



SEC Concept Release: Short Sales

Securities and Exchange Commission

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Short Sales

Agency: Securities and Exchange Commission.

Action: Concept release; Request for comments.

Summary: The Securities and Exchange Commission is seeking public comment on the regulation of short sales of securities. In this release, we seek comment on, among other things: lifting the limits on short sales of exchange listed securities under advancing market conditions; providing an exception for actively traded securities; focusing short sale restrictions on certain market events and trading strategies; removing short sale restrictions on hedging transactions; revising short sale regulation in response to certain market developments; revising the definition of "short sale"; extending short sale regulation to non-exchange listed securities; and eliminating short sale regulation altogether.

Dates: Comments must be received on or before [insert date that is 60 days after date of publication in the *Federal Register*].

Addresses: Persons wishing to submit written comments should send three copies to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-24-99. Comments submitted by E-mail should include this file number in the subject line. Comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (<http://www.sec.gov>).

For Further Information Contact: Any of the following attorneys in the Office of Risk Management and Control, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, at (202) 942-0772: James Brigagliano, Alan Reed, or Michael Trocchio.

Supplementary Information

I. Introduction

The Securities and Exchange Commission (Commission) adopted Rule 10a-1¹ (short sale rule or Rule) under the Securities Exchange Act of 1934 (Exchange Act)² at a time when the securities markets had less trading volume and simpler trading strategies than current markets. Since the adoption of the short sale rule, securities trading has increased drastically in volume, velocity, and complexity. There have also been substantial improvements in market transparency and surveillance mechanisms. Short sale regulation, however, has remained fundamentally unchanged. This separation between Rule 10a-1 and the markets has resulted in frequent requests for relief from the short sale rule and suggestions for modification of it. Our goal is to examine ways to modernize our approach to provide the most appropriate regulatory structure for short sales.

Among other things, we propose to assess whether the restrictions of Rule 10a-1 produce benefits to the markets that are proportionate to the costs associated with those restrictions. We believe that a comprehensive assessment of Rule 10a-1 is necessary to achieve this goal. Therefore, we are seeking public comment on the regulation of short selling. In particular, we solicit comment on eight concepts related to the regulation of short sales of securities:

- suspending the short sale rule when the security or market is above a threshold price;
- providing an exception for actively traded securities;
- focusing short sale restrictions on certain market events and trading strategies;
- excepting hedging transactions from short sale regulation;
- revising short sale regulation in response to certain market developments;

- revising the definition of "short sale";
- extending the short sale rule to non-exchange listed securities; and
- eliminating Rule 10a-1.

The comments we receive will assist us in determining whether to propose changes to the short sale rule and in tailoring the scope of any such changes.

A. Background

A short sale³ is the sale of a security that the seller does not own or that the seller owns but does not deliver. In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by returning the security to the lender, typically by purchasing equivalent securities on the open market. In general, short selling is utilized to profit from an expected downward price movement, or to hedge the risk of a long position in the same security or in a related security.

Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that short sales are effected in the market by securities professionals, such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security. Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.⁴

Although short selling serves useful market purposes, it also may be used as a tool for manipulation.⁵ One example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. Many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash.⁶ Short selling was one of the central issues studied by Congress before enacting the Exchange Act, but Congress made no determinations about its permissibility.⁷ Instead, Congress gave the Commission broad authority to regulate short sales in order to stop short selling abuses.⁸

B. Current Regulation of Short Selling

1. Rule 10a-1

Section 10(a) of the Exchange Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as necessary to protect investors.⁹ After conducting an inquiry into the effects of concentrated short selling during the market break of 1937, the Commission adopted Rule 10a-1 under that grant of authority.¹⁰ The core provisions of the Rule are largely the same today as when they were adopted.

Paragraph (a) of Rule 10a-1 generally covers short sales in any security registered on a national securities exchange (listed securities) if trades of the security are reported pursuant to an "effective transaction reporting plan" and if information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.¹¹ Paragraph (b) applies to short sales on a national exchange in securities that are not covered by paragraph (a). Short sales of securities not registered on an exchange and transactions in securities covered by paragraph (b) that are effected in the OTC market are not subject to the Rule.¹²

Rule 10a-1(a)(1) provides that, subject to certain exceptions, a listed security may be sold short: (i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it is higher than the last different price (zero-plus tick). Conversely, short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions is commonly described as the "tick test." The reference price for the tick test is either

the last transaction price reported pursuant to an effective transaction reporting plan¹³ or on a particular exchange.¹⁴ Both the New York Stock Exchange, Inc. (NYSE) and the American Stock Exchange LLC (Amex) have elected to use the prices of trades on their own floors for the tick test.¹⁵

The Commission adopted the tick test after considering the effects of short selling in downward moving markets.¹⁶ In adopting this approach, the Commission sought to achieve three objectives:

- (i) allowing relatively unrestricted short selling in an advancing market;
- (ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and
- (iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.¹⁷

These objectives continue to be the foundation for Rule 10a-1. They represent the Commission's goal to prevent short selling that could manipulate or depress the market for a security, irrespective of the intention of the short seller.¹⁸ Because Congress granted specific statutory authority to regulate short sales, the Commission adopted a rule that restricts certain types of short sales. Thus, a person can violate the rule without manipulative or fraudulent intent.

A number of exceptions have been incorporated into Rule 10a-1 for a range of activities that are not deemed to present the concerns that the Rule was designed to address.¹⁹ The Commission has also granted relief from the Rule in specific situations that did not appear to present the opportunity for abuse that the Rule was designed to prevent.²⁰ Recently, the Commission has received a variety of additional requests for relief from the Rule. Some of these requests, if granted, would result in fundamental changes in the operation of the Rule. We think public comment on these proposals would assist us in evaluating them. Therefore, we have reflected the requests in this release.

2. Short Selling Over-the-Counter Securities

Rule 10a-1 only covers short sales of securities listed or traded on an exchange.²¹ In 1986, the NASD commissioned a study of short sales in the Nasdaq market.²² This study concluded that adopting restrictions similar to the tick test for Nasdaq securities would impose a restraint on trading. However, the NASD proposed a short sale rule covering Nasdaq National Market System (NMS) securities,²³ citing a competitive disadvantage between the NASD and the exchanges.²⁴ In 1994, the Commission approved the NASD's rule.²⁵ It is currently designated as NASD Rule 3350.²⁶

NASD Rule 3350 prohibits short sales by NASD members in NMS securities at or below the current best (inside) bid as shown on the Nasdaq screen when that bid is lower than the previous best (inside) bid (this is referred to as the "bid test"). It contains certain exemptions, including an exemption for qualified Nasdaq market makers, options market makers, and warrant market makers. Rule 3350 also includes exceptions similar to those provided under Rule 10a-1. The NASD also requires members to report regularly to the NASD their total short positions in all customer and proprietary firm accounts.²⁷

In 1996, the NASD produced a study of the economic impact of the Nasdaq short sale rule.²⁸ This study concluded that the Nasdaq short sale rule is effective in restricting short sale activity at the inside bid during large price declines and has no adverse effects on market quality. It stated that "the Nasdaq Short Sale Rule meets its intended objective - to slow down the piling-on of short sales when prices fall - with very little adverse impact on normal short sale activity on Nasdaq."²⁹

C. Previous Reviews of Short Selling

1. The 1963 Special Study

In 1963, the Commission included an examination of short selling in response to the request by Congress for a study of the securities markets.³⁰ One purpose of the Special Study was to determine "the relationships between changes in short positions and subsequent price trends."³¹ The Special Study observed that the ratio of short sales to total volume increases in a declining market. It concluded that the short sale rules did not prevent the harmful effects of short selling that the rules were designed to prevent. The Special Study recommended improvements in short sale data collection.

2. The 1976 Proposing Release

In 1976, the Commission ordered a public investigation and proposed temporary rules related to short selling.³² The Commission stated that the proceedings were "intended to be the first step in a thorough and comprehensive reexamination of short sale regulation in the light of changing market and regulatory conditions and to provide a framework for public discussion of the issues."³³

These proposals were intended to enable the Commission to collect data regarding the effects of unrestricted short-selling on the markets. The 1976 Release noted the problems of insufficient data that the Special Study faced in 1963. It added that "the availability of data with respect to short selling continues to be inadequate to establish meaningful conclusions" regarding the general effects of short selling or the efficacy of short sale regulation.³⁴ The Commission believed that it was possible that no conclusive statistical evidence regarding the short or long-term effects of short selling could be gathered while Rule 10a-1 limited short selling activity, and that some type of suspension of the existing short sale rules might be necessary. Accordingly, the Commission proposed alternative temporary rules that would have suspended the tick test in varying degrees.

The Commission proposed three alternative temporary rules. The first alternative would have suspended the operation of the short sale rule for all securities registered, or admitted to unlisted trading privileges, on a national securities exchange. The second alternative would have suspended the operation of the tick test only for equity securities (other than warrants, rights, or options) that are registered, or admitted to unlisted trading privileges, on more than one national securities exchange and for which transactions are reported in the consolidated system. The final alternative would have suspended the operation of the tick test only for the fifty most active equity securities (other than warrants, rights, or options) during the 12 calendar months preceding the effective date of the rule.

The Commission received 12 comment letters in response to the 1976 Proposals.³⁵ Eight commenters, including the NYSE and Amex, strongly opposed any suspension of the tick test. The common sentiment against the proposed changes was that the short sale rule provides important protection for investors that should not be removed. The NYSE's reasons for opposing any changes in short sale regulation are representative of the comments against adopting any of the proposals. The NYSE believed the most damaging consequences of the changes would be: (1) wider day-to-day price fluctuations; (2) disadvantages for public customers who could not withdraw limit orders to purchase before market professionals sold short; (3) accelerated price declines and increased volatility; (4) distortions in the markets for secondary and tertiary stocks; and (5) impaired market liquidity because block positioners would be discouraged from taking positions. Two commenters thought that the Commission needed more information before eliminating the tick test. AT&T, the only issuer to comment, opposed the revision or elimination of Rule 10a-1 because of the potential increase in the volatility of its stock. One commenter thought that all short sales should be unregulated.³⁶

In 1980, the Commission withdrew the proposals, principally due to the public comments opposing the elimination of the tick test.³⁷

3. 1991 Congressional Report on Short Selling

In 1991, the House Committee on Government Operations released a report on short selling.³⁸ The House Report stated that the "effects of short selling on the securities markets are not widely understood," and that "[m]any people have questioned the effectiveness of the present uptick rule and, by implication at least, question whether any purpose would be served by implementing a similar rule for NASDAQ trading."³⁹

The House Report made numerous findings and recommendations, including that: (1) short selling plays an important and constructive functional role in the equity market; (2) the uptick rule acts as a price stabilizing force and should be retained; (3) short sale regulation should be extended to the Nasdaq system; (4) many complaints about short selling are not soundly based and may be the result of a poor understanding of short selling; (5) "a pattern of abusive and destructive rumor mongering, targeted specifically at companies in the equity securities of which some short-selling investors have established major short positions, appear[ed] to be occurring;" (6) a large part of the problem with equity securities targeted by short sellers is the psychological misperception that short sellers possess much greater manipulative power than they really do; (7) a method for collecting daily short-selling activity and weekly short interest data from broker-dealers should be developed and this information should be available electronically to the market in aggregate form; and (8) Congress should enact a reporting requirement for large individual short positions.⁴⁰

Since the House Report, a number of changes have occurred that impact its findings. The NASD adopted a short sale rule covering NMS securities. Both the NYSE and the NASD adopted rules requiring members to report data on their short sale activities. In 1991, the Commission published a concept release requesting comment on reporting material short positions.⁴¹ The Commission has not taken any further action on this matter.

D. Recent Developments

Despite the many studies and recommendations, the basic provisions of Rule 10a-1 have remained unchanged for 60 years. Developments in the markets, however, may have diminished the need for the Rule in its current form. Among other things, the national securities exchanges today have high levels of transparency and regulatory surveillance. Transparency helps market participants observe and evaluate market price movements which limits the ability of short sales to unevenly affect prices. The self-regulatory organizations (SROs) also have sophisticated surveillance technologies that allow them to monitor market activity on a real-time basis. This surveillance reduces the risk of undetected manipulation and permits regulators to

monitor the types of activities that Rule 10a-1 is designed to prevent. As the markets change, commentators continually question the relationship between the objectives of Rule 10a-1 and its operation.⁴²

Short selling is instrumental to a growing number of sophisticated investment models and instruments. For example, short sales are used to hedge option positions and to engage in a variety of arbitrage strategies.⁴³ Short selling is also integral to other trading and investment strategies that are not tied to individual securities, but involve baskets of securities. The restrictions in the Rule may inject unnecessary inefficiencies into such trading strategies. To accommodate the developments, we have granted a number of requests for relief from Rule 10a-1.⁴⁴ The growing array of requests for relief indicate that present short sale regulation may have become unduly burdensome and possibly ill-suited for the present and future markets.

II. Concepts Regarding Short Sale Regulation

In this section of the release, we present for public comment eight concepts regarding short sale regulation: (1) suspending the short sale rule when the security or market is above a threshold price; (2) providing an exception for actively traded securities; (3) focusing short sale restrictions on certain market events and trading strategies; (4) excepting hedging transactions from short sale regulation; (5) revising the short sale rule in response to certain market developments; (6) revising the definition of "short sale"; (7) extending the short sale rule to non-exchange listed securities; and (8) eliminating Rule 10a-1.

We seek comment on these concepts to assist our review of Rule 10a-1 and short selling in the current market. We encourage commenters addressing the concepts in this release to present data to support their positions.

A. Suspending the Short Sale Rule When the Security or Market Is Above a Threshold Price

One objective of short sale regulation is to permit relatively unrestricted short selling in an advancing market. The tick test in Rule 10a-1, however, applies in all market conditions. Thus, even in a generally advancing market, a short sale would be inhibited when the price of the transaction does not permit the seller to meet the tick test.⁴⁵ This restriction may allow the prices of securities to advance beyond the prices that the market would reflect if short selling were unrestricted. Some argue that the restrictions contribute to market volatility because prices move up without the checks that unrestricted short selling would provide.

In response to recent criticism of the Rule, we seek comment on suspending the tick test when a security's price is above a threshold.⁴⁶ This alternative approach assumes that the current Rule is unnecessarily restrictive in upward moving markets. By suspending the tick test when the security or the market is above a threshold price, short sellers could sell without regard to price movements. The tick test would apply, however, at any time the price of the security (or a market index) went below the threshold (*i.e.*, the tick test would apply at prices below the threshold). We request comment on this concept to determine if such an alternative is consistent with the Rule's objective to allow relatively unrestricted short selling in an advancing market.

We further request comment on what benchmark would be appropriate for establishing the threshold price discussed in this alternative approach. One possible benchmark is the previous day's closing price of a security.⁴⁷ Another possible benchmark could be a percentage decline in the price of the security. For example, the threshold could be 5 percent or 10 percent below the previous closing price of the security. A general market indicator also could be used as a benchmark. For example, the tick test's application could correspond to the operation of SRO rules that impose limitations when markets experience significant declines.⁴⁸ Once the market indicators crossed the threshold, the tick test would apply.

- Q1. Does Rule 10a-1 permit relatively unrestricted short selling in an advancing market? If not, please provide specific examples to demonstrate that this objective is not currently met.
- Q2. Does more short selling occur in an advancing market or a declining one?
- Q3. Should the threshold price for suspending the tick test be the previous closing price of the security?
- Q4. Should the threshold price correlate to a point change or a percentage change in the price of a security?
- Q5. Would volatile markets create complexity for this structure as short sellers must continually take into account the market price of the security to determine whether short selling is restricted?
- Q6. If the security's price moves below the threshold price, should the tick test remain in effect during the trading session even if the price subsequently moves above the threshold price?
- Q7. Is there another price or manner of determining a more effective threshold for this purpose?
- Q8. Could a short seller initiate downward momentum on the price of a security through short selling down to the threshold price? If so,

could this momentum cause the depressing effect on the market for a security that Rule 10a-1 is intended to prevent?

- Q9. Is it appropriate or preferable to base short sale regulation on general market movements, rather than the price of individual securities?

B. Providing an Exception for Actively Traded Securities

Some of the Commission's anti-manipulation rules assume that highly liquid securities are less vulnerable to manipulation and abuse than securities that are less liquid. For example, Rule 101 of Regulation M has an exception for securities with a public float value of at least \$150 million and an average daily trading volume of at least \$1 million.⁴⁹ A similar approach may be effective for regulating short sales.

- Q10. Are highly liquid securities less vulnerable to the abuses that Rule 10a-1 is designed to prevent?
- Q11. Are the Regulation M requirements for liquidity under the exception in Rule 101(c)(1) adequate standards for this purpose? If not, what values would work better for this purpose?
- Q12. Rule 10a-1 is not focused solely on preventing manipulative activity. Is it appropriate to use these anti-manipulation approaches in the short sale context?

C. Focusing Short Sale Restrictions on Certain Market Events and Trading Strategies

Certain market events and trading strategies may make a security more vulnerable to abusive short sale activity. The Commission previously has recognized that certain events increase the potential for short selling abuse.⁵⁰ Specific market events related to an issuer or a security (such as a pending merger or acquisition) may cause this increased vulnerability. Also, there may be certain times in a trading day when there is a heightened concern about manipulation.⁵¹ We, therefore, request comment on whether short selling should continue to be regulated or even prohibited during specific market conditions.

- Q13. Are there corporate events (e.g., mergers, acquisitions, or tender offers) that make a security vulnerable to abusive short selling?
- Q14. Are there other cyclical, or regular market events (e.g., option expiration dates or the opening and closing of a trading session) that make a security vulnerable to abusive short selling?
- Q15. Are there other trading abuses or manipulations involving short sales under unusual market conditions that Rule 10a-1 currently does not address? If so, could the Rule be amended to prevent these abuses?
- Q16. Should short selling be prohibited for a period preceding a significant corporate or market event?
- Q17. If the Rule was eliminated, should restrictions continue to apply preceding a significant corporate or market event?

D. Excepting Hedging Transactions From Short Sale Regulation

Today, short selling is integral to many complex trading strategies involving a variety of sophisticated financial instruments. Short sales are often used in these strategies to hedge a position in another security or a related financial instrument. Short positions and short sales related to such hedges are treated the same under Rule 10a-1 as any other short activity. Complying with Rule 10a-1 potentially increases transaction costs on persons using short hedging because of delays caused by waiting for upticks. The risks of a particular strategy, therefore, also may increase as a result of the Rule. We seek comment on whether hedged short positions should be excluded from calculating a person's net position. We also seek comment on whether we should propose adding an exception to Rule 10a-1 that would cover short sales conducted exclusively for the purpose of establishing a *bona fide* hedge.⁵²

- Q18. Is the definition of "*bona fide* hedge" currently used by the Commission appropriate and adequate?

We have received a number of inquiries seeking relief from Rule 10a-1 for short sales that are part of a *bona fide* hedge. Proponents argue that it is unlikely that short sales used to create *bona fide* hedges present a threat of manipulation because gains from the short position would be offset by losses in an equivalent security, *i.e.*, they are "economically neutral."⁵³ Rule 10a-1 currently may inhibit such short sales even though they present little risk of the abuses that it was designed to guard against. We have provided exceptions from and interpretations of Rule 10a-1 for economically neutral short sales that do not present an incentive for abuse.

Rule 10a-1 presently provides exceptions for:

- (i) *bona fide* arbitrage⁵⁴ undertaken to profit from a current difference between a convertible security and the underlying common stock;⁵⁵

and

- (ii) *bona fide* arbitrage undertaken to profit from a current difference between the price of a security in the United States and its price abroad.⁵⁶

Both of these exceptions allow short sales without compliance with the tick test, where the sales are to take advantage of temporary price differentials between related securities or different markets.

Rule 10a-1 also has a limited exception for block positioning activities by broker-dealers.⁵⁷ This exception permits a broker-dealer selling securities that it acquired as a block positioner to disregard, in determining whether it is net long or net short, proprietary short positions to the extent those short positions are the subject of one or more offsetting positions created in the course of *bona fide* arbitrage, risk arbitrage,⁵⁸ or *bona fide* hedge activities. The Commission relied upon the premise that the short positions excluded from the calculation are not subject to the same potential for abuse as short positions that are not linked to an offsetting position.

We recently granted relief for certain specialist activities that expands on the aggregation relief discussed above.⁵⁹ The exemptions provide greater flexibility where short positions are subject to *bona fide* hedges. As with the block positioner exception and the Merrill Lynch Letter,⁶⁰ the exemptions exclude hedged short positions from the calculation of a net position. In addition, the short sales were limited to the specialists' performance of obligatory market functions.

Using a rationale similar to that underlying the limited exception for block positioning activities, our staff took a limited no-action position to facilitate unwinding certain index arbitrage positions with a long stock component. This relief from the tick test applies to broker-dealers unwinding long index arbitrage positions. As with block positioners, this no-action position was limited to circumstances where the sale of securities was deemed a short sale solely as a result of the netting of the index arbitrage long position with one or more short positions created in the course of arbitrage or hedging activities. These securities positions were considered economically neutral, and the unwinding of the index arbitrage position was not thought to involve the types of abuses that Rule 10a-1 was designed to prevent. In these contexts, the staff assumed that economically neutral transactions do not present the incentive to engage in short sales in a manner that would cause or accelerate a decline in the market, because any gain from the short stock would be offset by a loss in the security or securities making up the *bona fide* hedge or arbitrage position.⁶¹

- Q19. Should the Commission exclude hedged short positions for the purposes of determining what a person's net position is under Rule 3b-3?
- Q20. Should long stock positions that are fully hedged be excluded from the calculation of a person's net position in that stock?

In addition, we have received requests for relief from Rule 10a-1 to permit short sales that are part of trading strategies conducted to establish *bona fide* hedges. Many of the strategies use statistical formulas or relationships between or among securities to determine the offsetting transaction for the hedge. For example, the purchaser of a convertible security may short the underlying security to hedge against a potential decline in the price of the underlying security. The short sales used in these strategies are distinguishable from short sales that reflect an opinion about the current or future market price of a security.

A broad array of financial instruments can be hedged using short sales of securities. These instruments may not be related to the security sold short, but they nonetheless are economically equivalent. Because of the potential variety of instruments that may be hedged with short sales, we believe that an exception would have to be crafted broadly enough to afford flexibility. For example, the Rule could except short sales that are conducted to offset "qualified financial contracts" (QFC), using the definition in the Federal Deposit Insurance Corporation Act that includes "any securities contract, forward contract, repurchase agreement, swap agreement, and any similar agreement...."⁶²

- Q21. Should a broad exception covering short sales offset by equivalent securities be proposed? If so, what securities should be considered equivalent?
- Q22. Is "economic neutrality" the proper basis for such an exception? If not, what types of relationships (using a short hedge) that appear to be economically neutral present a potential for manipulation that Rule 10a-1 is designed to prevent?

The relationship between a short position and the instrument hedged by the short position will vary according to custom and practice. Firms that are more tolerant of risk may not fully hedge a position. Instead, they may use a ratio hedge that reflects their tolerance of risk. Such hedging techniques may be difficult for regulatory agencies to evaluate and determine whether a particular hedge should be viewed as a *bona fide* hedge.⁶³

- Q23. Should an exception for hedging transactions be limited to transactions or positions that involve a complete hedge? If so, how should a complete hedge be defined and measured?

Q24. What type of surveillance should the Commission consider for monitoring short sales conducted as part of economically neutral transactions?

E. Revising the Short Sale Rule in Response to Certain Market Developments

If Rule 10a-1 is retained (in whole or in part), certain basic adjustments may be required to keep pace with changes to the operation of the national securities exchanges. We request comments on two potential changes: expansion of trading hours into after-hours trading sessions and conversion to price quotations using a decimal format. Please comment on any other changes to the operation of the national securities exchanges or alternative trading systems (ATSs) that you believe may affect the regulation of short selling.

1. After-hours Trading Sessions

Securities trading is rapidly expanding beyond the regular trading hours of 9:30 a.m. to 4 p.m. This evolution is manifested by the proliferation of trading in ATSs and consideration of extended trading sessions by both the NYSE and Nasdaq. As in regular hours trading, short sellers could add liquidity and contribute to pricing efficiency in after-hours trading.

The tick test of Rule 10a-1 currently operates relative to the last reported price on the Consolidated Tape. If the Consolidated Tape does not operate after the close of regular trading hours, short sales can only be executed at a price above the closing price on the Consolidated Tape for the security (or, at the closing price if that price was an uptick). This result could greatly limit the ability to execute short sales in after hours trading.

We note that Rule 10a-1 permits exchanges to use the price of the last transaction on the exchange, rather than the last price reported to the Consolidated Tape, as the last reported price. Thus, an exchange operating an after-hours session could rely on this provision. ATSs cannot rely on this provision. Thus, short sales through ATSs must use the last price reported to the Consolidated Tape.

- Q25. If the Consolidated Tape does not operate during after hours trading, should we consider adopting an exception to permit each ATS to use the last transaction in its system as the reference price?
- Q26. What impact would multiple permissible prices at which short sales could be executed have on the effectiveness of short sale regulation?
- Q27. If a number of ATSs all operated using their internal prices for Rule 10a-1 compliance, each could produce a different "closing" price at the close of trading on the ATS. How would multiple after-hours "last sale" prices affect the first trade in the morning trading session when the Consolidated Tape recommences operation?

2. Decimalization

We also note that the securities industry is targeting June 30, 2000, as the date when price quotations will be expressed in terms of decimals rather than fractions. Decimal pricing may result in exchanges setting the Minimum Price Variation (MPV) (*i.e.*, the smallest amount by which the price of a security can change), which today is 1/16 (\$.0625) for most equity securities, at one cent or potentially even smaller. A further result of the use of smaller MPVs is that the short sale rule may be triggered by a change in price that, on a percentage basis, could reflect an extremely small decrease in the price of the security. For example, the average price per share traded on the NYSE for June 1999 was approximately 45 7/8. In an environment where the MPV is 1/16, a decrease in the share price by 1/16 (.136%) would trigger the short sale rule. In an environment where the MPV is one cent, the short sale rule would be triggered by a decrease of the share price by 1/100 (.02%).

At least one study has analyzed the effects of smaller spreads on the operation of Rule 10a-1.⁶⁴ The study concludes that smaller increments, such as one cent, would improve execution quality for certain short sales and hurt others.

- Q28. How did the recent decrease in the MPV from 1/8 to 1/16 affect short selling?
- Q29. How will the potential use of a smaller MPV affect the operation of Rule 10a-1?
- Q30. Is a price change as small as one penny per share the type of market impact that the short sale rule is designed to prevent?
- Q31. Would the use of a smaller MPV support modifying or eliminating Rule 10a-1?
- Q32. Should Rule 10a-1 be altered to remain effective with respect to smaller MPV?

F. Revising the Definition of "Short Sale" Under Rule 3b-3

The definition of "short sale" set forth in Rule 3b-3 is integrally related to regulating short sales under Rule 10a-1. As with Rule 10a-1, many developments in the securities markets have challenged the current definition.

1. Aggregation

Short sellers are required to net all of their positions to determine whether they are "short" under the definition in Rule 3b-3. Continual netting is cumbersome and impractical for large, multi-service firms. As a result, the staff of the Commission has granted relief to these firms to ease the burdens of complying with Rule 10a-1, while preserving the protections that the rule provides.⁶⁵

- Q33. Should we consider changing the definition of "short sale" to reduce the need to aggregate positions within a single entity? Please describe other situations where an alternative to firm-wide aggregation is justified.

2. Strategies for Creating a Temporary "Long" Position

Certain trading strategies have developed that may be used to avoid the restrictions of the short sale rule. Traders employing such strategies enter arrangements with a counterparty to create a position in an equity security that technically is long, but gives the traders no real economic stake in the equity security. Typically, these strategies rely on the provision of Rule 3b-3 that provides that a person has a long position in a security if he has "entered into an unconditional contract, binding on both parties thereto, to purchase [the stock] but has not yet received it."⁶⁶ Often, these strategies involve the creation of a married put prior to, or simultaneous with, a sale of the stock.⁶⁷ Soon after creating this arrangement (*i.e.*, later in the day), it is unwound when the market participant purchases shares to return to the counterparty.

A potential for abuse exists where the trader aggressively sells the "long" stock position, destabilizing the price of the stock, and soon after repurchases the stock in the market to return to the counterparty. This type of strategy may present a heightened potential for manipulation. While there are legitimate reasons to engage in married puts (or other similar arrangements), we are concerned that they may be used for improper purposes.

- Q34. Please describe examples of any manipulative strategies that exploit the current definition of "short sale," and whether regulatory measures should be adopted to combat such strategies.

G. Extending the Short Sale Rule to Non-Exchange Listed Securities

Current short sale regulations cover securities that are either listed on an exchange or traded in the Nasdaq NMS. As a result, they cover securities that are generally characterized by high trading liquidity. In addition, these markets have a relatively high degree of transparency.

Securities traded in the OTC markets (*e.g.*, Nasdaq Small Cap, the NASD's OTCBB, the Pink Sheets) are not subject to short sale restrictions. The staff frequently receives complaints alleging short sale abuses involving securities in the OTC markets. As a corollary to other concepts presented in this release, we seek comment on regulating short sales in this market sector. We recognize that Section 10(a) does not grant specific authority to the Commission to regulate short sales of securities not listed on a national exchange. Thus, regulations that extend short sale regulation to new market sectors would have to be adopted under other available statutory authority.

- Q35. Should we consider extending short sale regulation to cover non-exchange listed securities?
- Q36. If so, how should the new regulation restrict short sales? Does the current NASD short sale rule provide an applicable model for this purpose?

H. Eliminating Rule 10a-1

As noted above, the need for short sale regulation has often been debated. We believe that the developments in the securities markets noted in this release warrant a general review of Rule 10a-1. Therefore, we are also seeking comment on whether we should consider eliminating Rule 10a-1 as a prophylactic measure and rely on the antifraud and anti-manipulation provisions of the securities laws to address abusive short selling.

One school of thought believes that unrestricted short selling can involve abusive activity that influences market prices for securities. This view was strongly expressed to Congress during its investigations of the securities markets prior to enacting the Exchange Act, which gave the Commission the authority to regulate short sales.⁶⁸ Proponents of this view believe that successive short selling by speculators may accelerate the impact of their bearish outlook for a security.⁶⁹ In 1963, the Special Study concluded that the aggravating influence of short sales occurred even with regulatory restrictions (which are still in place today).⁷⁰ However, data about the

actual relationship between short selling and price movements in the securities markets is scarce.²¹

In contrast, a number of commentators have argued that short sale regulation prevents the market from reflecting the true or "efficient" price of a security.²² These commentators specifically criticize Rule 10a-1 for imposing costs on market participants as they wait for an uptick.²³ We have considered these observations and determined that the concept of eliminating the tick test deserves analysis in light of recent market developments. If we eliminate the Rule, short selling would only be subject to recordkeeping, reporting, and the general antifraud and anti-manipulation rules.²⁴

- Q37. Are the objectives of Rule 10a-1 legitimate concerns in today's markets?
- Q38. Are the provisions of Rule 10a-1 necessary in the securities markets? If so, please give specific examples that demonstrate this need.
- Q39. Does Rule 10a-1 continue to serve a valid purpose in a declining market by preventing short sellers from accelerating declines in securities prices, or "depressing" the market?
- Q40. Does Rule 10a-1 prevent efficient pricing or slow the incorporation of negative perceptions into an efficient price? Does the need for more efficient pricing, if there is a need, outweigh the protective benefits of Rule 10a-1?
- Q41. Is Rule 10a-1 effective in preventing manipulative short selling?
- Q42. Would deregulation of short selling lead to an increase of speculation in the market? If so, would this increase disadvantage investors that are not engaged in speculation?
- Q43. Does Rule 10a-1 limit price volatility in the securities that it covers?
- Q44. Would investors avoid securities, or classes of securities, that they perceive to be vulnerable to abusive short selling? If so, would this result be exacerbated by deregulation of short selling?
- Q45. Would antifraud surveillance and enforcement actions be enough to protect investors from abusive short selling?
- Q46. If we rescind Rule 10a-1, should we reconsider a recordkeeping and/or disclosure requirement for significant short positions?²⁵
- Q47. Would dissemination of aggregate open short positions on a daily basis decrease the necessity of Rule 10a-1? What costs would be associated with such a program?
- Q48. If we rescind Rule 10a-1, should we consider adopting a rule that requires a seller to identify a source of borrowable shares prior to executing a short sale?
- Q49. If we rescind Rule 10a-1, should SROs continue to regulate short selling through their rules?
- Q50. If the short sale rule is retained, should we consider ways to regulate short sales of all securities, not just those listed on exchanges (specifically, OTC securities, including those securities quoted in the non-Nasdaq OTC markets)?
- Q51. If the short sale rule is retained, should we consider replacing the tick test with a bid test similar to NASD Rule 3350?

Typically, market professionals are able to act quickly in response to news. Eliminating the short sale rule may enable short sellers to act even more rapidly. Open public limit orders may be hit in rapid succession at prices that no longer are attractive to the investors that placed the orders. As a result, these orders may be hit before the investors have the opportunity to cancel them.

- Q52. Without the tick test, would market professionals have an unfair advantage over public investor limit orders?
- Q53. Would unrestricted short selling increase the risk for certain trading strategies (e.g., block positioning)?

III. Conclusion

The securities markets and short selling activities have changed significantly from the era in which Rule 10a-1 was adopted. We solicit comment on alternative approaches to regulating short sales to determine the appropriate response to these continuing developments.

By the Commission.

Jonathan G. Katz

Secretary

Dated: October 20, 1999

Footnotes

- ¹ 17 CFR 240.10a-1.
- ² 15 U.S.C. 78a *et seq.*
- ³ Rule 3b-3 under the Exchange Act, 17 CFR 240.3b-3, defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Pursuant to Rule 3b-3, a seller of an equity security subject to Rule 10a-1 must aggregate all positions in that security in order to determine whether the seller has a "net long position." Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119. *See also Letter regarding Rule 10a-1 - Aggregation Units* (November 23, 1998) (permitting broker-dealers to net positions for "aggregation units" (rather than firm-wide) for the purpose of complying with Rule 10a-1).
- ⁴ Such arbitrage activity is specifically excepted from compliance with the provisions of the short sale rule in paragraph (e)(7) of Rule 10a-1. 17 CFR 240.10a-1(e)(7).
- ⁵ *See, e.g., S.E.C. v. Gardiner*, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price).
- ⁶ *See* 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203-04, note 213 (3d ed. 1989).
- ⁷ *See* 2 Securities and Exchange Commission, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. 247 (1963) (Special Study).
- ⁸ *Id.*
- ⁹ 15 U.S.C. 78j(a).
- ¹⁰ *See* Securities Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213. In this release, the Commission also adopted Rule 3b-3.
- ¹¹ Rule 10a-1 uses the term "effective transaction reporting plan" as defined in Rule 11Aa3-1 (17 CFR 240.11Aa3-1) under the Exchange Act. *See* 17 CFR 240.10a-1(a)(1)(i).
- ¹² The National Association of Securities Dealers, Inc. (NASD) has adopted a short sale rule that applies to Nasdaq National Market System (NMS) securities. *See infra* Section I.B.2.
- ¹³ 17 CFR 240.10a-1(a). An "effective transaction reporting plan" is a plan approved by the Commission for collecting, processing, and disseminating transaction reports in reported securities. *See* 17 CFR 11Aa3-1(a)(3).
- ¹⁴ 17 CFR 240.10a-1(b).
- ¹⁵ NYSE Rule 440B and Amex Rule 7.
- ¹⁶ The tick test replicated the approach used by the NYSE at the time.
- ¹⁷ *See* Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (1976 Release).
- ¹⁸ *See, e.g., SEC v. Tudor Investment Corp.*, 62 S.E.C. Docket 2269, No. 96 CV 02119 (D.D.C. Sept. 12, 1996) (concentrated short sales of stocks of the Dow Jones Industrial Average (DJIA) seen as significant factor in a drop in value of the DJIA).
- ¹⁹ *See* 17 CFR 240.10a-1(e)(1) - (13).
- ²⁰ *See, e.g., Letter regarding Instinet Corporation Crossing Network*, [1992] Fed. Sec. L. Rep. (CCH) ¶ 76,290 (July 1, 1992); *Letter regarding Portfolio System for Institutional Trading*, [1991-1992] Fed. Sec. L. Rep. (CCH) ¶ 76,097 (December 31, 1991); *Letter regarding Off-Hours Trading by the Amex*, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,802 (August 5, 1991); *Letter regarding Operation of Off-Hours Trading by the NYSE*, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,736 (June 13, 1991); *Letter regarding Merrill Lynch, Pierce, Fenner & Smith, Inc.* (December 17, 1986), published with modifications in Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (Merrill Lynch Letter).
- ²¹ However, the Rule applies to transactions in exchange listed securities whether effected on an exchange or in the OTC markets.
- ²² *See* Irving Pollack, *Short-Sale Regulation of NASDAQ Securities* (1986) (Pollack Study).
- ²³ NMS securities are securities of issuers that meet a series of standards similar to those required for listing on an exchange. These securities are distinguished from securities traded on the Nasdaq SmallCap market.
- ²⁴ *See* Securities Exchange Act Release No. 34277 (July 6, 1994), 59 FR 34885.

²⁵ *Id.* In the approval order, the Commission recognized that exchange markets were able to attract customers with claims that their markets protect against potential short selling abuses. However, several commenters cited the Pollack Study, *supra* note 21, to support their opposition to the NASD short sale rule. Originally approved for only 18 months, the NASD and the Commission have extended Rule 3350 numerous times. Most recently, the Commission approved an extension of the rule until December 31, 1999. Securities Exchange Act Release No. 41568 (June 28, 1999), 64 FR 36416.

²⁶ *NASD Manual*, Conduct Rules, Rule 3350.

²⁷ *NASD Manual*, Conduct Rules, Rule 3360.

²⁸ The Economic Impact of the Nasdaq Short Sale Rule, Prepared by D. Timothy McCormick and Lorraine Reilly (1996) (Nasdaq Economic Study).

²⁹ *Id.* at 30.

³⁰ Special Study, *supra* note 7, at 246-294.

³¹ *Id.* at 248.

³² See 1976 Release, *supra* note 17.

³³ *Id.* at 56530.

³⁴ *Id.* at 56534.

³⁵ See Comment letters in Public File No. S7-665, available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

³⁶ *Comment letter from Lynch, Jones & Ryan* (March 23, 1977).

³⁷ Securities Exchange Act Release No. 17347 (November 28, 1980), 45 FR 80834.

³⁸ Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation (Part 1) (House Report), H.R. Rep. No. 102-414 (1991), reprinted in CCH Federal Securities Law Reports Number 1483 Part II (1992).

³⁹ *Id.* at 1. As discussed above, the NASD adopted its short sale rule in 1994.

⁴⁰ *Id.*

⁴¹ Securities Exchange Act Release No. 29278 (June 7, 1991), 56 FR 27280, 27281 (1991 Release).

⁴² See, e.g., Jonathan R. Macey, Mark Mitchell, and Jeffrey Netter, *Restrictions on Short Sales: an Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*, 74 Cornell L. Rev. 799 (1989); and J. Randall Woolridge and Amy Dickinson, *Short Selling and Common Stock Prices*, Financial Analysts Journal, January-February 1994.

⁴³ Arbitrage can involve inherent relationships between securities, such as convertible arbitrage, or statistical relationships, as used in "pairs trading."

⁴⁴ See, e.g., *Letter regarding Optimark* (October 31, 1997), included in Public File No. S7-24-99, available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

⁴⁵ See Alexander, Gordon J., and Mark Peterson, *Short Selling on the New York Stock Exchange and the Effects of the Uptick Rule*, Journal of Financial Intermediation, Vol. VIII, Issue 1 (June 1999) (this article concludes that the short sale rule fails to meet its objective to allow relatively unrestricted short selling in advancing markets).

⁴⁶ This approach to short sale regulation has been suggested by others. See *Letter from David A. Roker to Chairman Arthur Levitt* (March 5, 1998), included in Public File No. S7-24-99, available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

⁴⁷ Transaction prices in securities covered by Rule 10a-1 must be reported in accordance with Rule 11Aa3-1. 17 CFR 240.10a-1(a)(1)(i).

⁴⁸ See, e.g., NYSE Rule 80A (which, among other things, imposes certain trading restrictions when the Dow Jones Industrial Average (DJIA) declines or advances by at least the "two-percent value" as calculated in the rule from its previous closing level).

⁴⁹ See 17 CFR 242.101(c)(1).

⁵⁰ See Rule 105 of Regulation M (prohibiting a person from purchasing securities in a distribution if he or she has sold that security short within five days prior to the pricing of the distribution). 17 CFR 242.105.

⁵¹ *Cf.* Securities Exchange Act Release No. 17222 (October 17, 1980), 45 FR 70890 (discussing certain time restrictions on issuer repurchases at the

opening and closing of trading sessions).

⁵² For the purposes of Rule 10a-1, the Commission has described a *bona fide* hedge as largely a matter of custom and practice, but it must involve long and short positions in related securities where one security is exercisable, convertible, or otherwise related by its terms to the other security, and substantially offsets the risk of that security. To be considered *bona fide*, the hedge must offset most or all of the risk of the security being hedged. See, e.g., Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415, 24420 (1992 Release) (citing Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084). We request comment on whether this definition is appropriate or adequate.

⁵³ See Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120 note 14.

⁵⁴ *Bona fide* arbitrage is "an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to 'lock in' a gross profit or spread resulting from a current differential in pricing." See, 1992 Release, *supra* note 51, at 6089.

⁵⁵ 17 CFR 240.10a-1(e)(7).

⁵⁶ 17 CFR 240.10a-1(e)(8).

⁵⁷ 17 CFR 240.10a-1(e)(13).

⁵⁸ Risk arbitrage is a transaction effected with a view to profit from the consummation of a merger, acquisition, tender offer or other similar transaction involving a recapitalization.

⁵⁹ See, e.g., *Letter regarding Select Sector SPDRs II* (February 12, 1999); *Letter regarding Select Sector SPDRs* (December 28, 1998).

⁶⁰ See Merrill Lynch Letter, *supra* note 20.

⁶¹ Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120. See also Securities Exchange Act Release No. 20715 (March 13, 1984), 49 FR 9414, 9415; 1992 Release at 24419.

⁶² 12 U.S.C. 1821(e)(8)(D)(i).

⁶³ See Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084, at 6090.

⁶⁴ See Alexander, Gordon J. and Mark A. Peterson, *Quote Jumping, Minimum Tick Variation, and the Execution of Short Sell Orders*, 1999 working paper, included in Public File No. S7-24-99, available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

⁶⁵ See *supra* note 2.

⁶⁶ 17 CFR 240.3b-3(2). See also 1992 Release, *supra* note 51.

⁶⁷ Married puts can be used to hedge the price paid for a stock through the simultaneous purchase of a stock and deep-in-the-money puts for the stock.

⁶⁸ See Special Study, *supra* note 7, at 247.

⁶⁹ See Woolridge, *supra* note 42 (concluding that short sellers do not enjoy unfair profits by forcing the price of a security down through short sales).

⁷⁰ Special Study, *supra* note 7, at 293 - 294.

⁷¹ See, e.g., 1976 Release, *supra* note 17, at 56534.

⁷² See, e.g., Macey, *supra* note 42.

⁷³ See Alexander, *supra* note 45.

⁷⁴ E.g., 15 U.S.C. 78i(a) and 78j(b); 17 CFR 240.10b-5.

⁷⁵ See 1991 Release, *supra* note 41.

<http://www.sec.gov/rules/concept/34-42037.htm>