general exception contained in (e)(7). Subparagraph (d)(5) of Rule 201 would continue to except short sales effected in bona fide arbitrage transactions involving convertible, exchangeable, and other rights to acquire the securities sold short, where such rights of acquisition were originally attached to or represented by another security, or were issued to all the holders of any such class of securities of the issuer. In addition, we have proposed adding language to the exception to require a person relying on the exception to subsequently acquire or purchase the security upon which the arbitrage is based.[116] For example, if a person sells short securities to profit from a current price differential based upon a convertible security that entitles him to acquire an equivalent number of securities of the securities sold short, he must subsequently tender the instrument for conversion to obtain the underlying securities and complete the arbitrage in order to satisfy the terms of the exception. We have also proposed minor amendments to the language of the exception to make it more understandable.

Q. Should the exception be retained for purposes of the proposed Rule 201? If not, state specific reasons why the exception should be removed from the Rule.

Q. Minor changes have been made to the text of existing exception (e)(7) in the proposed rule to simplify its language. Are these changes helpful? Does the proposed amendment to the exception alter its meaning in a way that would affect its substance?

Q. Is the proposed amended exception too narrow or too broad? If so, state specifically why, and how it should be restructured in relation to the purposes of Regulation SHO.

Q. Should the requirement that the transactions be made in a separate domestic arbitrage account be eliminated? If so, should the exception permit domestic arbitrage to be effected in an arbitrage account in which international arbitrage could also be effected?

Q. Should exception (e)(7) be combined with (e)(8), the international arbitrage exception? Would such a combination create compliance problems or other issues?

Recently, Commission staff has received inquiries regarding the operation of (e)(7) in the context of a corporate merger. In particular, market participants have sought advice whether upon finalization of a merger agreement, wherein a date certain is determined for the merger, a party who is entitled to receive stock of the acquiring company under the terms of the merger agreement is entitled to sell short this stock without regard to the tick test pursuant to the domestic arbitrage exception. Unlike the arbitrage contemplated in (e)(7), the right to acquire another security in a merger scenario arises only by the terms of the merger agreement and not through a right vested in the security itself. We believe that this type of arbitrage is not within the scope of paragraph (e)(7), and therefore we are not proposing to include it.

Q. Should short sales effected in connection with a merger be excepted from the provisions of Rule 201? If so, at what point in the merger process should a party be deemed entitled to acquire the acquiring company's stock?

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one, excepting all odd-lot transactions, seemed to make other odd-lot exceptions unnecessary, the 1938 adopting release included all three exceptions without discussion. Securities Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

[110] *See* Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570.

[111] The definition of a ''market maker'' is found in Section 3(a)(38) of the Exchange Act, and includes specialists. 15 U.S.C. 78c(a)(38).

[112] Securities Exchange Act Release No. 1645 (April 8, 1938).

[113] *Id.*

[114] *See* Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (interpretation concerning the application of Section 11(a)(1) to bona fide arbitrage).

[115] *Id.*

[116] As discussed, the Commission has interpreted the term ''bona fide arbitrage'' to involve the contemporaneous purchase and sale of securities effected to ''lock in'' a gross profit or spread from a current differential in pricing. *Id.* We believe requiring a person relying on the exception to subsequently acquire or purchase the security upon which the arbitrage is based is consistent with this interpretation.

5. International Arbitrage

The international arbitrage exception in Rule 10a–1 (e)(8) has also remained unchanged since its adoption in 1939.[117] The international arbitrage exception was added following an extended study of international arbitrage operations in their relation to short selling.[118] The Commission concluded that the exception was necessary to facilitate ''transactions which are of a true arbitrage nature, namely, transactions in which a position is taken on one exchange which is to be immediately covered on a foreign market.'' [119]

The Commission proposes to retain the international arbitrage exception because we understand that the exception is still being used and does not conflict with the goals of the proposed bid test. As with the domestic arbitrage exception, we have proposed amendments to the language in the exception in order to make it more understandable. In addition, we have incorporated language from current exception (e)(12) of Rule 10a–1 that provides that, for the operation of the international arbitrage exception, a depositary receipt for a security shall be deemed to be the same as the security represented by the receipt. This language was originally included in the Commission's 1939 release adopting the international arbitrage exception, but was incorporated separately in subparagraph (e)(12). We believe this provision should be moved from its current location to the international arbitrage exception because it directly pertains to the operation of that exception.

Q. Should the international arbitrage exception be retained for purposes of the proposed Rule 201? If not, state specific reasons why the exception should be removed from the Rule.

Q. Minor changes have been made to the proposed rule to simplify the language of the existing exception. Are these changes helpful? Do they alter the meaning of the exception in a way that diminishes its value or prohibits bona fide international arbitrage activity in relation to Rule 201?

Q. Is the proposed amended exception too narrow? If so, state specifically why it is too narrow and how it should be restructured to allow beneficial international arbitrage activity that does not carry the kind of manipulative or destabilizing trading that proposed Rule 201 is designed to address.

Q. Should the requirement that the transactions be made in a separate international arbitrage account be eliminated? If so, should the exception permit international arbitrage to be effected in an arbitrage account in which domestic arbitrage could also be effected, rather than in a separate international arbitrage account?

Q. Should exception (e)(8) be combined with (e)(7), the domestic arbitrage exception? Would such a combination create compliance problems or other issues?

6. Distribution Over-Allotment

Subsection (e)(10) generally excepts from Rule 10a–1 sales of securities by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any lay-off sales by such a person in connection with a distribution of securities through rights or a standby underwriting commitment.[120] Proposed Rule 201 would retain the over-allotment exception in substance, although minor changes have been made to simplify its language.[121] Under the proposed bid test, the exception would permit short sales in connection with an over-allotment at or below the bid, thus enabling an underwriter to price an offering at or below the last bid. We propose including this exception in Rule 201 of Regulation SHO because these sales are all at the offering price and, therefore, do not implicate one of the goals of short sale regulation, *i.e.*, preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level.

Q. Is this exception necessary? Under what circumstances would an underwriter or syndicate member price an offering below the best bid? Would extending the exception to short sales below the bid have any negative market impact?

7. Equalizing Short Sales and Trade-Throughs

Exceptions (e)(5)(ii) and (e)(11) were adopted in order to eliminate a potential conflict between Rule 10a–1 and Rule 11Ac1–1 under the Exchange Act (Quote Rule).[122] The (e)(5) equalizing exception, as discussed in further detail below, permits market makers to effect short sales on a zero-minus tick (*i.e.*, at the same price as the last trade price), but does not permit short sales, either as a dealer or agent, at a price lower than the last trade price reported in the consolidated system (*i.e.*, on a minus tick). As a result, there arose a potential conflict between the operation of Rule 10a–1 and the ''firmness requirement'' [123] of the Quote Rule in situations where execution of an offer quotation by a broker or dealer would be rendered unlawful because of a trade-through [124] even though the offer had been at a price permitted under Rule 10a–1 at the time that broker or dealer had communicated it to its exchange or association for inclusion in the consolidated quotation system.[125]

In order to resolve this potential conflict, the Commission adopted (e)(5)(ii) to permit market makers to execute transactions at their offer following a trade-through, and (e)(11) to permit non-market makers to effect a short sale at a price equal to the price associated with their most recently communicated offer up to the size of that offer [126] so long as the offer was at

[117] Securities Exchange Act Release No. 2039 (March 10, 1939).

[118] *Id.*

[119] *Id.* We believe that the provision necessitating that the transaction be ''immediately'' covered on a foreign market requires the foreign market to be open for trading at the time of the transaction in order to qualify for this exception.

[120] *See* Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570 (October 2, 1974). Although the exception was not adopted until 1974, the Commission's approval of the concept of excepting over-allotments from the short sale rule is long-standing. *See, e.g.*, Securities Exchange Act Release No. 3454 (July 6, 1946), in which the Commission approved the NYSE's special offering plan, which permitted short sales in the form of over-allotments to facilitate market stabilization.

[121] *See* subparagraph (d)(7) of proposed Rule 201 of Regulation SHO.

[122] *See* Securities Exchange Act Release No. 17314 (November 20, 1980), 45 FR 231 (November 28, 1980).

[123] 17 CFR 240.11Ac1–1(c)(1). The Quote Rule requires that, subject to certain exceptions, the broker or dealer responsible for communicating a quotation shall be obligated to execute any order to buy or sell presented to him, other than an odd lot order, at a price comprising the responsible broker or dealer's published bid or offer in any amount up to his published quotation size.

[124] A trade-through generally occurs when an Intermarket Trading System (ITS) participant purchases an ITS security at a price that is higher than the displayed price at which the security is being offered at another ITS participating market, or sells an ITS security at a price that is lower than the displayed price at which the security is being bid at another ITS participant.

[125] The following example from the release adopting the exception illustrates the potential conflict: A market maker who currently has a short position in XYZ stock communicates an offer which, if executed against at that time, would be in compliance with Rule 10a–1, *e.g.*, at a price of 20⅛ when the last trade price reported in the consolidated system is also 20⅛. There is a ''trade through'' of the market maker's offer on another market center that causes an up-tick to be reported in the consolidated system at 20¼. Finally, a buy order is sent to the market maker after the trade through at 20¼ has been reported. In order to ensure compliance with 10a–1, the market maker must refuse to execute the order at his offer of 20⅛ because doing so would result in a short sale being effected on an impermissible minus tick, however, in refusing to effect the trade, he would arguably violate the ''firmness requirement'' of the Quote Rule. In addition, when a market maker ''backs away'' from an order, he may, in effect be revealing that he had a short position in the security, thus making it more difficult to liquidate that position at favorable prices. *See, supra* n. 122.

[126] The Commission explained in the release that the scope of the exception in Rule 10a–1(e)(11) was limited to the size of the broker or dealer's displayed offer because the need for the exception only arises to the extent that the broker or dealer's

a price, when communicated, that was permissible under Rule 10a–1. The (e)(11) exception was added in response to several comments that, in addition to orders for their own account, specialists and other floor members also often represent as part of their displayed quotation orders of other market participants (*e.g.*, public agency orders or proprietary orders of non-market makers) that also might be ineligible for execution under Rule 10a–1 following a trade-through in another market.[127]

We believe that the rationale for adopting exceptions (e)(5)(ii) and (e)(11), namely resolving a conflict between the short sale rule and the quote rule arising from a trade-through, would not exist under the proposed bid test. Under the proposed rule, the reference point for a market participant seeking to execute a short sale would not be the last trade price, which could be a down tick created by a trade through, but rather the current consolidated best bid.

It appears that under the proposed bid test, a comparable situation as that envisioned under (e)(5)(ii) and (e)(11) would result in a locked or crossed market.[128] Locking or crossing a quote temporarily frustrates trading in a particular security, and there are various rules and regulations that guard against such practices.[129] We have stated in prior releases that continued locking and crossing of the market can negatively impact market quality, and have approved SRO rules aimed at reducing the frequency of locked and crossed markets and providing more informative quotation information, facilitating price discovery, and contributing to the maintenance of a fair and orderly market.[130]

However, we recognize that locked and crossed markets have not been eliminated entirely, and thus the same conflict between the firm quote rule and the short sale rule could arise under the proposed bid test. We believe that this situation would exist where a market participant posts an offer to sell short at a valid price, *i.e.*, above the best bid, but the bid subsequently moves up and either locks or crosses the market participant's posted offer. A market participant in this situation could still be required to execute buy orders directed to its posted offer, which would be at or below the best bid.[131] The Commission thus proposes to include an exception to Rule 201 of Regulation SHO permitting a responsible broker-dealer, as defined in Rule 11Ac1–1 under the Exchange Act[132] to effect a short sale at a price equal to its posted offer when the market is locked or crossed, when consistent with best execution obligations, provided however, that the exception would not apply to any broker-dealer who initiated the locked or crossed market.

Q. Would an exception from the proposed bid test permitting a short sale to be effected at the consolidated best offer if the market is locked or crossed be useful or necessary to remedy problems associated with locked and crossed markets? If so, describe such circumstances and the market participants to whom the exception should apply.

Q. Would such an exception be used appropriately to remedy the problem of locked and crossed markets, or could such an exception be susceptible to abuse? Is there another way to design an exception for locked and crossed markets?

Q. Some market participants that provide their customers with guaranteed executions of their buy orders at a price equal to the consolidated best offer would be prevented from selling short to fill customer buy orders in a locked or crossed market, due to the fact that the short sale would be executed at a price equal to or below the best bid. Should there be an exception to allow these market participants to execute short sales at their offer to facilitate customer buy orders in locked or crossed markets?

B. Exception Proposed To Be Eliminated

Exception (e)(6) of Rule 10a–1, the original ''equalizing exception,'' was adopted by the Commission in 1938 to allow a short sale of a security on a regional exchange at the same price as the then current price for the same security on the principal exchange, even though the short sale on the regional exchange would constitute a zero-minus or minus tick in relation to the last preceding trade price on the principal exchange.[133] The exception, limited to short sales effected on an exchange, permitted regional specialists to guarantee execution at a price at least as favorable to the customer as he would have obtained had his order been exposed to the principal exchange market.[134] The Commission believed that unless the regional exchanges were

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obligations under the Quote Rule may conflict with Rule 10a–1. Because the firmness requirement of the Quote Rule only applies to a broker or dealer's displayed offer, it was deemed appropriate to limit the exception to the size of the displayed offer. *See, supra* n. 122 at n.20.

[127] This concern was illustrated with the following example: A specialist who is short XYZ stock quotes an offer for 1,000 shares at 20⅛ at a time when the last sale reported in the consolidated system was such that the offer, if executed at that time, would be in compliance with Rule 10a–1. This offer for 1,000 shares consists of 300 shares offered by the specialist, a 400-share limit order in the specialist's book, and an offer from the crowd at the specialist's post for 300 shares, all at 20⅛. A trade through of this offer occurs on another exchange and an up-tick is reported in the consolidated system at 20¼. A buy order for 1,000 shares at 20⅛ is then sent to the exchange—after the trade through at 20¼ is reported. Without (e)(11), filling the complete order for 1,000 shares would not be permissible, since (e)(5)(ii), by its terms, applies only to a sale by a market maker for its own account. *Id* at n.18.

[128] In a locked market, the best bid price equals the best ask price; in a crossed market, the best bid price exceeds the best ask price. For example, assume that the current consolidated best bid for a security is 10.00. A market participant who has a short position in a security posts an offer to sell at 10.05. The market participant would be able to execute its short sale so long as it was above the consolidated best bid. Any bid that was posted at 10.05 would lock the market, and any bid posted above 10.05 would cross the market.

[129] *See, e.g.* NASD Rule 4613(e). NASD Rule 4613(e)(2) states that ''A market maker shall, prior to entering a quotation that locks or crosses another quotation, make reasonable efforts to avoid such locked and crossed market by executing transactions with all market makers whose quotations would be locked or crossed. Pursuant to the provisions of paragraph (b) of this Rule 4613, a market maker whose quotations are causing a locked or crossed market is required to execute transactions at its quotations as displayed through Nasdaq at the time of receipt of any order.''

[130] *See* Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020, 8046 (January 26, 2001); Securities Exchange Act Release No. 46410 (August 23, 2002), 67 FR 55897 (August 30, 2002) (File No. SR–NASD–2002–56). *See also* Securities Exchange Act Release No. 47735 (April 24, 2003), 68 FR 23787 (May 5, 2003) (File No. NASD–2003–38).

[131] *See* 17 CFR 240.11Ac1–1; *see also supra* n. 129. Paragraph (b) of Rule 4613 is the NASD Firm Quote Rule.

[132] Rule 11Ac1–1(a)(21) defines the term *responsible broker or dealer* to mean: (i) When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent; *provided, however,* That, in the event two or more members of an exchange have communicated on such exchange bids or offers for a covered security at the same price, each such member shall be considered a ''responsible broker or dealer'' for that bid or offer, subject to the rules of priority and precedence then in effect on that exchange; and *further provided,* That for a bid or offer which is transmitted from one member of an exchange to another member who undertakes to represent such bid or offer on such exchange as agent, only the last such member who undertakes to represent such bid or offer as agent shall be considered the ''responsible broker or dealer'' with respect to that bid or offer; and (2) when used with respect to bids and offers communicated by a member of an association to another broker or dealer or to a customer otherwise than on an exchange, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

[133] Securities Exchange Act Release No. 1579 (February 10, 1938), 3 FR 382 (1938). At the time the exception was adopted (and until April 30, 1976) the permissibility of short sales under Rule 10a–1 was determined for each particular exchange by comparing the price of the proposed short sale to the immediately preceding last trade price in the security to be sold short on that exchange.

[134] Pursuant to the Rule, such sales are excepted only with the approval of the exchange, and only if (1) trades in the security are not reported pursuant to an effective transaction reporting plan and (2) information as to such trades is not made available on a real-time basis.

allowed to fill purchase orders at prices that would have been obtained on the principal exchanges, regional exchanges would be unable to attract sufficient order flow to remain viable.[135]

In 1975 the Commission adopted amendments to Rule 10a–1 in conjunction with the full implementation of the consolidated transaction reporting system (''consolidated system'').[136] As amended, Rule 10a–1 applies a tick test referencing the last trade price reported in the consolidated system, however permits an exchange to make an election to use a tick test that references the last trade price reported in that exchange market.[137]

In addition to altering the reference point for determining the permissibility of short sales, the amendments also altered the reference point for the permissibility of equalizing short sales. Subsection (e)(5)(i) was added to provide an exception for short sales of certain securities effected by a registered specialist, exchange market maker, or third market maker at a price equal to the last price reported in the consolidated system.[138] The exception applies to short sales of securities registered or admitted to unlisted trading privileges on an exchange, whether effected on an exchange or over-the-counter, if transactions in the security are reported pursuant to an effective transaction reporting plan and made available on a real time basis to vendors of market transaction information.

The exception is intended to permit market professionals to protect customer orders against transactions in other markets in the consolidated system by allowing them to sell short at a price equal to the last trade price reported in the consolidated system, even if that sale was on a minus tick (a so-called ''zero-minus tick'').[139] Concurrent with the adoption of subsection (e)(5)(i), exception (e)(6) was amended to apply only to short sales of securities covered by Rule 10a–1(b), *i.e.*, to short sales of exchange-listed securities that are not reported to the consolidated system or made available on a real-time basis.[140]

We do not believe that the equalizing exceptions should be retained as part of proposed Regulation SHO. The rationale for exceptions (e)(6) and (e)(5)(i), *i.e.*, allowing short selling at a price that matches a given security's last trade price on another market center, would not exist under our proposed short sale rule. The proposed rule would reference the real-time consolidated best bid rather than the last trade price, and would not depend on prices in individual markets.[141] We therefore do not believe that a registered specialist or exchange market maker would need to ''equalize'' their price with a price on another market center.

Q. Is there any reason why exception (e)(6) should be retained?

Q. Is there any reason why exception (e)(5)(i) should be retained? For example, would broker-dealers that provide customers with executions at a price equal to transaction prices on a primary exchange require an exception to facilitate customer buy orders?

VII. Prior Exemption Letters Under Rule 10a–1

A. Exchange Traded Funds

Exchange Traded Funds (ETFs) are designed to provide investment results that correspond generally to price and yield performance of securities included in a particular index or securities portfolio. In light of the composite and derivative nature of ETFs, the Commission found that trading in ETFs would not be susceptible to the practices that Rule 10a–1 is designed to prevent and granted an exemption from Rule 10a–1 for transactions in these securities.[142] In particular, the Commission found that ETFs should rise or fall based on changes in the net asset value of the component stocks of the particular index and supply and demand.[143]

The relief is subject to a number of specified conditions. In particular, the corresponding index or portfolio represented by the ETF must consist of a ''basket'' of twenty or more different component stocks, in which the most heavily weighted component stock cannot exceed 25% of the weight of the index or portfolio. Moreover, the component stocks that in the aggregate account for a least 85% of the weight of the underlying index or portfolio must have a minimum public float value of at least $150 million and, with certain exceptions, a minimum ADTV with a value of at least $1 million during each of the previous 2 months of trading prior to the formation of the ETF series. We believe that these conditions continue to be necessary to ensure the composition of the ETFs is such that short selling in the ETFs does not implicate the type of trading activity that short sale regulation was designed to prevent.

The relief previously granted under Rule 10a–1 would continue to apply to cover exemptions from the price test provisions of Rule 201 of Regulation SHO.

Q. Should the Commission provide relief from proposed Rule 201 of Regulation SHO for transactions in ETFs? If so, are the conditions for relief appropriate? If not, please explain why.

Q. Should the relief be codified as an exception to proposed Rule 201 of Regulation SHO?

B. Short Sales Executed at the Closing Price

The Commission has granted conditional relief from the price test provisions of Rule 10a–1 to allow requesting exchanges[144] and broker-dealers[145] to execute short sales in after-hours crossing sessions at a price equal

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[135] *See* Securities Exchange Act Release No. 11468 (June 12, 1975), 40 FR 25442 (June 16, 1975) (adopting amendments to Rule 10a–1 and discussing the operation of Rule 10a–1(e)(6) as in effect prior to and after amendment).

[136] *Id.*

[137] 17 CFR 240.10a–1(a)(2). This aspect of the short sale rule, as amended, was designed to ameliorate potential regulatory and operational problems perceived by certain exchanges with a uniform short sale rule employing a tick test referenced to the consolidated system. Id.

[138] Rule 10a–1(e)(5)(i) exempts: Any sale of a security covered by paragraph (a) of this section (except a sale to a stabilizing bid complying with § 242.104 of this chapter) by a registered specialist or registered exchange market maker for its own account on any exchange with which it is registered for such security, or by a third market maker for its own account over-the-counter, (i) Effected at a price equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan.

[139] Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570.

[140] Paragraph (b) of Rule 10a–1 applies to any short sale effected on a national exchange of any security not covered by paragraph (a) of Rule 10a–1. Paragraph (a), in turn, covers any short sale effected on a national exchange of any security registered or admitted to unlisted trading privileges on a national exchange, if trades in the security are reported pursuant to an ''effective transaction reporting plan'' and if information as to such trades is made available on a real-time basis to vendors of market transaction information.

[141] We have proposed eliminating Rule 10a–1(a)(2), and thus any market center would be prevented from relying on its own bid as a reference point for compliance with the rule. *See, infra* part XII.

[142] *See, e.g.*, Letter re: SPDRs (January 27, 1993); Letter re: MidCap SPDRs (April 21. 1995); Letter re: Select Sector SPDRs (December 14, 1998); Letter re: Units of the Nasdaq-100 Trust (March 3, 1999); Letter re: ETFs (August 17, 2001) (class letter).

[143] The Commission, however, did not provide any relief from the tick test for short selling of the individual component stocks underlying an ETF.

[144] *See, e.g.*, Letter re: Off-Hours Trading by the Amex, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,802 (August 5, 1991); Letter re: Operation of Off-Hours Trading by the NYSE, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,736 (June 13, 1991).

[145] *See, e.g.*, Letter re: Burlington Capital Markets (July 1, 2003); Letter re: Bear, Stearns & Co., Inc. (January 19, 1996); Letter re: AZX, Inc. (November 15, 1995); Letter re: Instinet Corporation Crossing Network, [1992] Fed. Sec. L. Rep. (CCH) ¶ 76,290 (July 1, 1992); Letter re: Portfolio System for Institutional Trading, [1991–1992] Fed. Sec. L. Rep. (CCH) ¶ 76,097 (December 31, 1991).

to the closing price of the security.[146] Absent relief, such short sales could violate Rule 10a–1, in that the matching price (the closing price) of a security could be on a minus or zero-minus tick with respect to the last sale in the consolidated transaction reporting system. In granting this conditional relief, we have noted that short sale transactions executed at the closing price generally do not represent the type of abusive practices that Rule 10a–1 is designed to prevent. In particular, short sale orders entered in the after-hours crossing sessions cannot influence the matching price, but rather are priced by unrelated order flow and transactions occurring during the primary trading session, which are subject to the tick test. The relief previously granted under 10a–1 would continue to apply to cover exemptions from the price test provisions of Rule 201 of Regulation SHO.

Q. Do closing price transactions create perverse incentives for broker-dealers, such that they should not be granted an exception?

Q. Should the relief be codified as an exception to proposed Rule 201 of Regulation SHO?

VIII. Market Maker Exception From Proposed Uniform Bid Test

It has been argued that short selling by market makers helps offset imbalances in the supply and demand or gaps in the flow of buy and sell orders.[147] NASD Rule 3350 exempts from operation of the NASD's bid test short sales executed by qualified market makers in connection with bona fide market making.[148] There is currently no similar exception in Rule 10a–1, however, for the bona fide market making activities of specialists and third market makers in exchange-listed securities.

The chief reason advanced in support of the NASD market maker exception is that it enhances liquidity by permitting market makers to adjust inventory positions quickly.[149] If market makers were required to wait for an upbid to make a short sale, it is asserted that their ability to satisfy their market making functions would be impaired. The NASD has also argued that market makers perform an important market stabilizing function. According to a 1997 study by NASD Economic Research, market makers provide immediate, stabilizing liquidity.[150] If there is heavy selling pressure by investors and the market is moving down, market makers provide stability by standing ready to buy stock. According to the study, application of a short sale rule to market makers could reduce a market maker's ability to adjust inventory positions quickly, thereby reducing its supply of immediate liquidity to the marketplace.[151] The NASD study also states that application of the short sale rule to market makers could increase market makers' costs, which would be passed on to investors in the form of wider spreads.[152]

We do not find these arguments persuasive in the context of the proposed uniform bid test. In providing liquidity to customers, a market maker primarily buys at the bid and sells at the offer, or in between the bid and offer. We believe that a market maker should rarely need to sell short at or below the bid in its market making capacity.[153] The proposed rule permits unrestricted short sales at the offer or at any other price that is one cent or more above the bid, and thus the need for an exception to allow market makers to sell at or below the best bid seems limited.[154]

We are also concerned that the exception may be being used by entities that are not actually engaged in bona-fide market making.[155] For example, some issuers and investors have argued that some market makers are relying on the exception to continuously sell short into the bid—an activity that, as mentioned above, we find inconsistent with bona fide market making. The Commission believes that for the rule to have its intended positive effect on the market, all market participants, including market makers, should be subject to the rule.[156]

A market maker that is positioning inventory to profit from market moves would find it advantageous to be able to short into the bid, like any speculator. One of the historical goals of short sale regulation is to prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, and causing successively lower prices to be established by long sellers.[157] If such a seller is able to exhaust the existing bids in a security with short sales, and is able to attract long sellers to the market, the goal of accelerating the price decline of a particular security would be accomplished. Another goal of short sale regulation is that long sellers should have the right to sell first in a declining market.

Nevertheless, we believe that the proposed exception that would allow broker-dealers to execute customer sales on a riskless principal basis by looking to the customer's position would provide broker-dealers with additional flexibility to facilitate customer

[146] The relief is generally subject to the conditions that: (1) short sales of a security in the after-hours matching session shall not be effected a prices lower than the closing price of the security on its primary exchange; (2) persons relying on these exemptions shall not directly or indirectly effect any transactions designed to affect the closing price on the primary exchange for any security traded in the after-hours matching session; and (3) transactions effected in the after-hours matching session shall not be made for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.

[147] *See, e.g.*, Irving M. Pollack, *Short Sale Regulation of NASDAQ Securities* (1986), at 12.

[148] Rule 3350 (c) provides further that ''transactions unrelated to normal market making activity, such as index arbitrage and risk arbitrage that are independent from a member's market making functions, will not be considered bona fide market-making activity.'' *See* NASD Rule 3350. NASD IM–3350 also contains language specifying what type of activity does not constitute bona fide market making. *See, supra* n. 42.

[149] *See* Securities Exchange Act Release No. 34277 (July 7, 1994), 59 FR 34885 (July 29, 1994) (order granting temporary approval of Rule 3350 for an eighteen-month period (Temporary Approval Order)).

[150] *See* D. Timothy McCormick and Bram Zeigler, *The Nasdaq Short Sale Rule: Analysis of Market Quality Effects and The Market Maker Exemption, NASD Economic Research*, (August 7, 1997) at 22–23.

[151] *Id.* at 20.

[152] *Id.*

[153] The NASD's 1997 study indicates that during a sample month in 1997, market maker short sales at or below the inside bid accounted for only 2.41% of their total share volume. *Id.* at 27.

[154] In approving the market maker exception, the Commission noted that we would review the exception to determine whether the bid-test and exceptions are practicable and necessary on an ongoing basis. *See* Temporary Approval Order, supra, n. 149. Most recently, we extended the Rule 3350 pilot, including the market maker exemption, until December 15, 2003. *See* Securities Exchange Act Release No. 48035 (June 16, 2003), 68 FR 37183 (June 23, 2003). We noted that the extension was subject to modification or revocation should the Commission amend Rule 10a–1 in such a manner as to deem the extension unnecessary or in conflict with any adopted amendments.

[155] As initially approved, only market makers that met the Primary Market Maker (PMM) standards set forth in NASD Rule 4612 were eligible for an exception from the short sale rule. These PMM standards were subsequently suspended for all National Market Securities due to the potential impact of the Order Handling Rules. *See* Securities Exchange Act Release No. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997). As such, all market makers are currently eligible to rely on the exception.

[156] When we first approved the NASD's bid test and market maker exception in 1994, we recognized that the exception could result in problems of the type that have been reported by commenters. The Commission stressed the importance of monitoring the need for and effect of the exception on an ongoing basis, stating that experience with the test ''may raise issues that require reconsideration of some or all elements of the proposal.'' *See* Temporary Approval Order, *supra,* note 149. In particular, the Commission noted concerns that the market maker exception could create opportunities for abusive short selling. *Id.*

[157] Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., at 251 (1963).

orders.[158] In addition, we are proposing an exception from Rule 201 to allow broker-dealers to sell short at a price equal to the consolidated best bid, when consistent with best execution obligations, in order to fill customer orders it is required to execute pursuant to federal securities laws or SRO rules, such as NASD IM–2110–2 and the related interpretation of IM–2110–2 (Manning Interpretation). According to Nasdaq, the Manning Interpretation is designed to ensure that customer limit orders are executed in a fair manner and at similar prices at which a firm has traded for its own account.[159] If a broker-dealer executed an incoming market sell order at the consolidated best bid, it would then be obligated to fill other customer limit orders it held at that price.[160] However, if the broker-dealer had a net short position, it would be prohibited by proposed Rule 201 from filling the customer buy order at a price equal to the bid. We believe the proposed exception would remedy this conflict.

We seek comment on the importance of a market maker exception in the context of a market maker's role in providing liquidity. We also seek comment on the extent to which market makers might need to be able to short at the bid in order to facilitate a customer buy order, and inquire whether an exception limited to those situations would be necessary or appropriate.

Q. Should the proposed uniform bid test include a *bona-fide* market making exception? If so, why? How important is it for a market maker to be able to profit from position trading? Could there potentially be negative consequences to the market if there is not an exception for *bona-fide* market making transactions? Please describe.

Q. If a market making exception from the bid test is necessary, what should be done to limit its use to those engaged in *bona-fide* market making? Should the exception be tied to certain qualifications or conditions? If so, what should these qualifications or conditions be?

Q. If inclusion of a *bona-fide* market making exception is necessary, would there be any circumstances where a market maker acting in his market making capacity would need to sell short below the bid?

Q. How often do market makers or other broker-dealers sell short at the bid in response to customer buy orders? Would it be feasible to allow market makers or other broker-dealers to sell short at the bid to facilitate customer buy orders without undermining the purposes of the price test? If so, should there be limits on such short sales, for example to prevent a dominant market maker from filling customer orders at the bid in order to place downward pressure on the security's price?

Q. What other type of transactions should qualify for a bona fide market making exception?

IX. Proposed Changes to the Order Marking Requirement

A. Marking Orders

We propose combining current marking requirements in subsections (c) and (d) of Rule 10a–1 into new subsection (c) of Rule 201. New subsection (c) generally would differentiate between ''long,'' ''short,'' and ''short exempt'' orders. The marking requirement would apply to all exchange-listed securities and over-the-counter securities. An order could only be marked ''long'' when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer or will be prior to the settlement of the transaction. A sell order would be required to be marked ''short exempt'' if it were a short sale effected pursuant to an exception in Rule 201.

We believe that the proposed change would eliminate the current discrepancy between how Rule 3b–3 defines a short sale and the marking provisions found in Rule 10a–1. There are circumstances where an order can be marked ''long,'' but is a short sale executed without regard to the current tick test. For example, a person placing a sell order may be deemed to own a security under current Rule 3b–3(b)–(e),[161] but must borrow securities to consummate the delivery (*e.g.*, because the securities due upon a conversion of a security have not been received). While borrowing to settle a sale constitutes a short sale under Rule 3b–3, the seller would not be subject to the current tick test if at the time of the trade the seller owns the security and intends to deliver such security ''as soon as possible without undue inconvenience or expense.'' [162] This sale would be marked ''long'' under the current marking provisions of Rule 10a–1(d).

Under our proposed amendment, the sell order described above would not be marked ''long'' because, while the above seller may own the security, the security is neither in the physical possession or control of the broker-dealer nor is it reasonably expected to be prior to the settlement of the transaction. The seller would thus have to borrow the stock in order to effectuate delivery to the buyer. Instead the seller, availing themselves of exception (d)(1) of Rule 201, would mark the order ''short exempt.'' Requiring the order to be marked ''short exempt'' promotes consistency among related rules and uniformity among markets and market participants in the manner in which short sales are marked.

We believe that the proposed amendments would provide several benefits. The current marking requirements can lead to undetected violations of Rule 10a–1 because once the order is marked ''long,'' it is processed and executed as such, even though borrowed shares consummate the delivery on the sale. This complicates surveillance for violations of Rule 10a–1, as short sales executed under an exception from the rule can be masked as ''long'' sales. Further, under the current marking requirements there is no record of how short sellers are availing themselves of the various exceptions to Rule 10a–1. We believe that surveillance for compliance with proposed Rule 201 would be facilitated with accurate indications of when and under what circumstances the exceptions are utilized.

The practice of designating an order as ''short exempt,'' as proposed, has already developed. Many broker-dealers are already required to mark short sales as short exempt if they are effected under one of the exceptions from Rule 10a–1. For example, ITS participants [163] are required to designate commitment orders as ''short exempt'' when the short sale falls under an exception to the

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[158] *See, infra* part IX.B for a further discussion of the proposal regarding riskless principal trades.

[159] *See, e.g.,* Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001) (order granting approval of proposed rule change by the NASD regarding trading ahead of customer limit orders pursuant to decimal pricing in the Nasdaq market). *See also* NASD Rule 6440(f) (applying limit order protection rules to NASD members in exchange-listed securities).

[160] For example, a market maker receives an order to buy 1,000 shares of XYZ stock at $20 from a customer and represents the order in its Nasdaq quote. Market maker buys 1,000 shares of XYZ at $20 for its own account. Pursuant to the Manning Interpretation, the market maker would be obligated to sell to the customer to fill the customer's 1,000 share order.

[161] As discussed *infra*, Part X, Rule 3b–3 provides that a person is deemed to own a security if he or she: has entered into a binding, unconditional contract to purchase a security; own a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; have an option to purchase or acquire it and has exercised such option; or have rights or warrants to subscribe to it and have exercised such rights. A person who is deemed to own a security may mark orders to sell such securities long.

[162] 17 CFR 240.10a–1(e)(1).

[163] Current signatories to the ITS Plan include the American Stock Exchange LLC (Amex), Boston Stock Exchange, Inc. (BSE), Chicago Board Options Exchange, Inc. (CBOE), Chicago Stock Exchange, (CHX), Cincinnati Stock Exchange (CSE), NASD, NYSE, Pacific Exchange, Inc. (PCX), and Philadelphia Stock Exchange, Inc. (Phlx).

application of Rule 10a–1.[164] The NYSE has advised its members that it is ''appropriate'' to mark those short sale orders covered under exceptions to the rule as ''short exempt.''[165] In addition, NASD Rule 4991(i) requires all orders executed on Nasdaq be designated as ''buy,'' ''sell long,'' ''sell short,'' or ''sell short exempt.''[166] The proposed amendment would require orders to be marked as either ''long,'' ''short,'' or ''short exempt,'' providing greater uniformity.

Further, we believe that requiring a broker dealer to have physical possession or control of the security at execution, or, in the alternative, that the broker dealer obtain physical possession or control of the security prior to settlement, before marking the order ''long'' should facilitate the process of clearance and settlement in the current T + 3 environment. Disturbances in settlement processes can affect the stability and integrity of the financial system in general. Clearance and settlement systems are designed to preserve financial integrity and minimize the likelihood of systematic disturbances by instituting risk-management systems.[167] Requiring a broker-dealer to have possession or control of the securities before the broker-dealer can mark an order long should help to reduce failures to deliver. We anticipate that this proposed amendment would not be burdensome to market participants because most customer securities are not held by investors in physical form, but rather are held indirectly through their broker-dealer, *i.e.*, in ''street name.'' [168]

Q. What type of additional costs and burdens, if any, would be associated with requiring orders to be marked ''short exempt?''

Q. Does the requirement that a broker has physical possession or control of the security or will have physical possession or control prior to settlement place undue or unreasonable hardship on long sellers?

Q. Should proposed Rule 200 require a broker or dealer marking a sell order ''short exempt'' to identify the specific exception that the broker or dealer is relying on in marking it ''short exempt?'' If not, state why not.

[164] *See* Restated Intermarket Trading Plan, 33 (May 30, 1997).

[165] *See* NYSE Rule 440B.20.

[166] *See* NASD Rule 4991(i)(2).

[167] *See* Exchange Act Section 17A, 15 U.S.C 78q–1.

[168] DTC holds approximately 83% of all NYSE-traded shares outstanding and 72% of all Nasdaq-traded shares outstanding for the benefit of its participants (*i.e.*, broker-dealers and banks). See Securities Dematerialization White Paper, Securities Industry Association, at 17 (June 5, 2000).

B. Marking Requirements for Riskless Principal Transactions

Recently, some market makers have indicated that they would like exemptive relief from Rule 10a–1 to mark sell orders based on a customer's net position when a broker-dealer or market maker is effecting the execution of the customer's order on a riskless principal basis.[169] For example, a customer who is net long 1,000 shares of XYZ security enters an order to sell those securities with a market maker, the market maker then seeks to sell 1,000 shares of XYZ from his proprietary account to facilitate the trade prior to obtaining the securities from the customer. In this situation, market makers acting as riskless principal have sought an exemption from Rule 10a–1 to mark the market maker's sale from its proprietary account as ''long'' based on the customer's long position, regardless of the market maker's proprietary position in the security.

We believe that for the purposes of short sale regulation, the position of a broker-dealer should be deemed to be the same as a customer's position, regardless of whether the broker-dealer has a proprietary net ''long'' or ''short'' position, when the broker-dealer acts in a riskless principal capacity.[170] We believe that in this context, the broker-dealer effects the sale in a manner analogous to an agency execution. A short sale effected on an agency basis is marked according to the customer's net position. We therefore propose adding an exception to the proposed bid test of Regulation SHO that would allow broker-dealers to mark such sell orders ''short exempt.'' [171] Allowing a broker-dealer to mark an order in this manner does not implicate the stated concerns raised by short selling, *i.e.*, where a customer is long, specialist or market maker principal transactions should not be restricted in the same manner as short sales.[172]

We are concerned, however, that this exception from proposed Rule 201 not be used in an abusive or manipulative manner. Towards that goal, we would restrict this provision to riskless principal transactions as follows:

- A transaction in which a broker or dealer, after having received an order to sell a security, sells the security as principal at the same price to satisfy the order to sell;
- The sell order must be given the same per-share price at which the broker or dealer sold shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee;
- The broker or dealer must have written policies and procedures in place to assure that, at a minimum: the customer order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal account or customer account within 60 seconds of execution; the broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders effected pursuant to this exception.

We believe that these conditions would allow for the surveillance of the exception by linking the exception to specific incoming orders and executions, and by requiring the brokers and dealers to establish procedures for handling such transactions. Moreover, requiring the orders to be received prior to the offsetting transaction and the allocation of the offsetting transaction to the customer within 60 seconds would help avoid the exception from being abused by brokers or dealers who may attempt to retroactively claim the exception for transactions that were not done on a riskless principal basis.[173]

[169] Riskless principal transactions are generally described as trades in which, after receiving an order to sell (or buy) from a customer, the broker-dealer sells (or purchases) the security to (or from) another person in a contemporaneous offsetting transaction. *See* Securities Exchange Act Release No. 44291 (May 18, 2001), 66 FR 27760 (order adopting a *de minimis* exception to the definition of the term ''dealer'' solely for banks engaging in riskless principal transactions under 240.17 CFR 3a5–1); *see also* Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767–01 (March 17, 1994). More recently, the Commission modified its interpretation of Exchange Act Section 28(e), the ''safe harbor'' provision for money managers who use commission dollars of their advised accounts to obtain research and brokerage, so that it encompasses certain riskless principal transactions as defined by Nasdaq trade reporting rules. *See* Securities Exchange Act Release No. 45194 (December 17, 2001), 67 FR 6 (January 2, 2002) (NASD's rules define a riskless principal trade as a transaction in which a member after having a received an order to buy a security, purchases the security as principal at the same price to satisfy the order to sell. *See* NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6420(d)(3)(B)).

[170] For example, if the customer seeking to sell 1,000 shares of XYZ and the customer was net short in XYZ, a market maker engaging in a riskless principal transaction on behalf of the customer would have to mark the sell order from his principal account short regardless of his own net position.

[171] *See* subparagraph (d)(9) of proposed Rule 201 of Regulation SHO.

[172] *See* Securities Exchange Act Release No. 46994 (December 13, 2002), 67 FR 78033 (December 20, 2002) (order approving NASD amendment to the Manning Interpretation establishing a riskless principal customer facilitation exemption).

[173] The requirement that an offsetting transaction be allocated to either a riskless principal or

Continued

In order to assess whether this proposed exception properly addresses the needs of specialists or market makers, we ask the following questions:

Q. Does the proposed riskless principal exception allow brokers and dealers to facilitate customer orders handled on a riskless principal basis regardless of their proprietary net position? Are the conditions appropriate? In particular, is the requirement to allocate the offsetting transaction to the customer within 60 seconds appropriate?

Q. Is there any concern that this provision is not consistent with the goals of short sale regulation? If so, how?

X. Rule 3b–3

Rule 3b–3 defines the term ''short sale'' as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Rule 3b–3 also defines specific instances when a person shall be deemed to own a security, *i.e.*, a long position, for the purposes of Rule 10a–1.

We are proposing new Rule 200 to replace Rule 3b–3 and include several amendments to Rule 3b–3. As discussed in further detail below, we seek comment on including a modified version of current subparagraph (b) of Rule 3b–3 in Rule 200 that would require that a person not only have entered into an unconditional contract, binding on both parties thereto, to purchase the security, but also that the contract specify the irrevocable price and amount of securities purchased and provides for present delivery. We also propose amending the Rule to allow broker-dealers to calculate net positions in a particular security within defined trading units. Additionally, we propose that the definition of a short sale include the block-positioner exception from the current Rule 10a–1(e)(13). We also propose codifying in Rule 200 prior interpretations related to security futures products, and the unwinding of certain index arbitrage positions.

A. Unconditional Contracts To Purchase Securities

Under Rule 3b–3, a person owns a security if the person has ''purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it.'' [174] The staff has recently received inquiries about whether certain transactions qualify as an ''unconditional contract'' for the purposes of short sale regulation. In particular these inquiries focus on whether it is necessary for a contract to specify the price and amount of securities to be purchased in order to be considered an unconditional contract.

In 1992 the Commission proposed to clarify that an ''unconditional contract'' must specify a fixed, currently ascertainable price, and the exact amount of securities to be obtained in order for a person to be deemed to own a security under subparagraph (b) of Rule 3b–3.[175] The proposed amendments were intended to address potentially abusive trading practices associated with contracts for future purchases of securities where the price or volume was based on a formula or other contingent event. We were concerned about the potential for abuse associated with securities contracts where the purchase price is based on the next following closing price in the primary market for the stock or stocks. The concern was that a purchaser under such a contract may have incentive to sell the securities (long) that are subject to the contract prior to the close of trading on the primary market in a manner that would depress the closing price. Similarly, we expressed concern regarding shares expected to be received from dividend reinvestment plan purchases being considered in calculating a long position pursuant to Rule 3b–3 where the number of shares received under a plan was not known but only estimated based on a formula. The proposed amendments were never adopted or withdrawn.

As stated, the language of subparagraph (b) of Rule 3b–3 may be subject to abuse by individuals seeking to claim a long position only to avoid application of the tick test provisions in Rule 10a–1. Further, it is possible that where a contract mandates that securities will be purchased at the closing price, there may be incentive to depress the market price of the security to obtain the security at a lower price.[176] Moreover, there is the potential that contracts in which the amount of securities owned is not known until some later period may be designed to create a long position that would facilitate avoidance of the tick test. It appears to us that a fixed price and quantity of a contract to purchase securities, as well as present delivery of the securities, are essential elements in determining whether such a contract conveys ownership for purposes of short sale regulation,[177] and requiring these elements would restrict certain activities designed to manipulate the market. Therefore, we are proposing that Rule 200, subparagraph (b)(2) require that the unconditional contract specify the price and amount of securities to be purchased in order for a person to claim ownership of the securities underlying the contract under proposed Regulation SHO.

Q. Should proposed Rule 200 provide that in order for a person to be deemed to own a security by virtue of the fact that he has entered into an unconditional contract to purchase the security, the contract must specify the price and amount of the security to be purchased? If not, state why not.

In addition, questions have arisen about whether an unconditional contract must contemplate present delivery of securities in order for persons to claim ownership of securities under Rule 3b–3. In order for a person to claim ownership of a security, she should have title to the security or some other type of present or near-term ownership right to obtain the security. In the case of options, convertibles, rights, or warrants, the rule requires that a person exercise or convert the instrument in order to claim ownership of the underlying security. However, there is currently no express requirement that a person who has

customer account within 60 seconds is a condition that is consistent with previously stated Nasdaq policy regarding the handling of mixed capacity trades and compliance with the Manning Interpretation. *See* NASD Notice to Members 01–85, at Question 7 and Notice to Members 95–67, at Question 5.

[174] 17 CFR 240.3b–3(b).

[175] *See* Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992). Three commenters supported the price provision while four opposed it. Those who opposed it believed that a fixed-price requirement would prevent large transactions from being effected in an orderly manner and would place an undue burden on market participants who enter into contracts to buy and sell securities at a price to be determined in the future. Five commenters favored the fixed quantity provision and one commenter opposed it.

[176] *Id.*

[177] The Commission notes that in a typical ''equity line'' financing arrangement, an investor and the company enter into a written agreement under which the company has the right to ''put'' its securities to the investor. Under this ''put,'' the company has the right to tell the investor when to buy securities from the company over a set period of time and the investor has no right to decline to purchase the securities. The dollar value of the equity line is set in the written agreement, but the number of shares that the company will actually issue may be determined by a formula tied to the market price of the securities at the time the company exercises its ''put.'' *See* Division of Corporation Finance, Current Issues Outline Quarterly Update (March 31, 2001). As such, equity line financing arrangements and convertible financing arrangements would generally not meet the requirements for an unconditional contract, due to the fact that such arrangements may not specify a fixed price and quantity of the securities to be purchased, nor would they contemplate present delivery of the securities upon conversion or exercise of the put. All sales executed by the investor prior to the company exercising its ''put,'' or the investor exercising its conversion right, would thus be short sales subject to all applicable regulations, including the borrow and delivery requirements in proposed Rule 203, and, if the security sold is a ''covered security,'' the bid test provisions of proposed Rule 201.

entered into an unconditional, binding contract be expected to receive the securities imminently in order to claim ownership.

We are concerned that, without an express requirement that the contract contemplate present delivery, there is a danger that contracts would be formed solely for the purposes of creating a long position to evade the short sale rule, although there is no real intention to actually acquire the securities pursuant to the contract. As a result, we are seeking comment on whether buyers of securities pursuant to a contract should be required to have a reasonable expectation of imminent receipt of the securities prior to considering themselves to own the securities pursuant to proposed Rule 200. We are not proposing a present or imminent delivery requirement in proposed Rule 200 but instead we are seeking comment on such a provision.

Q. Should proposed Rule 200 require a definite time frame that limits when the buyer can consider themselves long, *i.e.*, a buyer would be deemed to own the securities only if the contract contemplates the buyer will receive the securities within 30 days?

Q. If so, what should the time frame be? Does industry practice provide some objective standard that is reasonable?

B. Ownership of Securities Underlying Securities Futures Products

We propose that new Rule 200 include language consistent with existing Commission guidance defining when a person shall be deemed to own a security underlying a security futures contract.[178] Specifically, we have stated that a person who holds a security future obligating him to take delivery of the underlying securities by physical settlement would not be considered long in these securities for the purposes of proposed Rule 100 until the security future terminates trading.[179] This interpretation is consistent with the way current Rule 3b–3 addresses several instances where a person owns a security that entitles a person to acquire securities underlying the instrument, *e.g.*, options, rights, warrants, and convertibles. In those instances, Rule 3b–3 requires the option, right, warrant, or convertible to be exercised, tendered, or converted before the person can be considered as having a long position in the underlying security. These provisions also implicitly contemplate that the person will shortly acquire the security being sold. For a physically-settled security future, the holder will obtain the underlying security only after the security future terminates trading. A security future settled by receipt of cash has no effect on a person's long position.

We are proposing subparagraph (b)(6) of Rule 200 that provides that a person holding a long security futures position is not considered to own the underlying security for the purposes of Rule 3b–3 until the security terminates trading.

Q. Should proposed Rule 200 require delivery of the securities underlying a futures contract before a person can consider himself long for the purposes of short sale regulation?

C. Aggregation Units

Rule 3b–3 requires a seller of an equity security subject to Rule 10a–1 to aggregate all of its positions in that security in order to determine whether the seller has a ''net long position'' in the security.[180] Broker-dealer firms have represented that firm-wide netting is costly, burdensome, and potentially counterproductive for large, multi-service brokerage firms. Firm-wide netting is currently required at least once a day.[181]

Many large broker-dealers are divided into ''desks'' that pursue separate trading strategies. At times, the firm may have a net short position in a security, but a particular desk may have a net long position in that security. This situation may result in a desk not being able to pursue an investment strategy that calls for the desk to sell its long position. This result appears to be unwarranted where the sale is not made to benefit the positions of other firm trading units. While the firm could form separate broker-dealers for each trading unit's strategy to support the independence of each trading unit, this approach would be costly and elevate form over substance.

In 1998, the staff issued a letter stating that the Division would not recommend that the Commission take enforcement action if a multi-service broker-dealer calculated its net position in a particular security within defined trading units independently from the positions held by the other aggregation units within the firm (''aggregation unit letter'').[182] We propose to incorporate aggregation unit netting into proposed Rule 200 because we believe that such netting allows aggregation units at multi-service broker-dealers to pursue different trading strategies, as well as provide liquidity to the market, without the restrictions of firm-wide netting.

Specifically, we propose to allow trading unit aggregation if: (1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies the trading objective of each, and supports its independent identity;[183] (2) each aggregation unit within the firm continuously determines, on a real-time basis, its net position for every security that it trades that is subject to proposed Rule 201 of Regulation SHO;[184] (3) each trader pursuing a particular trading objective or strategy is included in only one aggregation unit; and (4) individual traders are assigned to only one aggregation unit at a time. We believe that these conditions would help prevent potential coordinated manipulative activity amongst the aggregation units by ensuring they are separate and independent.[185]

We seek comment on our proposal to include the aggregation unit netting into Rule 200 of proposed Regulation SHO as well as firm-wide netting in general.

Q. Is this relief necessary for multi-service firms? How easily can these firms estimate

[178] *Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products*, Securities Exchange Act Release No. 46101 (June 21, 2002), 67 FR 43234 (June 27, 2002).

[179] Termination of trading is the moment at which an open position in a security future, either a long or short position, can no longer be closed or liquidated either by buying or selling an opposite position. A person obligated to deliver would be considered short at the termination of trading, and a person entitled to receive securities at the termination of trading would be considered long. *Id.*

[180] See 17 CFR 240.3b–3. *See also* Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120 (October 3, 1983) (to determine whether a person has a ''net long position'' in a security, all accounts must be aggregated).

[181] See Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949, 17950 (aggregation must be based on a listing of securities positions in all proprietary accounts as determined at least once each trading day). Allowing aggregation to be determined once per day was largely due to practical considerations arising from technological limitations at the time the interpretation was issued.

[182] *See* Letter regarding Bear, Stearns & Co. Inc.; Credit Suisse First Boston Corporation; Deutsche Bank Securities Inc.; Donaldson, Lufkin & Jenrette Securities Corporation; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith; Morgan Stanley & Co. Inc.; PaineWebber Inc.; Prudential Securities Inc.; Salomon Smith Barney Inc.; SG Cowen Securities Corporation; and Warburg Dillon Read LLC. (November 23, 1998), 1998 SEC No-Act LEXIS 1038.

[183] The independence of the units would be evidenced by a variety of factors, such as separate management structures, location, business purpose, and profit and loss treatment.

[184] This condition holds firms accountable for knowing the activities and positions of each aggregation unit.

[185] We believe that these conditions have worked well in restricting the exemptive relief to situations that do not appear to raise the abuses that the short sale price test is designed to prevent, and should be incorporated in the proposed exception. We also note that market participants that rely on the aggregation unit exception have designed their programming and surveillance systems in accordance with these conditions.

their real time positions for individual trading units? What about for the entire firm?

Q. Are the conditions included in proposed Rule 200 appropriate? Should there be additional conditions?

Q. Can the utility of the aggregation unit provision to multi-service firms be improved? If so, how? [186] Are the designated conditions appropriate?

Q. Should the aggregation unit provision be available to non-broker-dealers, for example, to hedge funds?

Q. On its face, Rule 3b–3 contemplates that a sale must be marked based on positions in all proprietary accounts in that security at the time of the sale. In light of the advances in technology since 1990, is it possible for firms or other entities to be able to determine their aggregate position in all proprietary accounts contemporaneously throughout the day? If not, why not?

Q. If firms or other entities are unable to determine their aggregate position in all proprietary accounts contemporaneously throughout the day, is there a means of allocating a daily aggregate position within the firm that would be capable of surveillance?

D. Block-Positioner Exception

The block-positioner exception is currently in subsection (e)(13) of Rule 10a–1.[187] Because this exception directly relates to a broker-dealer's calculation of its net position under current Rule 3b–3, we propose to incorporate the block-positioner exception without modification into Rule 200 of Regulation SHO.

Rule 3b–3 considers broker-dealers to have a short position in a security even though that position is fully offset by equivalent convertible securities, rights, warrants, or call options. Therefore, arbitrage activities may result in the block-positioner having a net short position. This short position would require compliance with the ''tick'' restrictions of the Rule and may inhibit the efforts of broker-dealers who engage in both block-positioning and offset activities. If a broker-dealer seeks to dispose of a block of securities it bought as a principal while acting in the capacity of a block-positioner, it may be unnecessarily hindered in doing so if it simultaneously has an equal or larger short position in the same security, even though that short position is fully offset as a result of arbitrage or hedging activity.

The block-positioner exception was created in order to facilitate the activities of broker-dealers who engage in both block positioning and arbitrage.[188] The Commission has recognized the important role block-positioners play in providing liquidity for large securities and in maintaining a fair and orderly market. When adopting this exception, the Commission noted that when a block-positioning firm's other short positions are fully offsetting other instruments, the result is an economically neutral position. The Commission noted that these other positions provide no incentive to effect sales from the block-positioning trading account in a manner that would cause or accelerate a decline in the market because gains in the short position would be offset by losses in the short position. The exception is limited in that it is available only to broker-dealers acting in the capacity of a block-positioner, and only if the short position is created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedging activities. We are proposing to include in proposed Regulation SHO the block positioner exception as it currently exists.

Q. Does the block-positioner exception continue to be needed?

Q. Does the block-positioner exception require any amendments? If so, what are alternatives to the way the rule currently operates?

E. Liquidation of Index Arbitrage Positions

Index arbitrage generally involves the purchase or sale of a ''basket'' of all stocks comprising a securities index or a smaller number of stocks designed to track day-to-day price movement of an index, and a contemporaneous offsetting sale or purchase of one or more commodity futures or options on a future or standardized option contracts on that index in an attempt to profit from price discrepancies between the stocks and the derivative index products. Index arbitrage often involves a liquidation (or ''unwinding'') transaction in order to realize arbitrage profits. Liquidation may consist of either simple elimination of each long or short stock position at expiration of the futures or option contract, or earlier termination of both the stock positions and the futures or option contract position.

Pursuant to Rule 3b–3, a seller of an equity security subject to Rule 10a–1 must aggregate all of the seller's positions in that security in order to determine whether the seller has a ''net long position'' in the security. Therefore, if a person does not have a net long position in a security, any sale of that security must be designated as a short sale and must comply with the tick test provisions of current Rule 10a–1. A person liquidating an index arbitrage position involving a long basket of stocks may be unable to sell all the securities contemporaneously with closing out the derivative instrument position because of the requirement to net short security positions in other proprietary accounts, and as a consequence may not realize the expected arbitrage profit.

In 1992 the Commission proposed codifying prior no-action relief from the tick test provisions of paragraphs (a) and (b) of Rule 10a–1 relating to liquidations of certain index arbitrage positions.[189] Specifically, we proposed a new exception from the tick test provisions of Rule 10a–1(a) and (b) for any sale by a person effected in connection with the liquidation of an index arbitrage position relating to a securities index that is the subject of a financial futures (or options on such futures) contract traded on a contract market designated by the Commodity Futures Trading Commission, or a standardized options contract as defined in Rule 9b–1(a)(4) under the Exchange Act,[190] notwithstanding that such person may not have a net long position in that security. The proposed exception was limited, however, to contexts where: (1) such person's net short position is solely the result of one or more short positions created and maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities; and (2) the sale does not occur during a period commencing at the time that the Dow Jones Industrial Average (DJIA) had declined by 50 points or more from its closing value on the previous day and terminating upon the establishment

[186] One commenter to the Concept Release said that while the Aggregation Letter is sensible in concept, firms have expressed difficulty devising procedures to meet its requirements. *See* Letter from Willkie, Farr & Gallagher (WFG).

[187] *See* Securities Exchange Act Release No. 20715 (March 6, 1984), 49 FR 9414 (March 13, 1984). Block positioning is the facilitation of a large purchase or sale of securities for a customer by buying or selling as principal the amount of securities that cannot be immediately placed or obtained from third parties.

[188] *Id.*

[189] Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992). The release proposed codifying as Rule 10a–1(g)(2) limited relief permitting the liquidation of certain existing index arbitrage positions involving long baskets of stock and short index futures or options without aggregating short stock positions in other proprietary accounts if those short stock positions are fully hedged. *See* Letter re: Merrill Lynch, Pierce, Fenner & Smith, Inc. (December 17, 1986); Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (April 30, 1990) (release clarifying and emphasizing certain aspects of the limited relief granted in the Merrill Lynch letter).

[190] Rule 9b–1(a)(4) states: ''Standardized options are option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relates to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.'' 17 CFR 240.9b–1(a)(4).

of the closing value of the DJIA on the next succeeding trading day. If the market decline restriction were in effect, each individual security would be required to be aggregated in the usual way with all of the seller's other positions in that security to determine whether the seller has a net long position.[191] The amendments proposed in the 1992 Release were never adopted.[192]

We propose to include in Rule 200 of Regulation SHO the relief for certain index arbitrage activities because we understand the relief is still being used and because codifying it would provide for ease of reference. We propose including it in Rule 200 with a minor change from the 1992 proposal. Namely Rule 200(f) would alter the second condition to specify that the relief would not be available during a period commencing at the time that the DJIA has declined below its closing value on the previous trading day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day during which the DJIA has not declined by two percent or more from its closing value on the previous day. This change would keep the language in proposed Rule 200 consistent with the current language in NYSE Rule 80A.[193]

The Commission notes that levels of program trading have increased in recent years,[194] and some have argued that this may be related to market volatility.[195] It should be noted that index arbitrage is not the only type of program trading.[196] The Commission requests comment on the usefulness and scope of the proposed amendment, including whether market participants believe that providing an exception from the proposed uniform bid test for some index arbitrage activity poses dangers for the markets.

Q. Is the relief for certain index arbitrage activities proposed to be incorporated in Rule 200 necessary under proposed Regulation SHO? Are the conditions appropriate?

XI. Hedging Transactions

In the Concept Release, the Commission requested comment on, among other things, exempting hedging transactions from short sale regulation. Currently, short sales related to hedges are treated the same under Rule 10a–1 as any other short sales. This is because Rule 3b–3 only takes equity positions into account, and it does not consider derivative positions related to these equity positions.[197] Some have suggested that bona fide hedging activity should be exempted from short sale regulation because such activity presents little threat of manipulation as gains from short hedging positions are offset by losses in a related security, *i.e.*, they are economically neutral positions.[198]

As discussed above, while the exceptions in the block-positioner and index arbitrage contexts do allow offsetting derivative positions to be considered, those exceptions provide limited aggregation relief for existing offsetting positions. They do not apply to short sales effected to establish an offsetting position. We have not included an exception for hedging short sales in our proposed Regulation SHO. We believe that a hedging exception is not necessary because the proposed bid test and pilot would provide market participants with additional flexibility in effecting short sales in order to hedge long exposure.

Q. Should a hedging exception be added to proposed Rule 201? If so, how should such an exception be designed so that it can be monitored and is not subject to abuse?

Q. Does the advent of trading in security futures absent short sale regulation, when combined with the proposed bid test and short sale pilot, address the concerns expressed by participants requesting an exception from Rule 201 for hedging? If not, why not?

Q. Should a hedging exception be included in Rule 201 that only applies to a particular group of market participants, *i.e.*, OTC market makers, option market makers, or specialists, that would allow short selling without regard to either a tick or bid test to offset the risk associated with their role in maintaining fair and orderly markets? Who should qualify for such an exception, what criteria would be used for determining whether short selling was part of maintaining fair and orderly markets, and how could the SROs and Commission surveil for compliance with such an exception?

XII. Elimination of Current Subparagraphs 10a–1(a)(2) and (a)(3)

One of the more significant changes in our proposal is the use of a bid test based on the consolidated best bid, which we believe would provide uniformity in short sale regulation for all markets in securities covered by proposed Rule 201. As a result, we are also proposing to eliminate the provision that markets currently have to use their own markets as a reference point for measuring the permissibility of short sales.

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[191] This proposed market decline restriction substantially paralleled, and would be invoked simultaneously with, the operation of NYSE Rule 80A, which at the time of the proposal applied when the DJIA index moved 50 points or more from the previous day's close. Rule 80A was more restrictive, in that it required all NYSE index arbitrage stock transactions, whether undertaken by a short or long seller, to be effected on a plus or zero-plus tick. The proposed exception, however, would have operated for a longer period of time than 80A, which at that time terminated once the DJIA recovers 25 points from the 80A trigger level. Instead, the exception would terminate upon the establishment of the closing value of the DJIA on the next succeeding trading day, in order to allow the markets to avoid incremental selling pressure at the close of trading on a volatile trading day and at the opening of trading on the following day, since trading activity at these times may have a substantial effect on the market's short-term direction.

[192] Commenters were generally in favor of codifying the exemption. However, the proposal was never acted upon.

[193] Under Rule 80A, when the DJIA index moves two percent or more from the previous day's close, index arbitrage orders in component stocks of the S&P 500 stock price index are subject to a tick test. In down markets sell orders may be executed only on a plus or zero-plus tick (and be marked ''sell plus''); in up markets buy orders may be executed only on a minus or zero-minus tick (and be marked ''buy minus''). The test remains in effect for the remainder of the trading day once it has been activated, but shall be removed if the DJIA subsequently moves within one percent of the previous day's closing value.

[194] The NYSE publishes weekly program trading data on its website at *www.nyse.com*. The data shows that program trading over the past few years has increased as a percentage of the overall NYSE average daily volume. For example, during July 28 through August 1, 2003, program trading amounted to 45.5% of the NYSE's average daily volume of 1,474.7 million shares, or 671.4 million shares a day.

[195] *See* David Henry, *Whipsawed by Wall Street,* Bus. Wk., (March 10, 2003); Karen Talley, *Program Trading Grows as a Force in Stock Market,* WSJ, (June 17, 2002).

[196] Program trading encompasses a wide range of portfolio-trading strategies involving the purchase or sale of a basket of at least 15 stocks with a total value of $1million or more. Program trading is calculated as the sum of the shares bought, sold and sold short in program trades. The total of these shares is divided by total reported volume. The NYSE reported on its website that during July 28 through August 1, 2003, 13.3% of program volume executed by NYSE member firms related to index arbitrage. For the period from June 30 through July 3, 2003, when the program trading percentage reached 52% of NYSE average daily volume, the highest levels reported for the year to date, 8.5% of program volume executed by NYSE member firms related to index arbitrage.

[197] Under Rule 3b–3, holdings in convertible securities, options, rights and warrants are only considered to be long positions if they have been converted or exercised. *See* Rule 3b–3(d).

[198] The CBOE submitted to the Commission a letter suggesting parameters of a possible hedging exception to Rule 10a–1. *See* Letter from CBOE (August 20, 2001). In particular, CBOE proposed a pilot program under which options market-makers and specialists would be exempt from the tick test provisions of the short sale rule when selling select listed stocks short to hedge positions in options that result from market-making obligations. Under the proposal, market makers and specialists would be able to sell CBOE pilot program stocks short on a minus or zero minus tick to hedge, on a delta equivalent basis only, pre-existing long exposure (stocks and options combined) or contemporaneous option transactions, subject to several provisions enumerated in their letter. The letter is available for review in the Commission's Public Reference Room (File No. S7–24–99).

This provision, currently subparagraph (a)(2) of Rule 10a–1, was added in response to operational difficulties associated with the tick test based on the last trade price reported in a security in the consolidated transaction reporting system.[199] At the time the provision was added, certain SROs asserted that the last trade price in the consolidated system should not be the reference point for the tick test because last trade price data was not available in a timely manner and because the principal exchanges did not have adequate information retrieval systems on their floors to ensure adherence with the short sale rule.[200]

We believe that this provision would no longer be needed in light of advances in the dissemination of market information and the proposed use of the consolidated bid for the price test. Currently, all participants in the markets have access to a consolidated, real-time stream of quotations for all the exchange and Nasdaq equity securities that would be subject to the bid test.[201] Further, unlike the tick test, where the sequence of trade prices plays a crucial role in determining when short sales can be effected, the sequence of the bids under the proposed bid test is not a factor in determining the price at which a short sale can be effected; rather, the reference is the best bid at the time of the short sale transaction. We thus believe that the concerns that gave rise to the (a)(2) provision are no longer present.[202] As a result, we propose to eliminate the ability of a market to use its own market information for purposes of the bid test of Regulation SHO.

We also propose to eliminate current subparagraph (a)(3) of Rule 10a–1. This subparagraph allows for an adjustment to the sale price of a security after a security goes ex-dividend, ex-right, or ex any other distribution when determining the price at which a short sale may be effected. Specifically, this provision allows for the reduction of all sale prices by the value of the distribution prior to the ''ex'' date. Under the proposed bid test, we do not believe (a)(3) is necessary because the last trade price would not be a factor in determining when a short sale can be effected, and the bid would immediately reflect the impact of the corporate action.

Q. Are there any regulatory or operational reasons to allow markets to use their own bid information in regulating short sales under the proposed rule?

Q. Would allowing markets to use their own bid information affect the operation or effectiveness of the proposed rule? If so, how?

Q. Is there any reason to retain the requirements of existing subparagraph (a)(3) of Rule 10a–1, which allows for the adjustment to the sale price of a security after a security goes ex-dividend, ex-right, or ex any other distribution, under the proposed bid test? For example, do exchanges that match opening trades prior to the opening quotes require such a provision?

XIII. Exclusion of Bonds

In 1992 the Commission proposed excluding from the application of Rule 10a–1 transactions in nonconvertible corporate bonds listed and effected on an exchange.[203] This action was in response to a petition for rulemaking by the Amex that paragraph (b) of the Rule be amended to exclude corporate bonds from short sale regulation.[204] Amex had noted that while paragraph 10a–1(a) of the Rule is not applied to bonds because transactions in corporate bonds are not required to be reported on a consolidated basis with other markets, bonds are covered under paragraph (b) regulating short sales of other securities on an exchange. According to the Amex, a competitive inequity was thus created between the exchanges and the over-the-counter market, where short selling is not regulated at all.[205] Moreover, it was argued that, because the majority of corporate bond transactions occur in the OTC market, it would be difficult for a market participant to effect a manipulation of the primary bond market through short sales on an exchange.

The Commission preliminarily concluded in the release that the application of Rule 10a–1 to bonds might impose an unnecessary regulatory burden on the exchange market because exchange trading of such bonds is not susceptible to the types of market abuse that the short sale rule is designed to prevent. Moreover, given the limited amount of bond trading effected on exchanges, there would appear to be little reason for concern over the effect of short selling of bonds on an exchange. Accordingly, the Commission proposed to exclude transactions in bonds from Rule 10a–1 by amending paragraph (b) to add the phrase ''except a bond or debenture.''[206] It was also determined that up until the time that final action was taken on this proposed amendment, no-action relief would be provided under Rule 10a–1 with regard to short sales in exchange-listed bonds.[207]

Commenters were generally in favor of this proposed amendment and some also recommended that convertible bonds be excluded from Rule 10a–1 as well.[208] The amendments proposed in the 1992 release were never adopted or withdrawn. We believe that the same rationales that were cited in 1992 generally continue to apply today. In addition, as there is not currently a source for consolidated quote information on corporate bonds similar to what exists for equity securities, it is evident that our proposed bid test could not be applicable in the bond market.[209] We have thus proposed that the uniform bid test in Regulation SHO would not apply to bonds.[210]

Q. Should corporate bonds be excluded from proposed Rule 201?

XIV. After Hours Trading/Foreign Markets Issues

A. After-Hours Trading

Trading in U.S. stocks outside of regular market hours is not a new

[199] *See* Securities Exchange Act Release No. 11276 (March 5, 1975), 54 FR 12522 (March 19, 1975) (release proposing subparagraph (a)(2) in response to stated operational and other difficulties associated with complying with Rule 10a–1) (Proposing Release); *see also* Securities Exchange Act Release No. 11468 (June 12, 1975), 40 FR 25442 (June 16, 1975) (adoption of proposed changes adding subparagraph (a)(2)) (Adopting Release).

[200] *Id.*

[201] *See, supra* part IV.B.

[202] In adopting subparagraph (a)(2) the Commission noted that the ''modernization of exchange facilities may eliminate the need to structure short sale regulation in this manner and that it should be possible ultimately to utilize the kind of uniform rule'' originally proposed. *See, supra* n. 199.

[203] *See* Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992).

[204] *See* Letters from Carrie E. Dwyer, Vice President and General Counsel, Amex, to John Wheeler, Secretary, SEC (December 30, 1985 and January 22, 1986); and Letter from Scott L. Noah, Assistant Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC (November 22, 1989) (Amex Letters).

[205] The Commission noted the fact that the NASD had filed in April of 1992 a proposed rule change to implement its own short sale regulation, however this ''bid test'' would not relate to OTC transactions in bonds. *See, supra* n. 203 at n. 34.

[206] Convertible bonds were not proposed to be excluded from the Rule. The Commission noted that convertible bonds are defined as ''equity securities'' in the Exchange Act (Section 3(a)(11), 15 U.S.C. 78c(a)(11)). Further, it was argued that short selling of convertible bonds (at least in the much larger OTC market) might have an impact on the price of related exchange-traded equity securities. Id at n. 43.

[207] *Id.*

[208] *See* Letters from American Bar Association, Bear Stearns & Co., Inc., New York Stock Exchange, Securities Industry Association, and Sullivan & Cromwell.

[209] In 2001, the Commission approved a proposal by the NASD to establish a corporate bond reporting and transaction dissemination facility, TRACE. *See* Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001) (SR–NASD–1999–65) (order approving TRACE).

[210] Should there in the future be a source for consolidated quote information on corporate bonds, we may decide to revisit the application of the bid test to bonds.

phenomenon.[211] For years, institutional investors and market professionals have sent after-hours orders to broker-dealers for execution as principal on alternative broker-dealer trading systems, such as ECNs. However, technological advances have changed the securities markets, and trading has expanded beyond the regular trading hours of 9:30 a.m. to 4 p.m. Eastern Time (ET).

We have supported investor choice in trading hours provided that essential protections for investors and the markets are not compromised. We have approved several SRO programs designed to further these goals, including extending consolidated last trade price and quotation information. We have also approved after hours and pre-opening trading sessions for the Archipelago Exchange (ArcaEx).[212] In addition, we have approved on a pilot basis a Nasdaq program to extend the operation of key trade and price reporting systems until 6:30 p.m. ET.[213] However, the NASD has not extended its short sale bid test, Rule 3350, to the after-hours market.[214] Nonetheless, NASD members are still required to make affirmative determinations that they will receive delivery of a security from their customers or that the member can borrow the security on behalf of the customer for delivery by settlement date before accepting short sale orders.[215]

We currently interpret the tick test to apply to all trades in listed securities, whenever they occur. By its terms, Rule 10a–1 uses as a reference point the last trade price reported to the tape. Thus, after the tape ceases to operate, the rule prevents any person from effecting a short sale at a price that is lower than the last sale reported to the tape. Most of the comments received in response to the Concept Release supported applying the short sale rule to after-hours trading.[216] We believe that the proposed uniform short sale rule should apply to after hours trades in all covered securities, requiring all short sales in covered securities to be effected at a price above the current best bid displayed as part of the consolidated best bid and offer. After the time the consolidated best bid ceases to be calculated and disseminated, the proposed rule would prevent short selling at a price at or below the last published consolidated best bid. We believe that applying the proposed bid test to after hours trades in all covered securities would extend the goals of short sale regulation to the after hours markets.

We solicit comment on this proposed operation of the rule, including, but not limited to, the following issues:

Q. Does the consolidated quote information that is collected and published after hours provide sufficient information to allow short selling after hours at a price above the consolidated best bid, or should the rule impose a fixed reference point above which all short sales must be effected, such as the consolidated best bid at the close of the regular session?

Q. Should the proposed short sale rule allow short selling above the best bid after the time that the consolidated best bid ceases to be collected and disseminated, if reliable quotes are still published?[217] Would this approach, which would most likely have multiple reference points, be a feasible alternative?

B. Off-Shore Trading

In July 1992, the Commission announced that it was undertaking a study of the U.S. equity markets and of the regulatory environment in which those markets operate.[218] As part of the study, the Commission addressed and sought comment on the practice of U.S. broker-dealers ''booking'' trades through their foreign desks or foreign affiliates to avoid U.S. transparency requirements, off-board trading restrictions, transaction fees, or limits on short sales. In what is commonly referred to as the ''fax market,'' a U.S. broker-dealer acting as principal for its customer negotiates and agrees to the terms of a trade in the U.S., but transmits or faxes the terms overseas to be ''printed'' on the books of a foreign office.[219]

Consistent with prior Commission action, we view short sale regulation as applying to trades in reported securities when the trade is agreed to in the United States, even if the trades are ''booked'' overseas.[220] For example, a

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[211] *See* Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (January 1994), at II–13 and II–14.

[212] *See* Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001). ArcaEx entered into an agreement with SIAC to extend the operation of the consolidated tape for exchange-listed stocks and Nasdaq NMS stocks from 8 a.m. to 8 p.m. ET.

[213] *See* Securities Exchange Act Release No. 42003 (October 13, 1999), 64 FR 56554 (October 20, 1999). Under the pilot, any Nasdaq market maker that chooses to post quotations and trade during these extended hours is obligated to post firm two-sided quotations when opening and making its market, but may enter or leave the market on the hour or half-hour up to 6:30 p.m. Regardless of an NASD's member's quotation activity, all transactions in Nasdaq National Market, Small Cap, Convertible Debt and OTC transactions in exchange-listed securities executed between the hours of 8 a.m. and 6:30 p.m. must be reported within 90 seconds.

[214] *See* NASD Head Trader Alert #2000–55 (August 7, 2000).

[215] *See* NASD Rule 3370.

[216] The NYSE and the NASD were among those commentators who recommended extending the short sale rule to cover after hours trading. The NYSE stated that, ''With respect to after-hours trading, the Exchange believes that the Rule should apply given the potential for trading abuses in a market environment with lesser trading volume and greater volatility.'' *See* Letter from James E. Buck, Senior Vice President and Secretary, NYSE (February 3, 2000). The NASD recommended that short sale regulation be extended to all securities being traded in extended hours sessions, including National Market and SmallCap securities. ''The justifications for regulating short-sales—the threats of abusive short-selling, extreme volatility, and reduced liquidity due to the high risk to market-makers—apply with equal, if not greater, force during extended hours trading.'' *See* Letter from Richard G. Ketchum, President, NASD, Inc. (February 15, 2000). However, as noted, the NASD subsequently determined not to apply Rule 3350 after-hours, due to the belief that the volume of trading after hours was not sufficient to justify imposing short sale regulation.

[217] For example, in its comment letter in response to the Concept Release, one commenter urged the Commission to allow short sales to be effected on ATSs based on their respective systems' last trade price when the tape is not operating. It was noted that this option could only be extended to such ATSs that meet certain thresholds relative to the overall trading volume in the after-hours market. *See* Letter from Orrick, Herrington & Sutcliffe, counsel for MarketXT (December 30, 1999). Island also suggested allowing ATSs operating after-hours to rely on their own bid as a reference point. *See* Letter from The Island ECN, Inc. (January 21, 2000).

[218] *See* Securities Exchange Act Release No. 30920 (July 14, 1992), 57 FR 32587 (July 22, 1992).

[219] This practice of ''booking'' trades overseas was analyzed and dealt with in further depth in the Division of Market Regulation's Market 2000 Report. In the Report, the Division estimated that approximately 7 million shares a day in NYSE stocks are faxed overseas, and many of these trades are nominally ''executed'' in the London over-the-counter market. The Report further stated that off-shore trades generally are not reported publicly. Rather, they are reported for regulatory purposes only to the NYSE and NASD pursuant to NYSE Rule 410 or to the NASD on Form T. *See* Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (January 1994), Study VII, p. 2.

[220] *See, e.g.*, Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (April 30, 1990) (stating that the no-action position exempting certain index arbitrage sales from the tick test provisions of Rule 10a–1 will not apply to an index arbitrage position that was established in an offshore transaction unless the holder acquired the securities from a seller that acted in compliance with Rule 10a–1 or other comparable provision of foreign law); *see also* Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302 (April 25, 1985) at n. 48 (stating that, ''Rule 10a–1 does not contain any exemption for short sales effected in international markets.''). The question of whether a particular transaction negotiated in the U.S. but nominally executed abroad by a foreign affiliate is a domestic trade for U.S. regulatory purposes was also addressed in the Commission's Order concerning Wunsch Auction Systems, Inc. (WASI). The Commission stated its belief that ''trades negotiated in the U.S. on a U.S. exchange are domestic, not foreign trades. The fact that the trade may be time-stamped in London for purposes of avoiding an SRO rule does not in our view affect the obligation of WASI and BT Brokerage to maintain a complete record of such trades and report them as U.S. trades to U.S. regulatory and self-regulatory authorities and, where applicable, to U.S. reporting systems.'' *See* Securities Exchange Act Release No. 28899 (February 20, 1991), 56 FR 8377 (February 28, 1991).

U.S. money manager decides to sell a block of 500,000 shares in a NYSE security. The money manager negotiates a price with a U.S. broker-dealer, who sends the order ticket to its foreign trading desk for execution. In our view, this trade occurred in the United States as much as if the trade had been executed by the broker-dealer at a U.S. trading desk. Under the proposed rule, if the sale agreed to is a short sale in an exchange-listed or Nasdaq NMS security, unless otherwise excepted, it must be effected at a price one cent above the current best bid displayed as part of the consolidated best bid and offer regardless of where it is executed.

Q. What factors should be used to determine whether a trade in a covered security is agreed to in the U.S.? If a trade is agreed to by a broker-dealer located outside the U.S., should the trade be viewed as agreed to outside the U.S., regardless of the location of the seller? Would the requirement that trades agreed to in the U.S. be effected at a price above the current best bid disadvantage U.S. broker-dealers in favor of foreign broker-dealers? If so, please explain.

Q. For trades agreed to in the United States and executed overseas, is the time of agreement a sufficient determinative event for the triggering of the rule?

XV. Limitations on Short Selling During Significant Market Declines

To protect investors and the markets, the Commission has approved proposals to restrict trading if key market indexes fall by specified amounts. In response to the October, 1987 market break, the Commission approved various exchanges' circuit breaker proposals to permit these brief, coordinated cross-market halts to provide opportunities during a severe market decline to reestablish an equilibrium between buying and selling interests in an orderly fashion, and help to ensure that market participants have a reasonable opportunity to become aware of, and respond to, significant price movements.[221] The coordinated cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the *ad hoc* and destabilizing halts which can occur when market liquidity is exhausted.[222] Currently, all stock exchanges and the NASD have rules or policies to implement coordinated circuit breaker halts.[223] The options markets also have rules applying circuit breakers.[224] The futures exchanges that trade futures on indexes have adopted circuit breaker halt procedures in conjunction with their price limit rules for index products.[225] Finally, security futures products are required to have cross-market circuit breaker regulatory halt procedures in place.[226]

We note that current short sale regulation focuses on the prices of individual securities rather than market segments or market indexes. Nevertheless, we seek comment on whether short selling should be restricted in the future in response to a severe market decline.

Q. Should short selling be restricted or prevented during a period of significant market decline, such as after circuit breakers have been lifted? If so, at what level should the restrictions take place, *i.e.*, if the market declines 10%, 20% etc.? How long a period of time should the restrictions remain in effect?

Q. Should short selling be restricted or prevented for any particular security if the price of that security declines significantly during the course of a trading day? If so, at what level should the restrictions take place, *i.e.*, if the price of the security declines 10%, 20% etc.? How long a period of time should the restrictions remain in effect?

XVI. Rule 105 of Regulation M—Short Sales in Connection With a Public Offering

The price of securities in an offering is generally based on a security's closing market price. When market prices are artificially distorted securities markets are prevented from functioning as independent pricing mechanisms and offering price integrity is eroded. Short sales of securities that depress the market price shortly before an offering is priced can cause (i) the postponement or abandonment of an offering, and (ii) the offering price to be lower than anticipated because artificial forces distort it.[227] The pre-pricing short sales may exert downward pressure on a security's market price causing the market price to decline. Consequently, the offering price is set lower than anticipated because it is now based off an artificially depressed market price. Short sellers who anticipate and receive an offering allocation cover their short sales at the lower, fixed offering price generating a profit. Rule 105 of Regulation M addresses this market abuse.

A. Scope of Rule 105 of Regulation M

Rule 105 of Regulation M prohibits a short seller from covering short sales with offered securities purchased from an underwriter, broker or dealer participating in the offering if the short sale occurred within the period of five days prior to pricing of the offering securities. The Rule promotes offering prices that are based upon market prices determined by natural market forces instead of prices distorted by artificial forces. Rule 105 of Regulation M applies to offerings of securities for cash pursuant to a registration statement or a notification on Form 1–A filed under the Securities Act of 1933. The Rule prohibits covering a short sale with offering securities purchased from an underwriter or broker or dealer participating in the offering if the short sale occurred during the Rule 105 of Regulation M restricted period, which is the shorter of the period beginning (i) five business days before pricing of the offered securities and ending with such pricing, or (ii) with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing. The Rule excepts shelf offerings filed under Rule 415 and offerings not conducted on a firm commitment basis as well as providing for exemptive relief. The Rule is prophylactic, and prohibits the conduct irrespective of the short seller's intent in effecting the short sale.

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[221] *See* Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637 (October 24, 1988) (approving rules of the Amex, CBOE, NASD, NYSE).

[222] *See* Circuit Breaker Report by the Staff of the President's Working Group on Financial Markets (August 18, 1998) (Circuit Breaker Report), n. 33.

[223] *See* Securities Exchange Act Release No. 39846 (April 9, 1998), 63 FR 18477 (April 15, 1998) (order approving proposals by Amex, BSE, CHX, NASD, NYSE, and Phlx). *See also e.g.*, NYSE Rule 80B. The current circuit breaker procedures call for cross-market trading halts when the Dow Jones Industrial Average (DJIA) declines by 10 percent, 20 percent, and 30 percent from the previous day's closing value.

[224] *See* Amex Rule 950 (applying Amex Rule 117, Trading Halts Due to Extraordinary Market Volatility, to options transactions); CBOE Rule 6.3B; ISE Rule 703; PCX Rule 4.22 (which applies to options contracts through Rules 6.1(a) and (e)); and Phlx Rule 133.

[225] *See, e.g.*, CME Rule 4002.I. The CME will implement a circuit breaker trading halt in SPX Futures if the 10% circuit breaker halt has been imposed in the securities markets and the futures are ''locked'' at their 10% price limit. Trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50% of the index capitalization. The CME will implement another circuit breaker trading halt in SPX Futures if the 20% circuit breaker halt has been imposed in the securities markets and the futures are locked at their 20% price limit. Once again, trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50% of the index capitalization.

[226] *See* Securities Exchange Act Release No. 45956 (May 17, 2002), 67 FR 36740 (May 24, 2002).

[227] Concerned about losses in ''cold'' issues, investors may engage in schemes to guarantee ''cold'' issue profits by effecting short sales prior to the pricing of an offering (pre-pricing short sales) and covering the short sales with offering securities.

B. Shelf Offerings

We believe that the use of shelf offerings (offerings filed under § 230.415 of the Securities Act of 1933) is common today. If an individual with notice of a shelf offering takedown effects short sales during the five days prior to pricing and covers his short sale with shelf offering securities, his conduct may cause the same downward price pressure that occurs with pre-pricing short sales in connection with non-shelf offerings. The trading has the same manipulative potential, the same effect on offering price, and causes the same abuse that Rule 105 of Regulation M is designed to prevent. Accordingly, we propose eliminating the current shelf offering exception in Rule 105 of Regulation M. We solicit comment concerning the proposed elimination of the shelf offering exception. We also seek comments concerning other areas of the Rule.

Q. In what manner are shelf offerings of equity securities marketed to potential investors? Include a discussion of the similarities and/or differences with respect to the marketing efforts of shelf and non-shelf offerings. Discuss the types of marketing efforts used and whether potential investors have notice of a shelf takedown before it occurs.

Q. Should Rule 105 of Regulation M be applicable to only equity offerings? What is the Rule's relevance with respect to debt offerings and the potential for manipulation with debt offerings or other offering types?

Q. Should the prohibitions of Rule 105 of Regulation M extend to derivative securities, *i.e.*, should a person be prohibited from covering put options entered into within the period five days prior to pricing with securities purchased from an underwriter, broker or dealer participating in the offering?

Q. Should the prohibitions of Rule 105 of Regulation M extend to short sales effected prior to the exercise of conversion rights under a debenture, or other security, and covering the short sales with securities issued in the conversion when the conversion consideration is based upon the security's market price during a certain time period prior to the conversion?

Q. Should a person who executes short sales during the five day business period prior to the pricing of an offering be permitted to cover preexisting short positions held prior to that five day period with offering securities? Please provide a detailed analysis, including a discussion regarding the fungibility of securities. Can you trace offering shares in a person's account to show that they are used to cover the preexisting short position as opposed to the short sales executed five days prior to pricing?

Q. Does the language ''cover a short sale'' provide the proper scope of prohibited activity? Is there additional or alternative language we should consider?

Q. What is the manner in which firms, including prime brokerage firms, monitor compliance with Rule 105 of Regulation M, both manually and with computer systems?

Q. Should Rule 105 apply to acquisitions from an issuer in a shelf takedown, such as a public equity line from an issuer or other direct purchase arrangement with an issuer?

C. Sham Transactions Designed To Give the Appearance of Covering With Open Market Securities

Recently, the Commission has become aware of, and taken action, with respect to conduct designed to evade, but which violates Rule 105 of Regulation M.[228] This conduct may involve short sales within the restricted period of Rule 105, the purchase of offering shares, and the contemporaneous sale and purchase of the same class of shares as the offering shares. For example, an individual may sell the shares in the market and immediately purchase an equivalent number of shares. Where the transaction is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk, that transaction may be a sham transaction.

The Commission would continue to consider enforcement action against those participating in sham transactions structured in a manner to give the appearance of compliance with Rule 105, but in fact, violate the rule. We are not proposing revisions to Rule 105 with respect to activities that violate the current rule. We seek comment, however, on criteria in addition to economic purpose or substance, change in beneficial ownership, and market risk, that may distinguish sham transactions from legitimate trading. The Commission also solicits comment regarding whether there should be additional language in the rule text of Rule 105 to address other transactions that cause the harm the Rule 105 is designed to prevent.

XVII. General Request for Comment

The Commission seeks comment generally on all aspects of proposed Regulation SHO and the proposed amendment to Rule 105 of Regulation M under the Exchange Act. In addition to the specific requests for comment found throughout this release, the Commission asks commenters to address whether proposed Regulation SHO furthers the Commission's objectives to (1) allow relatively unrestricted short selling in an advancing market, (2) prevent short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down, and (3) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed Regulation SHO and Rule 105.

XVIII. Paperwork Reduction Act

Proposed Regulation SHO would impose a new ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995,[229] and the Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information imposed by Regulation SHO.

A. Summary of Collections of Information

Proposed Regulation SHO, Rule 201 contains a requirement that all sell orders of securities registered under Section 12(g) of the Exchange Act be marked ''long,'' ''short,'' and ''short exempt.'' Currently, Rule 10a–1 prohibits the execution of a sell order for a security covered by Rule 10a–1 unless the order is marked either ''long'' or ''short.'' Proposed Regulation SHO would be a new collection of information because the collection would cover a much larger number of securities. Proposed Regulation SHO, Rule 201 would add two elements to this marking requirement. First, a new category for ''short exempt'' orders would be added. Second, the marking requirement would be extended to apply to all equity securities, including exchange-listed securities, Nasdaq NMS, Nasdaq SmallCap, OTCBB, and Pink Sheet securities. If the Commission adopts Proposed Regulation SHO, Rule 10a–1 would be repealed and any collection of information under Rule 10a–1 would be eliminated.

Sell orders of exchange-listed and Nasdaq securities are already marked ''long,'' ''short,'' or ''short exempt'' pursuant to Rule 10a–1, NYSE Rule

[228] *See,* Ascend Capital, LLC, Securities Exchange Act Release No. 48188 (July 17, 2003).

[229] 44 U.S.C. 3501 *et seq.*

440B.20, and the ITS Plan.[230] Nasdaq NMS and Nasdaq SmallCap securities are also currently subject to marking requirement pursuant to NASD Rule 4991. Proposed Regulation SHO, Rule 201 would simply codify current industry practice for exchange-listed and Nasdaq securities into a uniform marking requirement.

Proposed Regulation SHO, Rule 201 would also apply to securities not currently covered under Rule 10a–1. Proposed Regulation SHO's marking requirement would apply to all sell orders of equity securities registered under Section 12(g) of the Exchnage Act, including, exchange-listed, Nasdaq NMS and SmallCap, OTCBB, Pink Sheets, and any other securities registered under 12(g).

As a result, the collection of information under proposed Regulation SHO is the requirements that all sell orders of equity securities registered under the Exchange Act be marked ''long,'' ''short,'' or ''short exempt.''

B. Proposed Use of Information

The information required by proposed Regulation SHO is necessary for the execution of the Commission's mandate under the Exchange Act to prevent fraudulent, manipulative and deceptive acts and practices by broker-dealers. The purpose of the information collected is to enable a national securities exchange or national securities association to monitor whether a person effecting a short sale covered by proposed Regulation SHO is acting in accordance with Regulation SHO. In particular, requiring each order be marked either ''long,'' ''short,'' or ''short exempt'' would aid in ensuring compliance with proposed Rules 201 and 203. Moreover, the ''short exempt'' category would aid is surveillance for compliance with the proposed limited exception from the bid test for riskless principal transactions.

C. Respondents

The marking provision in Rule 201 would apply to all 6,752 active brokers or dealers that are registered with the Commission. The Commission has considered each of these respondents for the purposes of calculating the reporting burden under proposed Regulation SHO.

D. Total Annual Reporting and Recordkeeping Burdens

Proposed Rule 201 of Regulation SHO would require all brokers or dealers to mark all sell orders appropriately as ''long,'' ''short,'' or ''short exempt'' for all securities registered under Section 12(g) of the Exchange Act. We assume that all of the approximately 6,752 registered broker-dealers effect sell orders in securities covered by proposed Regulation SHO. For purposes of the Paperwork Reduction Act, the Commission staff has estimated that a total of 1,164,755,007 trades are executed annually.[231]

This is an average of approximately 172,505 annual responses by each respondent. Each response of marking orders ''long,'' ''short,'' or ''short exempt'' takes approximately .000139 hours (.5 seconds) to complete.[232] Thus, the total approximate estimated annual hour burden per year is 161,900 burden hours (1,164,755,007 responses @ 0.000139 hours/response). A reasonable estimate for the paperwork compliance for the proposed rules for each broker-dealer is approximately 24 burden hours (172,505 responses @ .000139 hours/response) or (a total of 161,900 burden hours / 6,752 respondents).

E. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–23–03. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–23–03, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549–0609. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

XIX. Consideration of Proposed Regulation SHO's Costs and Benefits

The Commission is considering the costs and the benefits of proposed Regulation SHO, which would replace Rules 3b-3, 10a-1, and 10a-2, as well as proposed amendments to Rule 105 of Regulation M. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here. In particular, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and others. Commenters should provide analysis and data to support their views on the costs and benefits associated with proposed Regulation SHO and proposed amendments to Rule 105 of Regulation M.

A. Proposed Rule 201: Price Test and Marking Requirements

1. The Proposed Uniform Bid Test

a. Benefits

We believe that the proposed bid test would simplify the application of the price test and provide flexibility to those seeking to sell short, especially in the current decimals environment. This increased ability to execute short sales in securities currently subject to Rule 10a-1 may lead to a reduction in transaction costs. Moreover, we believe that a uniform rule is preferable to applying different tests in different markets, which can require market participants to apply different rules to different securities, and thus may also reduce transaction costs. Also, there would be benefits associated with systems and surveillance mechanisms

[230] See Section IX.A regarding Marking Orders.

[231] In calendar year 2002 there were approximately 545,556,000 trades on the NYSE, and 607,824,500 on Nasdaq NMS and Nasdaq SmallCap, and 11,374,507 in OTCBB, Pink Sheet, and other (gray market) securities.

[232] We believe it is reasonable that it would only take 0.5 seconds or .00039 hours to mark an order ''long,'' ''short,'' or ''short exempt.''

that would only have to be programmed to consider a single test based on the consolidated best bid instead of two tests based on last sale and last bid information.

In addition, the degree of restrictiveness of a price test may affect how well the stock price represents fundamental values. For example, a flexible price test may allow a trader to more freely sell short a stock that he or she believes is overvalued. The Commission seeks comments on whether the proposed bid test would affect stock prices and whether proposed Rule 201would result in prices that are a better reflection of the issuer's fundamental values.

The Commission seeks estimates and views regarding the benefits to particular types of market participants as well as any other costs or benefits that may result from the adoption of proposed Regulation SHO. Please provide any specific data.

Another potential benefit of the proposed bid test is that it should simplify surveillance systems in that proposed Rule 201 would look to the consolidated best bid at the time of execution as the reference price for short sales. This should be less complicated than comparing the immediately preceding sale or bid as the reference point for short sale compliance. In addition, we note that having only one short sale rule instead of two would mean that new staff (compliance personnel, traders, etc.) would only need to be trained regarding one rule. Over the long run, we believe this would likely lead to decreased costs for training and compliance.

The Commission received approximately 35 formal requests for relief from Rule 10a-1 in 2002 in addition to approximately 340 phone calls. The Commission anticipates that a large percentage of the relief requested would no longer be necessary under the proposed uniform bid test. We expect that each request for relief requires a number of labor hours from traders and lawyers, both in-house and outside counsel, of a broker-dealer or exchange, when making informal (phone calls) or formal (letters) requests for exemptions from Rule 10a-1. The Commission requests empirical data to quantify this benefit.

b. Costs

As an aid in evaluating costs and reductions in costs associated with the proposed Rule 201, the Commission requests the public's views and any supporting information regarding the costs associated with implementing the proposed uniform bid test. The Commission believes that the proposed uniform bid test requiring short sales in exchange-listed and Nasdaq NMS securities to be effected at a price one cent above the consolidated best bid at the time of execution would impose costs on brokers or dealers, specialists, market makers, ECNs, Alternative Trading Systems (ATSs), and SROs. Adoption of the proposed uniform bid test in the various markets would require modifications to trading systems and surveillance systems. Under the proposal, systems trading exchange-listed securities and Nasdaq NMS securities would have to shift from Rule 10a-1's tick test and NASD Rule 3350's bid test, respectively, to the proposed uniform bid test. The Commission anticipates that these changes would result in immediate implementation costs associated with reprogramming trading and surveillance systems. One exchange informed us that reprogramming systems would take one month at a cost of approximately $100,000. A broker-dealer stated that it would take two months to reconfigure its systems to account for a new bid test but was unable to provide a cost estimate. These estimates do not include costs associated with training staff that would be effected by these systems modifications.

The Commission seeks examples of all types of entities that would be affected by this proposal. The Commission seeks specific comments on the costs associated with system changes, including the type of system changes necessary and quantification of costs associated with changing the systems, including both start-up costs and maintenance. Comments are also requested on the types of jobs and staff that would be affected by systems modifications and training about the new rule, the number of labor hours that would be required to accomplish these matters, and the compensation rates of these staff members. The Commission also requests data to quantify the benefits of this proposal relating to ongoing compliance and surveillance of a uniform bid test. In addition, there may be costs associated with changing surveillance systems to monitor for compliance with the proposed bid test. We request specific comment on the costs for reprogramming systems to accommodate the proposed bid test in Rule 201.

2. Market Makers

a. Benefits

NASD Rule 3350 currently exempts from operation of the NASD's short sale rule short sales executed by qualified market makers in connection with bona fide market making.[233] We do not propose a market maker exception to Rule 201. We believe this would benefit the markets by subjecting all participants to the same regulation. We believe that the proposal would allow all market participants to establish short positions without being disadvantaged by an exception to the rule only available to certain participants. For example, there may be benefits in limiting the ability of a market maker to profit from position trading in anticipation of a market decline. The Commission also requests comment on any benefits that may result from adopting a price test absent a market maker exception. The Commission also seeks comments on the benefits of not allowing anyone to sell short at or below the best bid in a declining market.

b. Costs

The absence of a market maker exception from Rule 201 may have implications for market makers' ability to supply liquidity. Some may argue that investors are harmed when market makers incur an increase in costs because market makers would pass the increased costs to investors. The Commission requests detailed comments on these, or any other, costs to market makers, investors or others associated with not adopting an exception from the proposed bid test for market makers.

The Commission also recognizes that proposed Rule 201 may result in lost trading or business opportunities in the various markets. For example, there may be a cost in lost trading or business opportunities for those who trade Nasdaq NMS securities, in that the proposed bid test is more restrictive than the current Nasdaq bid test, and the market maker exemption has been eliminated. Please quantify, if possible, whether there would be any lost trading or business opportunity costs.

4. Use of the Consolidated Best Bid

a. Benefits

Proposed Regulation SHO would use the consolidated best bid as a reference point for all short sales of exchange-listed or Nasdaq NMS securities wherever traded. The Commission believes that the use of the consolidated best bid is a benefit because it reflects the consolidated bids from the various market centers that trade exchange-listed and Nasdaq NMS securities and is continuously collected and disseminated on a real-time basis, in a single steam of information and would

[233] *See supra* part VIII for a further discussion.

be a more accurate depiction of the market's valuation of a security.

b. Costs

The Commission is aware that this change may result in increased costs to traders, specialists, broker-dealers, and floor brokers on the NYSE or Amex who have heretofore used the last sale occurring in their own market as a reference point for short sales. For example, there would be a cost to market participants in gaining access to the consolidated best bid by subscribing to a vendor. We believe, however, that most, if not all, market participants already have access to this information. The Commission seeks information quantifying the cost of gaining access to the consolidated best bid.

In addition, it is possible that the consolidated best bid may flicker more than an exchange's own best bid. Bid flickering may impede on the ability to execute short sales, which may result in increased costs. Please provide data to assist the Commission quantify these costs, if any.

5. Marking Orders

a. Benefits

Proposed Rule 201 would permit broker-dealers to mark orders long only if the customer owns the securities and they are in the customer's account, or would be prior to settlement. Proposed Rule 201 also would require broker-dealers to differentiate between ''long,'' ''short,'' and ''short exempt'' sell orders. We believe these provisions would provide several benefits. The Commission notes that the current marking requirements can lead to undetected violations of proposed Rule 201 because once the order is marked ''long,'' others handling the order execute the order as if it were a long sale, even though settlement on the sale may be effected by the delivery of borrowed securities. This can complicate surveillance for violations of the price test, as short sales executed under an exception from the price test can be masked as long sales. A benefit of this proposal is that surveillance for violations of proposed Rule 201 would be aided through accurate indications of when and under what circumstances these exceptions are utilized. An additional benefit is that the ''short exempt'' category would aid in surveillance for compliance with the proposed riskless principle exception to the bid test.

Further, we believe the proposed requirement that a broker-dealer cannot mark a sale ''long'' unless it has physical possession or control of the security, either when the order is placed or prior to settlement, is a benefit because it would facilitate the process of clearance and settlement. Disturbances in settlement processes can affect the stability and integrity of the financial system in general. Clearance and settlement systems are designed to preserve financial integrity and minimize the likelihood of systematic disturbances by instituting risk-management systems. Requiring a broker-dealer to have possession or control of the securities before it can mark an order long would assist in reducing settlement and credit risks.

The Commission proposes extending the marking requirements to all equity securities, including OTCBB and Pink Sheet securities. This proposal is designed to assist in surveillance for violations of the locate and delivery requirements proposed in Rule 203 of Regulation SHO.

b. Costs

The Commission does not currently believe any costs would arise from the proposed requirement that sell orders be marked long only if the securities to be sold are owned by the customer and either presently, or prior to settlement, in the customer's account. Most customer securities are not held by investors in physical form, but rather are held indirectly through their broker-dealer, *i.e.*, in ''street name.''

The Commission anticipates that any costs arising from the proposed requirement that certain sell orders be marked ''short exempt'' would be minimal because some self-regulatory organizations already either require or advise members to utilize the ''short exempt'' designation. We believe that the Commission's proposed amendment codifies current practice and provides the markets with a uniform practice. The Commission proposes extending the marking requirements to all equity securities, including OTCBB and Pink Sheet securities. The Commission recognizes that there is a paperwork burden cost associated with adding the ''short exempt'' category and extending the marking requirement to all equity securities. As discussed above in Section XVIII, the paperwork burden is estimated at approximately 24 burden hours for each broker-dealer registered with the Commission.[234] The Commission does not believe there are any additional costs to this proposal, however we seek any data supporting any additional costs not mentioned.

6. Exceptions to the Rule

a. Benefits

Proposed Regulation SHO would eliminate or alter exceptions to Rule 10a–1's tick test and create certain exceptions to the proposed bid test, which we believe would result in benefits. Proposed Regulation SHO proposes eliminating the equalizing exception, which is based on the last sale concept and would have no utility under the proposed bid test. This would further the goal of regulatory simplification.

In addition, the Commission believes that extension of the odd-lot exception to all market makers may reduce market makers' costs, since they would no longer need to register as odd-lot dealers or third market makers to avail themselves of the exception. Moreover permitting market makers to offset customer odd-lot orders and liquidate odd-lot positions without regard to the proposed uniform bid test would enhance market makers' ability to provide liquidity. To the extent that the benefits flowing from this increased liquidity can be quantified, we seek data and analysis on how to represent them accurately.

Moreover, the benefit of the proposal to alter Rule 10a–1's domestic arbitrage exception to require that a person relying on the exception must subsequently acquire or purchase the security upon which the arbitrage is based is that it would help reduce pricing disparities between securities. In addition, the proposed language change would help with surveillance for compliance with the exception.

In addition, the proposed limited exception to the bid test when the market is locked or crossed is beneficial because it increases liquidity by giving responsible broker-dealers flexibility to execute short sales in such situations. Moreover, the proposed exception permitting broker-dealers to sell short at the consolidated best bid to satisfy any obligations of a broker-dealer to customer limit orders, as determined by federal securities laws or rules of a self-regulatory organization, is a benefit because it ensures that customer limit orders are executed in a fair manner and at prices similar to the price at which a firm has traded for its own account. Finally, the proposed exception relating to pre-opening VWAP short sales would codify existing exemptive relief, thus providing the benefit of regulatory simplification, and may also promote a more liquid market for large traders.

[234] For a full discussion of the paperwork burden associated with the marking requirements see Section XVIII.

b. Costs

The Commission does not believe there would be any costs associated with altering the odd-lot and domestic arbitrage exceptions, eliminating the equalizing exception, creating new exceptions relating to locked or crossed markets and facilitating customer orders, and codifying existing VWAP exemptive relief. The Commission seeks comment, however, on whether any such costs exist, and if so, data to support such costs.

B. Proposed Rule 203: Locate and Delivery Requirements

1. Benefits

Proposed Rule 203 would enhance locate and delivery requirements for short sales in all equity securities. These changes are proposed in response to complaints from many issuers and investors concerning allegations of abusive ''naked short selling.'' The Commission proposes to adopt safeguards to address the problems associated with large persistent failures-to-deliver. The Commission believes that this requirement would help curtail manipulative naked short selling.

The Commission believes that it would be beneficial to establish uniform procedures to be utilized by short sellers to locate securities for borrowing, which could help promote and enhance the national clearance and settlement system. The Commission is proposing to prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale rule is executed: (1) Borrowed the security, or entered into an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the delivery date it is due. This uniform rule would further the goals of regulatory simplification and avoidance of regulatory arbitrage. Please describe any additional benefits resulting from the proposed uniform locate requirements.

The Commission is also proposing additional delivery requirements targeted at securities where there is evidence of large settlement failures. The proposal would specify that a short sale in any security that meets the threshold, *i.e.*, any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more, and that is equal to one-half of one percent of the issue's total shares outstanding, must be delivered, or the broker-dealer would be required to enter into a contract to borrow the security, or effect a buy in so that, in either event, the security would be delivered within two days after the settlement date. If the securities are not delivered within two days after the settlement date, for a period of ninety calendar days the broker or dealer shall not execute a short sale in such security for his own account or the account of the person for whose account the failure to deliver occurred unless the broker or dealer or the person for whose account the short sale is executed has borrowed the security, or entered into a bona fide arrangement to borrow the security, and will deliver the security on the date delivery is due. The proposed Rule would also require the rules of the registered clearing agency to include the following provisions: (A) A broker or dealer failing to deliver securities as specified in subparagraph (3) above shall be referred to the NASD and the Examining Authority (as defined in 15c3–1(c)(12)) for such broker or dealer for appropriate action; and (B) The registered clearing agency shall withhold a benefit equal to any mark to market amounts or payments that otherwise would be made to the participant failing to deliver, and assess appropriate charges.

The Commission believes that these additional delivery requirements would protect and enhance the operation, integrity, and stability of the markets. In particular, this requirement is targeted at securities with lower market capitalization that may be more susceptible to abuse. We also believe that clearly articulated rules restricting naked short selling would assist the Commission in its enforcement efforts.

The Commission believes that a large amount of fails at the clearing level may impose costs on the clearing agency. For example, certain issuers have taken steps to make themselves either ''certificate only,'' which require physical certification of company ownership for all share transfers, or ''custody only,'' which restricts ownership of their securities by depositories or financial intermediaries. The Commission believes these custody arrangements are highly costly to the clearing agencies, depositories and financial intermediaries. The Commission believes this proposed additional delivery requirement would provide a benefit because it would mitigate some of these costs. Please provide data supporting this, and any other, benefit that the proposal would provide in mitigating such costs, including benefits to clearing agencies, depositories and financial intermediaries in implementing and complying with this proposal.

Proposed Rule 203 would also make two changes to existing long sale delivery rules. First, the rule would extend current delivery requirements for long sales of listed securities to all equity securities, including Nasdaq NMS, Nasdaq SmallCap, OTCBB, and Pink Sheet securities. The intended benefits of this change are uniformity across markets and a reduction in the number of fails to deliver on long sales. Moreover, the Commission believes that this modification would facilitate the process of clearance and settlement. The amended rule would also permit a broker-dealer effecting a long sale to fail to deliver, or to deliver borrowed securities, if prior to the sale, the seller told the broker-dealer he owned the security and would deliver it to the broker-dealer prior to settlement. This change is necessary to conform the proposed rule with proposed Rule 201(c), which would require an order to be marked long only if the seller informs his broker-dealer that he owns the security and the broker-dealer will have physical possession or control of the security prior to settlement. It is intended that this change would both reduce the number of over-the-counter fails, and facilitate the process of clearance and settlement. The Commission requests data to quantify the value of the benefits identified.

2. Costs

The Commission recognizes that the proposed locate and delivery requirement may increase costs for market participants who engage in short selling. However, we believe that these costs would be minimal, because the proposed rules largely incorporate existing SRO locate rules, such as NYSE Rule 440C.10 and NASD Rule 3370. The Commission is, however, proposing an exception from these requirements for short sales executed by specialists or market makers in connection with bona-fide market making activities. In addition, any costs that may be initially incurred would be mitigated over time because the uniform rule should lead to regulatory simplification with regard to training and surveillance. Please describe any additional costs resulting from the proposed uniform borrow requirements to market participants already subject to locate requirements by SROs. The Commission requests data to quantify the costs identified.

This proposal would apply to all equity securities, including securities that have quotations published on the OTCBB and Pink Sheets. Issuers and investors have complained about

''naked short selling'' in these thinly-capitalized securities trading over-the-counter. The proposed locate and delivery requirements would address some of these concerns. There may be costs associated with implementing these borrowing requirements for OTCBB and Pink Sheets securities. The Commission requests comment on the costs of implementing these requirements, as well as costs associated with ongoing compliance and surveillance associated with this proposal. The Commission is also concerned with the impact this proposal may have on small issuers. Please provide data to quantify the costs to small issuers and potential investors in these small issuers, including whether reduced short selling opportunities may make the securities in these markets more susceptible to having overvalued stock prices. In addition, we request comment on the extent to which the recommended proposals may affect the ability of small issuers to secure financing through the issuance of convertible debentures. Please describe and analyze any other costs associated with this proposal.

The Commission also recognizes that there would be costs to market participants in implementing and complying with the proposed additional delivery requirements targeted at securities with substantial settlement failures. The Commission seeks estimates and views regarding these costs for particular types of market participants, as well as any other costs or benefits that may result from adoption of the proposal.

The Commission is not proposing any exception from the proposed additional delivery requirements for shorts sales in connection with bona-fide market making because we believe that extended fails to deliver appear characteristic of an investment or trading strategy, rather than one related to market making. The Commission believes that there may be costs to market makers that have open extended fail positions. We have requested comment on the need for market makers engaging in bona-fide market making to maintain extended fail positions. Please provide information detailing any costs that may be associated with not providing a market maker exception to the proposed additional delivery requirements. In particular, we request comment on any lost trading or business opportunity costs to market makers, any potential impact on investors, and a detailed description of any such costs.

In general, the Commission acknowledges that the proposed additional delivery requirements may bring about new costs for market participants. The Commission requests data to quantify the costs identified. Broker-dealers, market makers, SROs, and clearance and settlement firms may incur costs in making initial system changes necessary to implement these new requirements, as well as maintain ongoing compliance and surveillance mechanisms. We request specific comment on the system changes to computer hardware and software, or surveillance costs necessary to implement this rule. If this rule requires additional labor, please indicate what type of jobs are affected, how many additional hours are required and the approximate costs of these additional hours.

C. Proposed Rule 202(T): Temporary Short Sale Rule Suspension

1. Benefits

The proposed pilot program would suspend the operation of the proposed bid test provision for selected stocks that the Commission believes are less susceptible to manipulation because they are more liquid and have a high market capitalization. The proposed pilot program is intended to provide the Commission with empirical data to assess whether the proposed bid test should be removed for liquid securities. The empirical data collected would enable the Commission to study the effects of deregulated short selling on, among other things, market volatility, price efficiency, and liquidity. The proposed pilot program would assist the Commission in determining if, and to what extent, a price test inhibits the markets. The data would also be used to study the extent to which the proposed bid test achieves the stated objectives of the short sale rule by comparing trading activity in liquid securities that are subject to a price test with liquid securities that are not subject to a price test. The markets would benefit in the long run from the possibility of removing a rule that may weaken markets or, alternatively, by retaining a rule that may strengthen markets.

In addition, the Commission recognizes that, in the presence of short sale restrictions in equity securities, the absence of short sale regulation for securities futures may make trading security futures an attractive hedging alternative to equities. The pilot is designed to remedy potentially unfair competition caused by disparate regulation between equities and security futures products. We believe that the proposed pilot program would give the Commission an opportunity to determine whether suspension of the proposed bid test would enhance competition among equities and securities futures in the most liquid securities. The Commission requests data to quantify the costs and the value of the benefits relating to security futures products and this proposal.

The Commission anticipates that broker-dealers, including market makers, may be able to provide greater liquidity in securities included in the proposed pilot program, because the absence of the proposed bid test would make it easier to fill buy orders. The Commission believes that this could benefit investors, however, the Commission seeks comment on how to assess the potential benefits of short selling without a bid test restriction in these selected securities. In addition, the Commission seeks comment on the benefits of acquiring the potential empirical data gathered from the proposed pilot program. Would the proposed pilot program effectively allow the Commission to better understand short sales and short sale restrictions? Please provide estimates and views on these potential benefits.

2. Costs

The Commission anticipates that the proposed pilot program may cause additional costs to brokers, dealers, SROs, and potentially issuers and investors. While we anticipate that SROs and broker-dealers would need to make system changes in order to exclude the selected securities from the proposed bid test, we do not know what these changes would cost. The Commission seeks detailed comment on the extent of required system changes and costs associated with implementation of the pilot program, and on any potential cost to investors due to the absence of a price test applied to these securities. In particular, the Commission seeks comment on whether the pricing of such securities is going to be more or less efficient, and whether manipulation of market prices (either upward or downward) is apt to be more or less prevalent.

The Commission believes issuers may incur some costs associated with inclusion in the pilot program and seeks estimates and views on potential costs to those issuers selected for the pilot program.

D. Proposed Rule 200: Definition of a Short Sale

1. Unconditional Contracts

a. Benefits

Proposed Rule 200 requires that unconditional contracts provide for present delivery, and specify the price

and number of securities to be sold. In addition, the proposal would require that persons who claim to be long actually receive a specified number of securities at a specified price and at a specified time. The benefit of this proposal is that it would prevent abuse by individuals seeking to claim a long position merely to avoid application of the price test provisions in proposed Rule 201. Specifically, if the price must be in the contract, there would be no incentive to attempt to depress the market price of security, such as depressing the price prior to closing where a contract mandates that the security be purchased at the closing price.

b. Costs

The Commission does not anticipate any costs for this proposal. However, the Commission notes that some broker-dealers may claim that such a proposal would inhibit their trading strategy and increase the cost of doing business. The Commission seeks comment on how such a proposal would affect the trading of retail and institutional investors and the potential costs, if any, of limitations to the trading strategies of investors.

2. Securities Futures

a. Benefits

Proposed Rule 200 would codify existing guidance issued by the Commission as to when a person is deemed to own a security underlying a security futures contract.[235] Codifying this guidance would provide ease of reference for compliance with the short sale rule for those trading in security futures.

b. Costs

The Commission acknowledges, however, that the existing interpretation may present costs associated with lost business opportunities for individuals who intended to use securities futures for trading strategies. In light of this, and in recognition that some participants may not have commented on the guidance when it was issued, the Commission requests data to quantify the costs and the value of the benefits identified.

3. Aggregation Units

a. Benefits

We have also proposed to incorporate aggregation unit netting into Rule 200. This proposal would allow multi-service broker-dealers to calculate net positions in a particular security within defined trading units independently from the positions held by the other aggregation units within the firm, subject to certain conditions. This proposal is intended to allow multi-service firms to pursue different trading strategies under certain circumstances without being inhibited by the requirements of a price test when effecting short sales, which should increase efficiency and flexibility at large firms.

b. Costs

The Commission does not believe there are any costs associated with this proposal because firms are not required to use aggregation units.

E. Proposed Amendments to Regulation M, Rule 105

1. Benefits

The proposed amendment to Rule 105 of Regulation M would eliminate the exception for offerings filed under § 230.415, commonly referred to as the shelf offering exception. We believe the elimination of the shelf offering exception would update Rule 105 of Regulation M and provide a uniform treatment of shelf offerings and non-shelf offerings in light of our belief that both shelf offerings and non-shelf offerings are susceptible to the manipulative abuse that Rule 105 of Regulation M is intended to prevent.

We believe that the proposed amendment to Rule 105 of Regulation M would benefit issuers and investors by promoting shelf-offering prices that are based upon market prices that are not artificially influenced. We believe this should safeguard the integrity of the capital raising process with respect to shelf offerings and enhance investor confidence in our market. The proposal would also protect issuers conducting shelf offerings from receiving reduced offering proceeds as a result of manipulative conduct. These benefits are difficult to quantify. The Commission encourages commenters to provide data or other facts to support their views concerning these and any other benefits not mentioned here.

2. Costs

We request comment as to whether the proposed elimination of the shelf offering exception would impose greater costs on market participants than the current rule. We recognize that the proposed elimination of the shelf offering exception would diminish a short seller's ability to effect a covering transaction by restricting the source of securities from which he may cover. Such costs are difficult to quantify and we solicit detailed description of the type and amount of any such costs from commenters. We believe, however, that any costs associated with restricting a short sellers' ability to cover with offering shares is balanced by the benefits derived from preventing the manipulative activity of effecting pre-pricing short sales and covering with offering shares. Additionally, we solicit comment concerning the costs to issuers, shareholders, and others of pre-pricing short sales prior to a shelf offering takedown and covering with shelf offering shares. Such costs may include costs associated with postponement or abandonment of an offering or a lower than anticipated offering price.

XX. Consideration on Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[236] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[237] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Proposed Regulation SHO is intended to promote regulatory simplification by applying a uniform bid test to short sales in exchange-listed and Nasdaq NMS securities that occur in various markets and enhanced locate and delivery requirements to all equity securities. The Commission preliminarily believes that proposed Regulation SHO would promote efficiency because market participants would have to apply only one price test to exchange-listed and Nasdaq NMS securities, and the pilot program would give the Commission the opportunity to study how the new price test affects a broad range of securities in different markets. We also preliminarily believe that the locate and delivery requirements would promote efficiency by addressing large failures to deliver

[235] Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products, Securities Exchange Act Release No. 46101 (June 21, 2002), 67 FR 43234 (June 27, 2002).

[236] 15 U.S.C. 78c(f).

[237] 15 U.S.C. 78w(a)(2).

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, 78i, 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 0–10 [240] 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).

have to make changes to exclude these securities from the uniform bid test.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed rules and the proposed temporary rule.

G. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[241] the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the Rule, or any part thereof, for small entities.

The primary goal of the proposed amendments and the temporary rule is to promote uniformity in short sale regulation wherever trades in certain securities occur. As such, we believe that imposing different compliance or reporting requirements, and possibly a different timetable for implementing compliance or reporting requirements, for small entities would undermine the goal of uniformity. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposals to further clarify, consolidate or simplify the proposed amendments for small entities. The Commission also preliminarily believes that it would be inconsistent with the purposes of the Exchange Act to use performance standards to specify different requirements for small entities or to exempt broker-dealer entities from having to comply with the proposed rules and temporary rule.

H. Request for Comments

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. Those comments should specify costs of compliance with the proposed temporary rule, and suggest alternatives that would accomplish the objective of proposed amendments and temporary rule.

XXIII. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, 23(a) thereof, 15 U.S.C. 78b, 78c, 78i, 78j, 78k–1, 78o, 78q, 78q–1, 78w(a), the Commission proposed to adopt § 240.200, 240.201, 240.202(T), 203, along with amendments to Regulation M, Rule 105.

Text of Proposed Regulation SHO, Amendments and Temporary Rule

List of Subjects in 17 CFR Parts 240 and 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7202, 7241, 7262, and 7263; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Sections 240.3b–3, 240.10a–1, and 240.10a–3 are removed and reserved.

PART 242—REGULATIONS M, SHO, ATS, AND AC AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

3. The authority citation for part 242 continues to be read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78l, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78g(h), 78w(a), 78dd–1, 80a–23, 80a–29, and 80a–37.

4. The part heading for part 242 is revised as set forth above.

5. Part 242 is amended by adding §§ 242.200 through 242.203 to read as follows:

Regulation SHO—Regulation of Short Sales

Sec.

Regulation SHO—Regulation of Short Sales

§ 242.200 Definition of ''short sale.''

(a) The term *short sale* shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

(b) A person shall be deemed to own a security if:

(1) He or his agent has title to it; or

(2) He has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it, and the contract specifies the price and amount of the securities to be purchased; or

(3) He owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or

(4) He has an option to purchase or acquire it and has exercised such option; or

(5) He has rights or warrants to subscribe to it and has exercised such rights or warrants; or

(6) He holds a security futures contract to purchase it and has received notice that his position will be physically settled and is irrevocably bound to receive the underlying security.

(c) A person shall be deemed to own securities only to the extent that he has a net long position in such securities.

(d) A broker or dealer shall be deemed to own a security, even if it is not net long, if:

(1) It acquired that security while acting in the capacity of a block positioner; and

(2) To the extent that the broker or dealer's short position in the security is the subject of offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

(e) In order to determine its net position, a broker or dealer shall aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position. Independent trading unit aggregation is available only if:

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

(2) Each aggregation unit within the firm must continuously determine its net position for every security that it trades that is subject to § 242.201;

(3) Each trader pursuing a particular trading objective or strategy must be included in one aggregation unit; and

(4) Individual traders must be assigned to only one aggregation unit at a time.

(f) When unwinding index arbitrage positions involving long baskets of stock

[241] 5 U.S.C. 603 (c).

and one or more short index futures traded on a board of trade or one or more standardized options contracts as defined in § 240.9b–1(a)(4) of this chapter, persons need not aggregate the long stock position with short stock positions in other proprietary accounts provided that:

(1) The short stock positions have been created and maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities; and

(2) The sale does not occur during a period commencing at the time that the Dow Jones Industrial Average has declined by two percent or more from its closing value on the previous day and terminating upon the establishment of the closing value of the Dow Jones Industrial Average on the next succeeding trading day.

§ 242.201 Price test and marking requirements

(a) Definitions. For the purposes of this section:

(1) The term *actively traded security* shall have the same meaning as in § 242.101(c)(1).

(2) The term *average daily trading volume* shall have the same meaning as in § 242.100(b).

(3) The term *consolidated best bid and offer* shall have the same meaning as in § 240.11Ac1–5(a)(7) of this chapter.

(4) The term *covered security* shall mean all national market system securities as defined in § 240.11Aa2–1 of this chapter, but shall exclude Nasdaq Small Cap securities, as determined by NASD rules.

(5) The term *odd lot* shall mean an order for the purchase or sale of a covered security in an amount less than a round lot.

(6) The term *responsible broker or dealer* shall have the same meaning as in § 240.11Ac1–1(a)(21) of this chapter.

(7) The term *riskless principal* shall mean a transaction in which a broker or dealer after having received an order to sell a security, sells the security as principal at the same price to satisfy the order to sell. The sell order must be given the same per-share price at which the broker or dealer sold shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee. In addition, for purposes of this section, a broker or dealer must have written policies and procedures in place to assure that, at a minimum: the customer order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; the broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders which a broker or dealer relies pursuant to this exception.

(b) All short sales of any covered security must be effected at a price at least one cent above the current best bid displayed as part of the consolidated best bid and offer at the time of execution.

(c) A broker or dealer must mark all sell orders of any security as either ''long,'' ''short,'' or ''short exempt.'' A broker or dealer shall mark an order to sell a security ''long'' only if the seller owns the security being sold and either:

(1) The security to be delivered is in the physical possession or control of the broker or dealer; or

(2) The security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. An order shall be marked ''short exempt'' if the sale is effected pursuant to one of the exceptions in paragraph (d) of this section.

(d) The provisions of paragraph (b) of this section shall not apply to:

(1) Any sale by any person of a covered security, for an account in which he has an interest, if such person owns the security and intends to deliver such security as soon as is possible without undue inconvenience or expense;

(2) Any sale by a broker or dealer of a covered security for an account in which it has no interest, pursuant to an order marked long;

(3) Any sale of a covered security by a market maker to off-set customer odd-lot orders or to liquidate an odd-lot position by a single round lot sell order which changes such broker or dealer's position by no more than a unit of trading;

(4) Any sale of a covered security by a responsible broker or dealer effected at a price equal to the consolidated best offer when the market for the covered security is locked or crossed, provided however, that the exception shall not apply to any broker or dealer who initiated the locked or crossed market;

(5) Any sale of a covered security for a special arbitrage account by a person who is presently entitled to acquire another security, provided that the security sold short is in the same class as the security he is entitled to acquire, the short sale is in an amount equivalent to the number of the securities that he is entitled to acquire, the sale is effected to profit from a current price difference between the security sold short and the security he is entitled to acquire, and the person subsequently acquires or purchases the security upon which the short sale was based. A person shall be deemed entitled to acquire a security if:

(i) He has an unconditional right or option to acquire or purchase the security at a specific price and in a specific amount when the short sale is effected; and

(ii) The right of acquisition was originally attached to or represented by another security, or was issued to all holders of the securities;

(6) Any sale of a covered security for a special international arbitrage account effected to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States, provided that the short seller has an offer to buy on a foreign market that allows him to immediately cover the short sale at the time it was made. For the purposes of this section, a depositary receipt of a security shall be deemed to be the same security as the security represented by such receipt;

(7)(i) Any sale of a covered security by an underwriter or member of a syndicate or group participating in the distribution of a security in connection with an over-allotment of securities; or

(ii) Any lay-off sale by an underwriter or member of a syndicate or group in connection with a distribution of securities through rights or a standby underwriting commitment;

(8) Any sale of a covered security at the volume weighted average price (VWAP) that meets the following criteria:

(i) The sale is entered into and matched before the regular trading session opens and the execution price of the VWAP matched trade will be determined after the close of the regular trading session; and

(ii) The VWAP for the covered security is calculated by:

(A) Calculating the values for every regular way trade reported in the consolidated system, or on a primary market that accounts for seventy-five percent or more of the covered security's average daily trading volume for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price;

(B) Compiling an aggregate sum of all values; and

(C) Dividing the aggregate sum by the total number of reported shares for that day in the security; and

(iii) The transactions are reported using a special VWAP trade modifier; and

(iv) Short sales used to calculate the VWAP will themselves be subject to the provisions of paragraph (b) this section, unless excepted or exempted, and § 240.203 of this chapter; and

(v) The VWAP matched security:

(A) Qualifies as an ''actively-traded security''; or

(B) The proposed short sale transaction is being conducted as part of a basket transaction of twenty or more securities in which the subject security does not comprise more than five percent of the value of the basket traded;

(vi) The transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security;

(vii) A broker or dealer shall be permitted to act as principal on the contra-side to fill customer short sale orders only if the broker or dealer's position in the covered security, as committed by the broker-dealer during the pre-opening period of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the covered security's relevant average daily trading volume;

(9) A sale of any covered security when the broker or dealer is effecting the execution of a customer ''long'' sale on a riskless principal basis, regardless of the broker or dealer's proprietary net position; and

(10) A sale of any covered security at a price equal to the consolidated best bid by a broker or dealer to satisfy any obligations of the broker or dealer to a customer limit order, as determined by federal securities laws or the rules of a self-regulatory organization.

(e) Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.

§ 242.202(T) Temporary short sale rule suspension.

General rule. Short sales in specified securities constituting a subset of the Russell 1000 index, or such other securities as the Commission designates as permissible by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving due consideration to the security's liquidity, volatility, market depth and trading market, may be effected without regard to the provisions of paragraph (b) of § 242.201. All other provisions of § 242.201 shall remain in effect.

§ 242.203 Borrowing and delivery requirements.

(a) *Long sales.* (1) If a broker or dealer knows or has reasonable grounds to believe that the sale of a security was or will be effected pursuant to an order marked ''long,'' such broker or dealer shall not lend or arrange for the loan of any security for delivery to the broker for the purchaser after sale, or fail to deliver a security on the date delivery is due, unless the broker or dealer knows or has been informed by the seller that the seller owns the security and will deliver it to the clearing broker or dealer prior to the scheduled settlement of the transaction.

(2) The provisions of paragraph (a)(1) of this section shall not apply to:

(i) The loan of any security by a broker or dealer through the medium of a loan to another broker or dealer; or

(ii) Any loan of, arrangement for the loan of, or failure to deliver any security, if, prior to such loan, arrangement or failure to deliver, a national securities exchange, in the case of a sale effected thereon, or a national securities association, in the case of a sale not effected on an exchange, finds:

(A) That such sale resulted from a mistake made in good faith;

(B) That due diligence was used to ascertain that the circumstances specified in § 242.201(c) existed; and

(C) Either that the condition of the market at the time the mistake was discovered was such that undue hardship would result from covering the transaction by a ''purchase for cash'' or that the mistake was made by the seller's broker and the sale was at a price permissible for a short sale under § 242.201(b).

(b) *Short sales.*

(1) A broker or dealer may not execute a short sale order for its own account or the account of another person unless the broker or dealer, or the person for whose account the short sale is executed:

(i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or

(ii) Had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due.

(2) The provisions of paragraph (b)(1) of this section shall not apply to short sales executed by specialists or market makers in connection with bona-fide market making activities. Bona-fide market making activities shall not include activity that is related to speculative selling strategies or investment purposes of the broker or dealer or is disproportionate to the usual market making patterns or practices of the broker or dealer in that security.

(3) For any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more, and that is equal to at least one-half of one percent of the issue's total shares outstanding, if a broker or dealer executes a short sale for its own account or the account of another person, and if for any reason whatever securities have not been delivered within two days after the settlement date:

(i) For a period of ninety calendar days the broker or dealer shall not execute a short sale in such security for his own account or the account of the person for whose account the failure to deliver occurred unless the broker or dealer or the person for whose account the short sale is executed has borrowed the security, or entered into a bona fide arrangement to borrow the security, and will deliver the security on the date delivery is due; and

(ii) The rules of a clearing agency registered pursuant to Section 17A (15 U.S.C. 78q–1) of the Act shall include the following provisions:

(A) A broker or dealer failing to deliver securities as specified in subparagraph (3) above shall be referred to the NASD and the Examining Authority (as defined in 15c3–1(c)(12)) for such broker or dealer for appropriate action; and

(B) The registered clearing agency shall withhold a benefit equal to any mark to market amounts or payments that otherwise would be made to the participant failing to deliver, and assess appropriate charges.

(c) Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.

Dated: October 28, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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