



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>18</sup>

In 1994, the Commission granted temporary approval to the NASD to apply its own short sale rule to Nasdaq

NMS securities.<sup>19</sup> NASD Rule 3350 prohibits short sales by NASD members in Nasdaq NMS Securities<sup>20</sup> at or below the current best (inside) bid when that bid is lower than the previous best (inside) bid (commonly referred to as the bid test).

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

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

#### B. Market Effects of Short Selling

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

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates or hedges against a downward

movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.<sup>22</sup>

Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices.<sup>23</sup> One

example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest.<sup>24</sup> Further, unrestricted short selling can exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons.

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

#### C. Market Developments

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

<sup>18</sup> See Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976).

<sup>19</sup> See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

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

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

<sup>22</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>23</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 (2d 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>24</sup> Many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash. See 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203-04, note 213 (3d ed. 1989).

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

<sup>26</sup> *Id.*