

concerned over the volume of odd-lot transactions, which possibly indicated that the exception was being used to circumvent the Rule. As a result, the exception was changed to the present two exceptions.<sup>110</sup>

Subparagraph (e)(3) is limited to odd-lot dealers registered in the security and third-market makers. The exception allows short sales by odd-lot dealers registered in the security and by third market-makers (of covered securities) to fill customer odd-lot orders.

Subparagraph (e)(4) provides relief for any sale to liquidate an odd-lot position by a single round lot sell order that changes such broker-dealer's position by no more than a unit of trading. We understand the odd lot exception to still be of utility and not in conflict with the goals of the proposed bid test. We propose combining the two exceptions into one odd-lot exception under subparagraph (d)(3) of Rule 201 of proposed Regulation SHO.

In addition, we propose extending these exceptions to all market makers acting in the capacity of an odd-lot dealer. When the Rule was adopted, odd-lot dealers dealt exclusively with odd-lot transactions, and were so registered. Today, specialists assigned to a security are typically the odd-lot dealer in that security. We propose to broaden the use of this exception to all brokers or dealers acting as "market makers" in odd-lots.<sup>111</sup>

Odd-lot transactions by market makers to facilitate customer trades are generally not of a size that could facilitate a downward movement in the market. Therefore, those acting in the capacity of a "market maker" should be able to off-set customer odd-lot orders and liquidate an odd-lot position by a single round lot sell order that changes such broker-dealer's position by no more than a unit of trading without regard to the restrictions of the current tick test or proposed bid test.

Q. Are these exceptions relating to odd-lots appropriate in today's markets?

Q. Should these exceptions apply to all market makers in odd-lots or should the exception be more limited?

Q. Are these odd-lot exceptions susceptible to abuse?

Q. Should all odd-lot transactions have an exception from the Rule? Would providing

one, excepting all odd-lot transactions, seemed to make other odd-lot exceptions unnecessary, the 1938 adopting release included all three exceptions without discussion. Securities Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

<sup>110</sup> See Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570.

<sup>111</sup> The definition of a "market maker" is found in Section 3(a)(38) of the Exchange Act, and includes specialists. 15 U.S.C. 78c(a)(38).

an exception for all odd-lot transactions pose a risk of increased short sale manipulation, e.g., would traders break up trades into 99 share odd-lots in order to avoid the price test?

#### 4. Domestic Arbitrage

Current subsection (e)(7) of Rule 10a-1 was adopted in 1938 to allow short selling associated with certain bona fide domestic arbitrage transactions.<sup>112</sup> In adopting this exception, we stated that it "applies only to bona fide arbitrage transactions in a security effected, under certain circumstances described in the exception, by persons who own rights or privileges entitling them to acquire that security."<sup>113</sup> The exception has remained unchanged since its adoption.

The term "bona fide arbitrage" generally describes an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to lock in a gross profit or spread resulting from a current differential in pricing of two related securities.<sup>114</sup> The Commission continues to believe that bona fide arbitrage activities are beneficial to the markets because they tend to reduce pricing disparities between securities.<sup>115</sup> These activities also carry limited risk of the kind of manipulative or destabilizing trading that Rule 10a-1 was designed to address.

We therefore propose that proposed Rule 201 of Regulation SHO would retain the general exception contained in (e)(7). Subparagraph (d)(5) of Rule 201 would continue to except short sales effected in bona fide arbitrage transactions involving convertible, exchangeable, and other rights to acquire the securities sold short, where such rights of acquisition were originally attached to or represented by another security, or were issued to all the holders of any such class of securities of the issuer. In addition, we have proposed adding language to the exception to require a person relying on the exception to subsequently acquire or purchase the security upon which the arbitrage is based.<sup>116</sup> For example, if a

<sup>112</sup> Securities Exchange Act Release No. 1645 (April 8, 1938).

<sup>113</sup> *Id.*

<sup>114</sup> See Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (interpretation concerning the application of Section 11(a)(1) to bona fide arbitrage).

<sup>115</sup> *Id.*

<sup>116</sup> As discussed, the Commission has interpreted the term "bona fide arbitrage" to involve the contemporaneous purchase and sale of securities effected to "lock in" a gross profit or spread from a current differential in pricing. *Id.* We believe requiring a person relying on the exception to subsequently acquire or purchase the security upon

person sells short securities to profit from a current price differential based upon a convertible security that entitles him to acquire an equivalent number of securities of the securities sold short, he must subsequently tender the instrument for conversion to obtain the underlying securities and complete the arbitrage in order to satisfy the terms of the exception. We have also proposed minor amendments to the language of the exception to make it more understandable.

Q. Should the exception be retained for purposes of the proposed Rule 201? If not, state specific reasons why the exception should be removed from the Rule.

Q. Minor changes have been made to the text of existing exception (e)(7) in the proposed rule to simplify its language. Are these changes helpful? Does the proposed amendment to the exception alter its meaning in a way that would affect its substance?

Q. Is the proposed amended exception too narrow or too broad? If so, state specifically why, and how it should be restructured in relation to the purposes of Regulation SHO.

Q. Should the requirement that the transactions be made in a separate domestic arbitrage account be eliminated? If so, should the exception permit domestic arbitrage to be effected in an arbitrage account in which international arbitrage could also be effected?

Q. Should exception (e)(7) be combined with (e)(8), the international arbitrage exception? Would such a combination create compliance problems or other issues?

Recently, Commission staff has received inquiries regarding the operation of (e)(7) in the context of a corporate merger. In particular, market participants have sought advice whether upon finalization of a merger agreement, wherein a date certain is determined for the merger, a party who is entitled to receive stock of the acquiring company under the terms of the merger agreement is entitled to sell short this stock without regard to the tick test pursuant to the domestic arbitrage exception. Unlike the arbitrage contemplated in (e)(7), the right to acquire another security in a merger scenario arises only by the terms of the merger agreement and not through a right vested in the security itself. We believe that this type of arbitrage is not within the scope of paragraph (e)(7), and therefore we are not proposing to include it.

Q. Should short sales effected in connection with a merger be excepted from the provisions of Rule 201? If so, at what point in the merger process should a party be deemed entitled to acquire the acquiring company's stock?

which the arbitrage is based is consistent with this interpretation.