

In order to assess whether this proposed exception properly addresses the needs of specialists or market makers, we ask the following questions:

Q. Does the proposed riskless principal exception allow brokers and dealers to facilitate customer orders handled on a riskless principal basis regardless of their proprietary net position? Are the conditions appropriate? In particular, is the requirement to allocate the offsetting transaction to the customer within 60 seconds appropriate?

Q. Is there any concern that this provision is not consistent with the goals of short sale regulation? If so, how?

X. Rule 3b-3

Rule 3b-3 defines the term "short sale" as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Rule 3b-3 also defines specific instances when a person shall be deemed to own a security, *i.e.*, a long position, for the purposes of Rule 10a-1.

We are proposing new Rule 200 to replace Rule 3b-3 and include several amendments to Rule 3b-3. As discussed in further detail below, we seek comment on including a modified version of current subparagraph (b) of Rule 3b-3 in Rule 200 that would require that a person not only have entered into an unconditional contract, binding on both parties thereto, to purchase the security, but also that the contract specify the irrevocable price and amount of securities purchased and provides for present delivery. We also propose amending the Rule to allow broker-dealers to calculate net positions in a particular security within defined trading units. Additionally, we propose that the definition of a short sale include the block-positioner exception from the current Rule 10a-1(e)(13). We also propose codifying in Rule 200 prior interpretations related to security futures products, and the unwinding of certain index arbitrage positions.

A. Unconditional Contracts To Purchase Securities

Under Rule 3b-3, a person owns a security if the person has "purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it."¹⁷⁴ The staff has recently received inquiries about whether certain

transactions qualify as an "unconditional contract" for the purposes of short sale regulation. In particular these inquiries focus on whether it is necessary for a contract to specify the price and amount of securities to be purchased in order to be considered an unconditional contract.

In 1992 the Commission proposed to clarify that an "unconditional contract" must specify a fixed, currently ascertainable price, and the exact amount of securities to be obtained in order for a person to be deemed to own a security under subparagraph (b) of Rule 3b-3.¹⁷⁵ The proposed amendments were intended to address potentially abusive trading practices associated with contracts for future purchases of securities where the price or volume was based on a formula or other contingent event. We were concerned about the potential for abuse associated with securities contracts where the purchase price is based on the next following closing price in the primary market for the stock or stocks. The concern was that a purchaser under such a contract may have incentive to sell the securities (long) that are subject to the contract prior to the close of trading on the primary market in a manner that would depress the closing price. Similarly, we expressed concern regarding shares expected to be received from dividend reinvestment plan purchases being considered in calculating a long position pursuant to Rule 3b-3 where the number of shares received under a plan was not known but only estimated based on a formula. The proposed amendments were never adopted or withdrawn.

As stated, the language of subparagraph (b) of Rule 3b-3 may be subject to abuse by individuals seeking to claim a long position only to avoid application of the tick test provisions in Rule 10a-1. Further, it is possible that where a contract mandates that securities will be purchased at the closing price, there may be incentive to depress the market price of the security to obtain the security at a lower price.¹⁷⁶ Moreover, there is the potential that contracts in which the amount of securities owned is not known until some later period may be designed to

create a long position that would facilitate avoidance of the tick test. It appears to us that a fixed price and quantity of a contract to purchase securities, as well as present delivery of the securities, are essential elements in determining whether such a contract conveys ownership for purposes of short sale regulation,¹⁷⁷ and requiring these elements would restrict certain activities designed to manipulate the market. Therefore, we are proposing that Rule 200, subparagraph (b)(2) require that the unconditional contract specify the price and amount of securities to be purchased in order for a person to claim ownership of the securities underlying the contract under proposed Regulation SHO.

Q. Should proposed Rule 200 provide that in order for a person to be deemed to own a security by virtue of the fact that he has entered into an unconditional contract to purchase the security, the contract must specify the price and amount of the security to be purchased? If not, state why not.

In addition, questions have arisen about whether an unconditional contract must contemplate present delivery of securities in order for persons to claim ownership of securities under Rule 3b-3. In order for a person to claim ownership of a security, she should have title to the security or some other type of present or near-term ownership right to obtain the security. In the case of options, convertibles, rights, or warrants, the rule requires that a person exercise or convert the instrument in order to claim ownership of the underlying security. However, there is currently no express requirement that a person who has

¹⁷⁷ The Commission notes that in a typical "equity line" financing arrangement, an investor and the company enter into a written agreement under which the company has the right to "put" its securities to the investor. Under this "put," the company has the right to tell the investor when to buy securities from the company over a set period of time and the investor has no right to decline to purchase the securities. The dollar value of the equity line is set in the written agreement, but the number of shares that the company will actually issue may be determined by a formula tied to the market price of the securities at the time the company exercises its "put." See Division of Corporation Finance, Current Issues Outline Quarterly Update (March 31, 2001). As such, equity line financing arrangements and convertible financing arrangements would generally not meet the requirements for an unconditional contract, due to the fact that such arrangements may not specify a fixed price and quantity of the securities to be purchased, nor would they contemplate present delivery of the securities upon conversion or exercise of the put. All sales executed by the investor prior to the company exercising its "put," or the investor exercising its conversion right, would thus be short sales subject to all applicable regulations, including the borrow and delivery requirements in proposed Rule 203, and, if the security sold is a "covered security," the bid test provisions of proposed Rule 201.

customer account within 60 seconds is a condition that is consistent with previously stated Nasdaq policy regarding the handling of mixed capacity trades and compliance with the Manning Interpretation. See NASD Notice to Members 01-85, at Question 7 and Notice to Members 95-67, at Question 5.

¹⁷⁴ 17 CFR 240.3b-3(b).

¹⁷⁵ See Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992). Three commenters supported the price provision while four opposed it. Those who opposed it believed that a fixed-price requirement would prevent large transactions from being effected in an orderly manner and would place an undue burden on market participants who enter into contracts to buy and sell securities at a price to be determined in the future. Five commenters favored the fixed quantity provision and one commenter opposed it.

¹⁷⁶ *Id.*