

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR PARTS 240 and 242

[Release No. 34-54891; File No. S7-21-06]

RIN 3235-AJ76

### Amendments to Regulation SHO and Rule 10a-1

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is proposing to amend the short sale price test under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed amendments are intended to provide a more consistent regulatory environment for short selling by removing restrictions on the execution prices of short sales ("price tests" or "price test restrictions"), as well as prohibiting any self-regulatory organization ("SRO") from having a price test. In addition, the Commission is proposing to amend Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt," if the seller is relying on an exception from a price test.

**DATES:** Comments should be received on or before February 12, 2007.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-21-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-21-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also

available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** James A. Brigagliano, Acting Associate Director, Josephine J. Tao, Branch Chief, Lillian Hagen, Special Counsel, Victoria L. Crane, Special Counsel, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 551-5720, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6628.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting public comment on the removal of Rule 10a-1 [17 CFR 240.10a-1] and proposed amendments to Rules 200 and 201 of Regulation SHO [17 CFR 242.200 and 242.201] under the Exchange Act.

#### I. Introduction

Section 10(a) of the Exchange Act<sup>1</sup> gives the Commission plenary authority over short sales<sup>2</sup> of securities registered on a national securities exchange as necessary or appropriate in the public interest or for the protection of investors. The Commission originally adopted Rule 10a-1 in 1938 to restrict short selling in a declining market.<sup>3</sup>

The core provisions of Rule 10a-1 have remained virtually unchanged since its adoption almost 70 years ago. As discussed in more detail below, however, over the years, in response to changes in the securities markets, including changes in trading strategies and systems used in the marketplace, the Commission has added exceptions to Rule 10a-1 and granted numerous written requests for relief from the rule's restrictions. In addition, under current price test regulation, different price tests apply to securities trading in different markets. We also note that current price test restrictions apply generally only to large or more actively-traded securities. We believe that the increased demand for exemptions from the restrictions of Rule 10a-1, and the disparate application of current price test regulation, limit the reach of current price test restrictions, potentially create an unlevel playing field among market

participants, and allow for regulatory arbitrage.

In 2004, we adopted Rule 202T of Regulation SHO,<sup>4</sup> which established procedures for the Commission to temporarily suspend price tests so that the Commission could study the effectiveness of these tests.<sup>5</sup> Pursuant to the process established in Rule 202T of Regulation SHO, we issued an order ("First Pilot Order") creating a one year pilot ("Pilot") temporarily suspending the provisions of Rule 10a-1(a) and any price test of any exchange or national securities association for short sales of certain securities.<sup>6</sup>

The Pilot was designed to assist the Commission in assessing whether changes to current short sale regulation are necessary in light of current market practices and the purposes underlying short sale regulation.<sup>7</sup> The Commission stated in the Regulation SHO Adopting Release that conducting a pilot pursuant to Rule 202T would "allow us to obtain data on the impact of short selling in the absence of a price test to assist in determining, among other things, the extent to which a price test is necessary to further the objectives of short sale regulation, to study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity, and to obtain empirical data to

<sup>4</sup> 17 CFR 242.202T.

<sup>5</sup> See *id.*; see also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48012-48013 (August 6, 2004) ("Regulation SHO Adopting Release").

<sup>6</sup> Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004). Specifically, the First Pilot Order suspended price tests for: (1) Short sales in the securities identified in Appendix A to the First Pilot Order; (2) short sales in the securities included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the effective transaction reporting plan of the Consolidated Tape Association ("consolidated tape") on the following day; and (3) short sales in any security not included in paragraphs (1) and (2) effected in the period between the close of the consolidated tape and the open of the consolidated tape on the following day. In addition, the First Pilot Order provided that the Pilot would commence on January 3, 2005 and terminate on December 31, 2005, and that the Commission might issue further orders affecting the operation of the First Pilot Order. 69 FR at 48033. On November 29, 2004, we issued an order resetting the Pilot to commence on May 2, 2005 and end on April 28, 2006 to give market participants additional time to make systems changes necessary to comply with the Pilot. Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004). On April 20, 2006, we issued an order ("Third Pilot Order") extending the termination date of the Pilot to August 6, 2007, the date on which temporary Rule 202T of Regulation SHO expires. Exchange Act Release No. 53684 (April 20, 2006), 71 FR 24765 (April 26, 2006). The purpose of the Third Pilot Order is to maintain the status quo with regard to price tests for Pilot securities while the staff completes its analysis of the Pilot data and the Commission conducts any additional short sale rulemaking.

<sup>7</sup> 69 FR at 48032.

<sup>1</sup> 15 U.S.C. 78j(a).

<sup>2</sup> Rule 200(a) of Regulation SHO 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." 17 CFR 242.200(a).

<sup>3</sup> See Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

help assess whether a price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities.”<sup>8</sup> As noted in the Regulation SHO Adopting Release, the empirical data from the Pilot was to be obtained and analyzed “as part of [the Commission’s] assessment as to whether the price test should be removed or modified, in part or whole, for actively-traded securities or other securities.”<sup>9</sup>

Thus, the Commission’s Office of Economic Analysis (“OEA”) gathered the data made public during the Pilot, analyzed this data and provided the Commission with a draft summary report on the Pilot.<sup>10</sup> The OEA Staff’s Draft Summary Pilot Report examined several aspects of market quality including the overall effect of price tests on short selling, liquidity, volatility and price efficiency. The Pilot data was also designed to allow the Commission and members of the public to examine whether the effects of price tests are similar across stocks.<sup>11</sup>

In addition, the Commission encouraged outside researchers to examine the Pilot. In response to this request, the Commission has received three completed studies (the “Academic Studies”) from outside researchers that specifically examine the Pilot data.<sup>12</sup>

<sup>8</sup> Regulation SHO Adopting Release at 48009.

<sup>9</sup> Regulation SHO Adopting Release at 48013. In the Regulation SHO Adopting Release we noted that “the purpose of the [P]ilot is to assist the Commission in considering alternatives, such as: (1) Eliminating a Commission-mandated price test for an appropriate group of securities, which may be all securities; (2) adopting a uniform bid test, and any exceptions, with the possibility of extending a uniform bid test to securities for which there is currently no price test; or (3) leaving in place the current price tests.” Regulation SHO Adopting Release at 48010.

<sup>10</sup> See Office of Economic Analysis U.S. Securities and Exchange Commission, *Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot* (September 14, 2006) (the “OEA Staff’s Draft Summary Pilot Report”), available at [http://www.sec.gov/about/economic/shopilot091506/draft\\_reg\\_sho\\_pilot\\_report.pdf](http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf).

<sup>11</sup> In the Regulation SHO Adopting Release, the Commission stated its expectation that data on trading during the Pilot would be made available to the public to encourage independent researchers to study the Pilot. See Regulation SHO Adopting Release at 48009, n.9. Accordingly, nine SROs began publicly releasing transactional short selling data on January 3, 2005. The nine SROs were the AMEX, ARCA, BSE, CHX, NASD, Nasdaq, National Stock Exchange, NYSE and Phlx. The SROs agreed to collect and make publicly available trading data on each executed short sale involving equity securities reported by the SRO to a securities information processor. The SROs published the information on a monthly basis on their Internet Web sites.

<sup>12</sup> See Karl Diether, Kuan Hui Lee and Ingrid M. Werner, *It’s SHO Time! Short-Sale Price-Tests and Market Quality*, June 20, 2006 (“Diether, Lee and Werner”); Gordon J. Alexander and Mark A. Peterson, *(How) Do Price Tests Affect Short Selling?*

The Commission also held a public roundtable (the “Regulation SHO Roundtable”) that focused on the empirical evidence learned from the Pilot data (the OEA Staff’s Draft Summary Pilot Report, Academic Studies, and Regulation SHO Roundtable are referred to collectively herein as, the “Pilot Results”).<sup>13</sup> The Pilot Results contained a variety of observations, which we considered in determining whether or not to propose removal of current price test restrictions. Generally, the Pilot Results urged removal of current price test restrictions. In addition, the empirical evidence did not support extending a price test to either small or thinly-traded securities.<sup>14</sup>

Based on our review of the Pilot Results and of the status of current price test restrictions, we are proposing to remove the tick test of Rule 10a–1 and add Rule 201 of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. Rule 201 would also prohibit any SRO from having a price test. In addition, because we are proposing to remove all current price test restrictions, and prohibit any price test by any SRO, we are proposing to amend Rule 200(g) of Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as “short exempt” if the seller is relying on an exception from the price test of Rule 10a–1, or any price test of any exchange or national securities association.<sup>15</sup>

We note that today’s markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of abusive or manipulative short selling going undetected if we were to remove price test restrictions, and permit regulators to monitor the types of activities that Rule 10a–1 and other price tests are designed

May 23, 2006 (“Alexander and Peterson”); J. Julie Wu, *Uptick Rule, short selling and price efficiency*, August 14, 2006 (“Wu”).

<sup>13</sup> A transcript from the roundtable (“the Roundtable Transcript”) is available at <http://www.sec.gov/about/economic/shopilottrans091506.pdf>.

<sup>14</sup> The Pilot Results are discussed in more detail in Section II.D below.

<sup>15</sup> This proposal affects price tests and related marking requirements only. It does not relate to other provisions of Regulation SHO. We note, however, that in a separate proposal we recently proposed amendments to provisions of Regulation SHO that would eliminate the “grandfather” provision and limit the options market maker exception. See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (“Regulation SHO Amendments Proposing Release”). This proposal does not alter the proposed amendments in the Regulation SHO Amendments Proposing Release.

to prevent. The general anti-fraud and anti-manipulation provisions of the federal securities laws would also continue to prohibit activity that improperly influences the price of a security.<sup>16</sup>

## II. Background

### A. Short Selling and Its Market Uses and Effects

A short sale is the 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.<sup>17</sup> In order to deliver the security to the purchaser, the short seller borrows the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the security to the lender. A short seller hopes to profit from the transaction by selling short at a higher price than the price at which it repurchases the securities to return to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

Short selling provides the market with at least two important benefits: market liquidity and pricing efficiency.<sup>18</sup> Market liquidity may be provided through short selling by market professionals, such as market makers (including specialists) and block positioners, to offset temporary imbalances in the buying and selling interest for securities. These short sales make stock available to purchasers and reduce the risk that the price paid by purchasers is artificially high because of a temporary contraction of selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.

In addition, short selling contributes to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. Short sales reflect the view that the security is overvalued and the price of the security will fall, just as long purchases reflect the view that the security is undervalued and the price

<sup>16</sup> See, e.g., Securities Act of 1933 Section 17(a), Exchange Act Sections 9(a), 10(b), and 15(c) and Rule 10b-5 thereunder. See also Regulation M, Rule 105.

<sup>17</sup> 17 CFR 242.200(a).

<sup>18</sup> See Owen A. Lamont and Richard H. Thaler, *Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs*, Journal of Political Economy, May 2001.

will rise. Both the long purchaser and the short seller hope to profit, or hedge against loss, by buying low and selling high, though the strategies 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.<sup>19</sup>

Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices.<sup>20</sup> One example is the “bear raid” where an equity security is actively sold short to drive down prices in the hope of convincing less informed investors of a negative material perception of the stock, triggering sell orders. Falling prices could also trigger margin calls and possibly forced liquidations of the security, depressing the price further.<sup>21</sup>

This unrestricted short selling could exacerbate a declining market in a security by eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security’s price is falling for fundamental reasons.

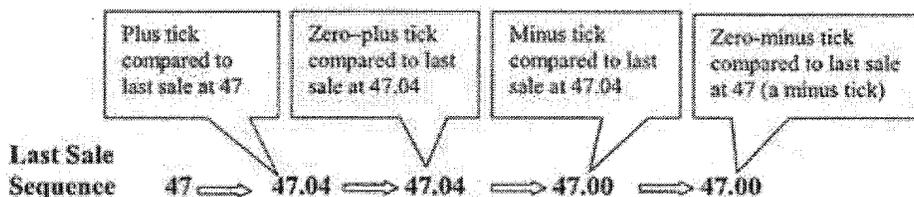
#### B. Current Short Sale Regulation

One way short sales are regulated in the United States is through price tests, which regulate the execution prices of short sales. Current short sale regulation applies different price tests to securities trading in different types of markets. 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 or appropriate in the public interest for the protection of investors.<sup>22</sup> After conducting an inquiry into the effects of concentrated short selling during the market break of 1937, the Commission adopted the price test contained in Rule 10a–1 in 1938 to restrict short selling in a declining market.<sup>23</sup> The core provisions of the rule

are largely the same today as when they were adopted.

Paragraph (a) of Rule 10a–1 covers short sales in securities registered on, or admitted to unlisted trading privileges (“UTP”) on, a national securities exchange (“listed securities”), if trades of the security are reported pursuant to an “effective transaction reporting plan” and information regarding such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.<sup>24</sup>

Rule 10a–1(a)(1) provides that, subject to certain exceptions, a listed security may be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it is higher than the last different price (zero-plus tick).<sup>25</sup> 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 following transactions illustrate the operation of the tick test:



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

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

objectives: (i) Allowing relatively unrestricted short selling in an advancing market; (ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and (iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.<sup>26</sup>

Rule 10a–1 applies only to listed securities and, therefore, securities quoted on the over-the-counter bulletin board (“OTCBB”) and pink sheets are

not subject to Rule 10a–1. In addition, prior to January 13, 2006, before The NASDAQ Stock Market LLC (“Nasdaq”) began operations as a national securities exchange, Nasdaq securities were not subject to Rule 10a–1.

In 1994, the Commission granted temporary approval to the National Association of Securities Dealers, Inc. (“NASD”) to apply its own short sale rule, NASD Rule 3350 (“former NASD Rule 3350” or “former NASD Rule 3350’s bid test”), to Nasdaq Global

<sup>19</sup> 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.

<sup>20</sup> See, e.g., *S.E.C. v. Gardiner*, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); *U.S. v. Russo*, 74 F.3d

1383, 1392 (2nd Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b–5).

<sup>21</sup> At that time, many people blamed “bear raids” for the 1929 stock market crash and the market’s prolonged inability to recover from the crash. See 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203–04, n.213 (3d ed. 2006).

<sup>22</sup> See 15 U.S.C. 78j(a).

<sup>23</sup> See *supra* n.3.

<sup>24</sup> Rule 10a–1 uses the term “effective transaction reporting plan” as defined in Rule 600 of

Regulation NMS (17 CFR 242.600) under the Exchange Act. See 17 CFR 240.10a–1(a)(1)(i).

<sup>25</sup> The last sale price is the price reported pursuant to an effective transaction reporting plan, i.e., the consolidated tape, or to the last sale price reported in a particular marketplace. Under Rule 10a–1, the Commission gives market centers the choice of measuring the tick of the last trade based on executions solely on their own exchange rather than those reported to the consolidated tape. See 17 CFR 240.10a–1(a)(2).

<sup>26</sup> See Exchange Act Release No. 13091

(December 21, 1976), 41 FR 56530 (December 28, 1976).

Market securities<sup>27</sup> on a pilot basis.<sup>28</sup> Under former NASD Rule 3350, Nasdaq Global Market securities traded over-the-counter (“OTC”) and reported to an NASD facility were subject to former NASD Rule 3350’s bid test.<sup>29</sup> In addition, Nasdaq Global Market securities traded on, or reported to, Nasdaq were subject to former NASD Rule 3350’s bid test.

Former NASD Rule 3350 was, by its terms, inapplicable to Nasdaq Capital Market securities.<sup>30</sup> In addition, short sales in Nasdaq Global Market securities effected on any national securities exchange that traded Nasdaq Global Market securities on a UTP basis were not subject to former NASD Rule 3350.

On January 13, 2006, the Commission approved Nasdaq’s application to become a national securities exchange.<sup>31</sup> Once Nasdaq’s exchange application became effective, Rule 10a–1 would have applied to all Nasdaq securities wherever traded. In Nasdaq’s exchange application, however, Nasdaq requested an exemption from Rule 10a–1 and proposed to adopt a short sale rule, Nasdaq Rule 3350 (“Nasdaq Rule 3350” or “Nasdaq’s bid test”), similar to former NASD Rule 3350, so that it could continue to regulate short sales in Nasdaq Global Market securities under a bid test.<sup>32</sup> Nasdaq also requested to

exempt Nasdaq Capital Market securities from Rule 10a–1’s tick test.<sup>33</sup> In granting Nasdaq’s requested exemptions, the Commission noted that it believed that it is important to maintain the status quo of short sale regulation during the Pilot in order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary.<sup>34</sup> Nasdaq Rule 3350 prohibits short sales in Nasdaq Global Market securities at or below the current best (inside) bid displayed in the National Market System when the current best (inside) bid is below the preceding best (inside) bid in the security.<sup>35</sup>

Similarly, to maintain the status quo for Nasdaq Global Market securities traded OTC and reported to a NASD facility during the Pilot, we granted an exemption to the NASD to permit Nasdaq Global Market securities traded OTC and reported to a NASD facility to continue to be subject to a bid test similar to that contained in former NASD Rule 3350 rather than Rule 10a–1’s tick test, and Nasdaq Capital Market securities traded OTC and reported to a NASD facility to continue to not be subject to any price test.<sup>36</sup> Thus, with respect to trades in Nasdaq Global Market securities reported to the NASD’s Alternative Display Facility (“ADF”)<sup>37</sup> or the Trading Reporting Facility (“TRF”),<sup>38</sup> NASD Rule 5100 prohibits short sales at or below the current national best (inside) bid when the current national best (inside) bid is

below the previous best (inside) bid in the security.<sup>39</sup>

For these same reasons, we also granted an exemption for exchanges trading Nasdaq Global Market and Nasdaq Capital Market securities on a UTP basis to continue to do so without being subject to any price test until completion of the Pilot.<sup>40</sup>

In summary, under the current market structure, Nasdaq Global Market securities traded on Nasdaq or the OTC market and reported to a NASD facility are subject to Nasdaq’s or NASD’s bid tests.<sup>41</sup> Other listed securities traded on an exchange, or otherwise, are subject to Rule 10a–1’s tick test. Nasdaq securities traded on exchanges other than Nasdaq are not subject to any price test. In addition, many thinly-traded securities, such as Nasdaq Capital Market securities, and securities quoted on the OTCBB and pink sheets, are not subject to any price test wherever traded.

### C. Current Price Test Exemptions

As noted above, the core provisions of Rule 10a–1 have remained essentially unchanged since the rule was adopted in 1938. Over the years, however, in response to changes in trading strategies and systems used in the marketplace, the Commission has added exceptions to Rule 10a–1<sup>42</sup> and granted numerous written requests for relief from the rule’s restrictions. These requests for exemptive relief have increased dramatically in recent years in response to significant developments in the securities markets, such as

<sup>27</sup> Nasdaq Global Market securities were formerly known as Nasdaq National Market securities. In connection with Nasdaq commencing operations as a national securities exchange, the Nasdaq National Market was renamed the Nasdaq Global Market and Nasdaq National Market securities were renamed Nasdaq Global Market securities. See NASD Rule 4200(a)(6) (providing that the Nasdaq Global Market is the successor to the Nasdaq National Market); see also Exchange Act Release No. 54071 (June 29, 2006), 71 FR 38922 (July 10, 2006). In this release, references to Nasdaq Global Market securities includes Nasdaq National Market securities, as applicable.

<sup>28</sup> See Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994). The NASD’s short sale rule was originally approved on an eighteen-month pilot basis. The NASD proposed, and the Commission approved, extensions of former NASD Rule 3350 several times. See, e.g., Exchange Act Release No. 53093 (January 10, 2006), 71 FR 2966 (January 18, 2006).

<sup>29</sup> Former NASD Rule 3350’s bid test provided that short sales in Nasdaq Global Market securities must not be effected at or below the current national best (inside) bid when the current national best (inside) bid is below the preceding national best (inside) bid.

<sup>30</sup> Nasdaq Capital Market securities were formerly known as Nasdaq SmallCap securities. See Exchange Act Release No. 34–52489 (September 21, 2005), 70 FR 56948 (September 29, 2005).

<sup>31</sup> See SEC Order in the Matter of the Application of The Nasdaq Stock Market LLC for registration as a National Securities Exchange, Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006).

<sup>32</sup> Nasdaq Rule 3350 contains provisions similar to former NASD Rule 3350 regarding short sales in Nasdaq Global Market securities executed on, or reported to, Nasdaq. See Nasdaq Rule 3350. See also 71 FR at 3561.

<sup>33</sup> See *id.*

<sup>34</sup> See 71 FR at 3562.

<sup>35</sup> See Nasdaq Rule 3350.

<sup>36</sup> See letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation to Marc Menchel, Executive Vice President and General Counsel, NASD, Inc. (June 26, 2006) (providing exemptive relief to allow (i) Nasdaq Global Market securities traded OTC and reported to a NASD facility to be subject to NASD Rule 5100 (“NASD Rule 5100” or “NASD’s bid test”) rather than Rule 10a–1, and (ii) Nasdaq Capital Market securities traded OTC and reported to a NASD facility to not be subject to either Rule 10a–1 or NASD Rule 5100).

<sup>37</sup> The ADF is a facility operated by NASD on a pilot basis for members that choose to quote or effect trades in Nasdaq securities otherwise than on an exchange. The ADF collects and disseminates quotations and trade reports, and compares trades. See NASD Rule 4100A.

<sup>38</sup> The TRF permits NASD members that internalize customer orders through the Nasdaq Stock Market facility of the NASD to continue to internalize such orders pursuant to NASD rules and to report trades to the TRF of the NASD. The TRF uses Nasdaq’s technology, *i.e.*, ACT, to accept OTC trade reports from NASD members in Nasdaq securities. See Exchange Act Release No. 54085 (June 30, 2006), 71 FR 38910 (July 10, 2006).

<sup>39</sup> See NASD Rule 5100.

<sup>40</sup> See letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation to David C. Whitcomb, Jr., Senior Vice President and Chief Regulatory Officer, the Chicago Stock Exchange, Inc. (July 20, 2006) (providing an exemption from any price test for exchanges trading Nasdaq securities on a UTP basis. Exchanges may, however, adopt a bid test to apply to trading in Nasdaq securities).

<sup>41</sup> Recently, the Commission approved proposed rule changes by Nasdaq and the NASD to exempt securities comprising the Nasdaq-100 Index from Nasdaq Rule 3350 and NASD Rule 5100, respectively. See Exchange Act Release No. 54435 (September 13, 2006), 71 FR 55042 (September 20, 2006); Exchange Act Release No. 54558 (October 2, 2006), 71 FR 59573 (October 10, 2006).

<sup>42</sup> Paragraph (e) of Rule 10a–1 contains the exceptions to the rule. The exceptions to the tick test are designed to permit certain types of trading activities that are intended to benefit the markets or that are believed to carry little risk of the kind of manipulative or destabilizing trading that Rule 10a–1 was designed to address. See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003); 17 CFR 240.10a–1(e). In addition, in considering whether to propose removing the price tests of any exchange or national securities association for all securities, the Commission reviewed the exceptions to the NASD’s and Nasdaq’s bid tests, such as the bona-fide market maker exception contained in each of those rules. See NASD Rule 5100(c); Nasdaq Rule 3350(c).

decimalization and the spread of fully automated markets. Among others, the Commission has granted exemptions from Rule 10a-1: (i) For transactions in exchange traded funds (“ETFs”);<sup>43</sup> (ii) to permit registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit orders at the consolidated best offer, regardless of the last trade price;<sup>44</sup> (iii) for certain transactions executed on a volume-weighted average price (“VWAP”) basis;<sup>45</sup> (iv) to electronic trading systems that match and execute trades at independently derived prices during random times within specific time intervals;<sup>46</sup> and (v) to allow broker-

<sup>43</sup> See, e.g., letter from Racquel L. Russell, Esq., Branch Chief, Office of Trading Practices and Processing, Division of Market Regulation to George T. Simon, Esq., Foley & Lardner LLP (June 21, 2006); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to Claire P. McGrath, Vice President and Special Counsel, AMEX (August 17, 2001). In granting such exemptions, the Commission noted that its decision was generally based on the fact that the market value of ETF shares would rise and fall based on changes in the net asset value of the component stocks in the particular index, and supply and demand. Each of the approvals for relief is conditioned on the ETF meeting certain enumerated conditions, either specific to certain products or included as part of a broader “class exemption.”

<sup>44</sup> See letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Bernard L. Madoff, Chairman, Bernard L. Madoff Investment Securities LLC (February 9, 2001). This relief is strictly limited to the facilitation of customer market and marketable limit orders and is not available as a means of soliciting customer orders.

<sup>45</sup> See, e.g., letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation to Soo Yim, Wilmer, Cutler & Pickering (December 7, 2000); letter from James A. Brigagliano, Assistant Director to Andre E. Owens, Esq., Schiff Hardin & Waite (March 30, 2001); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Sam Scott Miller, Esq., Orrick, Herrington & Sutcliffe LLP (May 11, 2001); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to William W. Uchimoto, Esq., Vie Institutional Services (February 12, 2003); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Amy N. Kroll, Esq., Foley & Lardner (March 16, 2004). Among other things, the relief is limited to VWAP transactions that are arranged or “matched” before the market opens at 9:30 a.m. but are not assigned a price until after the close of trading when the VWAP value is calculated. The Commission granted the exemptions based, in part, on the fact that these VWAP short sale transactions appear to pose little risk of facilitating the type of market effects that Rule 10a-1 was designed to prevent. In particular, the pre-opening VWAP short sale transactions do not participate in, or affect, the determination of the VWAP for a particular security. Moreover, the Commission stated that all trades used to calculate the day’s VWAP would continue to be subject to Rule 10a-1.

<sup>46</sup> See, e.g., letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, to Alan J. Reed, Jr., First Vice President and Director of Compliance, Instinet Group, LLC. (June 15, 2006) (granting Instinet modified exemptive relief from Rule 10a-1 for certain

dealers to fill customer orders, without the restrictions of the tick test, if: (a) A broker-dealer receives a sell order from a customer who is net “long” the securities being sold, and the broker-dealer then seeks to execute that order, either in whole or in part, by selling the security as riskless principal, even if the broker-dealer has an overall net “short” position in such security; or (b) a broker-dealer receives a buy order from a customer, and the broker-dealer then seeks to execute that order, either in whole or in part, by purchasing the security as riskless principal, and then selling the security to the customer, even if the broker-dealer has an overall net “short” position in such security.<sup>47</sup> We have granted these exemptions because we believe that the types of trading activities described in each of the exemptive request letters do not appear to involve the types of abuses that Rule 10a-1 was designed to address.<sup>48</sup> We believe, however, that by granting these exemptions we limit the reach of the price test restrictions contained in Rule 10a-1 and potentially create an unlevel playing field among market participants. Moreover, the fact that an increasing number of market participants have requested these exemptions indicates to us that the current rule may no longer be suited to the wide variety of trading strategies and systems currently used in the marketplace.

#### D. Pilot Results

The Pilot commenced on May 2, 2005 and is scheduled to terminate no later than August 6, 2007.<sup>49</sup> The purpose of the Pilot was to allow the Commission to study the effectiveness of current price test restrictions and, in particular, to assist the Commission in determining whether current price test restrictions should be removed or modified, in part or whole, for some or all securities.<sup>50</sup>

transactions executed through Instinet’s Intraday Crossing System). These systems have requested relief from Rule 10a-1 because matches could potentially occur at a price below the last reported sale price. Due to the passive nature of pricing and the lack of price discovery, trades executed through the passive systems generally do not appear to involve the types of abuses that Rule 10a-1 was designed to prevent.

<sup>47</sup> See Letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Ira Hammerman, Senior Vice President and General Counsel, Securities Industry Association (July 18, 2005).

<sup>48</sup> We note, however, that each exemption from Rule 10a-1 was granted subject to conditions for relief designed to ensure that the trading activities contemplated by the requests for relief do not implicate the types of trading activity that Rule 10a-1 was designed to prevent.

<sup>49</sup> See *supra* n.6 and supporting text.

<sup>50</sup> See Regulation SHO Adopting Release at 48012-48013.

Consistent with this purpose, the Commission has been able to collect empirical evidence on the effects of relatively unrestricted short selling on market volatility, price efficiency (including manipulation), and liquidity from the OEA Staff’s Draft Summary Pilot Report and the Academic Studies. The Commission has also collected information on whether unrestricted short selling affects actively-traded securities differently than thinly-traded securities (according to turnover) or affects large securities differently than small securities (according to market capitalization). In addition, the Commission has collected empirical evidence on the effect of price test restrictions on the level of short selling and options trading, the balance of trade, and the effect of disparate price test restrictions on different market centers trading the same securities. Finally, the Commission has collected information on whether the impact of Rule 10a-1 is different than the impact of former NASD Rule 3350 on short selling activity.

#### i. OEA Staff’s Draft Summary Pilot Report

OEA analyzed the effects of the Pilot on the securities included in the Pilot by comparing short selling activity, volatility, price efficiency, and liquidity in those securities to a control group of securities.<sup>51</sup> In particular, OEA estimated how these securities changed from the four months prior to the Pilot to the first six months of the Pilot and compared the Pilot securities’ changes to the control group securities’ changes.<sup>52</sup> OEA’s analysis was conducted separately for listed securities and Nasdaq Global Market securities. OEA’s main empirical results are discussed below.

Because price test restrictions are meant to keep short sales from creating

<sup>51</sup> OEA selected the securities to be included in the Pilot by sorting the 2004 Russell 3000, first by listing market and then by average daily dollar volume from June 2003 through May 2004, and then within each listing market, selecting every third company starting with the second. Because the selection process relied on average daily dollar volume, companies that had their Initial Public Offering (“IPO”) in May or June 2004, just prior to the Russell reconstitution, were not included. The securities in the control group came from the remainder of the 2004 Russell 3000 not included in the Pilot (excluding the IPOs in May or June 2004 and any securities added to the Russell 3000 after June 2004). See OEA Staff’s Draft Summary Pilot Report at 22 (discussing the selection of securities included in the Pilot and the control group).

<sup>52</sup> Table 2 of the OEA Staff’s Draft Summary Pilot Report shows that the Pilot stocks were statistically similar to the control group securities during the four months prior to the Pilot. See *id.* at 61.

excessive downward price pressure,<sup>53</sup> OEA studied whether price test restrictions dampen volatility. In particular, OEA studied whether price test restrictions dampen short-term intraday volatility associated with temporary order imbalances or daily volatility associated with price changes. OEA found that price test restrictions did not have a significant impact on daily volatility for either listed or Nasdaq Global Market securities, while price test restrictions appear to dampen intraday volatility, particularly in listed securities.<sup>54</sup>

OEA analyzed the Pilot data to determine what impact, if any, price test restrictions have on price efficiency. OEA found that the Pilot data provided limited evidence that price test restrictions distort a security's price.<sup>55</sup> In addition, the Pilot data did not provide any indication that there is an association between manipulative short selling, such as "bear raids," and price test restrictions on short selling.<sup>56</sup>

Price test restrictions could inhibit the free movement of a security's price, and thereby, make markets less liquid. Price test restrictions could also induce more liquidity by forcing short sellers to engage in more passive trading strategies. To test these potential effects, OEA analyzed whether price test restrictions have an impact on liquidity by comparing quoted and effective spreads and quoted bid and ask depth for those securities contained in the Pilot and the control group. OEA found that price test restrictions resulted in an increase in quote depths. Liquidity levels, however, were unaffected by the removal of price test restrictions.<sup>57</sup>

An important element of the Pilot was to determine whether price test restrictions affect securities of varying size and trading volume differently. For the most part, OEA found that current price test restrictions affect securities to the same extent regardless of size or

trading volume.<sup>58</sup> For example, OEA found that regardless of a security's size or trading volume, price test restrictions discouraged short selling.<sup>59</sup> In addition, OEA found that price test restrictions did not distort a security's price or affect its liquidity in a way that was related to the size of, or trading volume in, the security.<sup>60</sup> OEA did find, however, that a security's size or volume mattered with respect to routing decisions and volatility. For example, OEA found that for Nasdaq Global Market securities, in the absence of a price test, there was a more significant increase in Nasdaq's market share of short sales than in smaller Nasdaq Global Market securities.<sup>61</sup> Similarly, OEA found that price test restrictions dampen both transitory and permanent price volatility in smaller securities while amplifying it in larger securities.<sup>62</sup> With respect to intraday volatility, OEA found that there was an increase in volatility in smaller securities and a decline in volatility in larger securities in the absence of price tests. This evidence was much weaker for Nasdaq Global Market securities than listed securities.<sup>63</sup>

When reviewing the results of the Pilot, OEA analyzed whether price test restrictions represent an economically meaningful constraint on short selling and, thereby, may induce some traders to avoid short selling or reduce the size of their short positions. OEA found that for both listed and Nasdaq Global Market securities, price test restrictions reduce the volume of executed short sales relative to total volume, indicating that price test restrictions act as a constraint on short selling.<sup>64</sup> In neither market, however, did OEA find a significant difference in short interest positions.<sup>65</sup>

Because not all market centers that trade Nasdaq Global Market securities apply price test restrictions, OEA analyzed whether removing price test restrictions affects where short sales in Nasdaq Global Market securities are executed. OEA found that Nasdaq's share of short selling volume is negatively impacted by price test restrictions, suggesting that some short

sellers route orders to avoid the application of a price test.<sup>66</sup>

In addition, OEA tested whether broker-dealers use the options markets to avoid application of a price test. OEA found no evidence, however, that price test restrictions on equity securities have any impact on options trading.<sup>67</sup>

OEA found that price test restrictions affect the ability of short sellers to demand liquidity by getting prompt execution of market orders. For listed Pilot securities, OEA found that the application of the tick test of Rule 10a-1 resulted in significantly fewer than 50% of transactions occurring on minus ticks or zero-minus ticks. In the absence of a tick test, OEA found that tick-to-tick changes in price were more balanced.<sup>68</sup> For Nasdaq Global Market securities, OEA found that the percentage of time the market was in a down bid state declined when the bid test was removed, suggesting that down bids occur more regularly when the bid test applies.<sup>69</sup> This result suggests that short selling under former NASD Rule 3350 might shorten the duration of upbids, reflecting the restriction that short sales can only hit upbids. Removing former NASD Rule 3350 resulted in longer lasting upbids.

In summary, OEA found little empirical justification for maintaining price test restrictions, especially for large securities. Despite changes in the displayed liquidity, all securities in the study had about the same realized liquidity and pricing efficiency whether or not price test restrictions apply. When OEA examined the differences between large and small securities, the most interesting pattern showed that price test restrictions actually amplify volatility in large securities while dampening it in small securities. While the majority of results do not suggest that removing price test restrictions would harm small securities, this volatility result is a potential concern.<sup>70</sup>

## ii. Academic Studies and Regulation SHO Roundtable

To better inform the Commission regarding the effects of the Pilot and, in turn, of price test restrictions, we encouraged researchers to provide the Commission with their own empirical analyses of the Pilot. In response to this request, the Commission received the

<sup>53</sup> See, e.g., supra n.3 and supporting text (providing that a primary reason that the Commission adopted Rule 10a-1 in 1938 was to restrict short selling in a declining market).

<sup>54</sup> See *infra* n.61-63 and supporting text.

<sup>55</sup> On the day the Pilot went into effect, listed Pilot securities underperformed listed control group securities by approximately 24 basis points. The Pilot and control group securities, however, had similar returns over the first six months of the Pilot. See OEA Staff's Draft Summary Pilot Report at 8.

<sup>56</sup> See *id.* at 48, 56.

<sup>57</sup> This conclusion is based on the result that changes in effective spreads were not economically significant (less than a basis point) and that the changes in the bid and ask depth appear not to affect the transaction costs paid by investors. Arguably, the changes in bid and ask depth appeared to affect the intraday volatility. However, OEA concludes that overall, the Pilot data does not suggest a deleterious impact on market quality or liquidity. See *id.* at 42, 56.

<sup>58</sup> See *id.* at Section IV.E.

<sup>59</sup> See *id.* at 52.

<sup>60</sup> See *id.* at 52-53. The report finds that former NASD Rule 3350 seems to generate statistically lower effective spreads for large or more active Nasdaq Global Market securities. However, the difference does not appear to be economically meaningful.

<sup>61</sup> See *id.* at 52.

<sup>62</sup> See *id.* at 53.

<sup>63</sup> See *id.* at 43, 53.

<sup>64</sup> See *id.* at 35.

<sup>65</sup> See *id.*

<sup>66</sup> See *id.* at 36.

<sup>67</sup> See *id.* at 37.

<sup>68</sup> See *id.* at 39.

<sup>69</sup> See *id.*

<sup>70</sup> But, *c.f.*, n.80 and supporting text (noting that one Academic Study did not document that volatility was affected by the size of the security).

Academic Studies.<sup>71</sup> In addition, the Commission held the Regulation SHO Roundtable that focused on the empirical evidence learned from the Pilot.<sup>72</sup> The Academic Studies and Regulation SHO Roundtable contained a variety of observations, which we considered in determining whether or not to propose removal of price test restrictions.

Generally, the Academic Studies and Regulation SHO Roundtable panelists, who were all economists, urged removal of short sale price test restrictions; although they also noted some market quality benefits of these restrictions. The results of the Academic Studies on volatility and price efficiency were largely consistent with the results in the OEA Staff's Draft Summary Pilot Report. However, the conclusions regarding liquidity differed. For example, some of the Academic Studies found that price test restrictions result in narrower spreads than if these restrictions did not apply.<sup>73</sup> Similarly, some Academic Studies found that bid and ask depths are greater when short sale price test restrictions apply.<sup>74</sup> Thus, according to

<sup>71</sup> See *supra* n.12. The Commission notes that although these Academic Studies examined the Pilot data, the Academic Studies vary with respect to the time periods and the composition of the sample securities examined and the methodologies used. Thus, the Commission realizes that differences in findings among the Academic Studies may be due, in part, to the different approaches used for each of the Academic Studies.

<sup>72</sup> See *supra* n.13 (providing a url link to the transcript of the Regulation SHO Roundtable).

<sup>73</sup> See, e.g., Wu at 5, 18. As an explanation for this finding, Wu notes that price test restrictions require short sellers to act as liquidity suppliers because price test restrictions might require short sellers to place more limit orders on the ask side. Wu notes that in the absence of price test restrictions, short sellers demand liquidity by being able to place market orders without restrictions. See *id.*; see also, Alexander and Peterson at 19; Diether, Lee and Werner at 19–23. Although Diether, Lee and Werner find that spreads widen when price test restrictions do not apply for NYSE-listed securities, this study also states that they do not interpret wider spreads as evidence that price tests are effective. See *id.* at 6, 31.

<sup>74</sup> See, e.g., Alexander and Peterson at 19–20 (finding smaller bid and ask depths for NYSE-listed securities included in the Pilot). Alexander and Peterson suggest that bid depth declines because short sale market orders can execute immediately, and when they do, depth at the bid is reduced. As an explanation for the decline in ask depth, Alexander and Peterson suggest that in the absence of short sale price test restrictions, market orders no longer turn into limit orders and, therefore, contribute to the ask depth. See *id.*; see also Diether, Lee and Werner at 20. Diether, Lee and Werner note that the suspension of price tests result in wider spreads because price tests “\* \* \* distort how people trade. Specifically, NYSE short sale orders are treated as liquidity supplying orders so as to comply with the Uptick Rule. As a result, short sellers forgo the option-value of their order flow. Moreover, their opportunities to trade in a timely manner are curtailed. The fact that short-sellers are unable to use marketable orders increases the costs of trading for buyers relying on passive

some of the Academic Studies the Commission received, the Pilot results indicate that removal of price test restrictions may result in a decrease in liquidity.<sup>75</sup> Several panelists at the Regulation SHO Roundtable questioned whether this result, that is, the decrease in liquidity after the removal of price test restrictions, is economically meaningful.<sup>76</sup>

In addition, we note that only one Academic Study examined whether Rule 10a–1 has a different impact on small securities than on large securities and found that the significance of the impact of the removal of Rule 10a–1 at times depended on the size (that is, market capitalization) of the securities examined.<sup>77</sup> While the results of this Academic Study suggest that Rule 10a–1 can have a larger impact on small securities, the specific results are not consistent with the results described in the OEA Staff's Draft Summary Pilot Report described above. For example, although OEA found the effect of Rule 10a–1 on short selling volume did not depend on size, this Academic Study found that removal of Rule 10a–1 resulted in a significant increase in short selling volume only in smaller securities.<sup>78</sup> Similarly, with respect to the widening of spreads following the removal of Rule 10a–1, this Academic Study found that the widening of spreads was more pronounced for smaller rather than larger securities, while OEA documents no relationship between size and spreads in the OEA Staff's Draft Summary Pilot Report.<sup>79</sup> Finally, unlike the OEA Staff's Draft Summary Pilot Report, this Academic Study did not document that volatility was affected by the size of the

pricing strategies (limit orders). In addition, short-sellers effectively “penny” long-sellers using limit orders. Thus, the regulation causes redistribution of welfare away from short-sellers and passive buyers and (long) sellers in favor of active buyers.” *Id.* at 31.

<sup>75</sup> See, e.g., Alexander and Peterson at 2, 20 (providing that the studies' results appear to indicate a decrease in liquidity associated with the removal of price tests). Alexander and Peterson note, however, that “while it is tempting to conclude that price tests improve liquidity, it is more appropriate to view them as distorting liquidity.” *Id.* at 27.

<sup>76</sup> See Roundtable Transcript at 50, 93, 99, 114, 151.

<sup>77</sup> See Wu.

<sup>78</sup> See *id.* at 4, 14 (finding that the increase in short selling volume occurred only in smaller NYSE-listed securities. Wu found that larger NYSE-listed securities did not experience a significant change in short selling volume).

<sup>79</sup> See *id.* at 5, 19 (finding that smaller NYSE-listed securities experience the most pronounced widening of spreads, while larger NYSE-listed securities saw no changes in spreads. Wu noted that an explanation for this result might be that small securities are harder to sell short and are more sensitive to liquidity shocks).

security.<sup>80</sup> Overall, when considering the results in this Academic Study and the OEA Staff's Draft Summary Pilot Report, the evidence regarding the application of price test restrictions to small securities is inconsistent. While there is some evidence supporting the application of price test restrictions to smaller securities, the evidence is not strong enough to warrant its continuation in any subset of securities or the expansion of price test restrictions to securities currently not covered by any price test restrictions.

Consistent with the results in the OEA Staff's Draft Summary Pilot Report, we note that some Academic Studies found that the significance of the impact of the removal of price test restrictions at times depended on which price test restrictions applied.<sup>81</sup> In particular, the magnitude of the changes from removing Rule 10a–1 are larger than the changes from removing former NASD Rule 3350, suggesting that Rule 10a–1 is more restrictive.

Two of the Academic Studies commented on whether the original rationale for adopting Rule 10a–1 in 1938 still applies in today's market. For example, one Academic Study noted that it found “little evidence to support the argument that price tests are needed to prevent short sellers from driving prices down from either shorting ‘successively lower prices’ or ‘exhausting all remaining bids at one price level, causing successively lower prices.’”<sup>82</sup> Another Academic Study noted that there is no empirical support for the rationale underlying the adoption of the tick test that unfettered short selling would produce significant volatility.<sup>83</sup> In addition, nine of the twelve panelists in the Regulation SHO Roundtable explicitly supported removing price test restrictions,<sup>84</sup> though a few of the nine noted a lack of evidence for removing price test restrictions from small securities.<sup>85</sup> The Commission considered these opinions in deciding whether to propose

<sup>80</sup> See *id.* at 16, 20.

<sup>81</sup> See e.g., Alexander and Peterson at 3 (stating that Nasdaq's bid test seems to be relatively inconsequential); see also, Diether, Lee and Werner at 30 (stating that this Academic Study's results show that the “NYSE Uptick Rule has a very different effect on the trading strategies of short-sellers compared to the Nasdaq bid-price rule”).

<sup>82</sup> See Alexander and Peterson at 18.

<sup>83</sup> See Diether, Lee and Werner at 23.

<sup>84</sup> Prof. Werner, Prof. Irvine, Prof. Alexander, Prof. Harris, Prof. Kyle, Prof. Lamont, Prof. Lehmann, Dr. Lindsey and Dr. Sofianos. See Roundtable Transcript at 48, 49, 72, 97, 100, 104, 111, 113, 119. The remaining panelists did not explicitly state an opinion regarding removing price test restrictions.

<sup>85</sup> Dr. Sofianos and Dr. Lindsey. See Roundtable Transcript at 117, 119, 123.

removing price test restrictions for all securities.

### III. Discussion of Proposed Amendments

#### A. Removal of Price Test Restrictions

We are proposing to remove the tick test of Rule 10a-1<sup>86</sup> and add Rule 201 of Regulation SHO<sup>87</sup> to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, we are proposing to prohibit any SRO from having a price test.

Price test restrictions have applied to short sales for almost 70 years. Current short sale regulation is disparate, however, with different price tests applying depending on the type of security being sold and where the short sale order is executed. Rule 10a-1's tick test applies only to short sale transactions in securities listed on a national securities exchange, other than Nasdaq securities, whether the transaction is effected on an exchange or otherwise. The NASD's bid test applies only to short sale transactions in Nasdaq Global Market securities reported to a NASD facility. Nasdaq's bid test applies only to trades in Nasdaq Global Market securities on Nasdaq. In addition, no price test applies to short sales of Nasdaq securities executed on other exchanges trading Nasdaq securities. This disparate regulation has the potential for confusion and compliance difficulties. In addition, we are concerned that this current market structure could competitively disadvantage investors because short sale orders obtain different treatment depending on where the orders are executed.

We also note that small or more thinly-traded securities, such as Nasdaq Capital Market securities and those quoted on the OTCBB and pink sheets continue to be unrestricted by any price test, while large or more actively-traded securities remain subject to a price test. Continuing to impose a price test on only larger securities or those that are more actively-traded would be anomalous, given the greater difficulty of manipulating the price of a security as market capitalization and trading volume increase.<sup>88</sup>

Moreover, we believe that the increasing number of requests for relief from the provisions of Rule 10a-1 that

the Commission has granted in recent years for a wide range of short selling activities have limited the applicability of the rule's price restrictions, potentially created an unlevel playing field among market participants and has indicated to us that current price test restrictions have not kept pace with the wide variety of trading strategies and systems currently used in the marketplace. Rule 10a-1 was adopted in 1938 and its restrictions on short selling have remained essentially unchanged since that time. Thus, we believe that this is an appropriate time to propose amendments that would provide for a more consistent and simpler approach to short sale regulation.<sup>89</sup>

In addition, based on the Pilot Results, we believe that removal of current price test restrictions would not have a significant impact on market quality. The Pilot Results found little evidence suggesting that the removal of the price test restrictions would harm market volatility, price efficiency, or liquidity. In fact, the empirical results indicate that the observed effect of a price test may have a larger negative than positive impact on markets. For example, the OEA Staff's Draft Summary Pilot Report suggests that price test restrictions result in decreased short selling volume.<sup>90</sup> Short selling provides the marketplace with important benefits such as liquidity and price efficiency. The OEA Staff's Draft Summary Pilot Report indicates that price test restrictions may limit these benefits. In addition, the OEA Staff's Draft Summary Pilot Report suggests that price test restrictions result in market participants routing orders to

avoid application of price test restrictions,<sup>91</sup> resulting in a loss of trading volume for market centers that have a price test. Other market centers may use the absence of a price test to their advantage to attract order flow away from market centers that have a price test. Thus, current price test regulation may competitively disadvantage certain investors because their short sale orders may or may not be subject to price test restrictions depending on which market center the order is executed.

As noted above, a primary reason that the Commission adopted Rule 10a-1 in 1938 was to restrict short selling in a declining market.<sup>92</sup> Although there is concern regarding the possibility of manipulation using short sales, we note that the OEA Staff's Draft Summary Pilot Report did not evidence an increase in manipulative short selling during the time period studied.<sup>93</sup> In addition, we believe that the high levels of transparency and sophisticated surveillance for securities traded on exchanges and other regulated markets would allow manipulative or abusive short selling activity to be detected and pursued in the absence of price test restrictions. Moreover, the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security.<sup>94</sup>

In addition, after a review of the Pilot Results, we believe that the empirical analyses not only provide support for removing price test restrictions for either large or actively-traded securities, but also do not provide strong support for extending a price test to either small or thinly-traded securities. For example, the OEA Staff's Draft Summary Pilot Report discusses whether the removal of price test restrictions affects thinly- and actively-traded securities (according to turnover) differently.<sup>95</sup> Generally, the results indicate that neither Rule 10a-1 nor former NASD Rule 3350 affects thinly-traded stocks differently than actively-traded stocks.

The OEA Staff's Draft Summary Pilot Report and one Academic Study also discuss whether the removal of price

<sup>89</sup> We note that in 2003, in the Regulation SHO proposing release, we proposed a price test that, if adopted, would have required that all short sales in covered securities be effected at a price at least one cent above the consolidated best bid at the time of execution. Additionally, the Commission sought comment on an alternative price test that would allow short selling at a price equal to or above the consolidated best bid if the current best bid was above the previous bid (i.e. an upbid). Under this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid if the current best bid was below the previous bid (i.e. a downbid). See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) (the "Regulation SHO Proposing Release"). Based on the comments received to that proposal, however, the Commission determined to defer consideration of the proposed uniform bid test until after completion of the Pilot. See Regulation SHO Adopting Release at 48010. Although a uniform bid test similar to that proposed in the Regulation SHO Proposing Release would also result in consistent price test regulation, based on our review of the applicability of current price test restrictions, in particular, the need for such price test restrictions in light of today's market structure and the Pilot Results, we do not believe that any price test restrictions are currently necessary.

<sup>90</sup> See OEA Staff's Draft Summary Pilot Report at 35.

<sup>91</sup> See *id.* at 36.

<sup>92</sup> See *supra* n.3.

<sup>93</sup> See OEA Staff's Draft Summary Pilot Report at 47-51 (discussing the Pilot data in connection with "bear raids"). We note that the OEA Staff's Draft Summary Pilot Report did not evaluate the impact of short selling activity in connection with extraordinary events, such as initial or secondary public offerings, mergers and acquisitions or private placements.

<sup>94</sup> See *supra* n.16.

<sup>95</sup> See OEA Staff's Draft Summary Pilot Report Section VI.E. at 51-54 and Wu at 4-5, 19-20.

<sup>86</sup> 17 CFR 240.10a-1.

<sup>87</sup> *Id.* at 242.201.

<sup>88</sup> See Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28, 1999) (noting that some of the Commission's anti-manipulation rules assume that highly liquid securities are less susceptible to manipulation and abuse than other securities).

test restrictions affect small and large stocks differently (according to market capitalization). These studies provide inconsistent results regarding whether Rule 10a-1 has a larger impact on the liquidity and volatility of smaller rather than larger securities. In addition, several Regulation SHO Roundtable panelists asserted that price test restrictions are unnecessary in smaller stocks because these stocks are harder to borrow and, therefore, are less likely to be sold short.<sup>96</sup>

Overall, because the results suggest that price test restrictions affect thinly-traded securities no differently than actively-traded securities and the results are inconsistent regarding the effects of price test restrictions on large and small stocks, we believe the current evidence is not strong enough to warrant a proposal to continue imposing price test restrictions on only a subset of either small or thinly-traded securities, or to extend price test restrictions to securities currently not subject to any price test restrictions. We request comment, however, regarding whether or not price test restrictions should apply to securities not currently covered by any price test restrictions.

We also note that current price test restrictions impose costs on market participants in terms of time and technology. For example, to comply with the tick test of Rule 10a-1, short sellers may incur additional transactional costs as they await a proper tick for execution. Moreover, in some cases, the tick test of Rule 10a-1 can create potential conflicts with best execution responsibilities (although the Commission has provided relief to minimize these instances).<sup>97</sup>

In addition, we are aware that in a decimals environment, with penny or even sub-penny price points and narrow spreads, a short seller can await or create an uptick with minimal burden.

<sup>96</sup> See Roundtable Transcript at 122-130.

<sup>97</sup> For example, as previously described by the Commission, "in order to resolve a potential conflict between the tick test and the quote rule, the Commission adopted (e)(5)(ii) to permit market makers to execute transactions at their offer following a trade-through, and (e)(11) to permit non-market makers to effect a short sale at a price equal to the price associated with their most recently communicated offer up to the size of that offer so long as the offer was at a price, when communicated, that was permissible under Rule 10a-1. The (e)(11) exception was added in response to several comments that, in addition to orders for their own account, specialists and other floor members also often represent as part of their displayed quotations orders of other market participants (e.g., public agency orders or proprietary orders of non-market makers) that also might be ineligible for execution under Rule 10a-1 following a trade-through in another market." Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972, 62986 (November 6, 2003).

On the other hand, in a decimals environment, the tick test of Rule 10a-1 may be triggered by a change in price that reflects an extremely small decrease in the price of the security. We do not believe that a price change as small as one penny per share results in the type of market impact that Rule 10a-1 was designed to prevent. Rather, we believe that current price test restrictions may have become unduly burdensome and are possibly ill-suited to present and future markets.

Thus, for all these reasons, we believe that this is an appropriate time to modernize and simplify price test regulation by proposing to remove Rule 10a-1's tick test and add Rule 201(a) of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any securities.

In addition, we are proposing to add Rule 201(b) of Regulation SHO that would provide that no SRO shall have a price test. A primary goal of the proposed amendments is to achieve greater regulatory consistency and simplification. To date, we have permitted SROs to adopt their own price tests. As noted above, this has resulted in a regulatory environment that applies different tests to securities trading in different markets, and even to the same security trading in different markets. We believe that by proposing to require that no SRO shall have its own price test, the goals of regulatory simplification and consistency would be better met.

We are aware, however, that some SROs may want to maintain or adopt a new price test. For example, we are aware that previously, SROs have adopted price tests to attract issuers concerned about the potential effects of short selling on the issuer's stock price. Thus, we solicit comment regarding whether we should allow SROs to have their own price tests.

Regardless of whether or not we adopt the proposed amendments, however, the Commission and the SROs will continue to monitor for, and pursue, abusive trading activities. In addition, as already noted, the general anti-fraud and anti-manipulation provisions of the federal securities laws will continue to prohibit trading activity that improperly influences the price of a security.<sup>98</sup>

#### Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Rule 10a-1 and

<sup>98</sup> In addition, as noted previously, this proposal would not amend any short selling regulations other than those related to price tests. See *supra* n.15.

Regulation SHO. In addition, we seek comment on the following:

- The proposed amendments state that no "short sale price test" shall apply to short sales in any security. Should we define the term "short sale price test" for purposes of these amendments?
- Some SROs have adopted price tests to attract issuers concerned about the potential effects of short selling on the issuer's stock price. The proposed amendments would prohibit any SRO from having its own price test. If the Commission removes Rule 10a-1, should the Commission continue to allow the SROs to adopt their own price tests? Should the Commission require uniformity with respect to any SRO price tests? Should any such SRO price tests be limited to certain securities? What would be the costs and benefits of allowing the SROs to adopt their own price tests?
- We request comment from issuers regarding their views of the impact of the proposed amendments on their securities. Are issuers concerned that unrestricted short selling could result in undue downward price pressure on their company's stock? Are issuers concerned that the proposed amendments could result in manipulative short selling of their company's stock? Alternatively, would these concerns be mitigated because the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security? Please submit any available empirical evidence of manipulation of pilot stocks.
- To what extent does the tick test of Rule 10a-1 impose market costs on traders desiring to sell short? For example, if the removal of price test restrictions were to result in wider spreads, could this result in higher transaction costs for all traders? What would be the impact on investors? Would the removal of the price test restrictions result in shifting higher trading costs from short sellers to other traders? To what extent would such costs justify any benefits of removing price test restrictions?
- Would the removal of price tests benefit the markets by allowing investors to more freely short sell potentially over-valued securities so that the security's price more accurately reflects its fundamental value? Would the removal of price tests lead to benefits such as a reduction in costs associated with systems and surveillance costs? What would be the costs to the markets of removing price

tests? Please provide any quantified evidence available.

- To what extent does the tick test of Rule 10a-1 affect the ability to sell short in a decimals environment? Please explain any difficulties of complying with the tick test or any other price test in a decimals environment. In light of all the exemptions from, and exceptions to, Rule 10a-1, how significant a test is it? On what types of trading activities does Rule 10a-1 have a significant or meaningful impact? Similarly, in light of the exceptions to NASD Rule 5100 and Nasdaq Rule 3350, how significant are these tests? On what types of trading activities do NASD Rule 5100 and Nasdaq Rule 3350 have a significant or meaningful impact? Please explain.

- To what extent, if any, is retention of price test restrictions valuable for investor confidence to commit capital to the markets?

- Is the tick test in Rule 10a-1 appropriate for some securities but not all securities? If the Commission were to maintain a price test for some securities, which types of securities should be subject to a price test?

- We note that in 2003, in the Regulation SHO Proposing Release, we proposed adopting a price test using the consolidated best bid as a reference point for permissible short sales.<sup>99</sup> Should the Commission adopt a new price test, such as a uniform bid test, that would replace all current price tests, including those of any exchange or national securities association? If so, should the new price test apply to all securities, including those not currently subject to a price test? What should be the requirements of any new price test?

- If the Commission were to maintain the tick test contained in Rule 10a-1, should the Commission amend the tick test to apply to all markets or securities equally?

- If the Commission were to maintain the tick test contained in Rule 10a-1, which, if any, of the exceptions contained in paragraph (e) of Rule 10a-1 should the Commission retain? Please explain. Should the Commission include exceptions not currently in Rule 10a-1? What should those exceptions address?

- If the Commission were to retain the tick test contained in Rule 10a-1, should the Commission codify all the exemptions the Commission has previously granted from this rule? If not all the exemptions, which exemptions should the Commission codify?

- NASD Rule 5100 and Nasdaq Rule 3350 contain exceptions for bona-fide market making. If the Commission were

to retain the tick test contained in Rule 10a-1 or adopt a new price test, should such price test include an exception for bona-fide market making? If the Commission were to continue to allow for a market maker exception in NASD Rule 5100 or Nasdaq Rule 3350 or adopt a price test that contains a market maker exception, should the Commission limit the applicability of the exception? How should it be limited? What would be the purpose of such limitations?

- We request specific comment regarding the importance of retaining a market maker exception, for example, with respect to liquidity, price efficiency, market depth, speed of execution and flexibility for capital commitment.

- Should the Commission retain a price test for times during which there are unusual market declines? If so, please discuss what type of price test should be retained and under what types of circumstances such a price test should be applied?

- To what extent, if at all, would removal of price test restrictions impact the ability of short sellers to be liquidity providers versus liquidity demanders?

- If the Commission were to maintain the current tick test of Rule 10a-1 or adopt a new price test, should the price test apply only during regular market hours or should the price test apply regardless of when trades occur? What are the benefits and costs of applying price tests in the after-hours market?

- To what extent does real-time access to information regarding issuers, their respective industries and other influences on a security's price reduce the ability to manipulate prices in declining markets through short selling?

- To what extent is a price test an impediment to trading in a down market? Is it preferable to allow unimpeded short selling in a down market? Are there circumstances where such trading should not be permitted?

- Would removal of all price test restrictions result in the markets being truly representative of what is a fair price for an individual security?

- Are there any technical or operational challenges that would arise in complying with the proposal if the Commission were to adopt the proposal?

- How much would the proposed amendments affect specific compliance costs or other costs for small, medium and large entities (brokers, dealers, and SROs)?

- Would the proposed amendments create additional costs for, or otherwise impact, short sellers, issuers, investors, or others?

- Should we provide a compliance date, separate from an effective date, if the Commission were to adopt the proposed amendments? If yes, please explain why a compliance date would be appropriate and give suggestions as to how long a compliance period would be needed.

- Nine reporting markets have been making public information on short selling transactions.<sup>100</sup> This information was vital to the study of the Pilot.

Would it be in the public interest to request that the markets continue to release this information? In particular, would it improve transparency of short selling? Would it help the Commission and the markets monitor for potential abuses if the Commission were to approve the removal of price tests? How costly would continuing to produce the data be? Are there any less costly alternatives to the current information being released by the markets?

- If the Commission were to adopt the proposed amendments, the Commission and the SROs would continue to monitor for manipulative activity. Should the Commission ask the SROs to submit periodic reports regarding the effects of the removal of price tests at regular intervals, for example, on a semi-annual or annual basis? What would be the costs associated with such reporting?

- Is the data from the Pilot sufficient for the purposes for which the Commission is using it? Is the data reliable? Are there any limitations in the Pilot Results that call the results and conclusions into question?

- The Pilot created a temporary rule amendment that affected a subset of securities trading in the market. To what extent would a permanent rule amendment applied to all stocks affect the market differently than the Pilot?

#### *B. Removal of "Short Exempt" Marking Requirement*

We are proposing to amend Rule 200(g) of Regulation SHO<sup>101</sup> to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt" if the seller is relying on an exception from the tick test of Rule 10a-1, or any price test of any exchange or national securities association.

Rule 200(g) of Regulation SHO provides that a broker-dealer must mark all sell orders of any security as "long," "short," or "short exempt."<sup>102</sup> Further, Rule 200(g)(2) of Regulation SHO provides that a short sale order must be

<sup>100</sup> See *supra* n.11.

<sup>101</sup> 17 CFR 242.200(g).

<sup>102</sup> See *id.*

<sup>99</sup> See *supra* n.89.

marked “short exempt” if the seller is “relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association.”<sup>103</sup> The “short exempt” marking requirement provides a record that short sellers are availing themselves of the various exceptions to, or exemptions from, the application of the restrictions of Rule 10a-1 or of any price test of any exchange or national securities association. However, if the Commission were to adopt the proposals to remove all price test restrictions, as well as prohibit any price test by any SRO, the “short exempt” marking requirement would no longer be applicable. Thus, we are proposing to remove this marking requirement. Broker-dealers would, however, continue to be required to mark sell orders as either “long” or “short” in compliance with Rule 200(g).<sup>104</sup>

#### Request for Comment

- If the Commission were to adopt the proposal to remove the “short exempt” marking requirement of Rule 200(g) of Regulation SHO, would it be sufficient to require broker-dealers to mark all sell orders of any equity security as either “long” or “short”? Under what circumstances, if any, would broker-dealers need to mark sell orders other than as “short” or “long”?

- To facilitate the application of Rule 10a-1, NASD Rule 5100, and Nasdaq Rule 3350, market makers and specialists receive information allowing them to distinguish short sales from other sales. In other words, the information on whether an order is marked “long,” “short,” or “short exempt” is made transparent to market makers and specialists but not to other market participants or the public. In the absence of price test restrictions, would the marking of sell orders need to be transparent to market makers and specialists? Would there be any systems or market quality costs/benefits associated with not revealing this information to specialists and market makers?

- Would there be any costs or burdens associated with removing the “short exempt” marking requirement of Rule 200(g) of Regulation SHO? If so, please explain.

#### IV. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Rule 10a-1 and

Regulation SHO. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendments to Rule 10a-1 and Regulation SHO. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

#### V. Paperwork Reduction Act

The proposed amendments to Regulation SHO would impose a “collection of information” within the meaning of the Paperwork Reduction Act of 1995;<sup>105</sup> however, the collection of information is covered by the approved collection for Exchange Act Rule 19b-4.<sup>106</sup> Proposed Rule 201(a) of Regulation SHO provides that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, proposed Rule 201(b) of Regulation SHO would prohibit any SRO from having a price test. Thus, to the extent that any SRO currently has a price test, that SRO would be required to amend its rules to comply with these proposed amendments to Regulation SHO. Any such amendments would need to be filed with the Commission as proposed rule changes, pursuant to Section 19(b) of the Exchange Act<sup>107</sup> and Rule 19b-4 thereunder. This collection of information, however, would be collected pursuant to Exchange Act Rule 19b-4 and, therefore, would not be a new collection of information for purposes of the proposed amendments.

#### VI. Consideration of Costs and Benefits of Proposed Amendments to Rule 10a-1 and Regulation SHO

The Commission is considering the costs and benefits of the proposed amendments to Rule 10a-1 and Regulation SHO. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here. In particular, the Commission requests comment from all market participants regarding the costs and benefits of unrestricted short selling activity. The Commission also requests comment regarding the costs associated with complying with the proposed

amendments, if the Commission were to adopt the proposed amendments. Specifically, we seek comment regarding any costs relating to the removal of price test restrictions adopted by the SROs. In addition, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Rule 10a-1 and Regulation SHO.

#### A. Removal of Price Test Restrictions

##### 1. Benefits

The proposed amendments would remove the tick test of Rule 10a-1 and provide that no SRO shall have a price test. We believe that this is an appropriate time to propose removing existing price test restrictions because the current regulation is disparate, potentially creates an unlevel playing, allows for regulatory arbitrage and has not kept pace with the types of trading systems and strategies currently used in the marketplace. In addition, today’s markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of undetected manipulation and permit regulators to monitor for the types of activities that Rule 10a-1 and other price tests are designed to prevent.

The Commission believes that removal of all price test restrictions would benefit market participants by providing market participants with the ability to execute short sales in all securities in all market centers without regard to price test restrictions. In addition, market centers would be competing for executions on a level playing field because they would not be affected by the existence or non-existence of price test restrictions.

The Commission believes that removing price test restrictions would be preferable to applying different tests in different markets, which can require market participants to apply different rules to different securities depending on which market the trade is executed. Thus, the proposed amendments would reduce confusion and compliance difficulties for market participants.

<sup>103</sup> See *id.* at 242.200(g)(2).

<sup>104</sup> See *id.* at 242.200(g).

<sup>105</sup> 44 U.S.C. 3501 *et seq.*

<sup>106</sup> 17 CFR 240.19b-4.

<sup>107</sup> 15 U.S.C. 78s(b).

We also believe that the proposed amendments would benefit exchanges and other market centers because market participants would no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The proposed amendments would remove a competitive disadvantage purportedly experienced by some market centers because market participants would no longer route orders to avoid application of a market center's price test. Nor would market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test.

In addition, the proposed amendments would result in benefits associated with systems and surveillance mechanisms because these systems and mechanisms would no longer need to be programmed to account for price test restrictions based on last sale and last bid information. We also note that in the absence of price test restrictions, new staff (compliance personnel, broker-dealers, etc.) would no longer need to be trained regarding rules relating to price tests. Over the long run, we believe this would likely lead to decreased training and compliance costs for market participants.

We are aware that the degree of restrictiveness of a price test may affect how well a security's price represents a company's true financial value. We seek comment regarding whether the absence of price test restrictions would result in prices that are a better reflection of a company's true financial value.

In addition, we seek estimates and views regarding the benefits to particular types of market participants as well as any other benefits that may result from the adoption of the proposed amendments. Please provide any specific data.

We also believe that the proposed amendments would lead to a reduction in costs because market participants and their lawyers, both in-house and outside counsel, would no longer need to make either informal (phone calls) or formal (letters) requests for exemptions from Rule 10a-1. We request empirical data to quantify this benefit.

We anticipate that broker-dealers, including specialists and market makers in listed securities, could provide greater liquidity in the marketplace because the absence of price test restrictions would make it easier for market participants to fill orders. In addition, an increase in trading volume resulting from the removal of price test restrictions could result in increased

price efficiency because prices may more fully reflect both buy and sell interest.

We solicit comment on any additional benefits that could be realized if the Commission were to adopt the proposed amendments, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

## 2. Costs

In order to comply with the Pilot when it became effective on May 2, 2005, market participants needed to modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from all price test restrictions. The Pilot exempts a select group of securities from price test restrictions during regular trading hours. Between the close of the consolidated tape and the open of the consolidated tape on the following day, however, all equity securities are exempted from price test restrictions. Thus, we believe that the infrastructure necessary to comply with the proposed amendments should, for the most part, already be in place. Any additional changes to the infrastructure should be minimal. In addition, because the proposed amendments would remove all price test restrictions, rather than for example, imposing a modified price test, we believe that further changes to systems and surveillance mechanisms or procedures should be relatively minor. Nor do we believe that market participants would need to incur costs to purchase new systems, or increase staffing based solely on the implementation of the proposed amendments.

In addition, the proposed amendments would remove a restriction on trading activity with which market participants must currently monitor for compliance. Thus, we do not believe that the proposed amendments would impose additional compliance costs. Moreover, we believe that any costs incurred to modify, establish or implement existing or new supervisory and compliance procedures due to the proposed amendments would be minimal because market participants should currently have in place supervisory or compliance procedures to monitor for trading activity that current price test restrictions are designed to prevent.

We seek comment as to how the proposed amendments would affect costs for market participants. We believe that market participants, including broker-dealers and SROs, would incur

costs related to systems changes to computer hardware and software, reprogramming costs, or surveillance costs that could be necessary to comply with this proposed rule. We believe that these costs would be on a one-time basis. We solicit comment on these costs as well as whether these costs would be incurred on a one-time or ongoing basis.

We also note that if the Commission were to adopt the proposed amendments, all SROs that have adopted price test restrictions would have to remove such price tests. As discussed above, the NASD and Nasdaq have their own bid tests that, under the proposed amendments, would no longer be applicable. In addition, some exchanges have adopted short sale rules in conformity with the provisions of the tick test of Rule 10a-1, which also would no longer be applicable if the Commission were to adopt the proposed amendments. We believe the SROs could incur costs associated with the processes to remove such rules, including filing rule changes with the Commission, as well as reprogramming systems designed to enforce these rules. We request comment regarding these costs, including costs relating to preparing and filing any necessary rule changes with the Commission.

Based on the Pilot Results, we believe that removing the tick test of Rule 10a-1 and providing that no price test, including any price test of any SRO, shall apply to short sales in any security, has the potential to increase transaction costs, decrease quoted depth and increase intraday price volatility, particularly in small stocks. The Pilot Results suggest, however, that these changes are small in magnitude and would not significantly increase costs or reduce liquidity.

We seek comment regarding the following specific costs:

- What are the economic costs of removing the tick test of Rule 10a-1 and any price test of any SRO for all securities? How would this affect the liquidity and transaction costs of equity securities? How would this affect the quoted depth and the price volatility of equity securities? Would the effects be more severe for liquid or illiquid securities? Would the effects be more severe for small or large securities?
- Are there any other costs associated with the proposal?
- How much would the removal of price test restrictions affect the compliance costs for small, medium, and large market participants (e.g., personnel or system changes)? We seek comment on the costs of compliance that could arise as a result of these proposed amendments. For instance, to

comply with the proposed amendments, would market participants be required to:

- Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?

- Increase staffing and associated overhead costs? Would market participants have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, *e.g.*, would retrained staff be unable to perform existing duties in order to comply with the proposed amendments? Would other resources need to be re-dedicated to comply with the proposed amendments?

- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.

- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

- Are there any other costs that may be incurred to comply with the proposed amendments?

#### B. Removal of "Short Exempt" Marking Requirement

##### 1. Benefits

The proposed amendment would remove the "short exempt" marking requirement of Rule 200(g) of Regulation SHO.<sup>108</sup> Rule 200(g)(2) of Regulation SHO provides that a short sale order must be marked "short exempt" if the seller is "relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association."<sup>109</sup> Thus, if the Commission were to adopt the proposed amendments that would remove all price test restrictions, as well as prohibit any SRO from having a price test, the "short exempt" marking requirement would no longer be applicable.

##### 2. Costs

Some market participants, including broker-dealers and SROs, may have to reprogram systems and update supervisory procedures due to the removal of the "short exempt" marking requirement. Sales of securities previously marked "short exempt," however, would continue to be marked either "long" or "short." Thus, we believe that such costs would be minor. We seek comment, however, on these and any additional costs that could be incurred, as well as specific data to support such costs.

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

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.<sup>110</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>111</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments would remove the price test restrictions of Rule 10a-1<sup>112</sup> and provide that no price test, including any price test of any SRO, shall apply to short sales in any security. The proposed amendments would also prohibit any SRO from having a price test. In addition, the proposed amendments would remove the "short exempt" marking requirement of Rule 200(g) of Regulation SHO because this marking requirement applies only if the seller is relying on an exception from the tick test of Rule 10a-1 or any short sale price test of any exchange or national securities association.

Current short sale regulation is disparate. For example, Rule 10a-1 applies only to short sale transactions in listed securities. The NASD's and Nasdaq's bid tests apply only to Nasdaq Global Market securities. No price tests apply to short sales in Nasdaq Capital Market securities or securities quoted on the OTCBB or pink sheets. In addition,

no price test applies to short sales of Nasdaq Global Market securities executed on exchanges trading Nasdaq securities on a UTP basis, unless the market on which the securities are being traded has adopted its own price test. Moreover, the current exceptions to, and exemptions from, the price tests for a wide range of short selling activities, have limited the applicability of the restrictions contained in these rules. The end result is inconsistent short sale regulation of securities, depending on the market where the securities are trading, and the type of short selling activity. Thus, the proposed amendments are intended to promote regulatory simplification and uniformity by no longer applying any price test restrictions on short selling.

We believe that the proposed amendments would not harm efficiency because the empirical evidence from the Pilot Results shows that the Pilot did not adversely impact price efficiency. Further, market participants would no longer have to apply different price tests to securities trading in different markets. We seek comment on whether the proposed amendments promote price efficiency, including whether the proposals might impact the potential for manipulative short selling.

In addition, we believe that the proposed amendments would not have an adverse impact on capital formation because the empirical evidence from the Pilot Results shows that the price tests have very little impact on overall market quality and, particularly in large securities, may be harmful to overall market quality. We solicit comment on whether the proposed amendments would promote capital formation, including to what extent the proposed removal of price test restrictions would affect investors' decisions to sell short certain equity securities.

We believe that the proposed amendments would promote competition among exchanges and other market centers because market participants would no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The proposed amendments would remove a purported competitive disadvantage experienced by some market centers because market participants would no longer route orders to avoid application of a market center's price test. Nor would market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test. Moreover, the proposed amendments would level the playing field for all market participants by requiring that no price test shall apply

<sup>108</sup> 17 CFR 242.200(g).

<sup>109</sup> See *id.* at 242.200(g)(2).

<sup>110</sup> 15 U.S.C. 78c(f).

<sup>111</sup> 15 U.S.C. 78w(a)(2).

<sup>112</sup> 17 CFR 242.10a-1.

to any short sale in any security in any market.

We solicit comment on whether the proposed amendments would promote competition, including whether market participants' decisions regarding on which market to execute a short sale would be affected by the removal of all price test restrictions.

We request comment on whether the proposed amendments would be expected to promote efficiency, competition, and capital formation.

### VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>113</sup> we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries;

or

- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

### IX. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA),<sup>114</sup> regarding the proposed amendments to Rule 10a-1 and Regulation SHO, Rules 200 and 201, under the Exchange Act.

#### A. Reasons for the Proposed Action

Based on the Pilot Results as well as our review of the status of short sale regulation in the context of the current application of Rule 10a-1 and other price tests, including the exceptions to the current rules and grants of relief from Rule 10a-1 by the Commission for a wide range of short selling activities, we are proposing to remove the tick test of Rule 10a-1 and to amend Regulation

SHO to provide that no price test, as well as any price test by any SRO, shall apply to short selling in any security. In addition, the proposed amendments would prohibit any SRO from having a price test. These amendments are designed to modernize and simplify short sale regulation in light of current short selling systems and strategies used in the marketplace, while providing greater regulatory consistency to short selling. We are also proposing to remove the "short exempt" marking requirement of Regulation SHO because this requirement only applies if a seller is relying on an exception to a price test.

#### B. Objectives

The proposed amendments are designed to provide consistent regulation for short selling in all securities regardless of when or where such trades occur by removing all price test restrictions. In addition, the proposed amendments are intended to provide greater flexibility in effecting short sales because market participants would no longer be constrained by price test restrictions. Moreover, in light of the number of exemptions the Commission has granted under Rule 10a-1 for a wide range of short selling activities, the proposed amendments are designed to accommodate trading strategies and systems currently utilized in the marketplace that conflict with current price test restrictions. The proposed amendment to the "short exempt" marking requirement of Rule 200(g) of Regulation SHO<sup>115</sup> is necessary because this requirement only applies if a seller is relying on an exception to a price test.

#### C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78f, 78i, 78j, 78k-1, 78o, 78o-3, 78q, 78s, 78w(a), the Commission is proposing to remove Rule 10a-1, § 240.10a-1 and to amend Regulation SHO, §§ 242.200 and 242.201.

#### D. Small Entities Subject to the Rule

The entities covered by the proposed rule would include small broker-dealers, small businesses, and any investor who effects a short sale that qualifies as a small entity. Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10 under the Exchange Act<sup>116</sup> states that the term "small

business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2005, the Commission estimates that there were approximately 910 broker-dealers that qualified as small entities as defined above.<sup>117</sup>

Paragraph (e) of Rule 0-10 under the Exchange Act<sup>118</sup> states that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) Has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10. No national securities exchanges are small entities because none meets these criteria. There is one national securities association (NASD) that would be subject to these proposed amendments. NASD is not a small entity as defined by 13 CFR 121.201.

Any business, however, regardless of industry, could be subject to the proposed amendments if it effects a short sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the proposed rule is not feasible.

#### E. Reporting, Recordkeeping, and other Compliance Requirements

The proposed amendments may impose some new or additional reporting, recordkeeping, or compliance costs on any affected party, including broker-dealers, that are small entities.

In order to comply with the Pilot when it became effective on May 2, 2005, small entities needed to modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from current price test restrictions. Thus, the systems and surveillance mechanisms required to comply with the proposed amendments should already be in place. We believe that any necessary additional systems and surveillance changes would be small because, due to the Pilot, systems are currently programmed to exempt

<sup>113</sup> Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>114</sup> 5 U.S.C. 603.

<sup>115</sup> 17 CFR 242.200(g).

<sup>116</sup> 17 CFR 240.0-10(c)(1).

<sup>117</sup> These numbers are based on OEA's review of 2005 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

<sup>118</sup> 17 CFR 240.0-10(e).

many securities from price test restrictions prior to the close of the consolidated tape and exempt all securities from price test restrictions between the close of the consolidated tape and the open of the consolidated tape on the following day.

We believe that any reprogramming costs or updating of surveillance mechanisms associated with the removal of the "short exempt" marking requirement should be minimal because sales of securities would continue to be required to be marked either "long" or "short." The proposed amendments, if adopted, would merely remove an alternative marking requirement.

We solicit comment on what new recordkeeping, reporting or compliance requirements may arise as a result of these proposed amendments.

#### *F. Duplicative, Overlapping or Conflicting Federal Rules*

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

#### *G. Significant Alternatives*

The RFA directs the Commission to consider significant alternatives that will accomplish the stated objective, while minimizing any significant adverse impact on small entities. Pursuant to Section 3(a) of the RFA,<sup>119</sup> the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The proposed amendments are intended to modernize and simplify price test regulation by removing restrictions on the execution prices of short sales contained in current price tests, such as Rule 10a-1. As such, we

believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the goal of this proposal. In addition, we have concluded similarly that it would be inconsistent with this goal of the proposed amendments to further clarify, consolidate or simplify the proposed amendments for small entities. Finally, the proposed amendments would impose performance standards rather than design standards.

#### *H. Request for Comments*

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on (i) the number of small entities that will be affected by the proposed amendments; and (ii) the existence or nature of the potential impact of the proposed amendments on small entities. Those comments should specify costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the objective of the proposed amendments.

#### **X. Statutory Authority**

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 23(a) thereof, 15 U.S.C. 78b, 78c, 78f, 78i, 78j, 78k-1, 78o, 78o-3, 78q, 78q-1, 78w(a), the Commission is proposing to remove Rule 10a-1, § 240.10a-1 and to amend Regulation SHO, §§ 242.200 and 201.

#### **Text of the Proposed Amendments to Rule 10a-1 and Regulation SHO**

##### **List of Subjects in 17 CFR Parts 240 and 242**

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

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

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

1. The general authority citation for part 240 is revised to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78l, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et. seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

#### **§ 240.10a-1 [Removed and reserved]**

2. Section 240.10a-1 is removed and reserved.

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

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

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

\* \* \* \* \*

4. Section 242.200 is amended by revising the introductory text of paragraph (g) to read as follows and by removing and reserving paragraph (g)(2):

#### **§ 242.200 Definition of "short sale" and marking requirements.**

(g) A broker or dealer must mark all sell orders of any equity security as "long" or "short."

\* \* \* \* \*

5. Section 242.201 is added to read as follows:

#### **§ 242.201 Price test.**

(a) No short sale price test, including any short sale price test of any self-regulatory organization, shall apply to short sales in any security.

(b) No self-regulatory organization shall have any rule that is not in conformity with, or conflicts with, paragraph (a) of this section.

Dated: December 7, 2006.

By the Commission.

Nancy M. Morris,  
Secretary.

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<sup>119</sup> 5 U.S.C. 603(c).