

orders.<sup>158</sup> In addition, we are proposing an exception from Rule 201 to allow broker-dealers to sell short at a price equal to the consolidated best bid, when consistent with best execution obligations, in order to fill customer orders it is required to execute pursuant to federal securities laws or SRO rules, such as NASD IM-2110-2 and the related interpretation of IM-2110-2 (Manning Interpretation). According to Nasdaq, the Manning Interpretation is designed to ensure that customer limit orders are executed in a fair manner and at similar prices at which a firm has traded for its own account.<sup>159</sup> If a broker-dealer executed an incoming market sell order at the consolidated best bid, it would then be obligated to fill other customer limit orders it held at that price.<sup>160</sup> However, if the broker-dealer had a net short position, it would be prohibited by proposed Rule 201 from filling the customer buy order at a price equal to the bid. We believe the proposed exception would remedy this conflict.

We seek comment on the importance of a market maker exception in the context of a market maker's role in providing liquidity. We also seek comment on the extent to which market makers might need to be able to short at the bid in order to facilitate a customer buy order, and inquire whether an exception limited to those situations would be necessary or appropriate.

Q. Should the proposed uniform bid test include a *bona-fide* market making exception? If so, why? How important is it for a market maker to be able to profit from position trading? Could there potentially be negative consequences to the market if there is not an exception for *bona-fide* market making transactions? Please describe.

Q. If a market making exception from the bid test is necessary, what should be done to limit its use to those engaged in *bona-fide* market making? Should the exception be tied to certain qualifications or conditions? If so, what should these qualifications or conditions be?

<sup>158</sup> See, *infra* part IX.B for a further discussion of the proposal regarding riskless principal trades.

<sup>159</sup> See, e.g., Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001) (order granting approval of proposed rule change by the NASD regarding trading ahead of customer limit orders pursuant to decimal pricing in the Nasdaq market). See also NASD Rule 6440(f) (applying limit order protection rules to NASD members in exchange-listed securities).

<sup>160</sup> For example, a market maker receives an order to buy 1,000 shares of XYZ stock at \$20 from a customer and represents the order in its Nasdaq quote. Market maker buys 1,000 shares of XYZ at \$20 for its own account. Pursuant to the Manning Interpretation, the market maker would be obligated to sell to the customer to fill the customer's 1,000 share order.

Q. If inclusion of a *bona-fide* market making exception is necessary, would there be any circumstances where a market maker acting in his market making capacity would need to sell short below the bid?

Q. How often do market makers or other broker-dealers sell short at the bid in response to customer buy orders? Would it be feasible to allow market makers or other broker-dealers to sell short at the bid to facilitate customer buy orders without undermining the purposes of the price test? If so, should there be limits on such short sales, for example to prevent a dominant market maker from filling customer orders at the bid in order to place downward pressure on the security's price?

Q. What other type of transactions should qualify for a *bona fide* market making exception?

## IX. Proposed Changes to the Order Marking Requirement

### A. Marking Orders

We propose combining current marking requirements in subsections (c) and (d) of Rule 10a-1 into new subsection (c) of Rule 201. New subsection (c) generally would differentiate between "long," "short," and "short exempt" orders. The marking requirement would apply to all exchange-listed securities and over-the-counter securities. An order could only be marked "long" when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer or will be prior to the settlement of the transaction. A sell order would be required to be marked "short exempt" if it were a short sale effected pursuant to an exception in Rule 201.

We believe that the proposed change would eliminate the current discrepancy between how Rule 3b-3 defines a short sale and the marking provisions found in Rule 10a-1. There are circumstances where an order can be marked "long," but is a short sale executed without regard to the current tick test. For example, a person placing a sell order may be deemed to own a security under current Rule 3b-3(b)-(e),<sup>161</sup> but must borrow securities to consummate the delivery (e.g., because the securities due upon a conversion of a security have not been received). While borrowing to settle a sale constitutes a short sale under Rule 3b-

<sup>161</sup> As discussed *infra*, Part X, Rule 3b-3 provides that a person is deemed to own a security if he or she: has entered into a binding, unconditional contract to purchase a security; own a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; have an option to purchase or acquire it and has exercised such option; or have rights or warrants to subscribe to it and have exercised such rights. A person who is deemed to own a security may mark orders to sell such securities long.

3, the seller would not be subject to the current tick test if at the time of the trade the seller owns the security and intends to deliver such security "as soon as possible without undue inconvenience or expense."<sup>162</sup> This sale would be marked "long" under the current marking provisions of Rule 10a-1(d).

Under our proposed amendment, the sell order described above would not be marked "long" because, while the above seller may own the security, the security is neither in the physical possession or control of the broker-dealer nor is it reasonably expected to be prior to the settlement of the transaction. The seller would thus have to borrow the stock in order to effectuate delivery to the buyer. Instead the seller, availing themselves of exception (d)(1) of Rule 201, would mark the order "short exempt." Requiring the order to be marked "short exempt" promotes consistency among related rules and uniformity among markets and market participants in the manner in which short sales are marked.

We believe that the proposed amendments would provide several benefits. The current marking requirements can lead to undetected violations of Rule 10a-1 because once the order is marked "long," it is processed and executed as such, even though borrowed shares consummate the delivery on the sale. This complicates surveillance for violations of Rule 10a-1, as short sales executed under an exception from the rule can be masked as "long" sales. Further, under the current marking requirements there is no record of how short sellers are availing themselves of the various exceptions to Rule 10a-1. We believe that surveillance for compliance with proposed Rule 201 would be facilitated with accurate indications of when and under what circumstances the exceptions are utilized.

The practice of designating an order as "short exempt," as proposed, has already developed. Many broker-dealers are already required to mark short sales as short exempt if they are effected under one of the exceptions from Rule 10a-1. For example, ITS participants<sup>163</sup> are required to designate commitment orders as "short exempt" when the short sale falls under an exception to the

<sup>162</sup> 17 CFR 240.10a-1(e)(1).

<sup>163</sup> Current signatories to the ITS Plan include the American Stock Exchange LLC (Amex), Boston Stock Exchange, Inc. (BSE), Chicago Board Options Exchange, Inc. (CBOE), Chicago Stock Exchange, (CHX), Cincinnati Stock Exchange (CSE), NASD, NYSE, Pacific Exchange, Inc. (PCX), and Philadelphia Stock Exchange, Inc. (Phlx).