

time of execution.⁷² This would be a significant change from the current tick test, which is based on last sale prices. The bid test also would operate differently from the current rule for Nasdaq securities. NASD's Rule 3350 prohibits NASD members from effecting short sales in NMS securities at or below the best bid when the best bid displayed is below the preceding best bid in a security. However, if there is an "upbid" in a security, *i.e.*, the best bid displayed is above the preceding best bid, there is no restriction on the price that a NASD member can sell an NMS security short.⁷³

Under the proposed uniform bid test, the price at which a short sale could be effected would move contemporaneously with the movement of the consolidated best bid.⁷⁴ In contrast, compliance with the current short sale price tests require a comparison of the previous last sale in relation to the most recent last sale in listed securities or a comparison of the current bid with the previous bid for Nasdaq securities.

We recognize that a quotation only proposes a transaction, whereas the last trade price reflects an actual trade. However, pursuant to Commission and SRO rules, quotations for all covered securities must be firm. Further, we believe that bids generally are a more accurate reflection of current prices for a security because last trade prices can be reported out-of-sequence within a 90 second window.

We believe the proposed bid test would promote the fundamental goals of short sale regulation. First, the proposed bid test would facilitate relatively unrestricted short selling in an advancing market, because the short selling reference price would move with the current interest of the market.

The proposed bid test also is designed to achieve the second and third objectives of the short sale rule, preventing short selling at successively lower prices and preventing short sellers from accelerating a decline in the market by exhausting all remaining bids at one price level. One of the negative uses of short selling is attempting to establish lower transaction prices in a security, hoping to induce others to liquidate their positions and lower prices further.⁷⁵ A short seller may attempt to accomplish this by exhausting higher priced bids in a security, thus creating the appearance of a declining market.⁷⁶ Barring short sales at prices equal to or below the consolidated best bid would prevent short sellers from exhausting the bids in a security and thus prevent short sellers from inducing a price decline. Since only long sellers could sell at the consolidated best bid, it is unlikely that short sellers could directly cause short selling at successively lower prices.⁷⁷

While we believe the uniform bid test is the most flexible approach to modernizing the short sale rule while continuing to promote the goals of short sale regulation, we understand that some market participants may desire an even greater range of prices at which to effect short sales. One alternative would be a bid test allowing short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (*i.e.*, an upbid). However, in this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid (not equal to the best bid) if the current best bid is below the previous

bid (*i.e.*, a downbid).⁷⁸ This alternative test would apply to the same securities as our uniform bid test.⁷⁹ While we are not proposing this alternative test as part of Regulation SHO, we seek comment on this test as another possible approach to regulating short sales.

We are aware that these proposals represent significant changes in the operation of Rule 10a-1. We request comment about the appropriateness of the proposed bid test and the alternative bid test.

Q. Should short sales continue to be limited by a price test? If the Commission did not adopt a price test under Regulation SHO, should it also preclude the ability of the SROs to have price tests?

Q. Would there be any benefits in eliminating a short sale price test? Would the elimination of a price test benefit the markets by allowing investors to more freely short sell potentially overvalued securities so that their price more accurately reflects their fundamental value? Are there other benefits to the removal of a price test, such as elimination of systems and surveillance costs?

Q. Would the proposed "bid test" in Rule 201, allowing short sales above the best consolidated bid, effectively prevent short selling being used as a tool for driving the market down?

Q. Would short sale regulation using the proposed bid test operate effectively in an auction market? If not, why not?

Q. Would short sale regulation using the proposed bid test operate effectively in a dealer market? If not, why not?

Q. Would there ever be a circumstance where there would not be a consolidated bid in an exchange-listed or Nasdaq NMS security? If so, please describe.

Q. The proposed bid test likely would inhibit short sales in a declining market because there would be few execution opportunities above the best bid. Is this appropriate?

Q. Is a one-cent increment an appropriate standard for allowing short sales above the best consolidated bid? If not, what is an appropriate increment?

Q. Would short sale regulation using the proposed bid test present any automated systems problems for market participants?

Q. Would the proposed bid test operate effectively in the current decimal environment, *i.e.*, would bid flickering inhibit the operation of the test?

⁷⁸ The following example demonstrates the operation of this alternative uniform short sale rule: If the consolidated best bid in a security is \$47.00, and the immediately preceding bid was \$46.99, short selling would be allowed at \$47.00 or higher. If the consolidated best bid in a security is \$47.00, and the immediately preceding bid was \$47.01, short selling would only be allowed at \$47.01 or higher.

⁷⁹ We note that, unlike the proposed bid test, this alternative test would incorporate the preceding bid into the calculation of the price at which a short sale could be executed. This would add a layer of complexity to the rule and could impose additional programming costs.

⁷² As stated in the Commission's approval of Nasdaq's penny short sale pilot, a \$0.01 increment for a short sale price test is a reasonable increment in a decimals environment. See Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 8, 2001). However, the Commission may revisit this requirement upon the completion of its analysis of statistical data relating to quoting and trading activity in a decimals environment.

⁷³ Should the Commission adopt changes to existing short sale regulations, the SROs would need to update their rules to reflect our modifications.

⁷⁴ Under the proposed bid test, if the best bid in a security is \$47.00, short selling would be allowed at \$47.01 or higher, regardless of whether the immediately preceding bid was \$46.99 or \$47.01 (*i.e.*, it does not matter whether the current bid is an upbid or downbid from the immediately preceding bid). Also, if the best bid in a security is \$47.00, and the last trade price in the security was \$47.05, short selling would be allowed at \$47.01 or higher (*i.e.*, the last sale price is irrelevant).

⁷⁵ See Securities Exchange Act Release No. 10668 (March 6, 1974), 39 FR 10604 (March 21, 1974).

⁷⁶ *Id.*

⁷⁷ The Commission would view activity by market participants to alter the consolidated best bid solely for the purpose of facilitating short sales as a violation of proposed Regulation SHO, as well as potentially the anti-fraud and anti-manipulation provisions of the federal securities laws, including Sections 9(a), 10(b), and 15(c) of the Exchange Act, and Rules 10b-5 and 15c1-2 thereunder. For example, a broker-dealer may attempt to circumvent the rule by entering into an arrangement with a customer in which the customer would sell short to the dealer one cent above the bid, and the dealer would charge a higher commission to cover the price. The dealer would then sell "long" at the bid. An example of this is as follows: Assume that the best bid is \$20.35. A broker-dealer could arrange with a customer to execute a short sale at \$20.36, and include a mark-up or commission of 6 cents. The net to the customer would thus be \$20.30. The broker-dealer could then sell long into the bid at \$20.35, thus earning a profit on the transaction. Not only may such activity violate reporting rules (see NASD Rule 6130(d)(3)), such activity could be viewed as fraudulent and/or manipulative by the Commission.