

## 5. International Arbitrage

The international arbitrage exception in Rule 10a-1 (e)(8) has also remained unchanged since its adoption in 1939.<sup>117</sup> The international arbitrage exception was added following an extended study of international arbitrage operations in their relation to short selling.<sup>118</sup> The Commission concluded that the exception was necessary to facilitate "transactions which are of a true arbitrage nature, namely, transactions in which a position is taken on one exchange which is to be immediately covered on a foreign market."<sup>119</sup>

The Commission proposes to retain the international arbitrage exception because we understand that the exception is still being used and does not conflict with the goals of the proposed bid test. As with the domestic arbitrage exception, we have proposed amendments to the language in the exception in order to make it more understandable. In addition, we have incorporated language from current exception (e)(12) of Rule 10a-1 that provides that, for the operation of the international arbitrage exception, a depositary receipt for a security shall be deemed to be the same as the security represented by the receipt. This language was originally included in the Commission's 1939 release adopting the international arbitrage exception, but was incorporated separately in subparagraph (e)(12). We believe this provision should be moved from its current location to the international arbitrage exception because it directly pertains to the operation of that exception.

Q. Should the international arbitrage 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 proposed rule to simplify the language of the existing exception. Are these changes helpful? Do they alter the meaning of the exception in a way that diminishes its value or prohibits bona fide international arbitrage activity in relation to Rule 201?

Q. Is the proposed amended exception too narrow? If so, state specifically why it is too narrow and how it should be restructured to allow beneficial international arbitrage activity that does not carry the kind of manipulative or destabilizing trading that proposed Rule 201 is designed to address.

<sup>117</sup> Securities Exchange Act Release No. 2039 (March 10, 1939).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* We believe that the provision necessitating that the transaction be "immediately" covered on a foreign market requires the foreign market to be open for trading at the time of the transaction in order to qualify for this exception.

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

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

## 6. Distribution Over-Allotment

Subsection (e)(10) generally excepts from Rule 10a-1 sales of securities by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any lay-off sales by such a person in connection with a distribution of securities through rights or a standby underwriting commitment.<sup>120</sup> Proposed Rule 201 would retain the over-allotment exception in substance, although minor changes have been made to simplify its language.<sup>121</sup> Under the proposed bid test, the exception would permit short sales in connection with an over-allotment at or below the bid, thus enabling an underwriter to price an offering at or below the last bid. We propose including this exception in Rule 201 of Regulation SHO because these sales are all at the offering price and, therefore, do not implicate one of the goals of short sale regulation, *i.e.*, preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level.

Q. Is this exception necessary? Under what circumstances would an underwriter or syndicate member price an offering below the best bid? Would extending the exception to short sales below the bid have any negative market impact?

## 7. Equalizing Short Sales and Trade-Throughs

Exceptions (e)(5)(ii) and (e)(11) were adopted in order to eliminate a potential conflict between Rule 10a-1 and Rule 11Ac1-1 under the Exchange Act (Quote Rule).<sup>122</sup> The (e)(5) equalizing

<sup>120</sup> See Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570 (October 2, 1974). Although the exception was not adopted until 1974, the Commission's approval of the concept of excepting over-allotments from the short sale rule is long-standing. See, *e.g.*, Securities Exchange Act Release No. 3454 (July 6, 1946), in which the Commission approved the NYSE's special offering plan, which permitted short sales in the form of over-allotments to facilitate market stabilization.

<sup>121</sup> See subparagraph (d)(7) of proposed Rule 201 of Regulation SHO.

<sup>122</sup> See Securities Exchange Act Release No. 17314 (November 20, 1980), 45 FR 231 (November 28, 1980).

exception, as discussed in further detail below, permits market makers to effect short sales on a zero-minus tick (*i.e.*, at the same price as the last trade price), but does not permit short sales, either as a dealer or agent, at a price lower than the last trade price reported in the consolidated system (*i.e.*, on a minus tick). As a result, there arose a potential conflict between the operation of Rule 10a-1 and the "firmness requirement"<sup>123</sup> of the Quote Rule in situations where execution of an offer quotation by a broker or dealer would be rendered unlawful because of a trade-through<sup>124</sup> even though the offer had been at a price permitted under Rule 10a-1 at the time that broker or dealer had communicated it to its exchange or association for inclusion in the consolidated quotation system.<sup>125</sup>

In order to resolve this potential conflict, the Commission adopted (e)(5)(ii) to permit market makers to execute transactions at their offer following a trade-through, and (e)(11) to permit non-market makers to effect a short sale at a price equal to the price associated with their most recently communicated offer up to the size of that offer<sup>126</sup> so long as the offer was at

<sup>123</sup> 17 CFR 240.11Ac1-1(c)(1). The Quote Rule requires that, subject to certain exceptions, the broker or dealer responsible for communicating a quotation shall be obligated to execute any order to buy or sell presented to him, other than an odd lot order, at a price comprising the responsible broker or dealer's published bid or offer in any amount up to his published quotation size.

<sup>124</sup> A trade-through generally occurs when an Intermarket Trading System (ITS) participant purchases an ITS security at a price that is higher than the displayed price at which the security is being offered at another ITS participating market, or sells an ITS security at a price that is lower than the displayed price at which the security is being bid at another ITS participant.

<sup>125</sup> The following example from the release adopting the exception illustrates the potential conflict: A market maker who currently has a short position in XYZ stock communicates an offer which, if executed against at that time, would be in compliance with Rule 10a-1, *e.g.*, at a price of 20 $\frac{1}{4}$  when the last trade price reported in the consolidated system is also 20 $\frac{1}{4}$ . There is a "trade through" of the market maker's offer on another market center that causes an up-tick to be reported in the consolidated system at 20 $\frac{1}{4}$ . Finally, a buy order is sent to the market maker after the trade through at 20 $\frac{1}{4}$  has been reported. In order to ensure compliance with 10a-1, the market maker must refuse to execute the order at his offer of 20 $\frac{1}{4}$  because doing so would result in a short sale being effected on an impermissible minus tick, however, in refusing to effect the trade, he would arguably violate the "firmness requirement" of the Quote Rule. In addition, when a market maker "backs away" from an order, he may, in effect be revealing that he had a short position in the security, thus making it more difficult to liquidate that position at favorable prices. See, *supra* n. 122.

<sup>126</sup> The Commission explained in the release that the scope of the exception in Rule 10a-1(e)(11) was limited to the size of the broker or dealer's displayed offer because the need for the exception only arises to the extent that the broker or dealer's