

Q. Would the proposed bid test fulfill the fundamental goals of short sale regulation?

Q. Would the alternative test allowing short selling at a price equal to or above the consolidated best bid if it is an upbid better fulfill the goals of short sale regulation?

B. Scope of the Uniform Bid Test

1. Securities Subject to the Price Test

The proposed bid test would apply to all securities currently subject to short sale price tests, *i.e.*, exchange-listed and Nasdaq NMS securities, wherever they are traded. Specifically, the proposed bid test would apply to all national market system securities as defined in § 240.11Aa2-1 of this chapter, but shall exclude Nasdaq Small Cap securities, as determined by NASD rules.

Market information for securities, including quotes, is disseminated pursuant to a variety of different national market system plans. Generally, the SROs have developed networks or systems that disseminate market information.⁸⁰ The NYSE, Amex, Nasdaq, and the regional exchanges are all required to make available to vendors the best bids in any common stock, long-term warrant, or preferred stock.⁸¹ This information is disseminated as a part of an effective transaction reporting plan pursuant to the Consolidated Tape Association Plan (CTA Plan) and the Consolidated Quotation Plan (CQ Plan). The NYSE, Amex, Nasdaq, and the regional exchanges all participate in the CTA Plan and CQ Plan.⁸² Finally, Nasdaq disseminates market information for securities in the two tiers of the Nasdaq market, *i.e.*, NMS and SmallCap stocks, as well as certain other securities traded OTC. Information for NMS securities is collected and disseminated pursuant to NASD's rules and the Nasdaq/UTP plan.⁸³

⁸⁰ In relevant part, these networks can be categorized as follows: (1) Network A—securities listed on the NYSE; (2) Network B—securities listed on Amex or the regional exchanges; and (3) Nasdaq system—securities qualified for inclusion in the Nasdaq system and certain other securities traded in the OTC market.

⁸¹ See Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1; Exchange Act Rule 11Ac1-4, 17 CFR 240.11Ac1-4.

⁸² CTA Plan, Sections I(q) and VII(a)(i) for NYSE securities (Network A), CTA Plan, Sections I(q) and VII(a) for Amex and the regional exchanges (Network B). These plans were adopted pursuant to Rule 11Aa3-1, 17 CFR 240.11Aa3-1, which governs the dissemination of transaction reports and last trade price information in national market system securities (equity securities listed on national securities exchanges or included in the national market tier of Nasdaq). In general, this rule requires an SRO to file a transaction reporting plan for such securities, and it requires SRO members to transmit information required by the plans to the SROs.

⁸³ See Securities Exchange Act Release No. 42208 (December 9, 1999) 64 FR 70613 (December 17,

These networks are designed to ensure that consolidated bids from the various market centers that trade exchange-listed and Nasdaq NMS securities are continually collected and disseminated on a real-time basis, in a single stream of information. Thus, all market participants would have access to the consolidated bids for all the securities that would be subject to the proposed uniform bid test.

2. Securities Not Subject to the Price Test

We are not proposing at this time to extend the uniform bid test to securities not currently covered by a short sale price test (*i.e.*, Nasdaq SmallCap, OTCBB, and Pink Sheet securities) in part because these markets have not been subject to the rule in the past. More significantly, we believe that the proposed locate and deliver requirements may address many of the concerns regarding abusive short selling in thinly-capitalized securities trading over-the-counter. In particular, these proposals should significantly discourage efforts to deliberately depress the price of these securities by removing the leverage abusive short sellers enjoy through short selling without incurring the costs of borrowing and delivering. We recognize, however, that issuers of less actively traded securities believe that they are particularly vulnerable to “abusive” short selling, and we seek specific comment on whether the proposed bid test or other price test should be extended to these securities.

Q. Should the proposed uniform bid test be extended to Nasdaq SmallCap and OTCBB Securities? Do these securities need the protection of the proposed uniform bid test?

Q. Should the proposed uniform bid test be extended to other OTC securities, *e.g.*, those quoted in the Pink Sheets? If so, are quotes in these securities disseminated in a manner that would allow for the use of the proposed uniform bid test? In addition, would the proposed bid test be workable due to the fact that the best bid in these securities could be outstanding for long periods of time? If not, could a last sale test or some other test be applied to these securities?

C. Bid Test Flexibility in a Decimals Environment

The Commission is aware of concerns about the ability to effect short sales using the tick test in a decimals environment. In particular, with the increase in the number of price points from 16 to 100 per dollar as a result of pricing in decimals, there has been an

1999) (concept release requesting comment on the regulation of market information fees and revenues).

increase in price flickering, *i.e.*, an increase in the number of times the last trade price in a security changes rapidly.

As a result market participants have sought relief from the tick test provisions of Rule 10a-1. For example, some third market makers in exchange-listed securities offer trade execution for eligible customer orders at a price equal to or better than the consolidated best offer. However, if the consolidated best offer is below the previous last reported sale in a security and the third market maker or specialist has a short position, sales at the consolidated best offer would violate the tick test of Rule 10a-1. The Commission has granted an exemption from Rule 10a-1 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.⁸⁴ The exemption provided relief in a decimals environment to market makers and specialists in instances where they would be providing liquidity in response to customer buy orders. Such relief would not be necessary with a bid test, since such sales (by any market participant) would always be effectuated above the best bid, specifically at the consolidated best offer or better.

Permitting short sales above the best bid should alleviate other difficulties complying with the tick test in a decimals environment. The Commission's Office of Economic Analysis (OEA) conducted a study that found that the proposed bid test is considerably less restrictive than the current tick test.⁸⁵ Specifically, OEA

⁸⁴ See Letter re: Bernard L. Madoff Investment Securities LLC (February 9, 2001) (exemption from Rule 10a-1 to allowing registered market makers and specialists to sell short to facilitate customer market and marketable limit orders at the consolidated best offer regardless of the last trade price). All such short sales effected pursuant to the exemption are required to be reported as “sell short exempt.” 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. Moreover, the exemption letter notes that whether an execution at the consolidated best offer constitutes best execution of a customer's trade will depend on all the facts and circumstances.

⁸⁵ The study was conducted using stocks listed on the NYSE during the month of July, 2003. The study did not examine the proposed bid test relative to the current Nasdaq bid test. The study is available in the Commission's Public Reference Room. See also Alexander and Peterson, 1999, *Short Selling on the New York Stock Exchange and the Effects of the Uptick Rule*, Journal of Financial Intermediation (a study of, among other things, short selling opportunities under the current tick test in a declining market).