

## **SUMMARY OF COMMENTS:**

### **Related to Proposed Short Sale Rule, Regulation SHO, Replacing Rules 3b-3, 10a-1, 10a-2 and Amending Rule 105 of Regulation M**

**Securities Exchange Act Release No. 48709  
File No. S7-23-03**

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**July 28, 2004**

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American Society of Corporate Secretaries (ASCS)

Investment Company Institute (ICI)

North American Securities Administrators Association (NASAA)

Securities Industry Association (SIA)

SIA Ad Hoc Committee on Locates/Fails (SIA Ad Hoc) (12/8/03 meeting)

SIA Derivative Products Committee (SIA Derivatives)

Securities Traders Association (STA)

The Bond Market Association (TBMA)

The Securities Traders Association of New York, Inc. (STANY)

The Specialist Association (Specialists)

**C) Attorneys & Law Firms**

Bagwell, H. Glenn Jr. (2 letters)

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Anonymous Canadian investment dealer headquartered in Canada

Saul Ewing, L.L.P. (4 letters), on behalf of:

Greenwood Partners, L.P. (3 letters)

Anonymous Private U.S. Equity Fund (1 letter)

Stoecklein Law Group, P.C. (Stoecklein)

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UBS Securities, L.L.C.

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Joint Response submitted by:

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Morgan Stanley & Co., Inc.

Knight Trading Group, Inc (Knight)

Lehman Brothers

LEK Securities Corporation (LEK Securities)

RT Asset Management, Inc. (Canada)

Susquehanna International Group, L.L.P. (Susquehanna)

TD Options, L.L.C.

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Headwaters Capital, L.L.C.

Home Director, Inc.

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Cascia, Leonard  
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Van Asch, Kristiaan (Ltrs. A, B, C, D)  
Van Custsem, Erik (Ltrs. A, B, C, D)  
Van Den Bosch, Jean (Ltrs. A, B, C, D)  
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Walker, Brendan  
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Westerly, Terry  
Whitley, Lynne

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National Securities Clearing Corporation (NSCC)

**G) National Securities Exchanges & Markets**

Archipelago Holdings, L.L.C., on behalf of ArcaEx (ARCA)

Chicago Board Options Exchange, Inc. (CBOE)

Joint Response submitted by:

Chicago Board Options Exchange, Inc. (CBOE)

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The Options Clearing Corporation (OCC)

Pacific Exchange, Inc. (PCX)

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The American Stock Exchange (AMEX)

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**II. Introduction**

On October 28, 2003, the Commission published for public comment a proposed rule, Regulation SHO, on short sales.<sup>1</sup> The proposed rule would replace Rules 3b-3, 10a-1 and 10a-2,

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<sup>1</sup> Securities Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003) (“Proposing Release”).

of the Securities and Exchange Act of 1934 (“the Act”).<sup>2</sup> Regulation SHO is designed to, among other things, address the problem of naked short selling. Additionally the rule amends Rule 105 of Regulation M. Regulation SHO is designed to, among other things, address the problem of naked short selling. The proposal requires short sellers in all equity securities to locate securities to borrow prior to selling, and imposes strict delivery requirements on securities with large settlement failures. Regulation SHO additionally sets forth a uniform bid test, applicable to all exchange-listed securities and Nasdaq NMS Securities, which permits effecting short selling at a price of one cent above the consolidated best bid. With respect to highly liquid securities, Regulation SHO proposes a temporary rule that suspends operation of the proposed bid test for a two-year pilot program. Comment was requested on each aspect of the proposal.

The Commission received letters from four hundred and sixty-two commenters in response to the proposed short sale rule release.<sup>3</sup> The comment letters set forth a variety of opinions from diverse market participants. The majority of comments received consisted of electronic letter submissions relating to the topic of naked short selling. Letters from individuals made up the largest group of commenters; however, the Commission received numerous substantive letters from major market participants, including broker-dealers, registered representatives, industry association groups, issuer companies, investors, law firms and academics. Given the diversity of the commenters, the comments covered the spectrum on the effects of naked short selling and the changes proposed in Regulation SHO. Despite contrasting opinions, the comments appeared to share an underlying concern with the use of manipulative devices as a means to control stock prices.

### **III. Scope of Regulation SHO**

As described above, Regulation SHO imposes certain requirements and restriction on short sellers in all equity securities. Rule 200 sets for the definitions on determining a “net long” position for purposes of ownership and aggregation. Rule 201 institutes the consolidated bid test that permits short sales to be effected at a price one cent above the consolidated best bid. The proposed price test would apply to all exchange-listed securities and Nasdaq National Market System Securities (“NMS Securities”), wherever traded. Rule 202(T) consists of a temporary rule that suspends the operation of Rule 201’s consolidated bid test for highly liquid securities during a two-year pilot. Rule 203 requires short sellers to locate securities to borrow prior to engaging in a short sale transaction, and imposes strict delivery requirements on securities of which there is evidence of significant settlement failures. The proposed amendment to Rule 105

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<sup>2</sup> 17 CFR 240.3b-3, 10a-1, 10a-2. 17 CFR 242.105.

<sup>3</sup> This number represents the total number of different commenter who submitted comments on the filing. Some of the commenters submitted comment under Regulation SHO, but substantively referred a rule filing amending NASD Rule 3370, File No. SR-NASD-2004-031. See Securities Exchange Act Release No. 49285 (Feb. 19, 2004), 69 FR 8717 (Feb. 25, 2004). The Commission’s Secretary’s Office counted a total of 438 comment letters under Regulation SHO. Their count covers the number of different letters received. Thus, submissions of form letters, referred to as “Letter Types” on the website, counted as one letter despite submissions from several individuals, e.g., eighteen individuals submitted “Letter Type A,” twenty-one individuals submitted “Letter Type B,” eighteen individuals submitted “Letter Type C,” etc. All comment letters may be viewed in the Commission’s Public Reference Room in File No. S7-23-03, or viewed at <http://www.sec.gov/rules/proposed/s72303.shtml>.

of Regulation M eliminates the rule's prior exemption for shelf offerings. The amendment would preclude short sellers from covering short sales with offered securities, including securities from a shelf offering, purchased from an underwriter, broker-dealer participating in the offering within five days prior to the pricing.

The Commission received many comments maintaining that the proposal introduced a wide ranging, comprehensive change from the current regulatory scheme. A few commenters sought clarification on the scope of Regulation SHO reached beyond equity securities.<sup>4</sup> Six commenters submitted arguments for the exclusion of bonds from the proposed short sale regulation.<sup>5</sup> One rationale provided supporting excluding debt securities was that the claim that the commenters believed that debt securities were not susceptible to the type of manipulative conduct short sale regulation was intended to prohibit.<sup>6</sup> Another commenter requested for the Commissions to provide a clear statement that exchange-traded options were not subject to Regulation SHO's provisions.<sup>7</sup>

#### IV. Naked Short Selling

As stated above, individual investor comments made up the largest assemblage of letters received. Many of these commenters did not specifically address the proposed regulatory changes set forth in Regulation SHO; instead, these commenters submitted broad views on the topic of naked short selling and Regulation SHO as a whole. Forty-six commenters expressed support Regulation SHO, as proposed, and urged the Commission for swift approval and implementation of the new rules.<sup>8</sup> Seventy-four commenters welcomed the Commission's attention to naked short selling, but expressed concerns that the proposed changes may not go far enough to cease manipulative abuses or cure prior abuses.<sup>9</sup> These commenters recommended

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<sup>4</sup> AMEX, LEK Securities, Inc., ("LEK Securities"), MFA, TBMA, Willkie Farr & Gallagher, LLP, ("Willkie Farr").

<sup>5</sup> See Part V(G), *infra*.

<sup>6</sup> See letters from MFA; TBMA; Willkie Farr.

<sup>7</sup> AMEX.

<sup>8</sup> Bob Anderson; Robert Bardwell; Richard Borman; J. Cochran; William D. Coogle; Kevin Cundy; Richard Deneefe; Guy Duchene; [Epipromo@aol.com](mailto:Epipromo@aol.com); Daniel Fine; Dr. Donald Florence; Richard Fox; Franklin Harrison; Michael Holcomb; Jamie Hornbuckle; Tom Ischy; [Jjumpin2@wmconnect.com](mailto:Jjumpin2@wmconnect.com); Steven P. Kelly; Joseph H. Kennedy, Jr.; Carl Kruse; Brian McGovern; D. Marren; Janet Moreland; Ron Pearce; John Polansky; John Polli; Richard T. Remski; Beatrice Rhinhold; Chris Roberts; Joseph Rocco; James Rogan; Lars D. Roose; Crystal Sandoval; Ryan Sarnataro; Lee Schriver; Mary Ann Slowik; Robert K. Smith; Ronnie Smitherman; Connie Sweeney; Peter J. Thompson; Reggie Thompson; Allen F. Treffy; Kris Vansteenwegen; Douglas Vaughn; Lewie Webb; Terry Westerly.

<sup>9</sup> Mark Anderson; Sharon B.; H. Glenn Bagwell, Jr.; Sander Bol; Guido Bracke; William J. Breslin; Alan S. Cameron; Carol Carolan; Judy Cline; T.E. Cohen; Richard G. Dahlen; Matthew R. Davis; Eddy De Caluwe; [cyberfiction@hotmail.com](mailto:cyberfiction@hotmail.com); Dr. Jim DeCosta; Eroi Denizkurt; Peter D'Hont; David Drosd; Edward Dunn; Rick Farrington; FastSet Research Systems, Inc.; Dean Faulkner; Allen Fisk; Daniels Frank; Tim Fuhrmann; Greta Geerts; Xavier Gernaey; Russel Godwin; Christopher Halligan; Kenneth Hanlon; Scott W. Hatfield; Sandra Hicks; Joe Hoofnagle; Alden James; William Johnson; David M. Klausmeyer; (. . . continued)

that Regulation SHO incorporate one or more of the following: stronger enforcement and penalties for failures, retrospective relief for past and current failures, require greater disclosure of short positions and stock lending, require reconciliation of all trades and force settlement. Approximately one hundred commenters submitted views opposing all naked short selling activities and insisting that the Commission prohibit such activities the future.<sup>10</sup> One commenter requested the Commissions to simply enforce the current rules.<sup>11</sup> In addition, three commenters requested that the Commission stop any short selling.<sup>12</sup>

In addition to letters opposing naked short selling, the Commission received many comments supporting its use. Forty-six commenters emphasized the importance of short selling, and specifically, naked short selling, as a means to combat overvaluation and stock fraud on the OTCBB and Pink Sheets.<sup>13</sup> Most of these commenters disputed claims that naked short selling is a current problem or that it harms the market. Additionally, these commenters either opposed or

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Tim Kelley; Peter E. Kent; Wayne P. Lill, Jr.; Danny Lippens; Frank Lombaert; Jeffery Long; Frank McDermott; Dany Meeus; T. Mira; Michael Morrison; NASAA; [newboy@tjtd.com](mailto:newboy@tjtd.com); John M. O'Quinn; Lillian Pardon; Dave Patch; Coene Patrick; Simon Perry; Pink Sheets; Daniel M. Prescott; John Rideout; [rudi.mat@padora.be](mailto:rudi.mat@padora.be); Chuck Schroeder; Alan Schwartz; Thomas Skadeland; SONECON; Eddy Stroobants; Pete Temple; Kristiaan Van Asch; Erik VanCustem; Jean Van Dan Bosch; Sven Van Droogenbroeck; Leen van Rijen; David Waldron; WBS&A, Ltd.; Thomas Wojciechowski; Richard Yost; Jeffery Yates; Bob Zaborowski.

<sup>10</sup> Gordon Anderson; Mark Anderson; Frank Barone; Bruce M. Barrett; Christina A. Barrett; Jake K. Barrett; Chris Basket; Joshua Bender; Jeffery R. Bennett; [bevrc@fronteinet.net](mailto:bevrc@fronteinet.net); [bizpal@earthlink.net](mailto:bizpal@earthlink.net); Daniel Bowman; Gerald A. Brown; Bill Buckner; C. Austin Burrell; Richard Byrd; Leonard Cascia; Lawrence Chernoff; Judy Cline; Yvan Coessens; John W. Corn; J.E. Currie; Ron Czecholinski; Paul Davis; Katalin de Krompay; Robert W. Delp; [Drew@bomberfly.com](mailto:Drew@bomberfly.com); Wendy G. Dworken; David E.; Steven Edelman; James Ellis; Floyd Faulkner; Jack Fenchel; Richard D. Forsman; Martha G.; [Genepaste@aol.com](mailto:Genepaste@aol.com); John W. Greathouse, Jr.; William A. Gregg; Michael Hamilton; Randy Hand; J. Hanten; Raymond Hardy; Dan Heilman; Marion Huseby; Don Jackson; [Jhotochin@aol.com](mailto:Jhotochin@aol.com); Mike Jirele; Anthony L. Johnson; Robert Johnson; Ron Jones; Victor A. Karl; Dean Kothman; Larry Kucera; Chris Lucas; Jay Lucas; Kevin M.; Vincent Manna; Douglas Marvod, III; Charles Medsker; Stephan W. Miller; Michael Montague; Erick Morris; Ray Morrow; [Ms\\_Mattice@webtv.net](mailto:Ms_Mattice@webtv.net); Dave Munson; David Murray; [nite\\_raider@hushmail.com](mailto:nite_raider@hushmail.com); John O'Brien; G.P.; Barnaby Page; Constatino Papadi; David Patch; Bob Peck; Robert G. Peterson; Richard Reahard; Patty Relkov; Steve Rothschild; Travis Rozean; Tony Ryals; Ken Sanders; Joseph Scheib; Frank Sleik; Jake T. Snake; Roger Sooners; James Stolee; Justin L. Tindall; Marc Van den Broeck; Peter L. Veregin; Byron Webb; Ryan Weber; Joseph Weldon; Lynn Whitley; Richard Wismer; Ronald Witt; Stanley A. Worthley; [Yanks2569@aol.com](mailto:Yanks2569@aol.com); Jeff Yates; S. Zapata; Randall K. Ziegler.

<sup>11</sup> Tom Christoph.

<sup>12</sup> Rosio Buechler; Bill Katakis; Ray Meeks.

<sup>13</sup> Asensio & Co.; Doyle Beaty; Scott Benglen; Boyd K. Billington; [boss@optonline.net](mailto:boss@optonline.net); Thomas K. Broder; J. Ralph Brown; Todd Chaffee; Lawrence Chang; Daniel B. Cohen; Merlin Cottier; [Ctcarbs@yahoo.com](mailto:Ctcarbs@yahoo.com); Mary Cummins; William E. Dunshie; O. Elowe; Mark Feldberg; Feldman & Weinstein; [fresco1@bellsouth.net](mailto:fresco1@bellsouth.net); Andrew Firm; Dougals R. Garrod; [ger@hush.com](mailto:ger@hush.com); Peter Johnson; Tara Johnson; Michael Kelley; Christian King; J. Knepp; Jon Kniss; Chad Kostas; Thomas Malone; Hale Martin; Jeanne Martin; Peter A. Mason; Jenny McAdams; Gary McGratten; Peter Michaelson; Nick Tracy Enterprises, Ltd.; [Osmar92@optonline.net](mailto:Osmar92@optonline.net); Pickard & Djinis; L. Yahya Piracha; James Porter; John Salick; [stockarlets2003@yahoo.com](mailto:stockarlets2003@yahoo.com); Floris van Heteren; Mark VanNess; Farid Yared; Daniel Wyns.

heavily questioned the appropriateness of further regulating naked short selling, since there were adequate rules that already addressed short selling activity.<sup>14</sup> Although almost all of these commenters opposed regulation of naked short selling, some suggested alternative approaches to both current and proposed short sale regulation.<sup>15</sup> Some of the offered alternatives include: reducing minimum margin requirements, application of Regulation SHO to stock with a high number of open short positions, establishing minimum listing standards for bulletin board stocks, and increasing short position disclosure.

#### **IV. Proposed Regulation SHO**

The Commission received several comment letters that provided substantive analysis on the specific regulatory changes proposed in Regulation SHO. For reading consistency, these comments are summarized in the order of which the related topics were presented in the proposing release.

##### **A) Rule 203, Borrowing and Delivery Requirements**

###### **1. Short Sales- Locate**

Nearly one hundred commenters<sup>16</sup> submitted their views on the short sale requirements set forth in proposed Rule 203, which, in general terms, prohibits short sales without locating securities for delivery prior to effecting the sale. Most commentators welcomed the Commission's proposal as a means to circumvent manipulation through naked short selling.

Some commenters expressed concern with the mere scope of the term "reasonable grounds." Several of these commenters requested for the Commission clarify "reasonable

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<sup>14</sup> See e.g. letter from Feldman Weinstein; Saul Ewing, LLP, (Saul Ewing).

<sup>15</sup> See letters from Boyd K. Billington; J. Ralph Brown; William E. Dunshie; Andrew Firm; [info@ourstreet.net](mailto:info@ourstreet.net); Peter Johnson; Michael Kelly; J. Knepp; Chad Kostas; Thomas Malone; Hale Martin; Gary McGratten; L. James Porter; Mark VanNess; Daniel Wyns.

<sup>16</sup> AMEX; James Angel; ARCA; Scott Arenstein; ASCS; H. Glenn Bagwell; Sander Bol; Guido Bracke; William J. Breslin; Yuseff J. Burgess; Alan A. Cameron; Carol Carolan; Citigroup; Judy Cline; Richard G. Dahlen; Eddy De Caluwe; Dr. Jim DeCosta; Peter D'Hont; David Drosd; Edward Dunn; Rick Farrington; Dean A. Faulkner; Daniels Frank; Feldman Weinstein; Allen Fisk; Douglas R. Garrod; Greta Geerts; Anthony Gentile; Xavier Gernaey; Russell Godwin; Goldman; GoPublicToday.com; Chris Gregg; Chris Halligan; Headwaters Capital; Sandra Hicks; Joe Hoofnagle; ICI; ISE; ITG, Inc.; Jag Madia; Alden James; William Johnson; William Johnson; Tim Kelley; David Klausmeyer; Eric Knight; Knight; LEK Securities; James Lem; Wayne P. Lill, Jr.; Danny Lippens; Frank Lombaert; Marshall Shictman & Assoc.; Colum McDermott; Dany Meeus; Merrill; MFA; T. Mira; Morgan Stanley; NASAA; NASDAQ; NSCC; NYSE; OCC; John M. O'Quinn; Lillian Pardon; Dave Patch; Coene Patrick; PCX; PHLX; Pickard & Djinis; Daniel Prescott; Christopher Rice; John Rideout; Gregory Rivine; [rudimat@pandora.be](mailto:rudimat@pandora.be); Saul Ewing; Chuck Schroeder; Alan Schwartz; SIA; Thomas Skadeland; [Smfehrmann@firstenergycorp.com](mailto:Smfehrmann@firstenergycorp.com); Specialists; SONECON; STANY; Stoecklein Law Group (Stoecklein); Eddy Stroobants; Susquehanna; TBMA; TCORS; Kristiaan Van Asch; Erik VanCustem; Jean Van Den Bosch; Sven Van Droogenbroeck; Leen van Rijen; Willkie Farr; Thomas Wojciechowski; David Woldron; Jeffery Yates; Richard Yost.

grounds” because they believed that, as drafted, it is broad to assure industry compliance.<sup>17</sup> However, two broker-dealer commenters recommended that the Commission grant firms with the flexibility to determine the appropriate means to measure their compliance.<sup>18</sup> ITG, Inc., in their response, directed the Commission to NASD Rule 3370(b)(4) to illustrate their point.<sup>19</sup>

In response to the Commission’s inquiry on what is an appropriate method by which short sellers can comply with the requirement to have “reasonable grounds” to believe that the securities could be borrowed for delivery, some commenters urged permitting broker-dealers to rely on “easy to borrow” lists. SIA’s letter stated that “easy to borrow” lists are reliable for assessing stock loan or borrow liquidity and preventing settlement failures.<sup>20</sup> The NYSE expressed its support for “easy to borrow” lists, but added that broker-dealers should be required to keep current through maintaining adequate procedures for updating and removing securities on the list.<sup>21</sup> Conversely, another commenter expressed reservation on the reliability of “easy to borrow” list since the borrowed shares can be recalled.<sup>22</sup> Another commenter suggested that the Commission require actual possession, via book entry, or a letter of intent assuring that the underlying security can in fact be covered.<sup>23</sup> The commenter indicated that this is necessary because hard to borrow and easy to borrow lists may not be indicative of the actual situation.<sup>24</sup>

Notwithstanding the overall support for the proposed borrow requirement, some commentators expressed specific concerns with its overall usefulness. One commenter stated the opinion that requiring a locate of shares available for borrowing, to execute a short sale, is redundant if the rule imposes strong penalties for failure to deliver.<sup>25</sup> Additionally, a few commenters noted the distinction between certain short selling activities that should be considered when assessing the application of a borrowing requirement. For example, one commenter acknowledged that the borrowing rule makes sense for short positions that remain open for a number of days; nevertheless, the commenter disagreed on its application to any day

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<sup>17</sup> H. Glenn Bagwell, Jr.; Terry E. Cohen; Dr. Jim DeCosta; Jag Media; Marshall Shictman & Assoc.; SIA; TCORS.

<sup>18</sup> ITG, Inc.; LEK Securities.

<sup>19</sup> NASD Rule 3370 is titled, Prompt Receipt and Delivery of Securities. In brief, Rule 3370(b)(4)(c) does not specify the manner by which a NASD member must annotate compliance with their “affirmative determination” obligation; rather, it permits the member to decide. NASD 33570(b)(4)(c).

<sup>20</sup> SIA; see also NYSE; Susquehanna.

<sup>21</sup> NYSE

<sup>22</sup> Headwaters Capital; cf. Willkie Farr.

<sup>23</sup> Marshall Shictman & Assoc.

<sup>24</sup> Id.

<sup>25</sup> James Angel.

trading activity, where short positions are covered before the end of the trading day.<sup>26</sup> On account of this distinction, the commenter maintained that day trading should not be limited by the need for borrowing since the commenter does not believe that there is harm caused by short-term open “naked” short positions.<sup>27</sup> MFA’s comment letter brought forth a similar paradigm with an investor short selling and then covering the short, perhaps several times during a trading session. In this scenario, MFA contends that requiring more locates than necessary will dry up the available stock borrowing pool.<sup>28</sup> MFA, as well as other commenters, assert that the already limited supply of stock for borrowing may exaggerate the availability problem.<sup>29</sup>

Some commenters urge the Commission to consider unintended consequences that may result from the strict borrow and delivery requirements. These commenters contend that restricting short sales of OTCBB and Pink Sheet securities to situations where stock is available for borrowing will play directly into the hands of stock manipulators.<sup>30</sup> Such commenters believe that the borrow requirement would remove important market constraints on pricing inefficiencies and upward manipulation by virtue of restricting the supply of securities, which typically increases prices.<sup>31</sup> On behalf of its clients, Willkie Farr’s letter asserted that the proposed rule would encourage manipulative games to squeeze short sellers.<sup>32</sup> In addition, due to the lack of float associated with companies traded on the OTCBB and Pink Sheets, the commenters contend that imposing the locate requirement may eliminate short selling in those markets.<sup>33</sup> One commenter, who expressed extreme concern with the locate requirement, suggested that the Commission establish a way to borrow small stock before adopting the requirement.<sup>34</sup>

Additionally, nine commenters submitted comments regarding current stock lending practices.<sup>35</sup> Some of these commenters requested that the Commission require stock lenders to obtain permission from the owner of the stock prior to lending the shares. Additionally, a couple

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<sup>26</sup> Gregory Rivine

<sup>27</sup> Id.

<sup>28</sup> MFA; cf. Willkie Farr.

<sup>29</sup> James Angel; Davis Polk; Pickard Djinis. Alan Schwartz; Willkie Farr.

<sup>30</sup> Mark Feldberg; [ger@hush.com](mailto:ger@hush.com); [info@ourstreet.net](mailto:info@ourstreet.net); Michael Kelley; J. Kniss; William Johnson; Thomas Malone; Jenny McAdams; Pickard Djinis. John Rideout.

<sup>31</sup> Scott Benglen; Christian King; Pickard Djinis; John Rideout.

<sup>32</sup> Willkie Farr.

<sup>33</sup> [Ctcarbs@yahoo.com](mailto:Ctcarbs@yahoo.com); [fresco1@bellsouth.net](mailto:fresco1@bellsouth.net); Michael Kelley;

<sup>34</sup> [Ctcarbs@yahoo.com](mailto:Ctcarbs@yahoo.com).

<sup>35</sup> James Angel; ASCS; H. Glenn Bagwell, Jr.; Robert Bardwell; CBOE; David Klausmeyer; Wayne P. Lill, Jr.; NASAA; Alan Schwartz; [smfehrmann@firstenergy.com](mailto:smfehrmann@firstenergy.com); Richard H. Troy.

of these commenters suggested that an owner of the stock receive some form of compensation for the lent shares. The ASCS expressed specific concerns with its affect on proxy voting.<sup>36</sup> In their letter, ASCS explained the importance of accuracy on record keeping relating to stock ownership. ASCS contends that stock lending activities complicate the process and weaken the proxy voting chain. Because lenders are not required to disclose the stock loan, clients of the lender will not know that their voting right was transferred to the borrower of the stock, if held on the record date.<sup>37</sup> ASCS acknowledges that a lender has the ability to recall the loan; however, ASCS asserts that this process is seldom used.<sup>38</sup> Other stock lending comments related to requiring a centralized inventory or loan post for stock lending<sup>39</sup> and curtailing the practice of over-lending by the Depository Trust Company (DTC).<sup>40</sup>

Lastly, one commenter questioned the Commission’s authority with respect to regulating the short sale practices in the over-the-counter market.<sup>41</sup> The commenter, a law firm writing on behalf of its client, stated that the Commission is treading beyond its traditional role, which is linked to price regulation. Furthermore, the commenter recommended that the Commission exercise caution as it assumes regulating practices that have been “under the exclusive jurisdictional oversight of the SROs.”<sup>42</sup>

## 2. Short Sales – Delivery

Over seventy-five commenters submitted comments on Regulation SHO’s proposed additional delivery requirements that extended to all equity securities registered under Section 12 of the Exchange Act.<sup>43</sup> Similar to the borrowing portion of the rule, the Commission received mixed commentary in relation to the proposed delivery requirements.

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<sup>36</sup> ASCS.

<sup>37</sup> ASCS.

<sup>38</sup> Id.

<sup>39</sup> Pickard Djinis; Alan Schwartz.

<sup>40</sup> H. Glenn Bagwell, Jr.; NASAA. NSCC’s letter includes a direct response to this comment. In particular, NSCC asserts that it does not lend more shares than participants designate in their accounts as available for borrowing, which are also unencumbered by other claims. NSCC claims it receives daily notification from participants regarding whether the participants have securities on deposit. See letter from NSCC.

<sup>41</sup> See letters from Saul Ewing.

<sup>42</sup> Id.

<sup>43</sup> For short sales in stocks that meet a threshold for significant number of fails, the selling broker-dealer must deliver the security no later than two days after the settlement date. If for any reason such security is not delivered within two days after the settlement date, the broker-dealer would be restricted from executing future short sales in such security for the person or whose account the failure to deliver occurred for the period of 90 calendar days. See Proposing Release, note 1 supra.

Five industry commenters, who expressed opposition to the proposed requirements, maintained that there were already established rules that sufficiently regulated delivery and the completion of sell orders.<sup>44</sup> The letters submitted by LEK Securities, SIA and Willkie Farr pointed to the Commission's existing customer protection rules, set forth in Rule 15c3-3 of the Act, as one current mechanism governing the topic of delivery.<sup>45</sup> Additionally, Feldman Weinstein's letter maintained that NASD Rule 11830 is the appropriate mechanism to protect integrity of the settlement system.<sup>46</sup>

In response to the proposed threshold triggering the requirements, the Commission received several diverse comments.<sup>47</sup> One commenter asserted that classification of stocks with significant failures was untenable.<sup>48</sup> Two commenters suggested that the threshold be based on an issuer's public float rather than on the total shares outstanding.<sup>49</sup> One of these commenters,

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<sup>44</sup> Feldman Weinstein; LEK Securities; SIA; Willkie Farr.

<sup>45</sup> LEK Securities; Willkie Farr & Gallagher, LLP, ("Willkie Farr") on behalf of J.P. Morgan and UBS Securities. Rule 15c3-3 is titled, Customer Protection – Reserves and Custody of Securities. 17 CFR 240.15c3-3. Specifically, LEK Securities refers to Rule 15c3-3(m) as the mechanism ensuring completion of sell orders on behalf of customers. However, the commenter appears to have overlooked that subparagraph (m) of Rule 15c3-3 expressly does not apply to short sales:

If a broker or dealer executes a sell order of a customer (other than an order to execute a sale of securities which the seller does not own) and if for any reason whatever the broker or dealer has not obtained possession of the securities from the customer within 10 business days after the settlement date, the broker or dealer shall immediately thereafter close the transaction with the customer by purchasing securities of like kind and quantity: Provided, however, The term customer for the purpose of this paragraph (m) shall not include a broker or dealer who maintains a special omnibus account with another broker or dealer in compliance with section 4(b) of Regulation T. 17 CFR 240.15c3-3(m)

<sup>46</sup> See Feldman Weinstein; see also SIA. NASD Rule 11830 is titled, Mandatory Close-Out for Short Sales. The rule provides:

- a) A contract involving a short sale in Nasdaq securities described in paragraph (b) hereof, for the account of a customer or for a 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, must be closed by the broker/dealer representing the seller by purchasing for cash or guaranteed delivery securities of like kind and quantity..
- b) This requirement shall apply to Nasdaq securities, as published by the Association, which have clearing short position of 10,000 shares or more and that are equal to at least one-half ( 1/2) of one percent of the issue's total shares outstanding.
- (c) This mandatory close-out requirement shall not apply to bona fide market making transactions and transactions that result in fully hedged or arbitrated positions.

<sup>47</sup> The proposed threshold is triggered by a security that has fails to deliver 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. See Proposing Release.

<sup>48</sup> Headwaters Capital.

<sup>49</sup> Knight; TCORS.

Knights Trading Group, contends that the delivery failure threshold is lower than necessary to protect against short squeezes in the security. In place of the proposal, Knight suggested the Commission adopt a threshold that is triggered “when the number of undelivered shares exceeds the greater of 30% of stock’s float or 3-times stock’s average daily trading volume measured over four-week period.”<sup>50</sup> Knight states that the Commission would have to define “float” and ensure that information on the size of a stock’s float is accessible.<sup>51</sup>

In addition to the other comments related to the proposed threshold, the NSCC’s letter offers clarification on the type of data collection it maintains. According to the letter, NSCC analyzes daily whether any over-the-counter security has an aggregate fail-to-deliver position of 10,000 or more shares.<sup>52</sup> However, NSCC states that it does not determine if that aggregate position equals at least one-half of one percent of the total outstanding shares of the security.<sup>53</sup> NSCC noted that the NASD ascertains the particular calculation. Additionally, NSCC stated that it believes that functions should continue to be performed by “the appropriate examining authority to avoid imposing a new and more burdensome data collection and calculation requirement on NSCC.”<sup>54</sup>

Other commenters expressed the opinion that enforcing the additional safeguards to ensure delivery appeared simply unfeasible under the current securities settlement system.<sup>55</sup> For instance, NSCC’s letter stated that it believed that the manner in which the continuous net settlement system (“CNS System”) currently calculates each participant’s net position in a security does not determine whether a mark paid to a participant is a benefit nor whether it is received in connection with a qualifying fail-to-deliver position.<sup>56</sup> The letter explains that the CNS System does not retain information regarding individual transactions executed by a participant in a particular security, but rather, on a given day, “the CNS System nets all open positions of the participant together with such participant’s positions due to settle for the first time that day, down to a single value.”<sup>57</sup> NSCC claims that even if they could track a transaction through to settlement, it could not trace the mark to that transaction.<sup>58</sup>

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<sup>50</sup> Knight.

<sup>51</sup> Id.

<sup>52</sup> NSCC.

<sup>53</sup> Id.

<sup>54</sup> Id.

<sup>55</sup> CBOE; Citibank; Goldman; Merrill; MFA; Morgan Stanley; NSCC; Saul Ewing; SIA; Susquehanna; Willkie Farr.

<sup>56</sup> NSCC.

<sup>57</sup> Id.

<sup>58</sup> Id.

The feasibility of the rule’s two-day delivery requirement after settlement, or within five days from the trade dates, was heavily contested. Eight commenters submitted the opinion that the proposed time frame, within five days from the trade date, was too short and inflexible.<sup>59</sup> For example, the CBOE’s letter stated that the proposal did not provide sufficient time for guaranteed delivery or exercise of options to obtain a securities request.<sup>60</sup> The SIA’s letter stated that broker-dealers would need more than two days to cure “innocent” settlement failures.<sup>61</sup> Additionally, commenters asserted that sales of restricted stock or 144 transactions, might take longer to deliver.<sup>62</sup> On account of these delays, one commenter recommended that there should not be any set time limit for delivery.<sup>63</sup> The commenter added, that if the Commission found that unacceptable, then the Commission should retain the 10-day period found in NASD Rule 11830.<sup>64</sup> Several other commenters requested adoption of the 10-day period.<sup>65</sup> Another commenter requested the Commission consider allowing “five business days,” instead of calendar days, for correcting failures.<sup>66</sup>

In contrast to the time related arguments above, two commenters expressed the opinion that the proposed delivery time requirement was reasonable. One of the commenters, a law firm, stated that the proposed T+5 delivery requirement was sufficient time to deliver securities sold short.<sup>67</sup> The other commenter, the NYSE, stated that it believed that all publicly traded securities should be subject to this delivery requirement, not just for securities with evidence of significant number of fails.<sup>68</sup>

The Commission received several comments that argued against the proposed penalty scheme. Opponents maintained that, aside from being impractical for the industry, the penalties would not provide adequate discipline to remedy delivery failures. For example, some of these commenters argued that under the confines of the current settlement structure, it was “not

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<sup>59</sup> AMEX; CBOE; Knight; LEK Securities; Marshall Shictman & Assoc.; SIA Ad Hoc Committee on Locate & Fails; SIA; Willkie Farr.

<sup>60</sup> CBOE.

<sup>61</sup> Additionally, SIA stated the belief that imposing the strict delivery requirements would “capture many more instances of ordinary course settlement delays (due to errors, changes in availability, etc.) than of naked shorting.” SIA.

<sup>62</sup> Feldman Weinstein; Marshall Shictman & Assoc.

<sup>63</sup> Feldman Weinstein.

<sup>64</sup> NASD Rule 11830.

<sup>65</sup> CBOE; SIA Ad Hoc Committee on Locates & Fails; SIA; Willkie Farr.

<sup>66</sup> Knight.

<sup>67</sup> TCORS.

<sup>68</sup> NYSE.

practical, if not impossible” to assign fault for delivery failures to a particular clearing firm customer.<sup>69</sup> The letter from SIA offered a detailed explanation, stating, “[b]ecause of NSCC’s continuous net settlement system nets all buys and sells within a particular firm, the broker-dealer cannot determine which customer’s transaction gave rise to the fail.”<sup>70</sup> Additionally, despite expressing the opinion that the 90-day restriction was a good idea, one commenter stated that the restriction still may not deter real abusers because the customer could easily open another account for short selling until that account was frozen and start again.<sup>71</sup>

The proposed 90-day restriction, for failing to deliver a security that meets the additional delivery requirement, was a contested topic. One commenter stated that the restriction was “a good idea,” but the wording was too broad.<sup>72</sup> The commenter, as well as the CBOE, expressed the opinion that the delivery rule should not punish failures that occur due to another account’s failure.<sup>73</sup> Along similar lines, Knight’s letter asserted that the 90-day ban was inappropriate, especially if there was compliance with the locate requirement, but a delivery failure occurred due to reasons outside the seller’s control.<sup>74</sup> To address the concern, Knight recommended that the Commission adopt “account specific” approach, since it was unfair to penalize the broker-dealer for a delivery violation committed by a customer.<sup>75</sup> In contrast, other commenters expressed the opposing view stating that the rule should not penalize an investor nor hold the investor responsible for the broker-dealer’s failure.<sup>76</sup>

The concept of a mandatory buy-in requirement for delivery failures received support from several commenters. A group industry letter recommended that the Commission proceed with imposing a mandatory buy-in for failures, while eliminating the 90-day suspension and penalties associated with securities with a significant number of delivery failure.<sup>77</sup> The joint letter supported to statements made in SIA’s letter, that buy-ins were more practical since “it is possible to allocate the costs of a buy-in among multiple short sellers,” whereas allocation is not

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<sup>69</sup> CBOE.

<sup>70</sup> SIA; Citibank; Goldman, Merrill; Morgan Stanley.

<sup>71</sup> See James Angel; see also SIA.

<sup>72</sup> James Angel.

<sup>73</sup> James Angel; CBOE.

<sup>74</sup> Knight.

<sup>75</sup> Id.

<sup>76</sup> See letter from MFA; see also “Letter Type B,” submitted by Sander Bol; Guido Bracke; Eddy De Caluwe; Carol Carolan; Peter D’Hont; Daniels Frank; Greta Geerts; Xavier Gernaey; Danny Lippens; Frank Lombaert; Dany Meeus; Lillian Pardon; Coene Patrick; rudi.mat@pandora.be; Chuck Schroeder; Eddy Stroobants; Kristiaan Van Asch; Erik VanCustem; Jean Van Den Bosch; Sven Van Droogenbroeck; Leen van Rijen.

<sup>77</sup> Letter submitted by Citigroup, Goldman, Merrill and Morgan Stanley.

possible with a trading freeze.<sup>78</sup> In support of mandatory buy-ins, another commenter stated that the fear of a mandatory buy-in and threat of a market loss would be a greater deterrent than proposed restriction and withholding of the mark.<sup>79</sup> On the other hand, one commenter asserted that mandatory buy-ins are often unsuccessful in resolving the delivery failure and could, in effect, continue the problem.<sup>80</sup> The commenter explained that a seller could simply renew the short position by selling into the buy-in, creating another fail and another buy-in, etc.<sup>81</sup>

About half of the commenters focusing on the delivery portion of Rule 203 requested the Commission impose harsher penalties for failures to deliver.<sup>82</sup> Proponents for stronger penalties suggested that the restriction should prohibit broker-dealers and market makers from executing future short sales in such security for all other person, and not just for the person on whose account the failure to deliver occurred.<sup>83</sup> Additionally, some suggested that the Commission consider expanding penalties to include: suspending or revoking securities licenses of violators,<sup>84</sup> increasing the restriction from 90 days to 180 days,<sup>85</sup> prohibiting accountholders and firms from conducting any transactions for 90 days,<sup>86</sup> disgorgement of profits,<sup>87</sup> and larger fines.<sup>88</sup>

### 3. Market Maker Exception

The Commission received many comments pertaining to the limited exception incorporated in proposed Rule 203 for specialists and market makers. The exception provides relief from the locate requirement for specialists or market makers executing short sales in connection with bona-fide market making activities. In the proposal, the Commission justified providing a narrow exception on account that market makers and specialists may need to facilitate customer orders in a fast moving market without possible delays associated with

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<sup>78</sup> See id.; see also SIA.

<sup>79</sup> H. Glenn Bagwell, Jr.

<sup>80</sup> LEK Securities.

<sup>81</sup> Id.

<sup>82</sup> H. Glenn Bagwell, Jr.; William Breslin; C. Austin Burrell; [Cyberfiction@hotmail.com](mailto:Cyberfiction@hotmail.com); Richard G. Dahlen; Matthew R. Davis; Tim Fuhrmann; Kenneth Hanlon; NASAA; SONECON.

<sup>83</sup> NASAA; Simon Perry; TCORS.

<sup>84</sup> H. Glenn Bagwell, Jr.; William J. Breslin; NASAA.

<sup>85</sup> TCORS.

<sup>86</sup> SONECON.

<sup>87</sup> H. Glenn Bagwell, Jr.; NASAA.

<sup>88</sup> Simon Perry.

complying with the proposed "locate" rule. Moreover, the Commission took the position that specialists and market makers seek a net "flat" position in a security at the end of the day and often "offset" short sales with purchases such that they are not required to make delivery on the security.

Fourteen commentators<sup>89</sup> expressed support for the exception to the locate rules.<sup>90</sup> However, of the comments received almost all commenters expressed concern with regards to the breadth of the relief extended. Six commenters requested greater clarity on the meaning of "bona fide market making."<sup>91</sup> Specifically, these commenters recommended that the Commission adopt certain criteria to distinguish genuine market making criteria to eliminate the concern of abuse by those claiming to perform as a market maker. To facilitate creating the definitions, letters from both Knight and NASDAQ provided their recommendations for the terms "market maker" and "bona fide market making activity."<sup>92</sup> Additionally, NASDAQ offered a set of three standards, called "primary market maker (PMM) standards," designed to reward market makers that provide significant liquidity or commit significant capital to the market.<sup>93</sup>

The commenters who argued that the exception was too narrow were largely represented professional market participants. These commenters noted the difference between the defined

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<sup>89</sup> The figure reflects the number of commenters aside from the forty-three commenters who supported SHO as drafted without submitting specific comments on the exception.

<sup>90</sup> AMEX; James Angel; Scott Arenstein; CBOE; Headwaters Capital; ISE; JAG Media Holdings; Knight; NASDAQ; NYSE; OCC; PCX; PHLX; Specialists.

<sup>91</sup> AMEX; H. Glenn Bagwell, Jr.; Knight; NASDAQ; NYSE; SIA Ad Hoc Committee on Locates & Fails; SONECON.

<sup>92</sup> The definitions were submitted with regards to providing a general market maker exemption from the various provision of Regulation SHO. For the term "market maker," Knight recommended the following:

any dealer that (i) is registered as a market maker in good standing under the rules of an SRO, (ii) holds itself out as willing to buy and sell the securities in which it is registered for its own account on a regular or continuous basis, and (iii) publishes competitive, continuous two-sided quotations in its registered stocks in accordance with applicable SRO rules.

For defining "bona fide market making," Knight recommended that the term cover transactions by a market maker "as part of a course of dealing consistent with its obligations under the market maker definition, including activity to position the market maker's inventory for anticipated order flow." NASDAQ expressed support for Knight's suggested definitions.

<sup>93</sup> As long as a market maker met any one of the standard, the market maker would receive PMM designation. The first standard measures "whether a market maker provides liquidity via its quotation," which is confirmed by the SRO execution facility. The second standard measures "whether a market maker commits capital to the market by interacting with customer order flow," which is measured by analyzing trades on non-SRO systems. The third standard consists of a ratio of the first and second standard, "as a percent of the market maker's total volume in that stock." According to NASDAQ, a ratio closer to 1 is indicated an enhanced level of bona fide market making activity. See NASDAQ.

parameters included in proposed Regulation SHO<sup>94</sup> and the defined parameters contained in NASD Rule 3370.<sup>95</sup> According to the joint letter submitted by AMEX, CBOE, ISE, OCC, PCX and PHLX, the difference is significant on account that the NASD definition provided options market makers with greater flexibility to conduct market-making activities while limiting the ability to label truly speculative activity as market-making.<sup>96</sup> To buttress their claim, these commenters additionally point to NYSE Rule 440.10, which provides a broad exemption to the locate rule for specialist and market makers.<sup>97</sup> According to their statements, the breadth of the NYSE rule “is more rational and provides market makers with the necessary flexibility.” Ultimately, these commenters urge the Commission modify the rule to follow the NYSE model, but at the least, achieve consistency with the parameters described in NASD IM-3350.<sup>98</sup>

Thirteen commenters additionally argued a need for a bona fide market making exemption that would exempt market makers from both the locate and additional delivery requirements included in Rule 203.<sup>99</sup> For example, AMEX’s letter disagreed with the Commission statement that “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. . . .” Amex argued that there are circumstances, especially with thinly traded securities, in which a specialist or market maker may need to maintain a fail to deliver on a short sale longer than two days beyond the settlement date in the course of bona-fide market making.<sup>100</sup> According to AMEX, lacking an exemption to the delivery requirements would impair a market

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<sup>94</sup> “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.” Proposing Release at fn. 49.

<sup>95</sup> NASD Rule 3370, titled Prompt Receipt and Delivery of Securities, provides the following exemption in relation to proprietary short sales:

[n]o member shall effect a short sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery by the settlement date. This requirement will not apply to transactions . . . to bona fide market making transactions by a member in securities in which it is registered as a Nasdaq or ADF market maker, to bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two sided quotation . . . . NASD Rule 3370(b)(2)(B).

<sup>96</sup> See letter from AMEX; CBOE; ISE; OCC; PCX; PHLX.

<sup>97</sup> NYSE 440C.10.

<sup>98</sup> Bona fide market making excludes “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.” NASD IM-3350(a)(3).

<sup>99</sup> AMEX; James Angel; CBOE; ISE; Knight; NASDAQ; NYSE; OCC; PHLX; PCX; SIA; Specialists; Susquehanna.

<sup>100</sup> AMEX; James Angel.

maker's ability to make markets in such securities, thus, resulting with illiquid and inefficiently priced securities.<sup>101</sup>

Other commenters expressed similar views supporting an expanded market maker exemption. The NYSE contends that exposing specialists or market makers to the penalties for failing to deliver securities with significant settlement failures, within T+5, could inhibit a specialist's ability to fulfill market making obligations.<sup>102</sup> Rather, the NYSE stated its belief that adequate procedures at the clearing firm level should be in place to attempt to make the required delivery on behalf of the specialist or market maker.<sup>103</sup> According to Knight, without the exemption for market makers, market liquidity will decrease and cause greater volatility to stocks already prone to wide price swings.<sup>104</sup> Knight believes that market makers will hesitate to provide liquidity and take additional risk if they are uncertain about compliance.

If the Commission chose not to provide an exemption, a few commenters requested some form of alternative relief. AMEX requested the Commission consider amending provisions to substantially increase the threshold for fails so that the delivery requirements are triggered in only the most egregious situations.<sup>105</sup> Susquehanna stated that the delivery requirement should, "at a minimum, exempt market maker positions that are acquired prior to the effective date of the rule and . . . exempt any position that is acquired prior to the subject security being triggered as a limit-fail."<sup>106</sup> Additionally, Willkie Farr's letter expressed the view that market makers should only be required to locate and deliver for trades in illiquid stocks and only when they are net short at the end of the day.<sup>107</sup>

However, certain commenters provided comments that opposed granting any exception for market making in Regulation SHO.<sup>108</sup> The general consensus of these comments was that the exception provided too much room for abuse. Additionally, a few of these commenters asserted that there was not a market need for such exception because of market makers operate in a limited number of stocks.

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<sup>101</sup> AMEX.

<sup>102</sup> NYSE; AMEX.

<sup>103</sup> Id.

<sup>104</sup> Knight.

<sup>105</sup> AMEX.

<sup>106</sup> Susquehanna.

<sup>107</sup> Willkie Farr.

<sup>108</sup> T.E. Cohen; Richard G. Dahlen; LEK Securities; Thomas Malone; Marshall Shictman & Assoc.; Erick Morris; Ryan Weber. TCORS comment was that there should not be an exemption for market makers from the additional delivery requirements.

In addition to providing a bona fide market making exemption from both the locate and delivery requirements, several commenters requested the Commission provide the same relief through a bona fide hedging exemption, similar to the exemptions provided in both NASD Rule 3370 and NASD Rule 11830.<sup>109</sup> Most of these commenters requested the hedging relief in connection market making activities, especially options market making.<sup>110</sup> Only one commenter requested a transaction-based bona fide hedge exemption that is unrelated to market making functions.<sup>111</sup>

In favor of the hedge exemption for options market makers, the commenters assert that the reason for imposing both the locate and delivery requirement to short sales does not translate into the options market. Both the CBOE and the PCX assert that short sales by options market makers are limited to legitimate hedging of options, and are not permitted for speculative trading. Furthermore, these commenters state that it is “unlikely that options market makers would engage in non-hedge stock activity” due to the regulatory ramifications.<sup>112</sup>

According to their statements, options market makers must have flexibility to hedge their risk by buying and selling the underlying stock when the options market makers facilitate options orders, while fulfilling their “affirmative market making obligations.”<sup>113</sup> Additionally, the options market makers may maintain large short positions in underlying stocks for extended periods of time, not for speculative purposes, but to offset risk generated from facilitating orders.<sup>114</sup> In response to the Commission’s statement that most specialists and market makers try to have a “flat” position at the end of the day, the joint letter submitted by AMEX, CBOE, ISE, OCC, PCX, and PHLX asserts that most options market makers may seek “a market neutral position” at the end of the day, nevertheless, they may not be “flat in the sense of having no long or short positions or an equal number of both.”<sup>115</sup>

One commenter, who requested a transaction-based hedge exemption, submitted four letters stressing the importance of a bona fide hedge exemption.<sup>116</sup> All four letters support a

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<sup>109</sup> NASD Rule 3370, exempts transactions . . . that result in fully hedged or arbitrated positions. NASD Rule 3370(b)(2)(B). NASD Rule 11830, grants an exemption under subparagraph 11830(c), which states, “[t]his mandatory close-out requirement shall not apply to bona fide market making transactions and transactions that result in fully hedged or arbitrated positions.” NASD Rule 11830(c). AMEX; CBOE; ISE; OCC; PCX; PHL; Saul Ewing; Susquehanna.

<sup>110</sup> AMEX; CBOE; Headwaters Capital; ISE; OCC; PCX; PHLX; Susquehanna.

<sup>111</sup> The commenter requested an exemption to cover short sale positions that are hedged by certain public company issued warrants and rights. See letters from Saul Ewing.

<sup>112</sup> CBOE; PCX.

<sup>113</sup> Susquehanna.

<sup>114</sup> See letters from CBOE; Susquehanna; cf. Headwaters Capital.

<sup>115</sup> See letter from AMEX; CBOE; ISE; OCC; PCX; PHLX.

<sup>116</sup> See letters from Saul Ewing.

bona fide hedge exemption by asserting the exemption is critical to capital formation of small issuers.<sup>117</sup> Additionally, the commenter believes that tailoring the exemption to short sales fully hedged by certain public company issued warrants and/or rights, the exemption will not give rise to naked and manipulative short selling concerns.<sup>118</sup> The commenter's letter explains that the private equity funds act as "delta neutral arbitrageur[s]," which seek to offset the financing risk by purchasing an "in the money" put option exercisable for 30 to 90 days.<sup>119</sup> According to the commenter, lacking the ability to engage in such transaction, "would dramatically increase the cost of capital to the companies that could least afford it."<sup>120</sup>

In opposition to a hedging exemption, one commenter submitted the view that hedging in over-the-counter companies' warrants is equivalent to naked shorting.<sup>121</sup> The commenter asserted that the activity adds more "counterfeit shares" to the market.<sup>122</sup> Additionally, the commenter stated that warrants provide financiers an incentive to short against the investment.

#### 4. Long Sales

Fewer commenters submitted comment on proposed Rule 203(a), which applies to deliveries of long sales.<sup>123</sup> Three commenters expressed the opinion that the proposed changes would ensure greater consistency across markets and securities.<sup>124</sup> Despite their support of

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<sup>117</sup> The commenter's first letter, sent on behalf of Greenwood partners, L.P., recommends a hedging exception. Saul Ewing I. The second letter, also sent on behalf of its client, recalled historical information pertaining to the bona fide hedge exemptions adopted in NASD Rules 3370 and 11830. See letter from Saul Ewing, dated Feb. 13, 2004. The third letter focused on reliance of the hedge exemption in private equity funding structures, specifically with instances in which short sales of a developing company's stock are offset by an options position. See letter from Saul Ewing, dated Mar. 17, 2004 ("Saul Ewing III"). The fourth letter submitted a study evaluating the bona fide hedge exemption as it relates to NASD 3370 and 11830. See letter from Saul Ewing, dated April 20, 2004 ("Saul Ewing IV").

<sup>118</sup> Saul Ewing I. The commenter further states that limiting the exemption to short sales hedged by warrants or rights that contain terms in their respective issuer agreements "would preclude such instruments from being used to facilitate any for of 'death spiral' financing." Id.

<sup>119</sup> Saul Ewing I; Saul Ewing III.

<sup>120</sup> Saul Ewing III.

<sup>121</sup> See letter from Alden James, dated May 13, 2004.

<sup>122</sup> Id.

<sup>123</sup> Rule 203(a) proposes to extend the delivery requirements of Rule 10a-2 to all securities. Additionally, Rule 203(a) permits a broker-dealer to fail to deliver a long sale, 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. See Proposing Release.

<sup>124</sup> H. Glenn Bagwell, Jr.; Feldman Weinstein; LEK Securities.

consistency, two of these commenters raised concerns with certain circumstances relating to both honest and dishonest sellers. Specifically, Feldman Weinstein raised concerns with failures of honest long sellers resulting from processing delays. Feldman Weinstein requested an exception for a customer's fail to deliver if the customer owns the security from a private placement that may be delayed due to legal transfer processing.<sup>125</sup> Regarding dishonest sellers, another commenter raised concerns with the possibility of sellers disguising short sales as long sales.<sup>126</sup> To address the concern, this commenter suggested that the Commission require settlement of all trades within a reasonable time after the trade date, including those improperly labeled as long sales.<sup>127</sup>

The comments contained in "Letter Type A," a form letter submitted by seventeen commenters,<sup>128</sup> expressed dissatisfaction with the proposal because it did not account for delivery failures of long sales. The letter included seven recommendations for Regulation SHO. The recommendations relating particularly to long sales included requiring a specified time limit for settlement of both long and short sales and imposing fines for failures that extend beyond ten business days.<sup>129</sup>

Lastly, one commenter expressed the opinion that proposed Rule 203(a) was no longer necessary.<sup>130</sup> The commenter maintained that the proposed order marking, locate and delivery rules within Regulation SHO would address the problems Rule 10a-2 was designed to address.<sup>131</sup> Furthermore, the commenter stated that preservation of Rule 10a-2 would appear to be inconsistent with the Commission's action to reduce fails.<sup>132</sup>

## **B) Rule 201, Consolidated Bid Test**

Regulation SHO's proposed Rule 201, on establishing a uniform price test, received the most comments from industry participants. The proposed consolidated bid test permits effecting short sale transactions at a price one cent above the consolidated best bid. The proposed rule applies to short sales of all exchange-listed securities and Nasdaq NMS Securities. The

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<sup>125</sup> Feldman Weinstein.

<sup>126</sup> H. Glenn Bagwell, Jr.

<sup>127</sup> Id.

<sup>128</sup> Sander Bol; Guido Bracke; Eddy De Caluwe; Peter D'Hont; Daniels Frank; Greta Geerts; Xavier Gernaey; Frank Lombaert; Dany Meeus; Lillian Pardon; Coene Patrick; [rudi.mat@pandora.be](mailto:rudi.mat@pandora.be); Eddy Stroobants; Kristiaan Van Asch; Jean Van Den Bosch; Erik VanCustem; Sven Van Droogenbroeck.

<sup>129</sup> See Letter Type A.

<sup>130</sup> SIA.

<sup>131</sup> Id.

<sup>132</sup> Id.

Commission received comment on the consolidated bid test from one hundred and twenty-four commenters.<sup>133</sup>

Seven commenters expressed support for Regulation SHO's proposed uniform bid test; however, they argued for expanding the price test to a wider array of securities.<sup>134</sup> These seven commenters urged the Commission to include coverage of Rule 201 to securities traded in the Nasdaq Small Cap Market as well as in the OTCBB and Pink Sheets. Some of these commenters acknowledged the difficulties of applying a price test to these markets, especially due to the absence of a consolidated best bid OTCBB and Pink Sheets,<sup>135</sup> but still urged the Commission to expand the test upon development of quoting systems for less liquid securities.<sup>136</sup>

Four commenters directly stated that they preferred Regulation SHO's uniform bid test to the current tick test under Rule 10a-1 of the Act.<sup>137</sup> These commenters maintained that they welcomed a uniform application of short sale price regulations. In support of using the consolidated bid test, Charles Schwab's letter stated that a uniform rule would "eliminate the

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<sup>133</sup> It is important to note that many commenters did not profess to support or oppose the proposed test, but simply submitted requests for relief for various transactions. See letters from Steven Ackerman; AMEX; James Angel; Scott Arenstein; Eli Argento; H. Glenn Bagwell, Jr.; Alexander Benetti; Chris Berntsen; Eliay Bock; Scott Budner; Yusef J. Burgess; Blake C. Byczek; CBOE; Coreina Chan; Feming Chan; Charles Schwab; John Chinnock; Jake Chun; CHX; Citigroup; Dario Cosic; Davis Polk; Brian J. Dershow; Timothy K. Dolnier; Eric T. D'Orio; Michael Elzahr; Tolga Erman; Feldman Weinstein; Moshe Fogel; Chris Freddo; Kenneth J. Garby; Anthony Gentile; Carl Z. Giannone; Kristopher Goldhair; Goldman; Elizabeth Goldstein; Chris Gregg; Chris Griffen; Marc Griffen; Charles W. Hansford; Scott W. Hatfield; Zachary Hepner; Jonathan Hodges; Edward E. Hong; ICI; Brian Ingram; ISE; Marina Kaneti; Kevin Karlberg; Saetoon Kim; Gregory Kleiman; Eric Knight; Knight; Patrick Kwon; Anthony Lamme; David Lazarus; Bernard J. Lee; Lehman Brothers; LEK Securities; James Lem; Derrick Liu; Michael Lucarello; Madoff; Hummayun Majid; Marshall Shichtman & Assoc.; Ryan Marx; Dax Mathews; Robert J. Merrill; Merrill; MFA; Peter Murgolo; Raymond J. Murphy; Morgan Stanley; NASAA; NASDAQ; Shane D. Ness; Mark Noiseux; NYSE; OCC; Aaron Papowitz; PCX; PHLX; Pink Sheets; Tal Plotkin; Josue Portillo; Michael J. Protomastro; Michael S. Raffaele; Richard Rebatta; Michael A. Richardson; Gregory Rivine; Thomas J. Roklan; David Schwarz; Tal Sharon; Dean Sheikh; Todd Sherman; Hiro Shinohara; SIA; SIA Derivatives; Theodore J. Siegal; Daniel S. Silver; Shawn Smith; Dan Solomon; Specialists; STA; STANY; Susquehanna; TD Options; Howard Teitelman; Eric M. Trach; Michael W. Vaughn; Kiet Vo; Eric Walania; Brendan Walker; Alex Wang; Matthew Weinshall; Travis P. Whitten; James Whitticom; Jimmie E. Williams; Willkie Farr; Ryan Wolpert; Henry Wong. Samuel J. Yoon.

<sup>134</sup> This number is in addition to the forty-three commenters who supported Regulation SHO as proposed. See letters from H. Glenn Bagwell, Jr.; T.E. Cohen; Dr. Jim DeCosta; Feldman Weinstein; ICI; Marshall Shichtman & Assoc.; NASAA.

<sup>135</sup> Cf. letter from Pink Sheets. The letter states that Pink Sheets does not believe that there is any problem defining a national best bid and offer for OTC equity securities, since "NASD Rule 2320 is used in reference to 'best execution' and the same guidelines could be used for any NBBO needed for short selling regulations." *Id.*

<sup>136</sup> See letters from ICI; NASAA.

In spite of supporting the uniform bid test over Rule 10a-1, these commenters raised concerns about market application and effectiveness. See letters from CBOE; Charles Schwab; NASDAQ; STA; STANY.

current controversy” where certain SROs lack price regulations for Nasdaq securities while Nasdaq enforces the NASD’s short sale price rule.<sup>138</sup> STA’s letter expressed the view that a uniform short sale rule will allow market places to compete with each other on the basis on quality of execution, rather than on regulatory disparities.<sup>139</sup> Additionally, these commenters believed that a price test related to the bid provides more flexibility than a test related to the last tick or sale price.

In contrast to the above support, ten commenters expressed their preference for the current tick test, under Rule 10a-1, over Regulations SHO’s consolidated bid test.<sup>140</sup> Favoring the tick test, the NYSE letter asserted that the tick test is better “because it is based on a validated price (i.e., an actual sale) rather than a bid, which reflects an interest in trading.”<sup>141</sup> Additionally, seven commenters recommended keeping the current Rule 10a-1 structure until the Commission has completed the pilot program.<sup>142</sup> The general consensus was for the Commission to keep the status quo, thus minimizing costs incurred by market participants, until the Commission had reviewed the results of the pilot and could determine what price test, if any, would be appropriate.

In addition to Rule 201, the Commission sought comment on an alternative bid test, not proposed as part of Regulation SHO, that would allow short selling at a price equal to or above the consolidated best bid if the current best bid is an up-bid from the previous bid.<sup>143</sup> Nine commenters favored this alternative test over the consolidated bid test proposed in Rule 201.<sup>144</sup> The general consensus of these comments was that permitting short sellers to short on an up-bid provided necessary protection while preserving instant execution and liquidity. Nonetheless, several commenters additionally suggested for the Commission to adopt NASD Rule 3350<sup>145</sup> for Nasdaq and expand its test to all securities.<sup>146</sup> These commenters expressed the belief that the

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<sup>138</sup> Charles Schwab.

<sup>139</sup> STA.

<sup>140</sup> See letters from; Citigroup; Goldman; Lehman Brothers; Lux & Metzger; Merrill; Morgan Stanley; Peter Murgolo; NYSE; Specialists.

<sup>141</sup> NYSE.

<sup>142</sup> For commentary on the proposed pilot program see PartV(c) infra. CHX; Citigroup; Goldman; Lehman Brothers; Merrill; Morgan Stanley; SIA.

<sup>143</sup> See Proposing Release.

<sup>144</sup> See letters from AMEX; ARCA; Charles Schwab; Mike Ianni; MFA; Josue Portillo; SIA; Willkie Farr.

<sup>145</sup> NASD Rule 3350, titled Short Sale Rule, prohibits short sales by NASD members in Nasdaq NMS Securities at or below the current best (inside) bid when that bid is lower than the previous best (inside) bid, which is commonly referred to as the bid test. Additionally, Rule 3350 grants several exemptions. NASD Rule 3350.

<sup>146</sup> Charles Schwab; Knight; Raymond J. Murphy; Tal Plotkin; STA; STANY; but cf. Specialists.

current NASD rule, which prohibits short sales in declining markets and allows short sales in rising markets, maintained consistency with both short sale regulation and market liquidity.

However, most of the comments received on proposed Rule 201's bid test focused on the consequential effects from its requiring short sale executions at one cent above the consolidated best bid. Most commenters held the opinion that the test, itself, was inconsistent with the purpose behind short sale regulation because it prevented short sales in rising markets. These commenters expressed the belief that short sale regulation contemplated allowing short sellers to sell to the bid in rising markets.<sup>147</sup>

Several commenters argued that this requirement is ineffective at preventing manipulation. For example, three commenters who oppose the bid test, maintain that it is ineffective in preventing downward price pressure since participants can still engage in "pegging" activities and other short-term manipulative devices.<sup>148</sup> Willkie Farrs' letter contends, on behalf of its clients, that the proposal would open "opportunities for game-playing" by providing incentives for the party at the best bid to lower its bid by a penny, inviting short sellers to post ask quotations at the original bid price.<sup>149</sup> Moreover, in successive instances the activity could promote a market decline.<sup>150</sup> Other commenters raised the concern of bid "flickering," during the interim period between identification of the consolidated best bid and the execution of a short sale, which would create confusion and invalidate affected short sales.<sup>151</sup>

Other commenters assert that the proposed bid test would eventually promote unhealthy market practices. According to two commenters, participants could develop techniques to evade the test.<sup>152</sup> An example provided referred to a situation where a party arranges payment of one or two cents extra commissions for immediate execution.<sup>153</sup> According to the commenter, the commission on the sale is more than the loss to fill the trade. Additionally, two commenters stated the belief that the proposed bid test would unintentionally discourage investors from placing limit buy orders, consequently limiting market depth and decreasing transparency.<sup>154</sup>

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<sup>147</sup> See, e.g., letters from Charles Schwab; SIA; Specialists; Willkie Farr.

<sup>148</sup> See letters from Patrick Kwon; Aaron Papowitz; Michael J. Protomastro; Tal Sharon.

<sup>149</sup> Willkie Farr.

<sup>150</sup> Id.

<sup>151</sup> AMEX; Charles Schwab; Marshall Shictman & Assoc.; Specialists; NYSE.

<sup>152</sup> James Angel; LEK Securities.

<sup>153</sup> James Angel. The sale is filled at one cent above the bid and the broker-dealer covers the trade by hitting the bid. Id.

<sup>154</sup> James Angel; Knight.

Commenters raised additional market concerns relating to execution and pricing inefficiencies. For example, both the SIA's letter and the NYSE's letter claim that a price test requiring all short sale to be effected over the best bid would slow the speed of executions and impose unnecessary costs on market participants, including buyers.<sup>155</sup> Madoff's letter stated that Rule 201's bid test prohibits immediate execution of market short sale orders and essentially transform these orders into limit orders floating one cent above the bid.<sup>156</sup> By not allowing short sellers to sell at the bid, as MFA's letter claims, Rule 201's test would "impede trading and distort market pricing."<sup>157</sup>

Some commenters cautioned the Commission on the costs and time related to implementing the proposed bid test.<sup>158</sup> These commenters urged the Commission to provide the industry with enough time to implement the changes to the trading systems and compliance procedures. To ensure compliance with the new regulatory changes, NASDAQ's letter stated that the Commission should provide a delayed effective date "of at least six months."<sup>159</sup> AMEX's letter expressed the view that the cost and time to achieve compliance with Rule 201 would be more than stated in the Release.<sup>160</sup> AMEX estimated that it would take the exchange three and a half months to make the necessary surveillance changes and would cost roughly \$125,000.<sup>161</sup> CHX represented that the aggregate cost to the exchange and its floor members would amount to at least \$500,000.<sup>162</sup> Although it did not provide actual estimates, Lehman Brothers' letter maintained that implementation of the consolidated bid test would require significant and costly changes to market participants' systems and compliance procedures.<sup>163</sup>

Twenty commenters stated the belief that the Commission should eliminate any price test regulation of short sales.<sup>164</sup> Many of these commenters stated a belief that price restrictions are

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<sup>155</sup> SIA; NYSE.

<sup>156</sup> See Madoff; see also Knight.

<sup>157</sup> MFA.

<sup>158</sup> AMEX; CHX; Lehman Brothers; LEK Securities; NASDAQ

<sup>159</sup> NASDAQ.

<sup>160</sup> AMEX. In the Release, the Commission states that it received information from an exchange and a broker-dealer. The exchange submitted that the changes would take an estimate of one month and cost \$100,000. The broker-dealer did not provide a cost, but claimed the compliance would take up to two months. See Proposing Release.

<sup>161</sup> AMEX.

<sup>162</sup> CHX.

<sup>163</sup> Lehman Brothers.

<sup>164</sup> Chris Bernstein; Eliav Bock; Coreina Chan; John Chinnock; CHX; Marc Griffin; Zachary Hepner; Lehman Brothers; Derrick Liu; Robert Masiello; Robert Morrow; Hiro Shinohara; Daniel C. Sweeney; Howard Teitelman; Kiet Vo; Eric Walania; Travis P. Whitten; Ryan Wolpert; Henry Wong.

out-dated and unnecessary in a decimal environment. Some commenters who opposed the proposed bid test conceded that during times with unusual market declines some form of short sale restriction should apply.<sup>165</sup> One commenter, a proprietary trader, stated that a 10% circuit breaker would suffice during a major market collapse.<sup>166</sup> Other commenters asserted that the current controls are effective, even if there is a severe market decline.<sup>167</sup>

## **1. Retained Exceptions**

### **(a) Long Seller's Delay in Delivery**

Two commenters submitted comment on the long seller's delay exception.<sup>168</sup> One commenter stated that the exception was "essential" due to the functioning of the private placement market, "where late deliveries due to the slowness of issuers and their transfer agents . . . are common."<sup>169</sup> Another commenter maintained that the exception clearly demonstrates that Commission is not interested in considering persons who have "bona fide problems delivering stock to have violated the short sale rule."<sup>170</sup> However, the commenter expressed the opinion that, instead of including the exception, the Commission should have eliminated the second half of the short sale definition set forth in Rule 3b-3.<sup>171</sup>

### **(b) Error in Marking a Short Sale**

In response to Regulation SHO's retention of the exception, under (e)(2) of Rule 10a-1, for errors in marking a short sale, the Commission received comment from one commenter.<sup>172</sup> The commenter expressed support for the Commission's retention of the exception stating that the exception is necessary, "so as not to implicate a broker dealer [sic] who makes a bona fide error."<sup>173</sup>

### **(c) Odd-Lots**

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<sup>165</sup> Chris Bernsten; Carl Z. Giannone; Gregory Rivine.

<sup>166</sup> Carl Z. Giannone.

<sup>167</sup> Steven N. Levay; Michael Lucarello; Raymond J. Murphy.

<sup>168</sup> Feldman Weinstein; LEK Securities.

<sup>169</sup> Feldman Weintin.

<sup>170</sup> LEK Securities.

<sup>171</sup> Id.

<sup>172</sup> LEK Securities.

<sup>173</sup> Id.

Three commenters communicated their opinions relating to the retention of the odd-lot exception. Two of the commenters stated they believed that the Commission should not provide an exception for odd-lots.<sup>174</sup> LEK Securities' letter stated that it believed that handling odd-lots differently from round lots is "outdated" and "invites abuse."<sup>175</sup> According to LEK Securities, there is evidence that sophisticated market participants are breaking up large orders to take advantage of this exception. However, Knight's letter supported the Commission's proposed expansion of the odd-lot exception to market makers acting as odd-lot dealers.<sup>176</sup>

#### (d) Domestic Arbitrage

Nine commenters<sup>177</sup> submitted comment in response to the Regulation SHO's retention and modification of the domestic arbitrage exception currently under Rule 10a-1(e)(7).<sup>178</sup> The general stance of the comments was that the exception's requirement of acquisition of the securities, through conversion, is too narrow. Furthermore, the commenters believe that the Commission did not provide a clear regulatory purpose relating to narrowing the scope of the exception. The SIA's letter expressly states that the Commission did not provide justification for limiting the prior relief provided in Rule 10a-1.<sup>179</sup> Additionally, SIA urged the Commission to eliminate the acquisition or purchase requirement and added that the exception "should not favor conversion and delivery over simultaneously closing out both sides of the arbitrage."<sup>180</sup> Adding to this argument, Susquehanna's letter asserted that the new requirement "would diminish the value that domestic arbitrage now provides to the market without introducing any new pertinent contributions to market efficiency."<sup>181</sup>

To other commenters, the current exception in Rule 10a-1 was too narrow to accord with current market conditions and, thus, the additional limitations proposed are "unnecessary and

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<sup>174</sup> Richard G. Dahlen; LEK Securities.

<sup>175</sup> LEK Securities.

<sup>176</sup> Knight.

<sup>177</sup> James Angel; Feldman Weinstein; Knight; LEK Securities; MFA; SIA; Susquehanna; Willkie Farr.

<sup>178</sup> 17 CFR 240.10a-1(3)(7).

<sup>179</sup> SIA. Rule 10a-1(e)(7) provides:

Any sale of a security for a special arbitrage account by a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase with such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such of securities of the issuer. 17 CFR 240.10a-1(e)(7).

<sup>180</sup> SIA.

<sup>181</sup> Susquehanna.

inappropriate.”<sup>182</sup> Letters from MFA and Willkie Farr recommended that the Commission expand the exception to apply to both convertible securities and “exchangeable securities.”<sup>183</sup> Additionally, MFA’s letter recommended that the domestic arbitrage exception allow the hedge an equity-linked security by selling the underlying stock, without requiring compliance with the price test, if the total short sales do not exceed the amount of stock underlying the equity-linked security.<sup>184</sup>

The exception’s reference to a “special arbitrage account” additionally received some comment. Two commenters asserted that the requirement to set up special arbitrage accounts separately does not serve a regulatory purpose.<sup>185</sup> According to one of these commenters, the requirement merely creates a paperwork burden on investors, broker-dealers and clearing agencies.<sup>186</sup> SIA’s letter suggested the Commission change the term “arbitrage account” to “good faith account,” similar to its replacement in Regulation T.<sup>187</sup>

The domestic arbitrage section of the proposing release included a request for comment relating to merger arbitrage. Essentially, the Commission sought comment on whether to include an exception for short sales effected in connection with a merger. Five commenters submitted comment on the topic recommending the Commission provide an exception for merger arbitrage.<sup>188</sup> Willkie Farr’s letter maintained that merger arbitrage is not an activity that would likely to promote abuse.<sup>189</sup> LEK Securities expressed the view that a merger arbitrage exception should be allowed if the agreement specifies a certain merger price and closing date.<sup>190</sup> However, LEK Securities stated that there should not be an expanded exception to include an exception from Rule 203’s locate and delivery requirement.<sup>191</sup> SIA’s letter requested the exception

#### **(e) International Arbitrage**

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<sup>182</sup> See MFA; see also Knight; Willkie Farr.

<sup>183</sup> Per statements made in their letters, “exchangeable securities” means securities exchangeable for securities of a different issuer. MFA; Willkie Farr.

<sup>184</sup> Id.

<sup>185</sup> Feldman Weinstein; MFA.

<sup>186</sup> Feldman Weinstein.

<sup>187</sup> SIA. The SIA letter refers to 63 F.R. 2805 (Jan.16, 1998).

<sup>188</sup> LEK Securities; MFA; SIA; Willkie Farr.

<sup>189</sup> See letter from Willkie Farr.

<sup>190</sup> LEK Securities.

<sup>191</sup> Id.

The Commission proposed to retain the international arbitrage exception with certain changes to make the exception more understandable. Two commenters submitted their comments on amended international arbitrage exception in Regulation SHO.

One commenter expressed support for the retention of the exception from short sale price regulation.<sup>192</sup> The comment letter additionally stated that the firm believed that the particular amendments were appropriate and beneficial.<sup>193</sup> In response to the Commission's inquiry whether to combine the domestic arbitrage exception and the international arbitrage exception into one exception, the commenter maintained that it would not make a difference.

The other commenter argued for the Commission to eliminate the exception.<sup>194</sup> According to the commenter, the international arbitrage exception should be retained because it provides a "loophole" by encouraging firms to place orders through overseas affiliates instead of through domestic broker-dealers.<sup>195</sup>

#### **(f) Distribution Over-Allotment**

The Commission received comment from one commenter on the proposal's retention of the proposal's retention of the over-allotment exception with slight modification. The commenter, LEK Securities, responded to the Commission's inquiry on whether the exception was still necessary. According to LEK Securities, the exception is necessary so underwriters can sell the securities at the offering price even if the bid for the security moves higher than that price.<sup>196</sup>

#### **(g) Equalizing Short Sales & Trade Throughs**

In Regulation SHO, the Commission proposed to include an exception to Rule 201 that permits a "responsible broker-dealer"<sup>197</sup> to effect a short sale at a price equal to its posted offer

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<sup>192</sup> Id.

<sup>193</sup> Id.

<sup>194</sup> Marshall Shictman & Assoc.

<sup>195</sup> Id.

<sup>196</sup> LEK Securities.

<sup>197</sup> Under Rule 11Ac1-1(a)(21) of the Act, responsible broker-dealer is defined to mean the following:

(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

(. . . continued)

when the market is locked or crossed, when consistent with best execution obligations. However, the exception would not apply to any broker-dealer who initiated the locked or crossed market. Eight commenters submitted comment of the proposed changes to the exception.<sup>198</sup>

In response to the Commission's request for comment on the exception, all eight comments expressed the belief that the proposed exception would not remedy locked and crossed markets concerns. NASDAQ's letter stated that it believed that Regulation SHO should be linked to Proposed Regulation NMS given that the locked and crossed exceptions to Rule 201 are impractical in today's markets.<sup>199</sup> Additionally, the joint industry letter submitted by Citigroup, Goldman, Merrill and Morgan Stanley asserted that without prior resolution of market structure issues, such as "the continuing viability of the trade through rule and the adequacy of market linkages," Regulation SHO could exacerbate current inefficiencies in the equity markets.

In addition to the above comments, AMEX expressed in its letter that the exception's exclusion of broker-dealers who initiate the locked or crossed market is "excellent . . . in principal," yet "problematic in practice."<sup>200</sup> AMEX suggested that the Commission consider other ways to deal with the problem in light of AMEX's present inability to determine on a real-time basis which market center initiated the locked or crossed market.<sup>201</sup> LEK Securities stated it believed that the exception is appropriate, but the Commission should address the problem separately since "locking and crossing markets is . . . manipulative by its very nature."<sup>202</sup> Additionally, another commenter asserted that the Commission should consider the quality of the national best bid and offer ("NBBO") data feed as it attempts to address the problem.<sup>203</sup>

## 2. Eliminated Exception

The Commission chose not retain the equalizing exceptions, under 10a-1(e)(6) and (e)(5)(i) of the Act,<sup>204</sup> in Regulation SHO. In the proposal, the Commission stated that the

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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). 17 CFR 240.11Ac1-1(a)(21).

<sup>198</sup> James Angel; AMEX; Citigroup; Goldman; LEK Securities; Merrill; Morgan Stanley; NASDAQ.

<sup>199</sup> NASDAQ.

<sup>200</sup> AMEX.

<sup>201</sup> Id.

<sup>202</sup> LEK Securities.

<sup>203</sup> James Angel.

<sup>204</sup> 17 CFR 240.10a-1(e)(6), (e)(5)(i).

(. . . continued)

rationale for the exceptions would not apply to the proposed bid test since the price reference is the real-time consolidated best bid rather than the last trade and does not depend on individual market prices.<sup>205</sup>

The proposed eliminated exception received comments from two commenters. One commenter expressed accord with the Commission's belief that the equalizing exception was unnecessary under the proposed bid test.<sup>206</sup> On the other hand, the NYSE letter maintained that an exception was still necessary for foreign securities traded on the Exchange. The NYSE believes that it is "necessary to the creation of fair and orderly markets" to have the ability to effect short sales at the open to equalize the price of a foreign security with the last reported price for that security in its principal market.<sup>207</sup>

### **3. Prior Exemption Letters Under 10a-1**

#### **(a) Exchange Traded Funds**

Two commenters submitted comment on Regulation SHO's inclusion of the prior no-action relief granted to exchange traded funds ("ETFs") from Rule 10a-1.<sup>208</sup> Both AMEX and NASDAQ urged the Commission to codify the relief and expressed concurrence with the Commission's statement that trading in ETFs would not be susceptible to downward price manipulation.<sup>209</sup> Aside from its support, AMEX specifically requested clarification of ambiguity surrounding the conditions required to satisfy for no-action relief. AMEX's particular claim is that the no-action relief provided in the Class Letter did not specify the point(s) in time that the condition must be applicable.<sup>210</sup> According to AMEX, this ambiguity "may assume significance if the number of stocks in an ETF should decline over time due to corporate events."<sup>211</sup> The AMEX letter additionally requests the Commission to clarify the definition of ETF utilized in the Class Letter.

#### **(b) Short Sales Executed at the Closing Price**

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<sup>205</sup> See Proposing Release.

<sup>206</sup> LEK Securities.

<sup>207</sup> NYSE.

<sup>208</sup> AMEX; NASDAQ. Additionally, both commenters maintain that the Commission should provide an exemption from Rule 203's locate and delivery requirements for ETFs. Id.

<sup>209</sup> AMEX expressed, "trading [in ETFs] would not be susceptible to the practices that current Exchange Act Rule 10a-1 is designed to prevent." AMEX.

<sup>210</sup> AMEX makes reference to the "Class Letter," which lists the conditions for relief, from James Brigagliano, Assistant Director, Division of Market Regulation, to Claire P. McGrath, Vice President and Special Counsel, AMEX, dated Aug. 17, 2001. AMEX

<sup>211</sup> Id.

Regulation SHO continues to provide the relief for executing short sales in after-hours crossing sessions at a price equal to the closing price of the security that was previously granted under Rule 10a-1.<sup>212</sup> At this time, the Commission did not codify the relief in Regulation SHO, but sought comment on such codification.

One commenter submitted comment on the retained no-action relief regarding executing short sales at the closing price. The commenter expressed the view that the Commission should grant a “blanket exception” for all trades having a price derived algorithmically as long as the pricing mechanism operated independently from both buyer and seller.<sup>213</sup>

### (c) Flexibility for Passive Pricing Systems

Fourteen commenters submitted comments on the Commission's proposed codification of relief for certain VWAP trades.<sup>214</sup> While these commenters welcomed codification of prior exemptive relief, eleven commenters expressed the view that the granted exemptions were highly

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<sup>212</sup> As stated in the proposing release, the relief is subject to the following conditions:

(1) short sales of a security in the after-hours matching session shall not be effected at 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. Proposing Release at fn 146.

<sup>213</sup> LEK Securities.

<sup>214</sup> See letters from James Angel; Citigroup; Feldman Weinstein; Goldman; ICI; ITG, Inc.; LEK Securities; Merrill; Morgan Stanley; SIA; STA; Susquehanna; Willkie Farr. To qualify for relief from the bid test requires satisfying the following conditions: (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 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; 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). 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. See Proposing Release.

restrictive, and thus, recommend that the Commission broaden the exemption to include intra-day VWAP transactions.<sup>215</sup> ICI letter maintained that providing similar relief through a limited intra-day exemption, “would enhance the ability of institutional investors to effectuate transactions . . . and should not present the risks that the short sale rule was designed to address.”<sup>216</sup> LEK Securities’ letter offered expressed that it considered intra-day VWAP trades as harmless as those placed prior to the market opening.<sup>217</sup> Similarly, the joint letter submitted by Citigroup, Goldman, Merrill and Morgan Stanley stated that the limited relief, provided in Regulation SHO, unnecessarily precludes firms from providing liquidity services to customers for a transaction that does not implicate the underlying concerns of short sale regulation.<sup>218</sup>

#### 4. Market Maker Exception from Proposed Uniform Bid Test

Although Rule 10a-1, in its current form, does not provide an exception to market makers and specialists in exchange-listed securities, NASD Rule 3350 exempts market makers engaged in bona fide market making activities from the NASD’s price test.<sup>219</sup> The Commission approved the market-making exception to NASD Rule 3350, noting that the Commission would review the exception, on an ongoing basis, to determine whether the bid test and exceptions are practicable and necessary.<sup>220</sup> In Regulation SHO’s proposing release, the Commission chose not to provide similar market-making relief under Rule 201’s consolidated bid test because it did not believe that an exception was needed in the context of the new price test.

Despite the proposal’s expressly omitting a market maker exception from the consolidated bid test, the Commission received letters from forty-four commenters who adamantly opposed its inclusion in the proposal.<sup>221</sup> The general consensus expressed by these

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<sup>215</sup> Citigroup; Goldman; ICI; LEK Securities; Merrill; Morgan Stanley; SIA; STA; Susquehanna; Willkie Farr.

<sup>216</sup> ICI. As a means to facilitate the expanded exemption, the letter suggested a limited exemption, such as two hours, for VWAP price transactions over a period of time “sufficient to prevent the VWAP trade from being used to place downward pressure on a stock.” *Id.*

<sup>217</sup> LEK Securities.

<sup>218</sup> See letter from Citigroup, Goldman, Merrill & Morgan Stanley.

<sup>219</sup> In subparagraph (c)(1) of Rule 3350, the NASD provides an exemption to its short sale price test for “[s]ales by a qualified market maker or an ADF market maker registered in the security on Nasdaq in connection with bona fide market making activity.” NASD Rule 3350(c)(1).

<sup>220</sup> See Proposing Release (citing Securities Exchange Act Release No. 34277 (July 7, 1994), 59 FR 34885 (July 29, 1994)).

<sup>221</sup> Steven Ackerman; Emilia Alessandru; Eli Argento; Blake C. Byczek; Jake Chun; Louis J. D’Antuono; Timothy K. Dolnier; Michael Elzahr; Moshe Fogel; Chris Freddo; Kenneth J. Garby; Carl Z. Giannone; Charles W. Hansford; George Hassell; Edward E. Hong; Joshua Janelli; [Kevans7@satx.rr.com](mailto:Kevans7@satx.rr.com); Saetoon Kim; Eric Knight; Bernard J. Lee; Carl C. Lochen; Ryan Marx; Robert J. Merrill; Robert Morrow; NASAA; Shane E. Ness; Mark Noiseux; Tal Plotkin; Stanley Podlofsky; Michael J. Protomastro; Richard Rebatta; Thomas J. Roklan; Robert Seitel; Tal Sharon; Hiro Shinohara; Theodore J. Siegel; Shawn Smith; Eric M. Trach; Charles J. Trachta, Jr.; Michael W. Vaughn; Kiet Vo; Eric Waliana; Alex Wang; Matthew Weinshall.

commenters was that it was unfair to provide greater flexibility to one group of market participants. Illustrating this point, one commenter stated that the government's function should be "to ensure a level playing field for all the players, not just industry insiders."<sup>222</sup> Other opponents submitted stronger statements maintaining that market makers and their functions are outdated. For example, one commenter expressed that market makers' services should be unnecessary, "since all bids and asks for shares can be electronically made available instantly on computer networks."<sup>223</sup>

In contrast, proponents of a bone fide market making exception submitted several arguments to justify its necessity.<sup>224</sup> The supporting arguments, submitted by seventeen commenters, varied from fulfilling best execution obligations to price efficiency and needing flexibility for capital commitment. All maintained that a market maker exemption from the bid test is vital for servicing of various types of customer orders.

One argument submitted was that the proposed bid test failed provide market makers with the ability to fulfill best execution obligation with respect to price and timelessness of customer buy orders. In support of an exemption, Madoff's letter argued that market makers need flexibility to facilitate non-marketable limit orders and provide a practice known as "print protection."<sup>225</sup> Madoff's letter explains that print protection allows market makers and specialists to give assurances to clients that their orders are, "protected and provided with timely execution at a price equivalent to executions taking place anywhere in the National Market System." According to Madoff, it is critical for market makers to have the ability to sell short out of their inventory at a price that would otherwise be prohibited by short sale price test in order for market makers to preserve liquidity. Madoff's letter further asserted that a market maker's ability to provide effective print protection for limit orders, "is a factor in how a client defines and measures "best execution."<sup>226</sup>

Many proponents of the exemption also expressed disagreement with the Commission's statement that "a market maker should rarely need to sell short at or below the bid in its market making capacity."<sup>227</sup> These commenters held the opposite view, rather, that market makers need to sell below the bid to adjust positions quickly in anticipation of changing market conditions. One example, submitted by Knight, occurs during fast rising markets. According to Knight, dramatic price upswings may hinder a market maker from establishing a large enough long position to avoid going short while servicing customer demand. In these situations, it is

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<sup>222</sup> H. Glenn Bagwell, Jr.

<sup>223</sup> Carl C. Lochen.

<sup>224</sup> See letters from James Angel; Scott Arenstein; Citibank; Charles Schwab; Goldman; Knight; Lehman Brothers; Madoff; Merrill; Morgan Stanley; NASDAQ; SIA; STA; STANY; Susquehanna; Willkie Farr.

<sup>225</sup> See Madoff; see also SIA.

<sup>226</sup> Madoff.

<sup>227</sup> Securities Exchange Act Release No. 48709.

“difficult to sell short at or at the near the high end of a run” and thus, without the ability to short below the bid, market makers would increase their risk of incurring a loss.<sup>228</sup>

Aside from arguing the needs of market makers, proponents also argued the benefits an exemption would bring to investors and the market as a whole. NASDAQ’s letter asserts that Regulation SHO “overlooks” significant ways market makers provide liquidity, such as “guaranteeing executions at prices prevailing in other dealers’ markets, by working block orders, and by offering liquidity on a riskless principal basis beyond the number of shares displayed in their quote or in the held customer order.”<sup>229</sup> According to NASDAQ, only a portion these services will be permitted under the proposal. STANY’s letter stressed price discovery and capital commitment for customers while arguing the importance for a market maker exception to bid test.<sup>230</sup> In addition to reducing risk, the CBOE’s letter maintained that an exemption for market making, specifically options market making,<sup>231</sup> would increase market depth and liquidity.<sup>232</sup> According to STA, not including an exemption “is a grave error and could result in significant harm to public investors” by reducing liquidity and speed of execution.<sup>233</sup>

The proponents additionally argue that, without documenting harms or apparent abuses related to the exemption, it is premature to eliminate it.<sup>234</sup> The NASDAQ letter states that, even if the proposing release “assumes” that a small number of market makers are abusing the exemption, “there is no justification for withdrawing it from the those that use it properly.”<sup>235</sup> Additionally, a joint industry letter maintained that the firms were not aware of any abuses stemming from the exemption provided in NASD Rule 3350, since its approval. The firms further stated that, on account that the NASD did not find any harmful consequences to the exemption while it researched the period during the adoptive phase, the Commission should proceed deliberately and consider whether it has enough data to propose eliminating the exemption.<sup>236</sup> Similarly, STA’s letter stated that it believes that the Commission should conduct a study to determine whether current regulatory oversight of the exemption is ineffective, prior to removing the exemption.<sup>237</sup>

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<sup>228</sup> Knight.

<sup>229</sup> NASDAQ.

<sup>230</sup> STANY.

<sup>231</sup> See part V. E., infra, for a discussion on options market making in relation to a hedge exemption.

<sup>232</sup> CBOE.

<sup>233</sup> STA.

<sup>234</sup> See, e.g., Citigroup; Goldman; Merrill; Morgan Staley; NASDAQ; STA.

<sup>235</sup> NASDAQ.

<sup>236</sup> See letter from Citigroup, Goldman, Merrill; Morgan Stanley.

<sup>237</sup> STA.

As an alternative to adopting a market maker exemption, many commenters urged the Commission to expand the customer facilitation exemptions proposed in Regulation SHO.<sup>238</sup> These commenters maintain the proposed exceptions, i.e., the riskless principal exception and the best execution exception,<sup>239</sup> do not provide enough flexibility for market makers.<sup>240</sup> Specifically, many exemption proponents assert that the Commission should reconsider the negative consequences that may result from not covering executions that are not per se triggered by the obligation under the Manning Interpretation.<sup>241</sup> According to these commenters, a market maker may not be obligated by securities laws or SRO rules to fulfill a customer order, but may do so to enhance the execution and provide “better execution.”<sup>242</sup> STA’s letter requested that Regulation SHO, at minimum, exempt market makers solely for the purpose of ensuring better and best execution of customer purchase orders.<sup>243</sup> The lack of broader facilitation exceptions, the proponents contend, will limit the ability of market makers to respond to liquidity demands.

## **5. Proposed Changes to Order Marking Requirement**

### **(a) Marking Orders**

Incorporated into Rule 201, Regulation SHO combined the current marking requirements, under Rule 10a-1(c) and (d), to differentiate between "long," "short," and "short exempt" orders to all exchange-listed and over-the-counter securities. The proposal stated that 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. Additionally, if a short sale was effected pursuant to an exception in Rule 201, the sell order would be required to be marked "short exempt.”

Two commenters submitted comment in response to Regulation SHO’s order marking proposal.<sup>244</sup> One commenter stated that the proposed marking requirement would not impose a burden, but cautioned that various market centers handle orders differently.<sup>245</sup> Both commenters

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<sup>238</sup> See, e.g., Charles Schwab; Madoff; SIA.

<sup>239</sup> Proposed under Rule 201 in subparagraphs (d)(9) and (d)(10).

<sup>240</sup> See letters from Charles Schwab; Citigroup; Goldman; Knight; Madoff; Merrill; Morgan Stanley; STA.

<sup>241</sup> The Manning Interpretation related to the NASD’s order handling rules. 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. NASD-IM-2110-2.

<sup>242</sup> See Madoff; see also Charles Schwab; Citigroup; Goldman; Merrill; Morgan Stanley; STA.

<sup>243</sup> STA.

<sup>244</sup> LEK Securities; SIA.

<sup>245</sup> LEK Securities.

expressed doubt that the new order marking would aid in surveillance or settlement process.<sup>246</sup> Additionally, both commenters questioned whether the anticipated benefits of marking orders “short exempt” outweighed the costs of firms modifying their systems. The commenters maintained that the new marking would require broker-dealers to make necessary system changes, revise compliance materials and expend resources to train registered professionals.<sup>247</sup>

### **(b) Marking Riskless Principal Transactions**

Regulation SHO provides an exception from the proposed bid test for riskless principal transactions, allowing such transactions to be marked in accordance with the customer’s net position. In the proposal, the Commission stated that its belief 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 the broker-dealer’s proprietary net position, when the broker-dealer acts in a riskless principal capacity. The exception allows broker-dealers to mark such sell orders “short exempt.”

Two commenters provided to the Commission their comments regarding the riskless principal exception.<sup>248</sup> In response to the Commission’s inquiry on the appropriateness of the exception, LEK Securities’ letter stated that the restriction provided in the proposal were appropriate.<sup>249</sup> Charles Schwab’s letter, however, urged the Commission to “take care” in defining riskless principal transactions, to avoid regulatory inconsistencies with prior SRO interpretations.<sup>250</sup> Additionally, Charles Schwab expressed doubtfulness on whether the riskless principal exception could provide enough flexibility to facilitate certain customer orders.<sup>251</sup>

### **C) Rule 202, Pilot Program**

Fifty-eight commenters submitted comments relating to Regulation SHO’s proposed 2-year pilot program.<sup>252</sup> Rule 202 suspends Rule 201’s bid test for a group of highly liquid

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<sup>246</sup> LEK Securities; SIA.

<sup>247</sup> Id.

<sup>248</sup> Charles Schwab; LEK Securities.

<sup>249</sup> LEK Securities.

<sup>250</sup> Charles Schwab.

<sup>251</sup> Specifically, the letter focused on market-on-open orders and market-on-close orders. Id.

<sup>252</sup> See letters from James Angel; ARCA; Yusef J. Burgess; CBOE; Coreina Chan; Charles Schwab; CHX; Citigroup; [Comics@webtv.net](mailto:Comics@webtv.net); Dario Cosic; Davis Polk; Timothy K. Dolnier; Tolga Erman; Chris Freddo; Anthony Gentile; Kristopher Goldhair; Goldman; Chris Gregg; Marc Griffin; Charles W. Hansford; Zachary Hepner; Mike Ianni; ICI; Brian Ingram; Kevin Karlberg; Gregory Kleiman; Partick Kwon; Lehman Brothers; LEK Securities; Michael Lucarello; Lux & Mtezger; Merrill; MFA; Morgan Stanley; Robert Morrow; Raymond J. Murphy; NASDAQ; NYSE; [Osmar92@optonline.net](mailto:Osmar92@optonline.net); Tal Plotkin; David Schwarz; Sinan Selcuk; Todd Sherman; Hiro Shinohara; SIA; Dan Soloman; SONECON; Specialists;

(. . . continued)

securities during a two-year period for the purpose of studying the trading of these securities and whether to continue short sale price restrictions. Most industry participants favored a pilot program that suspends operation of any price test on a specified number of liquid securities.<sup>253</sup> Overall, thirty-eight commenters expressed support for some form of a pilot program.<sup>254</sup> Six of these commenters urged the Commission to adopt the pilot program before acting on the other rules proposed in Regulation SHO.<sup>255</sup>

In spite of expressing support for a pilot, several commenters recommended that the Commission consider certain modifications relating to the securities selected for the pilot. One commenter, CHX, asserted that the selection process was “insufficiently outlined” and recommended that the Commission seek public comment through a proposal detailing the factors on which the Commission would rely in selecting pilot issues.<sup>256</sup> Additionally, several commenters suggested that the Commission should expand the scope of stocks included in the temporary pilot.<sup>257</sup> Some of these commenters suggested the pilot include less liquid securities, such as less liquid Nasdaq NMS and listed securities.<sup>258</sup> The CBOE expressed the opinion that a beneficial study would seem to include of a more meaningful number of securities that meet certain capitalization standards, trading depth and liquidity.<sup>259</sup> The SIA suggested use of stocks that currently qualify for the Regulation M exception for actively traded securities because they are less susceptible to market manipulation and the cost of implementing may be reduced since many broker-dealers have systems in place to identify such stocks.<sup>260</sup> Alternatively, SIA recommended the pilot program consist of component securities of one of the more broad-based

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STA; STANY; Susquehanna; Daniel C. Sweeney; Howard Teitelman; WBS&A, Ltd.; Matthew Weinshall; Travis P. Whitten; Jimmie E. Williams; Willkie Farr.

<sup>253</sup> As stated in the release, the Commission would consider including one third of the securities in the Russell 100 index, or a different broad-based index if it were necessary or appropriate in the public interest and consistent with the protection of investors. See Proposing Release.

<sup>254</sup> James Angel; Yuseff J. Burgess; CBOE; Dario Cosic; Davis Polk; Timothy K. Dolnier; Tolga Erman; Chris Freddo; Kristopher Goldhair; Chris Gregg; Marc Griffin; Charles W. Hansford; Zachary Hepner; ICI; Mike Ianni; Brian Ingram; Kevin Karlberg; Gregory Kleiman; LEK Securities; Michael Lucarello; Lux & Metzger; MFA; Raymond J. Murphy; NASDAQ; [Osmar92@optonline.net](mailto:Osmar92@optonline.net); Tal Plotkin; David Schwarz; Sinan Selcuk; Theodore J. Siegel; Todd Sherman; SIA; Dan Solomon; STA; STANY; Howard Teitelman; Jimmie E. Williams; Willkie Farr.

<sup>255</sup> CHX; Citigroup; Goldman; Lehman Brothers; Merrill; Morgan Stanley; SIA.

<sup>256</sup> CHX.

<sup>257</sup> CBOE; Coreina Chan; Timothy K. Dolnier; Charles W. Hansford; Zachary Hepner; Gregory Kleiman; Michael Lucarello; NASDAQ; [Osmar92@optonline.net](mailto:Osmar92@optonline.net); Tal Plotkin; David Schwarz; Dan Solomon; STA; STANY; Hiro Shinohara; Daniel C. Sweeney.

<sup>258</sup> STA; STANY.

<sup>259</sup> CBOE.

<sup>260</sup> SIA.

indices, such as the S&P 500 and Nasdaq-100.<sup>261</sup> LEK Securities' letter proposed that the Commission rank the Russell 1000 stocks in order of market capitalization and pick every other stock to participate in the pilot.<sup>262</sup> According to assertions made in the letter, the process would yield two lists of stocks, one with price suspension and the other without.<sup>263</sup>

Another pilot expansion request involved increasing the exemptions available for the highly liquid securities selected. The commenter, writing on behalf of J.P. Morgan and UBS Securities, requested that the Commission additionally exempt large capitalization stock from the locate and delivery requirements under Proposed Rule 203, for securities that typically are not difficult to borrow.<sup>264</sup>

Aside from the particular scope of the pilot, some commenters expressed the opinion that the proposed two-year time span for the pilot is too long.<sup>265</sup> NASDAQ's letter proclaimed that the pilot should only last as long as absolutely necessary, to minimize the impact on issuers and the market. NASDAQ suggested that a six-month or twelve-month pilot would provide adequate data for the Commission to analyze the results.<sup>266</sup> STA's letter reiterated the opinion favoring a six-month test would provide sufficient additional market data for the Commission to access the effects of unrestricted short selling and determine whether a uniform bid test is necessary.<sup>267</sup> The NYSE letter, which recommended withdrawal of the pilot, contends the two years in "an exceptionally long time," especially since the program does not establish a quick mechanism to shorten or end if it proves to dislocate market prices.<sup>268</sup>

Relating to time and duration of the pilot, one commenter, SIA, recommended that the Commission not suspend the pilot program during periods of extraordinary market conditions.<sup>269</sup> SIA supported its assertion by stating that to be most effective, the pilot should function under the widest range of potential market conditions.<sup>270</sup>

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<sup>261</sup> Id.

<sup>262</sup> LEK Securities.

<sup>263</sup> Id.

<sup>264</sup> Willkie Farr.

<sup>265</sup> James Angel; Charles Schwab; NASDAQ; NYSE; STA; STANY.

<sup>266</sup> NASDAQ.

<sup>267</sup> STA.

<sup>268</sup> NYSE.

<sup>269</sup> SIA.

<sup>270</sup> SIA.

Six commenters voiced their opposition to any suspension of a price restriction, even for highly liquid securities.<sup>271</sup> These commenters expressed concerns for both the issuer companies and the effects on the market as a whole. In addressing the pilot, SONECON's letter acknowledged that smaller companies may be more susceptible to manipulation; nevertheless, SONECON argued, that does not mean larger companies are invulnerable.<sup>272</sup> The Specialists Association argued that, among other things, the pilot would unfairly disadvantage the issuers included in the two-year study.<sup>273</sup>

In relation to market effects, the NYSE alleged that the pilot would create a confusing system that will slow trading, lead to errors and baffle market participants.<sup>274</sup> Additionally, the NYSE believes that it should be permitted to retain a price test in absence of any restriction during the pilot period. According to Susquehanna's letter, removing longstanding market protections afforded by the short sale rule for a significant number of stocks did not appear worth the risk.<sup>275</sup>

#### **D) Rule 200, Amendments to Rule 3b-3**

Rule 3b-3 sets forth the definition of short sale as well as identifies the specific instances for determining a long position. Regulation SHO sought comments on the proposed modification of requirements relating to the following: unconditional contracts to purchase securities, ownership of securities underlying securities futures products, aggregation unit netting, inclusion of the block positioner exception to Rule 10a-1, and codification of certain index arbitrage relief. The proposed Rule 3b-3 changes did not receive much attention from commenters. However, from those who provided their comments, certain changes were strongly opposed. Sixteen commenters submitted their views on the amendments to Rule 3b-3.<sup>276</sup>

##### **1. Unconditional Contracts to Purchase Securities**

Proposed Rule 200, of Regulation SHO, would require that an unconditional contract additionally specify the price and amount of securities to be purchased in order for a person to claim ownership of the securities underlying the contract. Additionally, the proposal sought comments 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

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<sup>271</sup> See letters from [Comics@webtv.net](mailto:Comics@webtv.net); Anthony Gentile; Robert Morrow; NYSE; SONECON; Specialists.

<sup>272</sup> SONECON.

<sup>273</sup> Specialists.

<sup>274</sup> NYSE.

<sup>275</sup> Additionally, Susquehanna suggested the Commission drastically reduce the pilot to a "handful of stocks." Susquehanna.

<sup>276</sup> Charles Schwab; Citigroup; Feldman Weinstein; Goldman; ICI; ITG; Knight; LEK Securities; Merrill; MFA; Morgan Stanley; SIA; STA; STANY; Willkie Farr.

own the securities. Fifteen commenters submitted their views on the amendment to the definition of an unconditional contract to purchase securities.<sup>277</sup>

The general statement from commenters was a need for more flexibility with the definition of unconditional contract. All fifteen commenters expressed concerns with Rule 200's proposed fixed price component, while one of the fifteen commenters addressed both the fixed price and fixed amount requirements. Several of these commenters argued that a contract specifying the price as "on closing" or per a VWAP basis should satisfy the unconditional contract definition and satisfy the qualifications for "long."<sup>278</sup> Specifically, one of these commenters asserted that requiring a contract to specify an irrevocable price is "in stark contrast" to industry practice and could affect the ability of broker-dealers to facilitate certain sell orders.<sup>279</sup> SIA comments added their view that the proposal would hamper market liquidity by preventing transactions at a price "to be determine" by objective measures.<sup>280</sup> These commenters assert that facilitating contracts, which may tie a trade's price to an event or formula, do not present destabilizing market concern. In furtherance of this assertion, Knight's letter contends that these contracts are often used as means for investors to execute large transactions without causing temporary price spikes.<sup>281</sup>

One commenter offered comments on requiring contemplation of present delivery for a claim of ownership. The commenter stated that it believed that the Commission was engaged in a "useless search for non-existent abuses" and that present delivery "is a solution in search of a problem."<sup>282</sup> In addition, the commenter maintained that impediments to delivery, such as a contractual obligation in control of the issuer, should not preclude an investor from selling long.<sup>283</sup> Aside from asserting that it was inappropriate to impose restrictions on price and quantity of securities to be considered long, this commenter argued that any manipulation concerns can be address under anti-fraud provisions.<sup>284</sup>

The Commission received only one response to its inquiry into whether proposed Rule 200 should require a definite delivery time frame that would set limits to considering oneself long. The commenter, a broker-dealer, expressed the opinion that time was "not of the essence"

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<sup>277</sup> See letters from Charles Schwab; Citigroup; Feldman Weinstein; Goldman; ICI; ITG; Knight; LEK Securities; Merrill; Morgan Stanley; SIA; STA; STANY; Willkie Farr.

<sup>278</sup> See letters from Charles Schwab, ICI, ITG; Willkie Farr.

<sup>279</sup> See letter from ICI.

<sup>280</sup> SIA.

<sup>281</sup> See letter from Knight.

<sup>282</sup> See letter from Feldman Weinstein.

<sup>283</sup> *Id.* Additionally, the commenter made reference to the Division of Corporate Finance acceptance of the practice found in Manual of Telephone Interpretation, March 1999, Supplement 3.S.

<sup>284</sup> See letters from SIA; STANY.

in this context.<sup>285</sup> Furthermore, the commenter maintained that even if the delivery date is far in the future, if all of the conditions are met and the delivery date is fixed, the person should be considered long.

Additionally, the same commenter asserted that the concept of ownership in this context is outdated.<sup>286</sup> In place of ownership, the commenter stated that the Commission should consider a person's overall economic position to determine whether a seller is long or short. The commenter offered that a person might have title and still be economically short. Furthermore, merely looking at title invites market participants to construct strategies to avoid the bid test<sup>287</sup>

## 2. Ownership Of Securities Underlying Securities Futures Products

The Commission proposed the following changes within Rule 200 to achieve consistency with existing Commission guidance defining when a person shall be deemed to own a security underlying a security futures contract. The proposed provision on ownership of securities underlying securities futures products clarifies that a person holding a long security futures position is not considered to own the underlying security, for Rule 3b-3 purposes, until the security stops trading.

The Commission received comment from one commenter who addressed the proposed guidance.<sup>288</sup> The commenter, LEK Securities, stated that a person who holds a security future, which obligates the person to take delivery of the underlying securities by physical settlement, should be considered long the securities for purposes of the Rule 3b-3. LEK Securities asserted that securities futures products are "materially different" from options, rights, warrants and convertibles, which merely give the holder the right to acquire the securities, not the obligation. The controlling issue, according to LEK Securities, should be whether the contract provides a right or a binding obligation.<sup>289</sup>

## 3. Aggregation Units

Regulation SHO proposes to incorporate aggregation unit netting<sup>290</sup> into Rule 200. In the proposal, Rule 200 would permit trading unit aggregation if a broker-dealer meets the following requirements: (1) has a written plan of organization that identifies each aggregation unit, specifies the trading objective of each, and supports its independent identity; (2) each aggregation unit within the firm continuously determines, on a real-time basis, its net position for

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<sup>285</sup> LEK Securities.

<sup>286</sup> Id.

<sup>287</sup> Id.

<sup>288</sup> Id.

<sup>289</sup> Id.

<sup>290</sup> See Proposing Release (citing 1998 SEC No-Act LEXIS 1038 (November 23, 1998)).

every security that it trades that is subject to the proposed consolidated bid test; (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.<sup>291</sup>

Five commenters addressed Regulations SHO's inclusion of aggregation netting units.<sup>292</sup> Generally, the comments submitted were brief or did not address the questions presented by the Commission contained in the proposal. Letters submitted by both MFA and Willkie Farr stated a request for clarification on trading objectives that involve short-term holdings. Specifically, whether trading objectives involving short-term holdings can be put in different aggregation units if they're similar in appearance but involve different algorithms.<sup>293</sup> These commenters made the claim that requiring aggregation of these trading objectives is not workable.

On the topic of real-time aggregation, the Commission received opinions from three commenters. SIA's letter maintained that requiring real-time aggregation would create technical difficulties for many broker-dealers.<sup>294</sup> According to SIA, real-time aggregation would impose a great expense with little or no benefit.<sup>295</sup> Conversely, two commenters submitted comments claiming that real-time aggregation is possible and advances in technology have simplified the process.<sup>296</sup> One of these commenters, however, maintained that, in spite of the technology, many firms may have to request relief due to the individual circumstances of the firm.<sup>297</sup> Additionally, aside from supporting the aggregation proposal, Knight requested clarification on whether a broker-dealer without aggregation units must calculate its firm wide positions on a real-time basis.<sup>298</sup>

Two commenters responded to the Commission's question on whether to expand the aggregation relief to non-broker-dealers.<sup>299</sup> MFA requested consideration of expanding the relief to include buy-side investment firms. MFA asserts that the same rationale for providing the relief to broker-dealers applies to buy-side investment firms.<sup>300</sup> In contrast, another commenter

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<sup>291</sup> See Proposing Release.

<sup>292</sup> See letters from Knight; LEK Securities; MFA; SIA; Willkie Farr.

<sup>293</sup> See letters from MFA; Willkie Farr.

<sup>294</sup> SIA.

<sup>295</sup> Id.

<sup>296</sup> Knight; LEK Securities.

<sup>297</sup> LEK Securities.

<sup>298</sup> Knight

<sup>299</sup> See letters from LEK Securities; MFA.

<sup>300</sup> MFA.

opposed any expansion of aggregation unit relief to non-broker-dealers.<sup>301</sup> That commenter argued that it would be too difficult to enforce compliance since such entities are not subject to SRO oversight.

#### 4. Block Positioner Exception

Regulation SHO proposes to incorporate the block positioner exception, found in subsection (e)(13) of Rule 10a-1, without modification into Rule 200 because the exception directly relates to calculation of a broker-dealer's net position. The exception provides that broker-dealers shall be deemed to own a security, for purposes of Rule 3b-3, if that broker-dealer acquired the security while acting in the capacity of a block positioner. Furthermore, the broker-dealer does not have a net long position in the security if and to the extent that broker-dealer's short position in the security is the subject to one or more offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

Five commenters provided the Commission with comments that addressed the block positioner exception.<sup>302</sup> The SIA praised the Commission for incorporating the exception into proposed Rule 200.<sup>303</sup> The other three commenters expressed the view that the exception was too limited and should be expanded. LEK Securities, asserted that the exception unnecessarily favored one specific form of arbitrage over others. According to LEK Securities, this exception is "too trivial," and instead the Commission should require applying the mathematical models used by firms' risk departments to determine delta-weighted exposure for assessing the firms the economic position. The remaining commenters, STANY and Willkie Farr, requested that the Commission provide a more general exception that would allow broker-dealers to short stock to a customer to facilitate the customer's block purchase below (or above) the consolidate best bid.<sup>304</sup> These commenters stated that expanded exception would provide for higher quality executions. As a means to support their argument, the commenters state that such circumstances are acknowledged by NYSE Rule 97 as a means to facilitate a customer as opposed to the broker-dealer taking a directionally biased position.<sup>305</sup> Additionally, Willkie Farr's letter contends that broker-dealers facilitating customer block purchases by shorting to the customer are acting as intermediaries, not as independently motivated stock speculators.<sup>306</sup>

#### 5. Liquidation of Index Arbitrage Positions

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<sup>301</sup> LEK Securities.

<sup>302</sup> See letters from LEK Securities; SIA; STANY; Willkie Farr.

<sup>303</sup> SIA.

<sup>304</sup> See letters from STANY; Willkie Farr.

<sup>305</sup> Id.

<sup>306</sup> Willkie Farr.

Regulation SHO provides relief 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, or a standardized options contract as defined in Rule 9b-1(a)(4) under the Exchange Act, notwithstanding that such person may not have a net long position in that security. The relief is limited to the following contexts: (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 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. The proposed text would provide consistency with the current language in NYSE Rule 80A.

Three commenters submitted their views on the codification of relief provided to certain index arbitrage transactions. Both commenters stated their belief that the relief was necessary, but, as proposed, was too limited. Again, LEK Securities stated that the Commission was limiting the exception to one form of arbitrage and focusing on legal title, rather than on economic position. The letter from Willkie Farr recommended that the Commission provide the relief contained in the Merrill Lynch letter.<sup>307</sup> Additionally, Willkie Farr's letter claimed that the purpose for the 2% DJIA decline condition was unclear, especially in light of the existing circuit breakers.

### **E) Hedging Transactions**

Sixteen commenters expressed their disagreement with statements made in the proposing release that a hedging exception was not necessary in Regulation SHO since both the proposed bid test and pilot would provide additional flexibility in effecting short sales to hedge long exposures.<sup>308</sup> Thirteen of the sixteen commenters urged the Commission to include a hedging exemption from Rule 201 for activities related to options market making.<sup>309</sup> The remaining three commenters supported a general hedging exemption.

The proponents of a bona fide hedge exemption for options market makers requested the relief permitted under NASD Rule 3350.<sup>310</sup> According to these commenters, the arguments that

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<sup>307</sup> Willkie Farr makes reference to the Merrill Lynch letter. See letter re: Merrill Lynch, Pierce, Fenner & Smith, Inc. (Dec. 17, 1986); Securities Exchange Act Release No. 27938 (Apr. 23, 1990), 55 FR 17949 (Apr. 30, 1990) (clarifying and emphasizing certain aspects of the limited relief granted in the Merrill Lynch letter).

<sup>308</sup> AMEX, CBOE, Citigroup; Feldman Weinstein; Goldman; ISE; Knight; LEK Securities; Merrill; Morgan Stanley; OCC, PCX, PHLX; SIA Derivatives Products Committee; Susquehanna; TD Options.

<sup>309</sup> AMEX, CBOE, Citigroup; Goldman; ISE; Knight; Merrill; Morgan Stanley; OCC, PCX, PHLX; Susquehanna; TD Options.

<sup>310</sup> NASD Rule 3350(h)(1) permits the execution of a short sale for the account of an options market maker  
(. . . continued)

supported prior approval of the NASD's hedging exemption remain valid today. Amex's letter maintains that the relief is necessary due to the sizeable positions and risk market makers undertake, which they must hedge to avoid incurring loss of capital.<sup>311</sup> According to the joint letter submitted by options industry participants, the ten year-old exemption has permitted options market makers to provide greater liquidity and depth to the market, by allowing meaningful ways to hedge risk, without regards to short sale price restrictions.<sup>312</sup> Additionally, comment letters from PCX and T.D Options argued that an exemption from the bid test is crucial for options market makers because they must maintain options positions that are hedged with underlying stock.<sup>313</sup> Without such exemption, these commenters contend that options market makers will not be able to provide liquidity and narrow markets without incurring considerable risk.<sup>314</sup>

Additionally, these commenters assert that preserving the hedging exemption for options market makers is consistent with the goals of short sale regulation. In support of the exemption, T.D. Options claimed that, since hedged options positions are "economically neutral and therefore do not pose a threat of manipulation."<sup>315</sup> CBOE's letter maintained it is "highly unlikely" that options market makers would abuse the exemption because they would risk violations of margin and net capital regulations.<sup>316</sup> PCX's letter pointed to language contained in the Commission's approval of the NASD's hedging exemption in support of their argument.<sup>317</sup> Specifically, the letter stated, "[t]he Commission, itself, noted that such a limited exemption would not counter the effectiveness of the NASD's short sale rule. . . . Hence, the Commission clearly recognizes the importance of such an exemption."<sup>318</sup>

As stated above, three commenters submitted arguments favoring a general hedging exemption from the proposed bid test.<sup>319</sup> The letter from SIA's Derivatives Products Committee

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that would otherwise be prohibited by the short sale rule if, "(A) the options market maker is registered with a qualified options exchange as a qualified options market maker in a stock options class on a Nasdaq National Market security or an options class on a qualified stock index; and (B) the short sale is an exempt hedge transaction." NASD 3350(h)(1).

<sup>311</sup> AMEX.

<sup>312</sup> See joint letter from AMEX, CBOE, ISE, OCC, PCX, PHLX.

<sup>313</sup> PCX; T.D. Options; cf. Susquehanna.

<sup>314</sup> Id.

<sup>315</sup> T.D. Options.

<sup>316</sup> CBOE.

<sup>317</sup> PCX.

<sup>318</sup> PCX.

<sup>319</sup> Feldman Weinstein; LEK Securities; SIA Derivatives Products Committee.

(“the Committee”) recommended considering a “narrowly drawn” hedging exemption for short sales.<sup>320</sup> In brief, the exemption proposed by the Committee would apply to short sales effected by broker-dealers or its affiliate with the purpose to hedge either the broker-dealers exposure to a derivative transaction entered into with a customer, or within a propriety account, holding a long position in the underlying security or in a “Related Security,” as long as the long position was not otherwise hedged at the time the effected short sales.<sup>321</sup> The proposal additionally suggested that firms claiming the exemption “would employ their formula-based risk management and pricing models to determine the number of shares to be sold short in establishing the hedge.”<sup>322</sup> To address surveillance concerns, the systems monitoring these models would be available for Commission inspection.<sup>323</sup>

Another commenter, LEK Securities, equally supported reliance on risk management models for measuring hedge positions.<sup>324</sup> LEK Securities’ letter claimed that the Commission should not be concerned with misuse of the methodology, since broker-dealers have a “natural incentive to monitor and control their risk exposure.”<sup>325</sup> However, for surveillance purposes, their letter stated that ensuring compliance of non-regulated entities, *i.e.*, hedge funds, would be more difficult than with regulated entities, which are subject to routine examinations.

The proponents of a general hedging exemption assert its necessity for the market in addition to it being consistent with the goal of short sale price regulation. According to the Committee’s letter, short sales related to hedging do not involve the type of market behavior that short sale price regulation is designed to circumvent. Instead of being a tool for driving prices down, the Committee asserts that short selling to hedge a long position is a tool for risk management.<sup>326</sup> The Committee maintains that the success of a hedging strategy, in contrast to a speculative short selling strategy, relates to “the extent that the short sales are effected with minimum impact on the current price of the security being hedged.”<sup>327</sup> The Committee’s letter additionally asserts that hedging short sales help companies control losses related to market fluctuations.<sup>328</sup>

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<sup>320</sup> SIA Derivatives Products Committee.

<sup>321</sup> Id.

<sup>322</sup> Id.

<sup>323</sup> Id.

<sup>324</sup> LEK Securities.

<sup>325</sup> Id.

<sup>326</sup> SIA Derivatives Product Committee.

<sup>327</sup> Id.

<sup>328</sup> Id.

Alternatively, Feldman Weinstein offered a brief statement that hedging transactions should be treated in the same way as special arbitrage accounts.<sup>329</sup> Feldman Weinstein's letter recommended limiting the exemption to "sales equal to the investor's net long position in the security with a fixed price."<sup>330</sup>

#### **F) Elimination of Subparagraphs 10a-1(a)(2) and (a)(3)**

Based on the proposed consolidated bid test, intended to provide uniformity, Regulation SHO proposed to eliminate the requirement that markets must use their own markets as a reference point for measuring the permissibility of short sales set forth under Rule 10a-1(a)(2). The provision was adopted because certain SROs asserted that the 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.<sup>331</sup> Additionally, the proposal would remove subparagraph (a)(3)<sup>332</sup> 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.

Two commenters submitted comment in response to elimination of subparagraph (a)(3) of Rule 10a-1. LEK Securities asserted that the only problem with the consolidated bid test was that it would not work on the openings and closing rotations of the NYSE and AMEX, "because there is no obvious bid in these contexts."<sup>333</sup> According to LEK Securities, the Commission should, "exempt trades executed 'on open' or 'at the close' from any price test."<sup>334</sup> AMEX additionally requested the Commission to address the relevant measure to determine whether a short sale can be effected on the opening.<sup>335</sup>

#### **G) Exclusion of Bonds**

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<sup>329</sup> Feldman Weinstein.

<sup>330</sup> Id.

<sup>331</sup> See Securities Exchange Act Release No. 11276 (Mar. 5, 1975), 54 FR 12522 (Mar. 19, 1975) (proposing subparagraph (a)(2) in response to stated operational and other difficulties associated with complying with Rule 10a-1); see also Securities Exchange Act Release No. 11468 (June 12, 1975), 40 FR 25442 (June 16, 1975) (adopting the proposed changes to add subparagraph (a)(2)).

<sup>332</sup> Subparagraph (a)(3) of Rule 10a-1 allows 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.

<sup>333</sup> LEK Securities.

<sup>334</sup> Id.

<sup>335</sup> AMEX.

As stated previously, six commenters submitted arguments for the exclusion of bonds from the Regulation SHO's short sale regulation.<sup>336</sup> One rationale provided in support of excluding debt securities from the short sale regulation was the claim that debt securities were not susceptible to the type of manipulative conduct short sale regulation was intended to prohibit.<sup>337</sup> The commenters maintain that short sale regulation should not apply based on the method debt securities trade. Since the securities trade in relations to one another and on the basis of the spread over a benchmark Treasury, they are not as susceptible to manipulative conduct.<sup>338</sup> Additionally, because bonds trade through a separate bond data feed, and not on a consolidated report basis, as with other markets, would make short sale price regulation impracticable.<sup>339</sup>

The exclusion of bonds request included other aspects of Regulation SHO. In regards to Rule 203, on the new locate and delivery requirements, TBMA's letter requested clarification that the new rule did not apply to non-equity securities. TBMA requests clarity because it assumes that the proposal only applies to equity securities since the proposal did not suggest that Rule 203 would apply to non-equities, nor did it address or request comment on imposing the new requirements to the fixed income markets.<sup>340</sup>

## **H) After Hours Trading / Offshore Trading**

### **1. Hedging Transactions**

Twenty-one commenters submitted comments on applying the proposed bid test, under Rule 201, to after hours trading.<sup>341</sup> These commenters argued for the Commission to limit short sale price regulation to regular equity trading hours.<sup>342</sup> All asserted the common belief that it was very unlikely that a short seller could successfully manipulate the price of a stock after hours. One reason presented was that after-hours trade information was not subject to real time reporting requirements and not widely disseminated. In support of this rationale, Willkie Farr & Gallagher's letter maintained that such trades should not be subject to regulation due to the absence of price publication.<sup>343</sup> Additionally, MFA's letter defended this assertion by stating

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<sup>336</sup> See letters from LEK Securities, MFA, NYSE, TBMA, Willkie Farr.

<sup>337</sup> See letters from MFA; TBMA; Willkie Farr.

<sup>338</sup> MFA; Willkie Farr.

<sup>339</sup> NYSE; TBMA.

<sup>340</sup> TBMA. TBMA, in addition to other commenters, submitted comment on the exclusion of bonds from the Amendments to 105 of Regulation M. See Part V(I), *infra*.

<sup>341</sup> James Angel; [boss@optonline.net](mailto:boss@optonline.net); Charles Schwab; Citigroup; Davis Polk; Goldman; Mike Ianni; Brian Ingram; Lehman Brothers; LEK Securities; Merrill; MFA; Morgan Stanley; NASDAQ; Dean Sheikh; SIA; STA; STANY; Susquehanna; Willkie Farr.

<sup>342</sup> The regular trading hours are currently 9:30 a.m. to 4:00 p.m.

<sup>343</sup> Willkie Farr.

that without the trades printing to the tape, a short seller cannot communicate misleading information to market, and thus, is not likely to affect manipulation.<sup>344</sup>

Another explanation provided, which opposed extending the price test to after-hours short sales, focused on the limited number of participants and trades that occupy that market. Several commenters assert that the after-hours market is accessed by institutional or sophisticated investors, and generally do not involve retail investors.<sup>345</sup> According to the comments made in STANY's letter, "neither market professionals, nor the investing public, rely on the after-market prices as an accurate reflection of the market."<sup>346</sup> SIA's letter added the statement that investors transacting in the after-hours consider the prices "with circumspection" because of the limited liquidity available.<sup>347</sup>

Additionally, the after-hours trading commenters expressed concerns with using a previous bid that may not represent the market value during after-hours trading. Nasdaq asserted that after-hours trades typically reflect a previously negotiated agreement to execute at a benchmark price, which may not be indicative of the market price of the security at that moment in time. Another commenter asserted that use of a stale price did not make economic or regulatory sense.<sup>348</sup> Charles Schwab's letter expressed concerns that requiring the use of stale bid price would frustrate trading interests.<sup>349</sup> Additionally, three commenters urged the Commission to consider the consequence of market participants conducting their after-hours transactions to markets outside the United States.<sup>350</sup>

Despite expressing adamant views on not applying the price regulation after the market closes at 4:00 p.m. ET, some commenters offered some degree of a compromise. As an alternative, SIA requested that the Commission not impose the price restriction to short sales after both the consolidated tape and the Nasdaq tape close.<sup>351</sup> LEK Securities recommended the Commission use an individual market center/ECN reference was preferable to the last consolidated best bid.<sup>352</sup>

## 2. Offshore Trading

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<sup>344</sup> MFA.

<sup>345</sup> James Angel; Citigroup, Goldman; LEK Securities; Merrill; Morgan Stanley; SIA; Susquehanna.

<sup>346</sup> STANY.

<sup>347</sup> SIA; cf. Lehman Brothers.

<sup>348</sup> Willkie Farr.

<sup>349</sup> Charles Schwab; cf. Citigroup; Goldman; Merrill; Morgan Stanley.

<sup>350</sup> Davis Polk; Lehman Brothers; LEK Securities.

<sup>351</sup> SIA. The Nasdaq tape runs till 6:30 p.m. Eastern Time.

<sup>352</sup> LEK Securities.

According to the proposing release, short sale trades of an exchange-listed or Nasdaq NMS security is agreed to in the United States, regardless of where the short sale trade is executed, the short sale must be effected at a price one cent above the current best bid displayed. Five commenters expressed strong opposition to the Commission position on shorts sales and offshore trades.<sup>353</sup>

All five commenters believed that the Commission lacked justification regarding short sale regulation of trades that print outside the United States. SIA's letter refuted the Commission's statement, contained in Regulation SHO's proposing release, that the position was "consistent with prior Commission action."<sup>354</sup> According to SIA, the prior releases cited in Regulation SHO do not support the "expansive interpretation of extraterritorial application."<sup>355</sup> Instead, SIA believes that clarifying the distinction of a U.S trade and a foreign trade requires a separate rulemaking proceeding in compliance with the Administrative Procedures Act ("APA Act").<sup>356</sup>

Other commenters asserted that trading interests, regardless if they originated in the United States, have minimal impact on U.S. market pricing if such trades are executed overseas. Willkie Farr's letter asserted that, in the absence of publication of prices, "the risk of manipulative effect is slim to none."<sup>357</sup> Aside from refuting the need for regulation, the letter maintains that short sale regulation to offshore trades does not further any regulatory purpose.<sup>358</sup> Additionally, Susquehanna's letter suggested that the Commission might wish to direct efforts to address, instead, how to accommodate such trades in the U.S.<sup>359</sup>

## VI. Rule 105 of Regulation M

Regulation SHO proposes the elimination of Rule 105's exemption for shelf offerings. Rule 105 of Regulation M prohibits short sellers 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. Currently, the Rule

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<sup>353</sup> See letters from MFA; SIA; Susquehanna; Willkie Farr.

<sup>354</sup> SIA.

<sup>355</sup> Id.

<sup>356</sup> Id. Under the APA Act, an agency may not adopt a final rule without providing a notice of rulemaking and an opportunity for public comment. 5 U.S.C. s.553. According to SIA, the distinction would qualify as a "rule" under the APA Act, "as a statement of general or particular applicability and future effect." SIA.

<sup>357</sup> Willkie Farr.

<sup>358</sup> Id.

<sup>359</sup> Susquehanna.

exempts shelf offerings filed under Rule 415 and offerings not conducted on a firm commitment basis as well as providing for exemptive relief.

Three commenters submitted comments on the proposed amendment to Rule 105 of Regulation M. One of the commenters, TBMA, requested the Commission to consider expressly excluding non-equity securities from the prohibition.<sup>360</sup> In their letter, TBMA stated that the type of manipulation Regulation M intends to prohibit is less likely to occur in connection with debt offerings, since debt markets involve new issuance of a separate class of securities for which there is no current market to short such securities prior to pricing. The other two commenters, voice their opposition to the proposed changes. In place of eliminating the exemption, SIA recommended retaining the exception, but limiting it to “overnight” or “bought deal” offerings, which could be defined as shelf takedowns for which no preliminary prospectus is distributed to investors.<sup>361</sup> The other commenter argued that eliminating the shelf offering exemption will distort market prices by pushing shelf offerings upward.<sup>362</sup>

## VII. Effects on Competition and Regulatory Flexibility Act Considerations

In the proposing release, the Commission initial regulatory flexibility analysis indicated that the proposed rules might impose some new compliance and marking requirements on broker-dealers that are small entities. Nonetheless, the Commission expressed its preliminary view that adoption of Regulation SHO and the amendments to Rule 105 of Regulation M would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The Commission specifically requested comment on any competitive burdens and costs that might result from the proposal.

Very few commenters provided specific costs estimates in response to the proposal.<sup>363</sup> In relation to costs, commenters provided general statements of costs that might result from adopting the proposal. Two commenters maintained that both Regulation SHO and the amendments to Rule 105 of Regulation M would negatively impact capital formation for small issuers.<sup>364</sup> Other commenters simply claimed the costs would outweigh the benefits, or questioned whether regulatory efforts should be spent elsewhere.<sup>365</sup>

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<sup>360</sup> TBMA.

<sup>361</sup> SIA.

<sup>362</sup> Feldman Weinstein.

<sup>363</sup> Only two commenters provided costs estimates for technology and surveillance modifications related to the proposed consolidated bid test. See letters from AMEX; CHX.

<sup>364</sup> Feldman Weinstein; Saul Ewing I & III.

<sup>365</sup> See e.g., LEK Securities (referring to order-marking requirements) ; MFA (referring to the locate requirement); SIA (referring to real-time aggregation).

## VIII. Miscellaneous Comments

The joint industry letter submitted by Citigroup, Goldman, Merrill and Morgan Stanley urged the Commission to exempt certain types of trades from short sale price restrictions. The three trades, which the commenters explain are customer executions at a particular reference price, include client stops, VWAPs and closing price guarantees.<sup>366</sup> The letter maintains that Regulation SHO would frustrate execution methods of client preferences and order enhancement. According to the joint letter, these trades would not undermine the short sale regulation since the trades are not to drive down market prices, because such trades are “driven by client demands for capital commitment and potential price improvements.”<sup>367</sup> To minimize any short sale impact, the commenters suggested that the Commission require identifiers that signal to the market that the particular trade is not indicative of the current price, but rather, executed based on a reference or benchmark price.<sup>368</sup>

One commenter, the NYSE, sought clarification on the continued validity of the 1955 Commission interpretation that the initial sale of a newly-listed security may be a short sale.<sup>369</sup> The NYSE claims that it sought clarification on account that Regulation SHO was silent on the issue and the Amendments to Rule 105 of Regulation M do not address the concern. According to the NYSE, permitting short sales on the open in a security with no previous market might give rise to manipulative concerns and fails serve investor protection.<sup>370</sup>

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<sup>366</sup> See letter from Citigroup, Goldman, Merrill, Morgan Stanley. The letter provides examples of each of the three trades.

<sup>367</sup> Id.

<sup>368</sup> Id.

<sup>369</sup> NYSE.

<sup>370</sup> Id.