

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

Since the Concept Release was published, we have reviewed the comment letters and reexamined the structure and operation of Rule 10a-1, and related Rules 10a-2<sup>8</sup> and 3b-3.<sup>9</sup> We also considered the status of short sale regulation in the context of requests for relief from Rule 10a-1 submitted to the Commission for a wide range of short selling activities. Finally, we considered recent market changes, including increased instances of “naked” short selling, *i.e.*, selling short without borrowing the necessary securities to make delivery; decimalization; the advent of security futures trading; and an increasing amount of Nasdaq securities being traded away from the Nasdaq market, and thus not subject to any short sale price test. As a result of this assessment, we are seeking comment on proposed Regulation SHO, which would replace Rules 3b-3, 10a-1, and 10a-2, and that would temporarily suspend the short sale price test for specified liquid stocks. We also propose to amend Rule 105 of Regulation M to eliminate the shelf offering exception. The comments we receive will assist us in determining whether to adopt the proposed changes to these rules and the nature and scope of such changes.

#### A. Background and Current Short Sale Regulation

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>10</sup> In order to deliver the security to the purchaser, the

short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

The following example illustrates a typical short sale transaction:

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

Section 10(a) of the Exchange Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities

exchange (listed securities), as necessary to protect investors. After conducting an inquiry into the effects of concentrated short selling during the market break of 1937, the Commission adopted Rule 10a-1 in 1938 in order to restrict short selling in a declining market.<sup>13</sup> The core provisions of the Rule are largely the same today as when they were adopted.

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

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

<sup>13</sup> Securities Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

<sup>14</sup> Rule 10a-1 uses the term “effective transaction reporting plan” as defined in Rule 11Aa3-1 (17 CFR 240.11Aa3-1) under the Exchange Act. See 17 CFR 240.10a-1(a)(1)(i).

<sup>15</sup> The last sale price is the price reported pursuant to an effective transaction reporting plan, *i.e.*, the Consolidated Tape Association, also generally referred to as the “Tape.”

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

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

<sup>6</sup> Securities Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28, 1999).

<sup>7</sup> The comment letters and a comprehensive summary of the comments are available for inspection in the Commission's Public Reference Room in File No. S7-24-99.

<sup>8</sup> 17 CFR 240.10a-2.

<sup>9</sup> 17 CFR 240.3b-3.

<sup>10</sup> See Rule 3b-3 under the Exchange Act, 17 CFR 240.3b-3.

<sup>11</sup> See, *e.g.*, 12 CFR 220.12(c)(1) of Regulation T of the Board of Governors of the Federal Reserve System, which requires margin for a short sale of a nonexempted equity security of 150 percent of the current market value of the security. An investor may be required to deposit additional “maintenance margin” for transactions in short sales under margin requirements imposed by self regulatory organizations (SROs). See, *e.g.*, NASD Rule 2520(c) and NYSE Rule 431(c). Further, broker-dealers may institute higher short sale margin requirements than those imposed by self-regulatory organization rules. See, *e.g.*, NASD Rule 2520(d) and NYSE Rule 431(d).

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