

application of Rule 10a-1.<sup>164</sup> The NYSE has advised its members that it is “appropriate” to mark those short sale orders covered under exceptions to the rule as “short exempt.”<sup>165</sup> In addition, NASD Rule 4991(i) requires all orders executed on Nasdaq be designated as “buy,” “sell long,” “sell short,” or “sell short exempt.”<sup>166</sup> The proposed amendment would require orders to be marked as either “long,” “short,” or “short exempt,” providing greater uniformity.

Further, we believe that requiring a broker dealer to have physical possession or control of the security at execution, or, in the alternative, that the broker dealer obtain physical possession or control of the security prior to settlement, before marking the order “long” should facilitate the process of clearance and settlement in the current T + 3 environment. Disturbances in settlement processes can affect the stability and integrity of the financial system in general. Clearance and settlement systems are designed to preserve financial integrity and minimize the likelihood of systematic disturbances by instituting risk-management systems.<sup>167</sup> Requiring a broker-dealer to have possession or control of the securities before the broker-dealer can mark an order long should help to reduce failures to deliver. We anticipate that this proposed amendment would not be burdensome to market participants because most customer securities are not held by investors in physical form, but rather are held indirectly through their broker-dealer, *i.e.*, in “street name.”<sup>168</sup>

Q. What type of additional costs and burdens, if any, would be associated with requiring orders to be marked “short exempt?”

Q. Does the requirement that a broker has physical possession or control of the security or will have physical possession or control prior to settlement place undue or unreasonable hardship on long sellers?

Q. Should proposed Rule 200 require a broker or dealer marking a sell order “short exempt” to identify the specific exception that the broker or dealer is relying on in marking it “short exempt?” If not, state why not.

### B. Marking Requirements for Riskless Principal Transactions

Recently, some market makers have indicated that they would like exemptive relief from Rule 10a-1 to mark sell orders based on a customer's net position when a broker-dealer or market maker is effecting the execution of the customer's order on a riskless principal basis.<sup>169</sup> For example, a customer who is net long 1,000 shares of XYZ security enters an order to sell those securities with a market maker, the market maker then seeks to sell 1,000 shares of XYZ from his proprietary account to facilitate the trade prior to obtaining the securities from the customer. In this situation, market makers acting as riskless principal have sought an exemption from Rule 10a-1 to mark the market maker's sale from its proprietary account as “long” based on the customer's long position, regardless of the market maker's proprietary position in the security.

We believe that for the purposes of short sale regulation, the position of a broker-dealer should be deemed to be the same as a customer's position, regardless of whether the broker-dealer has a proprietary net “long” or “short” position, when the broker-dealer acts in a riskless principal capacity.<sup>170</sup> We believe that in this context, the broker-dealer effects the sale in a manner analogous to an agency execution. A short sale effected on an agency basis is marked according to the customer's net position. We therefore propose adding

<sup>169</sup> Riskless principal transactions are generally described as trades in which, after receiving an order to sell (or buy) from a customer, the broker-dealer sells (or purchases) the security to (or from) another person in a contemporaneous offsetting transaction. See Securities Exchange Act Release No. 44291 (May 18, 2001), 66 FR 27760 (order adopting a *de minimis* exception to the definition of the term “dealer” solely for banks engaging in riskless principal transactions under 240.17 CFR 3a5-1); see also Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767-01 (March 17, 1994). More recently, the Commission modified its interpretation of Exchange Act Section 28(e), the “safe harbor” provision for money managers who use commission dollars of their advised accounts to obtain research and brokerage, so that it encompasses certain riskless principal transactions as defined by Nasdaq trade reporting rules. See Securities Exchange Act Release No. 45194 (December 17, 2001), 67 FR 6 (January 2, 2002) (NASD's rules define a riskless principal trade as a transaction in which a member after having a received an order to buy a security, purchases the security as principal at the same price to satisfy the order to sell. See NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6420(d)(3)(B)).

<sup>170</sup> For example, if the customer seeking to sell 1,000 shares of XYZ and the customer was net short in XYZ, a market maker engaging in a riskless principal transaction on behalf of the customer would have to mark the sell order from his principal account short regardless of his own net position.

an exception to the proposed bid test of Regulation SHO that would allow broker-dealers to mark such sell orders “short exempt.”<sup>171</sup> Allowing a broker-dealer to mark an order in this manner does not implicate the stated concerns raised by short selling, *i.e.*, where a customer is long, specialist or market maker principal transactions should not be restricted in the same manner as short sales.<sup>172</sup>

We are concerned, however, that this exception from proposed Rule 201 not be used in an abusive or manipulative manner. Towards that goal, we would restrict this provision to riskless principal transactions as follows:

- A transaction in which a broker or dealer, after having received an order to sell a security, sells the security as principal at the same price to satisfy the order to sell;
- The sell order must be given the same per-share price at which the broker or dealer sold shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee;
- The broker or dealer must have written policies and procedures in place to assure that, at a minimum: the customer order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal account or customer account within 60 seconds of execution; the broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders effected pursuant to this exception.

We believe that these conditions would allow for the surveillance of the exception by linking the exception to specific incoming orders and executions, and by requiring the brokers and dealers to establish procedures for handling such transactions. Moreover, requiring the orders to be received prior to the offsetting transaction and the allocation of the offsetting transaction to the customer within 60 seconds would help avoid the exception from being abused by brokers or dealers who may attempt to retroactively claim the exception for transactions that were not done on a riskless principal basis.<sup>173</sup>

<sup>171</sup> See subparagraph (d)(9) of proposed Rule 201 of Regulation SHO.

<sup>172</sup> See Securities Exchange Act Release No. 46994 (December 13, 2002), 67 FR 78033 (December 20, 2002) (order approving NASD amendment to the Manning Interpretation establishing a riskless principal customer facilitation exemption).

<sup>173</sup> The requirement that an offsetting transaction be allocated to either a riskless principal or

<sup>164</sup> See Restated Intermarket Trading Plan, 33 (May 30, 1997).

<sup>165</sup> See NYSE Rule 440B.20.

<sup>166</sup> See NASD Rule 4991(i)(2).

<sup>167</sup> See Exchange Act Section 17A, 15 U.S.C 78q-1.

<sup>168</sup> DTC holds approximately 83% of all NYSE-traded shares outstanding and 72% of all Nasdaq-traded shares outstanding for the benefit of its participants (*i.e.*, broker-dealers and banks). See Securities Dematerialization White Paper, Securities Industry Association, at 17 (June 5, 2000).