

a price, when communicated, that was permissible under Rule 10a-1. The (e)(11) exception was added in response to several comments that, in addition to orders for their own account, specialists and other floor members also often represent as part of their displayed quotation orders of other market participants (e.g., public agency orders or proprietary orders of non-market makers) that also might be ineligible for execution under Rule 10a-1 following a trade-through in another market.¹²⁷

We believe that the rationale for adopting exceptions (e)(5)(ii) and (e)(11), namely resolving a conflict between the short sale rule and the quote rule arising from a trade-through, would not exist under the proposed bid test. Under the proposed rule, the reference point for a market participant seeking to execute a short sale would not be the last trade price, which could be a down tick created by a trade through, but rather the current consolidated best bid.

It appears that under the proposed bid test, a comparable situation as that envisioned under (e)(5)(ii) and (e)(11) would result in a locked or crossed market.¹²⁸ Locking or crossing a quote temporarily frustrates trading in a particular security, and there are various rules and regulations that guard against such practices.¹²⁹ We have stated in

obligations under the Quote Rule may conflict with Rule 10a-1. Because the firmness requirement of the Quote Rule only applies to a broker or dealer's displayed offer, it was deemed appropriate to limit the exception to the size of the displayed offer. *See, supra* n. 122 at n.20.

¹²⁷ This concern was illustrated with the following example: A specialist who is short XYZ stock quotes an offer for 1,000 shares at 20 $\frac{1}{4}$ at a time when the last sale reported in the consolidated system was such that the offer, if executed at that time, would be in compliance with Rule 10a-1. This offer for 1,000 shares consists of 300 shares offered by the specialist, a 400-share limit order in the specialist's book, and an offer from the crowd at the specialist's post for 300 shares, all at 20 $\frac{1}{4}$. A trade through of this offer occurs on another exchange and an up-tick is reported in the consolidated system at 20 $\frac{1}{4}$. A buy order for 1,000 shares at 20 $\frac{1}{4}$ is then sent to the exchange—after the trade through at 20 $\frac{1}{4}$ is reported. Without (e)(11), filling the complete order for 1,000 shares would not be permissible, since (e)(5)(ii), by its terms, applies only to a sale by a market maker for its own account. *Id.* at n.18.

¹²⁸ In a locked market, the best bid price equals the best ask price; in a crossed market, the best bid price exceeds the best ask price. For example, assume that the current consolidated best bid for a security is 10.00. A market participant who has a short position in a security posts an offer to sell at 10.05. The market participant would be able to execute its short sale so long as it was above the consolidated best bid. Any bid that was posted at 10.05 would lock the market, and any bid posted above 10.05 would cross the market.

¹²⁹ *See, e.g.* NASD Rule 4613(e). NASD Rule 4613(e)(2) states that "A market maker shall, prior to entering a quotation that locks or crosses another quotation, make reasonable efforts to avoid such

prior releases that continued locking and crossing of the market can negatively impact market quality, and have approved SRO rules aimed at reducing the frequency of locked and crossed markets and providing more informative quotation information, facilitating price discovery, and contributing to the maintenance of a fair and orderly market."¹³⁰

However, we recognize that locked and crossed markets have not been eliminated entirely, and thus the same conflict between the firm quote rule and the short sale rule could arise under the proposed bid test. We believe that this situation would exist where a market participant posts an offer to sell short at a valid price, i.e., above the best bid, but the bid subsequently moves up and either locks or crosses the market participant's posted offer. A market participant in this situation could still be required to execute buy orders directed to its posted offer, which would be at or below the best bid.¹³¹ The Commission thus proposes to include an exception to Rule 201 of Regulation SHO permitting a responsible broker-dealer, as defined in Rule 11Ac1-1 under the Exchange Act¹³² to effect a short sale at a price

locked and crossed market by executing transactions with all market makers whose quotations would be locked or crossed. Pursuant to the provisions of paragraph (b) of this Rule 4613, a market maker whose quotations are causing a locked or crossed market is required to execute transactions at its quotations as displayed through Nasdaq at the time of receipt of any order."

¹³⁰ *See* Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020, 8046 (January 26, 2001); Securities Exchange Act Release No. 46410 (August 23, 2002), 67 FR 55897 (August 30, 2002) (File No. SR-NASD-2002-56). *See also* Securities Exchange Act Release No. 47735 (April 24, 2003), 68 FR 23787 (May 5, 2003) (File No. NASD-2003-38).

¹³¹ *See* 17 CFR 240.11Ac1-1; *see also supra* n. 129. Paragraph (b) of Rule 4613 is the NASD Firm Quote Rule.

¹³² Rule 11Ac1-1(a)(21) defines the term *responsible broker or dealer* to mean: (i) When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent; *provided, however*, That, in the event two or more members of an exchange have communicated on such exchange bids or offers for a covered security at the same price, each such member shall be considered a "responsible broker or dealer" for that bid or offer, subject to the rules of priority and precedence then in effect on that exchange; and *further provided*, That for a bid or offer which is transmitted from one member of an exchange to another member who undertakes to represent such bid or offer on such exchange as agent, only the last such member who undertakes to represent such bid or offer as agent shall be considered the "responsible broker or dealer" with respect to that bid or offer; and (2) when used with respect to bids and offers communicated by a member of an association to another broker or

equal to its posted offer when the market is locked or crossed, when consistent with best execution obligations, provided however, that the exception would not apply to any broker-dealer who initiated the locked or crossed market.

Q. Would an exception from the proposed bid test permitting a short sale to be effected at the consolidated best offer if the market is locked or crossed be useful or necessary to remedy problems associated with locked and crossed markets? If so, describe such circumstances and the market participants to whom the exception should apply.

Q. Would such an exception be used appropriately to remedy the problem of locked and crossed markets, or could such an exception be susceptible to abuse? Is there another way to design an exception for locked and crossed markets?

Q. Some market participants that provide their customers with guaranteed executions of their buy orders at a price equal to the consolidated best offer would be prevented from selling short to fill customer buy orders in a locked or crossed market, due to the fact that the short sale would be executed at a price equal to or below the best bid. Should there be an exception to allow these market participants to execute short sales at their offer to facilitate customer buy orders in locked or crossed markets?

B. Exception Proposed To Be Eliminated

Exception (e)(6) of Rule 10a-1, the original "equalizing exception," was adopted by the Commission in 1938 to allow a short sale of a security on a regional exchange at the same price as the then current price for the same security on the principal exchange, even though the short sale on the regional exchange would constitute a zero-minus or minus tick in relation to the last preceding trade price on the principal exchange.¹³³ The exception, limited to short sales effected on an exchange, permitted regional specialists to guarantee execution at a price at least as favorable to the customer as he would have obtained had his order been exposed to the principal exchange market.¹³⁴ The Commission believed that unless the regional exchanges were

dealer or to a customer otherwise than on an exchange, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

¹³³ Securities Exchange Act Release No. 1579 (February 10, 1938), 3 FR 382 (1938). At the time the exception was adopted (and until April 30, 1976) the permissibility of short sales under Rule 10a-1 was determined for each particular exchange by comparing the price of the proposed short sale to the immediately preceding last trade price in the security to be sold short on that exchange.

¹³⁴ Pursuant to the Rule, such sales are excepted only with the approval of the exchange, and only if (1) trades in the security are not reported pursuant to an effective transaction reporting plan and (2) information as to such trades is not made available on a real-time basis.