

of the closing value of the DJIA on the next succeeding trading day. If the market decline restriction were in effect, each individual security would be required to be aggregated in the usual way with all of the seller's other positions in that security to determine whether the seller has a net long position.¹⁹¹ The amendments proposed in the 1992 Release were never adopted.¹⁹²

We propose to include in Rule 200 of Regulation SHO the relief for certain index arbitrage activities because we understand the relief is still being used and because codifying it would provide for ease of reference. We propose including it in Rule 200 with a minor change from the 1992 proposal. Namely Rule 200(f) would alter the second condition to specify that the relief would not be available during a period commencing at the time that the DJIA has declined below its closing value on the previous trading day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day during which the DJIA has not declined by two percent or more from its closing value on the previous day. This change would keep the language in proposed Rule 200 consistent with the current language in NYSE Rule 80A.¹⁹³

The Commission notes that levels of program trading have increased in

recent years,¹⁹⁴ and some have argued that this may be related to market volatility.¹⁹⁵ It should be noted that index arbitrage is not the only type of program trading.¹⁹⁶ The Commission requests comment on the usefulness and scope of the proposed amendment, including whether market participants believe that providing an exception from the proposed uniform bid test for some index arbitrage activity poses dangers for the markets.

Q. Is the relief for certain index arbitrage activities proposed to be incorporated in Rule 200 necessary under proposed Regulation SHO? Are the conditions appropriate?

XI. Hedging Transactions

In the Concept Release, the Commission requested comment on, among other things, exempting hedging transactions from short sale regulation. Currently, short sales related to hedges are treated the same under Rule 10a-1 as any other short sales. This is because Rule 3b-3 only takes equity positions into account, and it does not consider derivative positions related to these equity positions.¹⁹⁷ Some have suggested that bona fide hedging activity should be exempted from short sale regulation because such activity presents little threat of manipulation as gains from short hedging positions are offset by losses in a related security, *i.e.*, they are economically neutral positions.¹⁹⁸

¹⁹⁴ The NYSE publishes weekly program trading data on its website at www.nyse.com. The data shows that program trading over the past few years has increased as a percentage of the overall NYSE average daily volume. For example, during July 28 through August 1, 2003, program trading amounted to 45.5% of the NYSE's average daily volume of 1,474.7 million shares, or 671.4 million shares a day.

¹⁹⁵ See David Henry, *Whipsawed by Wall Street*, Bus. Wk., (March 10, 2003); Karen Talley, *Program Trading Grows as a Force in Stock Market*, WSJ, (June 17, 2002).

¹⁹⁶ Program trading encompasses a wide range of portfolio-trading strategies involving the purchase or sale of a basket of at least 15 stocks with a total value of \$1 million or more. Program trading is calculated as the sum of the shares bought, sold and sold short in program trades. The total of these shares is divided by total reported volume. The NYSE reported on its website that during July 28 through August 1, 2003, 13.3% of program volume executed by NYSE member firms related to index arbitrage. For the period from June 30 through July 3, 2003, when the program trading percentage reached 52% of NYSE average daily volume, the highest levels reported for the year to date, 8.5% of program volume executed by NYSE member firms related to index arbitrage.

¹⁹⁷ Under Rule 3b-3, holdings in convertible securities, options, rights and warrants are only considered to be long positions if they have been converted or exercised. See Rule 3b-3(d).

¹⁹⁸ The CBOE submitted to the Commission a letter suggesting parameters of a possible hedging exception to Rule 10a-1. See Letter from CBOE (August 20, 2001). In particular, CBOE proposed a

As discussed above, while the exceptions in the block-positioner and index arbitrage contexts do allow offsetting derivative positions to be considered, those exceptions provide limited aggregation relief for existing offsetting positions. They do not apply to short sales effected to establish an offsetting position. We have not included an exception for hedging short sales in our proposed Regulation SHO. We believe that a hedging exception is not necessary because the proposed bid test and pilot would provide market participants with additional flexibility in effecting short sales in order to hedge long exposure.

Q. Should a hedging exception be added to proposed Rule 201? If so, how should such an exception be designed so that it can be monitored and is not subject to abuse?

Q. Does the advent of trading in security futures absent short sale regulation, when combined with the proposed bid test and short sale pilot, address the concerns expressed by participants requesting an exception from Rule 201 for hedging? If not, why not?

Q. Should a hedging exception be included in Rule 201 that only applies to a particular group of market participants, *i.e.*, OTC market makers, option market makers, or specialists, that would allow short selling without regard to either a tick or bid test to offset the risk associated with their role in maintaining fair and orderly markets? Who should qualify for such an exception, what criteria would be used for determining whether short selling was part of maintaining fair and orderly markets, and how could the SROs and Commission surveil for compliance with such an exception?

XII. Elimination of Current Subparagraphs 10a-1(a)(2) and (a)(3)

One of the more significant changes in our proposal is the use of a bid test based on the consolidated best bid, which we believe would provide uniformity in short sale regulation for all markets in securities covered by proposed Rule 201. As a result, we are also proposing to eliminate the provision that markets currently have to use their own markets as a reference point for measuring the permissibility of short sales.

pilot program under which options market-makers and specialists would be exempt from the tick test provisions of the short sale rule when selling select listed stocks short to hedge positions in options that result from market-making obligations. Under the proposal, market makers and specialists would be able to sell CBOE pilot program stocks short on a minus or zero minus tick to hedge, on a delta equivalent basis only, pre-existing long exposure (stocks and options combined) or contemporaneous option transactions, subject to several provisions enumerated in their letter. The letter is available for review in the Commission's Public Reference Room (File No. S7-24-99).

¹⁹¹ This proposed market decline restriction substantially paralleled, and would be invoked simultaneously with, the operation of NYSE Rule 80A, which at the time of the proposal applied when the DJIA index moved 50 points or more from the previous day's close. Rule 80A was more restrictive, in that it required all NYSE index arbitrage stock transactions, whether undertaken by a short or long seller, to be effected on a plus or zero-plus tick. The proposed exception, however, would have operated for a longer period of time than 80A, which at that time terminated once the DJIA recovers 25 points from the 80A trigger level. Instead, the exception would terminate upon the establishment of the closing value of the DJIA on the next succeeding trading day, in order to allow the markets to avoid incremental selling pressure at the close of trading on a volatile trading day and at the opening of trading on the following day, since trading activity at these times may have a substantial effect on the market's short-term direction.

¹⁹² Commenters were generally in favor of codifying the exemption. However, the proposal was never acted upon.

¹⁹³ Under Rule 80A, when the DJIA index moves two percent or more from the previous day's close, index arbitrage orders in component stocks of the S&P 500 stock price index are subject to a tick test. In down markets sell orders may be executed only on a plus or zero-plus tick (and be marked "sell plus"); in up markets buy orders may be executed only on a minus or zero-minus tick (and be marked "buy minus"). The test remains in effect for the remainder of the trading day once it has been activated, but shall be removed if the DJIA subsequently moves within one percent of the previous day's closing value.