

entered into an unconditional, binding contract be expected to receive the securities imminently in order to claim ownership.

We are concerned that, without an express requirement that the contract contemplate present delivery, there is a danger that contracts would be formed solely for the purposes of creating a long position to evade the short sale rule, although there is no real intention to actually acquire the securities pursuant to the contract. As a result, we are seeking comment on whether buyers of securities pursuant to a contract should be required to have a reasonable expectation of imminent receipt of the securities prior to considering themselves to own the securities pursuant to proposed Rule 200. We are not proposing a present or imminent delivery requirement in proposed Rule 200 but instead we are seeking comment on such a provision.

Q. Should proposed Rule 200 require a definite time frame that limits when the buyer can consider themselves long, *i.e.*, a buyer would be deemed to own the securities only if the contract contemplates the buyer will receive the securities within 30 days?

Q. If so, what should the time frame be? Does industry practice provide some objective standard that is reasonable?

#### B. Ownership of Securities Underlying Securities Futures Products

We propose that new Rule 200 include language consistent with existing Commission guidance defining when a person shall be deemed to own a security underlying a security futures contract.<sup>178</sup> Specifically, we have stated that a person who holds a security future obligating him to take delivery of the underlying securities by physical settlement would not be considered long in these securities for the purposes of proposed Rule 100 until the security future terminates trading.<sup>179</sup> This interpretation is consistent with the way current Rule 3b-3 addresses several instances where a person owns a security that entitles a person to acquire securities underlying the instrument, *e.g.*, options, rights, warrants, and convertibles. In those instances, Rule

3b-3 requires the option, right, warrant, or convertible to be exercised, tendered, or converted before the person can be considered as having a long position in the underlying security. These provisions also implicitly contemplate that the person will shortly acquire the security being sold. For a physically-settled security future, the holder will obtain the underlying security only after the security future terminates trading. A security future settled by receipt of cash has no effect on a person's long position.

We are proposing subparagraph (b)(6) of Rule 200 that provides that a person holding a long security futures position is not considered to own the underlying security for the purposes of Rule 3b-3 until the security terminates trading.

Q. Should proposed Rule 200 require delivery of the securities underlying a futures contract before a person can consider himself long for the purposes of short sale regulation?

#### C. Aggregation Units

Rule 3b-3 requires a seller of an equity security subject to Rule 10a-1 to aggregate all of its positions in that security in order to determine whether the seller has a "net long position" in the security.<sup>180</sup> Broker-dealer firms have represented that firm-wide netting is costly, burdensome, and potentially counterproductive for large, multi-service brokerage firms. Firm-wide netting is currently required at least once a day.<sup>181</sup>

Many large broker-dealers are divided into "desks" that pursue separate trading strategies. At times, the firm may have a net short position in a security, but a particular desk may have a net long position in that security. This situation may result in a desk not being able to pursue an investment strategy that calls for the desk to sell its long position. This result appears to be unwarranted where the sale is not made to benefit the positions of other firm trading units. While the firm could form separate broker-dealers for each trading unit's strategy to support the independence of each trading unit, this approach would be costly and elevate form over substance.

In 1998, the staff issued a letter stating that the Division would not recommend that the Commission take enforcement action if a multi-service broker-dealer calculated its net position in a particular security within defined trading units independently from the positions held by the other aggregation units within the firm ("aggregation unit letter").<sup>182</sup> We propose to incorporate aggregation unit netting into proposed Rule 200 because we believe that such netting allows aggregation units at multi-service broker-dealers to pursue different trading strategies, as well as provide liquidity to the market, without the restrictions of firm-wide netting.

Specifically, we propose to allow trading unit aggregation if: (1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies the trading objective of each, and supports its independent identity;<sup>183</sup> (2) each aggregation unit within the firm continuously determines, on a real-time basis, its net position for every security that it trades that is subject to proposed Rule 201 of Regulation SHO;<sup>184</sup> (3) each trader pursuing a particular trading objective or strategy is included in only one aggregation unit; and (4) individual traders are assigned to only one aggregation unit at a time. We believe that these conditions would help prevent potential coordinated manipulative activity amongst the aggregation units by ensuring they are separate and independent.<sup>185</sup>

We seek comment on our proposal to include the aggregation unit netting into Rule 200 of proposed Regulation SHO as well as firm-wide netting in general.

Q. Is this relief necessary for multi-service firms? How easily can these firms estimate

<sup>182</sup> See Letter regarding Bear, Stearns & Co. Inc.; Credit Suisse First Boston Corporation; Deutsche Bank Securities Inc.; Donaldson, Lufkin & Jenrette Securities Corporation; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith; Morgan Stanley & Co. Inc.; PaineWebber Inc.; Prudential Securities Inc.; Salomon Smith Barney Inc.; SG Cowen Securities Corporation; and Warburg Dillon Read LLC. (November 23, 1998), 1998 SEC No-Act LEXIS 1038.

<sup>183</sup> The independence of the units would be evidenced by a variety of factors, such as separate management structures, location, business purpose, and profit and loss treatment.

<sup>184</sup> This condition holds firms accountable for knowing the activities and positions of each aggregation unit.

<sup>185</sup> We believe that these conditions have worked well in restricting the exemptive relief to situations that do not appear to raise the abuses that the short sale price test is designed to prevent, and should be incorporated in the proposed exception. We also note that market participants that rely on the aggregation unit exception have designed their programming and surveillance systems in accordance with these conditions.

<sup>178</sup> Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Securities Exchange Act Release No. 46101 (June 21, 2002), 67 FR 43234 (June 27, 2002).

<sup>179</sup> Termination of trading is the moment at which an open position in a security future, either a long or short position, can no longer be closed or liquidated either by buying or selling an opposite position. A person obligated to deliver would be considered short at the termination of trading, and a person entitled to receive securities at the termination of trading would be considered long. *Id.*

<sup>180</sup> See 17 CFR 240.3b-3. See also Securities Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120 (October 3, 1983) (to determine whether a person has a "net long position" in a security, all accounts must be aggregated).

<sup>181</sup> See Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949, 17950 (aggregation must be based on a listing of securities positions in all proprietary accounts as determined at least once each trading day). Allowing aggregation to be determined once per day was largely due to practical considerations arising from technological limitations at the time the interpretation was issued.