

commenters to the Concept Release took that position.⁶¹ A substantial number of other commenters disagreed and expressed support for a price test.⁶² We do not believe that proposing complete rescission of the short sale price test would be appropriate at this time, although we request comment about that approach. Instead, we propose a new, uniform price test that would apply to today's markets, and a pilot that would permit us to gather data about trading activity in the absence of a short sale price restriction.

IV. Proposed Bid Test

Current short sale regulation applies different price tests to securities trading in different markets. Rule 10a-1 applies only to short sale transactions in securities listed on a national securities exchange, whether the transaction is effected on an exchange or otherwise. The NASD's bid test applies to short sale transactions in Nasdaq NMS securities effected on either SuperMontage or the NASD's Alternative Display Facility (ADF), but not to Nasdaq SmallCap, OTCBB, and other securities traded over-the-counter. Moreover, no short sale price test applies to short sales of Nasdaq NMS securities executed away from SuperMontage and the ADF, unless the market on which the securities are being traded has adopted its own price test.⁶³ The end result is disparate short sale regulation of Nasdaq securities, depending on the market where the securities are trading. This situation may lend itself to regulatory arbitrage.⁶⁴

We note that Nasdaq has also applied to become a national securities exchange.⁶⁵ If Nasdaq becomes an exchange, Rule 10a-1 would apply to

Nasdaq securities because they would be exchange-listed securities reported pursuant to an "effective transaction reporting plan." Nasdaq has applied for relief from Rule 10a-1 in conjunction with the exchange registration.⁶⁶ The Commission has not yet acted upon the application. If the Commission were to grant an exemption from Rule 10a-1 to allow Nasdaq to apply Rule 3350 to Nasdaq exchange-listed securities, the same securities quoted and traded on Nasdaq and other exchanges would be subject to two different short sale rules. This has the potential for confusion and compliance difficulties. We believe that these considerations, along with the other market developments discussed previously, make this an appropriate time to propose amendments that would provide for a more consistent approach to short sale regulation.

A. Operation of the Uniform Bid Test

The current tick test uses the last trade price in a security as a reference point for determining permissible short sale prices under Rule 10a-1. The effectiveness of this test for exchange-listed securities depends on the centralized auction nature of most exchanges and the historical concentration on exchanges of transactions in exchange-listed securities, which helps produce a consistent sequence of trade reports. In 2002, for example, the NYSE accounted for 87.9% of share volume in NYSE listed equities.⁶⁷

The tick test, however, may not be as effective a means of regulating dealer markets. Nasdaq, in contrast to the auction markets, has no single market center that concentrates trading in Nasdaq securities. During regular trading hours, order flow in Nasdaq securities is divided among many different market makers, ECNs, and regional exchanges.⁶⁸ Trade reporting for Nasdaq securities involves multiple market makers reporting trades in the same stock from different locations

using different means of reporting. Although trades are required to be reported within 90 seconds after execution, they are published in reporting sequence, not trade sequence.⁶⁹ This reporting may create upticks and downticks that may not accurately reflect price movements in the security for the purposes of the tick test. To a lesser degree, this phenomenon occurs in exchange-listed securities that are traded in multiple venues.

We are proposing Rule 201 of Regulation SHO, which would replace Rule 10a-1's tick test with a test using the consolidated best bid as the reference point for permissible short sales. Specifically, subparagraph (b) of proposed Rule 201 would require that all short sales in exchange-listed and Nasdaq NMS securities, wherever traded, be effected at a price at least one cent above the consolidated best bid at the time of execution.⁷⁰ A bid test would apply a uniform rule to trades in the same securities that occur in multiple, dispersed, and diverse markets. Moreover, a bid test would provide greater flexibility in effecting short sales in a decimals environment, as discussed below. Finally, a bid test would better accommodate increasingly popular automated trading systems that utilize passive pricing and trading systems that offer price improvement based on the consolidated best bid and offer.⁷¹

The proposed bid test in Rule 201 would require that a short sale be effected at a price at least one cent above the best consolidated bid at the

⁶¹ See, e.g., letters from The Chicago Board Options Exchange (32), Cornerstone Securities Corporation (324), Electronic Traders Association (ETA) (327), Interactive Brokers; The Timber Hill Group (329), Island ECN (Island) (431), Managed Funds Association (MFA) (427), Charles Schwab (Schwab) (310), Sierra Trading Group, L.P. (39), Trimark Securities (330).

⁶² See, e.g., letters from the NASD (480), NYSE (467), Sherman and Sterling (424), North American Securities Administrators Association (NASAA) (321), Specialist Association (426).

⁶³ Transactions in these securities are not subject to short sale regulation under Rule 10a-1. See Securities Exchange Act Release No. 22975 (March 6, 1986), 51 FR 8801 (March 14, 1986) (the Commission adopted amendments to Exchange Act Rule 10a-1 to exclude from application of the rule transactions in NMS securities that are traded on an exchange on a listed or unlisted trading privileges basis).

⁶⁴ The Commission recently issued a Concept Release seeking comment on this and other issues presented in a petition submitted by Nasdaq. Securities Exchange Act Release No. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003).

⁶⁵ See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001).

⁶⁶ See Letter to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and Chief Legal Officer, NASD (August 7, 2000).

⁶⁷ See 2002 NYSE Annual Report.

⁶⁸ For example, in May 2003, there were an average of 73 market makers per issue in the top 1% of Nasdaq stocks by trading volume, 40.5 market makers per issue in the next 9% of stocks, and an overall average of 15.4 market makers per issue. The majority of Nasdaq trading occurs primarily at dealer market centers. The agency markets operated by the seven ECNs in May 2003 accounted for 23.3% of Nasdaq share volume. In addition, the Archipelago Exchange and the Cincinnati Stock Exchange each account for 12.8% of the Nasdaq Share Volume for a total of 25.6% of Nasdaq Share Volume. See www.marketdata.nasdaq.com.

⁶⁹ NASD Rule 4632, Transaction Reporting, requires market makers to transmit through the Automated Confirmation Transaction Service or "ACT" all last sale reports of transactions in designated securities executed during normal market hours within 90 seconds after execution. See NASD Rule 4632 (NMS securities) and Rule 4642 (Nasdaq SmallCap securities), and Rule 6420 (exchange-listed securities).

⁷⁰ To address the problem of locked and crossed markets, we have proposed an exception from the proposed bid test allowing a responsible broker or dealer, as defined in 17 CFR 240.11Ac1-1(a)(21), to effect a short sale at a price equal to the consolidated best offer when the market for the covered security is locked or crossed, provided however, that the exception shall not apply to any broker or dealer who initiated the locked or crossed market. See, *infra* Part VI.A.7 for a further discussion of this exception.

⁷¹ Passive pricing systems often effect trades at an independently-derived price, such as the midpoint of the bid-offer spread. Such pricing would often not satisfy the current tick test. However, midpoint pricing would generally satisfy a test requiring a short sale to be priced above the current best bid. We generally do not believe that such passive pricing systems present significant opportunities for short selling abuse. See *infra*, part IV.D, for a further discussion of passive pricing.