

Q. Do VWAP transactions create perverse incentives for broker-dealers, such that they should not be granted an exception? If an exception is included, are there ways to detect and limit the effects of these perverse incentives?

Q. Are the proposed conditions for the VWAP exception appropriate? If not, why not? Should there be any additional conditions?

V. Pilot Program

As a part of the Commission's review of short sale regulation, we are also proposing temporary Rule 202 of Regulation SHO that would suspend, on a pilot basis, the operation of the proposed bid test of proposed Rule 201 for specified liquid securities. We believe that the pilot is appropriate for several reasons. The pilot would enable us to study the effects of relatively unrestricted short selling on, among other things, market volatility, price efficiency, and liquidity. This would thus allow us to obtain empirical data to assess whether short sale regulation should be removed, in part or in whole, for actively traded securities. The pilot would also allow the Commission to determine the extent to which the proposed bid test achieves the three objectives of short sale regulation through the comparison of trading activity of similar stocks subject to the test and those not subject to the test.

In 1976 the Commission proposed a suspension of the tick test as a part of a comprehensive review of short sale regulation that was designed to obtain statistical data regarding short selling.⁹⁵ The pilot was never implemented due to concerns expressed by trading markets and listed companies.⁹⁶ However, there

have been significant developments in market surveillance since 1976 that now make a pilot more appropriate. Further, the Commission and SROs now have access to a wide range of trading data on potentially manipulative trading behavior.⁹⁷ Access to this information greatly enhances the ability of the Commission and the SROs to monitor trading behavior during the proposed suspension of the bid test and surveil for manipulative short selling.

We also believe that a pilot may be appropriate in light of the Commodity Futures Modernization Act of 2000 (CFMA) lifting the ban on security futures.⁹⁸ Among other things, investors are now allowed to enter into futures contracts for the sale of individual securities at a fixed point in the future and at a set price. In authorizing single stock futures trading, Congress exempted transactions in security futures products from short sale regulation. Short security futures, *i.e.*, obligating a person to make a future delivery of the underlying securities, may function as a substitute for short selling the underlying stock.⁹⁹ We believe that to the extent possible, consistent with investor protection, one market should not benefit over another because of regulatory differences. Thus,

(March 17, 1977). Another commenter stated that the tick test should be retained to prevent manipulative short selling even though some arguments could be made that short selling helps adjust markets to their proper levels more quickly. The commenter stated that it was beneficial to retain Rule 10a-1 until such time a rule could be devised that distinguished between manipulative and non-manipulative short sales. *See* Letter from Frank A. Hutson, Jr., Chairman, Securities Law Committee, American Society of Corporate Secretaries, Inc., to George A. Fitzsimmons, Secretary, SEC (May 3, 1977).

⁹⁷ For example, the NYSE has since implemented both on-line and off-line automated surveillance capability, and monitors trading on both a real-time and next day basis. Further, the NYSE also utilizes an audit trail through its Intermarket Surveillance Information System (ISIS) data base. Securities Exchange Act Release No. 22183 (June 28, 1985) 50 FR 27875 (July 8, 1985). Further, NYSE adopted a rule requiring all transactions in NYSE-listed stocks that are not reported to the Consolidated Tape to be reported to the Exchange in order to provide an accurate record of overall trading activity. In its filing with the Commission, NYSE stated that the information obtained pursuant to the rule will "augment and enhance its ability to surveil for and investigate, among other matters, insider trading, frontrunning, and manipulative activities, * * *". Securities Exchange Act Release No. 31358 (October 26, 1992) 57 FR 49736 (November 3, 1992) (order approving NYSE Rule 410B).

⁹⁸ Pub. L. 106-554, 114 Stat. 2763 (2000). Futures involving single stocks are generally defined as futures contracts (or options thereon) on single non-exempt securities and narrow based groups or indices of non-exempt securities.

⁹⁹ We note that the CFMA exception was a departure from traditional short sale regulation, which is security-based rather than market-based (*i.e.*, the tick test applies to a security irrespective of the market in which the short sale occurs.)

we intend to include liquid securities subject to futures trading in our proposed pilot.

As a result, we believe it is appropriate to propose a rule that would establish procedures for a temporary suspension of the trading restrictions of the price test of the Commission's short sale rule, and any short sale price test of any exchange or national securities association, for a limited number of securities. The securities that could be included in the pilot could be comprised of a subset of the Russell 1000 index, or such other securities as the Commission designates by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving due consideration to the security's liquidity, volatility, market depth and trading market. The relative weight given to these factors would vary. In particular, the Commission would consider including in the pilot one-third of the securities in the Russell 1000 Index.¹⁰⁰ To select the stocks for the pilot if we were to use the Russell 1000, we would sort the Russell 1000 by average daily dollar volume over the calendar year prior to the start of the pilot and use an objective method that would create two samples that should be approximately similar in average market value and average volume.¹⁰¹ Of course, as noted above, the Commission might include different stocks in the pilot or base the pilot on a different broad-based index if it were necessary or appropriate in the public interest and consistent with the protection of investors.

While we recognize that the price of any security can be manipulated, we believe that as trading volume increases, it becomes less likely that a trader would be able to cost-effectively

¹⁰⁰ The Russell 1000 Index comprises the 1,000 largest companies in the Russell 3000 Index (approximately 92% of the total market capitalization of the Russell 3000 Index). Inclusion in the Russell 1000 index is based completely on objective criteria, *i.e.*, market capitalization. A pilot containing stocks from the Russell 1000 index would allow us to analyze the effects of removing price restrictions on a broad range of liquid securities. A narrower index of liquid securities might not provide the breadth of information necessary to make an accurate determination of these effects. Conversely, broader indexes may contain certain securities that could be considered less liquid, which may not be appropriate for a pilot that focuses on short selling in liquid securities.

¹⁰¹ In addition, both samples should also contain Nasdaq and NYSE stocks, optionable stocks, stocks with associated security futures, and both value and growth stocks. We hope that both samples would have similar average short interest and similar expected volatility. Even if the two samples differ slightly along these dimensions, researchers can control for the variations using regression techniques.

⁹⁵ *See* Securities Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530. We proposed three alternative temporary rules that would have suspended the tick test to varying degrees in order for critical data to be collected. The three alternative temporary rules would have: (1) Suspended the operation of the short sale rule for all securities registered, or admitted to unlisted trading privileges on a national securities exchange; (2) suspended the operation of the tick test only for equity securities (other than warrants, rights, or options) that are registered, or admitted to unlisted trading privileges, on more than one national securities exchange and for which transactions were reported in the consolidated system; and (3) suspended the operation of the tick test only for the fifty most active equity securities (other than warrants, rights, or options) during the 12 calendar months preceding the effective date of the rule. However, the Commission withdrew this and other short sale rule proposals largely because commenters did not support the changes. Securities Exchange Act Release No. 17347 (December 1, 1980), 45 FR 80834 (December 8, 1980).

⁹⁶ One commenter expressed concern that removal of the tick test might accelerate market declines and increase volatility as well as create distortions in the market for secondary or tertiary stocks. *See* Letter from James E. Buck, Secretary, NYSE, to George A. Fitzsimmons, Secretary, SEC