

compared the minimum shortable price (MSP) using the proposed bid test and the current tick test. Under the proposed bid test, the MSP is always a minimum increment above the bid. Under the tick test, if the last transaction was on an uptick or zero-plus uptick, the MSP is equal to the latest transaction price. If the latest transaction price was on a minus tick or a zero-minus tick, the MSP is equal to the latest transaction price plus one tick.<sup>86</sup> OEA found that the tick test was more restrictive (the MSP was higher for the tick test than it was for the proposed bid test) 60.4% of the time, the proposed bid test and tick test were equally restrictive (the MSP for the tick test and the proposed bid test were the same) 15.5% of the time, and the proposed bid test was more restrictive (the MSP was at or below the bid) 24.1% of the time. As this study indicates, the proposed bid test should offer more short selling opportunities than the current tick test.

#### *D. Bid Test Flexibility for Passive Pricing Systems*

We have granted limited exemptive relief from the tick test provisions of Rule 10a-1 in connection with short sale transactions executed on a volume-weighted average price (VWAP) basis.<sup>87</sup> The relief is limited to VWAP transactions that are arranged or "matched" before the market opens at 9:30 a.m. but are not assigned a price until after the close of trading when the VWAP value is calculated.<sup>88</sup> We granted the exemption based, in part, on the fact that these VWAP short sale transactions appear to pose little risk of facilitating the type of market effects that Rule 10a-1 was designed to prevent. In particular, the pre-opening VWAP short sale transactions do not participate in or affect the determination of the VWAP for a particular security. Moreover, the

Commission stated that all trades used to calculate the day's VWAP would continue to be subject to Rule 10a-1.<sup>89</sup>

There are also electronic trading systems that match and execute trades at other independently-derived prices, such as the midpoint of the consolidated best bid and offer. Limited short sale relief has been granted to certain systems that match customer orders at random times within specific time intervals.<sup>90</sup> These systems had requested relief from Rule 10a-1 because matches could potentially occur at a price below the last reported sale price. Due to the passive nature of pricing and the lack of price discovery, trades executed through the systems generally do not appear to involve the types of abuses that 10a-1 was designed to prevent.<sup>91</sup>

We believe that the proposed bid test would accommodate the recent growth of matching systems that execute trades at an independently derived price above the consolidated best bid. Such executions would generally comply with the proposed bid test, while also enabling customer orders to seek executions that would provide price, and possibly size, improvement.

We note, however, that there may be instances where the final execution price of VWAP short sale transactions could be at or below the closing best bid for that security, and thus would violate the proposed bid test. Nevertheless, we propose codifying an exception to the bid test provisions of proposed Rule 201 to permit short sales at the VWAP, subject to the same conditions included in the above exemptions.<sup>92</sup> These would be the following: (1) All short sale orders will be received and matched

before the regular trading session opens and the execution price of VWAP matched trades will be determined after the close of the regular trading session; (2) the VWAP for the covered security is calculated by: calculating the values for every regular way trade reported in the consolidated system, or on a primary market that accounts for 75% or more of the covered security's average daily trading volume for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (3) the transactions are reported using a special VWAP trade modifier; (4) short sales used to calculate the VWAP will themselves be subject to the bid test; (5) the VWAP matched security qualifies as an "actively-traded security" (as defined under Rules 101(c)(1) and 102(d)(1) of Regulation M).<sup>93</sup> Where the subject listed security is not an "actively-traded security" or a S&P 500 Index security, the proposed short sale transaction would be permitted only if it is conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (6) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; (7) a broker or dealer shall be permitted to act as principal on the contra-side to fill customer short sale orders only if the broker or dealer's position in the subject security, as committed by the broker-dealer during the pre-opening period of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the subject security's relevant average daily trading volume, as defined in Regulation M.<sup>94</sup> Any VWAP short sale transaction that does not meet these conditions would need to comply with the bid test. In addition, all other provisions of Regulation SHO, including the marking requirements in Rule 201 and the locate and deliver requirements in Rule 203, would apply. We request comment on whether the proposed exception for VWAP executions, subject to these conditions, is appropriate.

<sup>86</sup> In OEA's analysis, if the tick test MSP was greater than the MSP from the proposed bid test, then the tick test was more restrictive than the proposed bid test because the bid test allows lower execution prices, and, of course, the converse conclusion would be reached if the opposite was true.

<sup>87</sup> See e.g. Letter re: VWAP Trading System (March 24, 1999); Letter re: Jeffries and Company, Inc. (Jeffco) (December 7, 2000); Letter re: POSIT (March 30, 2001); Letter re: Morgan, Stanley & Co., Inc. (May 11, 2001); Letter re: Vie Institutional Services (February 12, 2003).

<sup>88</sup> The VWAP for each security is generally determined by: (1) Calculating raw values for regular session trades reported by the Consolidated Tape during the regular trading day by multiplying each such price by the total number of shares traded at that price; (2) compiling an aggregate sum by adding each calculated raw value from step one above; and (3) dividing the aggregate sum by the total number of reported shares for that day in the security. See, e.g., Letter re: POSIT (March 30, 2001).

<sup>89</sup> The relief is subject to a number of conditions, including: limiting it to only those securities which would qualify as "actively-traded securities" as defined in Regulation M (unless the security is part of a "basket") 17 CFR 242.100; that there be no pre-arranged matching sale and purchase orders; a 10% average daily volume limitation when acting as principal on the contra-side of a VWAP short sale transaction; and that no transactions are made for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security. See, *supra* n. 87.

<sup>90</sup> See e.g. Letter re: POSIT (April 23, 2003).

<sup>91</sup> The relief was also conditioned on the fact that none of the persons relying on the exemption would be represented in, or otherwise influence the primary market bid or offer, and that none of the transactions effected on the electronic system would be made for the purpose of depressing or manipulating the price of the security. *Id.*

<sup>92</sup> We believe that these conditions have worked well in restricting the exemptive relief to situations that do not appear to raise the abuses that the short sale price test is designed to prevent, and should be incorporated in the proposed exception. We also note that market participants that have been granted these exceptions have designed their programming and surveillance systems in accordance with these conditions.

<sup>93</sup> At this time, securities that qualify as "actively traded securities" under Rule 101 of Regulation M and securities that comprise the S&P 500 index would qualify as "actively traded securities" for purposes of this exception.

<sup>94</sup> 17 CFR 242.100(b).