

allowed to fill purchase orders at prices that would have been obtained on the principal exchanges, regional exchanges would be unable to attract sufficient order flow to remain viable.¹³⁵

In 1975 the Commission adopted amendments to Rule 10a-1 in conjunction with the full implementation of the consolidated transaction reporting system ("consolidated system").¹³⁶ As amended, Rule 10a-1 applies a tick test referencing the last trade price reported in the consolidated system, however permits an exchange to make an election to use a tick test that references the last trade price reported in that exchange market.¹³⁷

In addition to altering the reference point for determining the permissibility of short sales, the amendments also altered the reference point for the permissibility of equalizing short sales. Subsection (e)(5)(i) was added to provide an exception for short sales of certain securities effected by a registered specialist, exchange market maker, or third market maker at a price equal to the last price reported in the consolidated system.¹³⁸ The exception applies to short sales of securities registered or admitted to unlisted trading privileges on an exchange, whether effected on an exchange or over-the-counter, if transactions in the security are reported pursuant to an effective transaction reporting plan and made available on a real time basis to vendors of market transaction information.

The exception is intended to permit market professionals to protect customer orders against transactions in other markets in the consolidated system by allowing them to sell short at a price equal to the last trade price reported in the consolidated system, even if that sale was on a minus tick (a so-called

"zero-minus tick").¹³⁹ Concurrent with the adoption of subsection (e)(5)(i), exception (e)(6) was amended to apply only to short sales of securities covered by Rule 10a-1(b), *i.e.*, to short sales of exchange-listed securities that are not reported to the consolidated system or made available on a real-time basis.¹⁴⁰

We do not believe that the equalizing exceptions should be retained as part of proposed Regulation SHO. The rationale for exceptions (e)(6) and (e)(5)(i), *i.e.*, allowing short selling at a price that matches a given security's last trade price on another market center, would not exist under our proposed short sale rule. The proposed rule would reference the real-time consolidated best bid rather than the last trade price, and would not depend on prices in individual markets.¹⁴¹ We therefore do not believe that a registered specialist or exchange market maker would need to "equalize" their price with a price on another market center.

Q. Is there any reason why exception (e)(6) should be retained?

Q. Is there any reason why exception (e)(5)(i) should be retained? For example, would broker-dealers that provide customers with executions at a price equal to transaction prices on a primary exchange require an exception to facilitate customer buy orders?

VII. Prior Exemption Letters Under Rule 10a-1

A. Exchange Traded Funds

Exchange Traded Funds (ETFs) are designed to provide investment results that correspond generally to price and yield performance of securities included in a particular index or securities portfolio. In light of the composite and derivative nature of ETFs, the Commission found that trading in ETFs would not be susceptible to the practices that Rule 10a-1 is designed to prevent and granted an exemption from Rule 10a-1 for transactions in these securities.¹⁴² In particular, the

Commission found that ETFs should rise or fall based on changes in the net asset value of the component stocks of the particular index and supply and demand.¹⁴³

The relief is subject to a number of specified conditions. In particular, the corresponding index or portfolio represented by the ETF must consist of a "basket" of twenty or more different component stocks, in which the most heavily weighted component stock cannot exceed 25% of the weight of the index or portfolio. Moreover, the component stocks that in the aggregate account for a least 85% of the weight of the underlying index or portfolio must have a minimum public float value of at least \$150 million and, with certain exceptions, a minimum ADTV with a value of at least \$1 million during each of the previous 2 months of trading prior to the formation of the ETF series. We believe that these conditions continue to be necessary to ensure the composition of the ETFs is such that short selling in the ETFs does not implicate the type of trading activity that short sale regulation was designed to prevent.

The relief previously granted under Rule 10a-1 would continue to apply to cover exemptions from the price test provisions of Rule 201 of Regulation SHO.

Q. Should the Commission provide relief from proposed Rule 201 of Regulation SHO for transactions in ETFs? If so, are the conditions for relief appropriate? If not, please explain why.

Q. Should the relief be codified as an exception to proposed Rule 201 of Regulation SHO?

B. Short Sales Executed at the Closing Price

The Commission has granted conditional relief from the price test provisions of Rule 10a-1 to allow requesting exchanges¹⁴⁴ and broker-dealers¹⁴⁵ to execute short sales in after-hours crossing sessions at a price equal

¹³⁵ See Securities Exchange Act Release No. 11468 (June 12, 1975), 40 FR 25442 (June 16, 1975) (adopting amendments to Rule 10a-1 and discussing the operation of Rule 10a-1(e)(6) as in effect prior to and after amendment).

¹³⁶ *Id.*

¹³⁷ 17 CFR 240.10a-1(a)(2). This aspect of the short sale rule, as amended, was designed to ameliorate potential regulatory and operational problems perceived by certain exchanges with a uniform short sale rule employing a tick test referenced to the consolidated system. *Id.*

¹³⁸ Rule 10a-1(e)(5)(i) exempts: Any sale of a security covered by paragraph (a) of this section (except a sale to a stabilizing bid complying with § 242.104 of this chapter) by a registered specialist or registered exchange market maker for its own account on any exchange with which it is registered for such security, or by a third market maker for its own account over-the-counter, (i) Effected at a price equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan.

¹³⁹ Securities Exchange Act Release No. 11030 (September 27, 1974), 39 FR 35570.

¹⁴⁰ Paragraph (b) of Rule 10a-1 applies to any short sale effected on a national exchange of any security not covered by paragraph (a) of Rule 10a-1. Paragraph (a), in turn, covers any short sale effected on a national exchange of any security registered or admitted to unlisted trading privileges on a national exchange, if trades in the security are reported pursuant to an "effective transaction reporting plan" and if information as to such trades is made available on a real-time basis to vendors of market transaction information.

¹⁴¹ We have proposed eliminating Rule 10a-1(a)(2), and thus any market center would be prevented from relying on its own bid as a reference point for compliance with the rule. See, *infra* part XII.

¹⁴² See, e.g., Letter re: SPDRs (January 27, 1993); Letter re: MidCap SPDRs (April 21, 1995); Letter re:

Select Sector SPDRs (December 14, 1998); Letter re: Units of the Nasdaq-100 Trust (March 3, 1999); Letter re: ETFs (August 17, 2001) (class letter).

¹⁴³ The Commission, however, did not provide any relief from the tick test for short selling of the individual component stocks underlying an ETF.

¹⁴⁴ See, e.g., Letter re: Off-Hours Trading by the Amex, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,802 (August 5, 1991); Letter re: Operation of Off-Hours Trading by the NYSE, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,736 (June 13, 1991).

¹⁴⁵ See, e.g., Letter re: Burlington Capital Markets (July 1, 2003); Letter re: Bear, Stearns & Co., Inc. (January 19, 1996); Letter re: AZX, Inc. (November 15, 1995); Letter re: Instinet Corporation Crossing Network, [1992] Fed. Sec. L. Rep. (CCH) ¶ 76,290 (July 1, 1992); Letter re: Portfolio System for Institutional Trading, [1991-1992] Fed. Sec. L. Rep. (CCH) ¶ 76,097 (December 31, 1991).