

manipulate the price of a security.¹⁰² Further, the high levels of transparency and surveillance for actively-traded securities on exchanges and other regulated markets make it more likely that any manipulation would be detected and pursued.¹⁰³

The proposed temporary Rule 202 would remain in effect for two years. We anticipate that a partial, two-year suspension of the short sale rule would allow the Commission to gather and analyze the data necessary to reach conclusions regarding trading behavior in the absence of short sale price restrictions. The sample period should provide data on advancing and declining markets, high volume and low volume, and different stages of volatility so that the suspension can be studied fully.¹⁰⁴

The Commission notes that the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to apply to trading activity in these securities, thus prohibiting trading activity designed to improperly influence the price of a security.¹⁰⁵ Further, the pilot would only suspend the operation of the proposed bid test. All other provisions of proposed Regulation SHO, including the marking requirements of Rule 201 and the locate and deliver requirements of Rule 203, would continue in effect. Finally, the Commission could terminate the operation of the pilot, in whole or in part, prior to the end of the proposed two-year period as it determines necessary or appropriate in the public interest or to protect investors by removing all securities selected for inclusion in the pilot.

Q. Is the proposed rule temporarily suspending the short sale price test for liquid stocks appropriate? Are liquid stocks more difficult to manipulate through short selling?

Q. Is a two-year temporary suspension of the short sale price test a sufficient period to fully study the impact? If not, what time period should be selected? Commenters should provide specific reasons to support their view in favor of establishing another time period.

¹⁰² See Securities Exchange Act Release No. 37094 (April 11, 1996), 61 FR 17108 (April 18, 1996) (proposing anti-manipulation rules including an exception to the rules for trading activity in high ADTV securities).

¹⁰³ *Id.*

¹⁰⁴ The Commission would study data from the pilot to determine the effect that the removal of the proposed bid test has on trading in the pilot securities. By the end of the two year period, we would consider extending the pilot in light of trading data and whether to pursue rulemaking to permanently remove the proposed bid test for a segment of securities.

¹⁰⁵ See, e.g., Securities Act Section 17(a), Exchange Act Sections 9(a), 10(b), and 15(c) and Rules 10b-5 and 15c1-2 thereunder.

Q. Is the proposed selection method for the pilot, including our contemplated use of the Russell 1000, appropriate? If not, what other selection method should be considered? Is it possible that one market could benefit over another market depending on the selection of stocks for the pilot?

Q. Should the short sale price test be automatically reinstituted in extraordinary market conditions, for instance, if, on an intraday basis, the price of a security falls more than a certain percentage based on the day's opening price (e.g., if the price of a security falls 10% from the day's opening price short sale restrictions would be reinstituted)?

Q. The pilot, in part, would allow the Commission to obtain data to assess whether the price test should be removed for some types of securities and to study trading behavior in the absence of the proposed bid test. After analyzing the results of the pilot, the Commission may propose that the bid test be removed for certain exchange-listed and NMS securities. Should the Commission await the results of the pilot before applying the uniform bid test to exchange-listed and Nasdaq NMS securities that may later have the bid test removed?

Q. Should the pilot apply to existing short sale rules even if we do not adopt the new uniform bid test?

Q. The securities included in the pilot would still be marked and specialists and market makers can observe this mark prior to executing the short sale. How would this affect the outcome and reliability of the pilot, if at all?

VI. Rule 10a-1 Exceptions

Paragraph (e) of Rule 10a-1 currently contains 13 exceptions to the tick test designed to permit certain types of trading activities that were intended to benefit the markets or that were believed to carry little risk of the kind of manipulative or destabilizing trading that the Rule was designed to address. We have reviewed these exceptions in light of proposed Rule 201, and we propose modifying some exceptions for inclusion in Rule 201 and excluding other exceptions from the Rule.

A. Exceptions Proposed To Be Retained

1. Long Seller's Delay in Delivery

Subsection (e)(1) of Rule 10a-1 has existed since the inception of the short sale rule in 1938. This exception allows short sales to be effected without regard to the current tick test if the seller owns the security sold and intends to deliver such security as soon as is possible without undue inconvenience or expense. It was created so that sellers who actually own a security will not be penalized in the event they are unable to deliver the security to their broker prior to settlement, despite every intention of doing so, or in the event the certificate turned in by the seller is not in a form appropriate for transferring.

In the event that the seller's shares are not delivered to the broker-dealer prior to settlement, borrowed shares may be used to consummate the sale. By definition, when borrowed shares are delivered, the sale is a short sale. We believe that this exception continues to be necessary to facilitate those limited circumstances where the seller owned the securities at the time of sale, however delivery may be briefly delayed, as when an option, right or warrant has been exercised but the underlying security has not yet been received by the seller. We propose to retain this exception from the proposed bid test substantially unchanged.¹⁰⁶

Q. Should this exception be retained in its current form?

Q. Is this exception outdated?

2. Error in Marking a Short Sale

Subsection (e)(2) of Rule 10a-1 has also existed since the inception of the Rule. This exception protects brokers in the event they execute a sale already marked long by another broker-dealer, but the sale turns out to be a short sale. The broker-dealer that marks the order long must abide by the provisions of the marking requirement that dictates when an order may be marked long and the executing broker-dealer may rely on this marking when executing the sell order. This exemption was created to avoid implicating a broker that has unknowingly participated in a violation of the Rule, and we believe the basis for including the exception still makes sense in the current environment.¹⁰⁷ We propose to retain this exception substantially unchanged.¹⁰⁸

Q. Should this exception be retained in its current form?

3. Odd Lot Transactions

An exception for certain odd-lot transactions was created in an effort to reduce the burden and inconvenience that short sale restrictions would place on odd-lot transactions. In 1938, the Commission found that odd-lot transactions played a very minor role in potential manipulation by short selling. Initially, sales of odd-lots were not subject to the restrictions of Rule 10a-1.¹⁰⁹ However, the Commission became

¹⁰⁶ See subparagraph (d)(1) of proposed Rule 201 of Regulation SHO.

¹⁰⁷ This exception does not apply where a broker-dealer knows or has reason to know that an order is incorrectly marked long. Knowledge may be inferred where a broker-dealer repeatedly accepts orders marked long from the same counterparty but requires borrowed shares for delivery or results in a "fail to deliver" on several occasions.

¹⁰⁸ See subparagraph (d)(2) of proposed Rule 201 of Regulation SHO.

¹⁰⁹ The Commission initially adopted three exceptions for odd-lot transactions. While the first