

their real time positions for individual trading units? What about for the entire firm?

Q. Are the conditions included in proposed Rule 200 appropriate? Should there be additional conditions?

Q. Can the utility of the aggregation unit provision to multi-service firms be improved? If so, how?¹⁸⁶ Are the designated conditions appropriate?

Q. Should the aggregation unit provision be available to non-broker-dealers, for example, to hedge funds?

Q. On its face, Rule 3b-3 contemplates that a sale must be marked based on positions in all proprietary accounts in that security at the time of the sale. In light of the advances in technology since 1990, is it possible for firms or other entities to be able to determine their aggregate position in all proprietary accounts contemporaneously throughout the day? If not, why not?

Q. If firms or other entities are unable to determine their aggregate position in all proprietary accounts contemporaneously throughout the day, is there a means of allocating a daily aggregate position within the firm that would be capable of surveillance?

D. Block-Positioner Exception

The block-positioner exception is currently in subsection (e)(13) of Rule 10a-1.¹⁸⁷ Because this exception directly relates to a broker-dealer's calculation of its net position under current Rule 3b-3, we propose to incorporate the block-positioner exception without modification into Rule 200 of Regulation SHO.

Rule 3b-3 considers broker-dealers to have a short position in a security even though that position is fully offset by equivalent convertible securities, rights, warrants, or call options. Therefore, arbitrage activities may result in the block-positioner having a net short position. This short position would require compliance with the "tick" restrictions of the Rule and may inhibit the efforts of broker-dealers who engage in both block-positioning and offset activities. If a broker-dealer seeks to dispose of a block of securities it bought as a principal while acting in the capacity of a block-positioner, it may be unnecessarily hindered in doing so if it simultaneously has an equal or larger short position in the same security, even though that short position is fully offset as a result of arbitrage or hedging activity.

The block-positioner exception was created in order to facilitate the activities of broker-dealers who engage in both block positioning and arbitrage.¹⁸⁸ The Commission has recognized the important role block-positioners play in providing liquidity for large securities and in maintaining a fair and orderly market. When adopting this exception, the Commission noted that when a block-positioning firm's other short positions are fully offsetting other instruments, the result is an economically neutral position. The Commission noted that these other positions provide no incentive to effect sales from the block-positioning trading account in a manner that would cause or accelerate a decline in the market because gains in the short position would be offset by losses in the short position. The exception is limited in that it is available only to broker-dealers acting in the capacity of a block-positioner, and only if the short position is created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedging activities. We are proposing to include in proposed Regulation SHO the block positioner exception as it currently exists.

Q. Does the block-positioner exception continue to be needed?

Q. Does the block-positioner exception require any amendments? If so, what are alternatives to the way the rule currently operates?

E. Liquidation of Index Arbitrage Positions

Index arbitrage generally involves the purchase or sale of a "basket" of all stocks comprising a securities index or a smaller number of stocks designed to track day-to-day price movement of an index, and a contemporaneous offsetting sale or purchase of one or more commodity futures or options on a future or standardized option contracts on that index in an attempt to profit from price discrepancies between the stocks and the derivative index products. Index arbitrage often involves a liquidation (or "unwinding") transaction in order to realize arbitrage profits. Liquidation may consist of either simple elimination of each long or short stock position at expiration of the futures or option contract, or earlier termination of both the stock positions and the futures or option contract position.

Pursuant to Rule 3b-3, a seller of an equity security subject to Rule 10a-1 must aggregate all of the seller's positions in that security in order to determine whether the seller has a "net

long position" in the security. Therefore, if a person does not have a net long position in a security, any sale of that security must be designated as a short sale and must comply with the tick test provisions of current Rule 10a-1. A person liquidating an index arbitrage position involving a long basket of stocks may be unable to sell all the securities contemporaneously with closing out the derivative instrument position because of the requirement to net short security positions in other proprietary accounts, and as a consequence may not realize the expected arbitrage profit.

In 1992 the Commission proposed codifying prior no-action relief from the tick test provisions of paragraphs (a) and (b) of Rule 10a-1 relating to liquidations of certain index arbitrage positions.¹⁸⁹ Specifically, we proposed a new exception from the tick test provisions of Rule 10a-1(a) and (b) for any sale by a person effected in connection with the liquidation of an index arbitrage position relating to a securities index that is the subject of a financial futures (or options on such futures) contract traded on a contract market designated by the Commodity Futures Trading Commission, or a standardized options contract as defined in Rule 9b-1(a)(4) under the Exchange Act,¹⁹⁰ notwithstanding that such person may not have a net long position in that security. The proposed exception was limited, however, to contexts where: (1) such person's net short position is solely the result of one or more short positions created and maintained in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities; and (2) the sale does not occur during a period commencing at the time that the Dow Jones Industrial Average (DJIA) had declined by 50 points or more from its closing value on the previous day and terminating upon the establishment

¹⁸⁹ Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415 (June 9, 1992). The release proposed codifying as Rule 10a-1(g)(2) limited relief permitting the liquidation of certain existing index arbitrage positions involving long baskets of stock and short index futures or options without aggregating short stock positions in other proprietary accounts if those short stock positions are fully hedged. See Letter re: Merrill Lynch, Pierce, Fenner & Smith, Inc. (December 17, 1986); Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (April 30, 1990) (release clarifying and emphasizing certain aspects of the limited relief granted in the Merrill Lynch letter).

¹⁹⁰ Rule 9b-1(a)(4) states: "Standardized options are option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relates to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate." 17 CFR 240.9b-1(a)(4).

¹⁸⁶ One commenter to the Concept Release said that while the Aggregation Letter is sensible in concept, firms have expressed difficulty devising procedures to meet its requirements. See Letter from Willkie, Farr & Gallagher (WFG).

¹⁸⁷ See Securities Exchange Act Release No. 20715 (March 6, 1984), 49 FR 9414 (March 13, 1984). Block positioning is the facilitation of a large purchase or sale of securities for a customer by buying or selling as principal the amount of securities that cannot be immediately placed or obtained from third parties.

¹⁸⁸ *Id.*