

phenomenon.²¹¹ For years, institutional investors and market professionals have sent after-hours orders to broker-dealers for execution as principal on alternative broker-dealer trading systems, such as ECNs. However, technological advances have changed the securities markets, and trading has expanded beyond the regular trading hours of 9:30 a.m. to 4 p.m. Eastern Time (ET).

We have supported investor choice in trading hours provided that essential protections for investors and the markets are not compromised. We have approved several SRO programs designed to further these goals, including extending consolidated last trade price and quotation information. We have also approved after hours and pre-opening trading sessions for the Archipelago Exchange (ArcaEx).²¹² In addition, we have approved on a pilot basis a Nasdaq program to extend the operation of key trade and price reporting systems until 6:30 p.m. ET.²¹³ However, the NASD has not extended its short sale bid test, Rule 3350, to the after-hours market.²¹⁴ Nonetheless, NASD members are still required to make affirmative determinations that they will receive delivery of a security from their customers or that the member can borrow the security on behalf of the customer for delivery by settlement date before accepting short sale orders.²¹⁵

We currently interpret the tick test to apply to all trades in listed securities, whenever they occur. By its terms, Rule 10a-1 uses as a reference point the last trade price reported to the tape. Thus, after the tape ceases to operate, the rule prevents any person from effecting a short sale at a price that is lower than the last sale reported to the tape. Most of the comments received in response to the Concept Release supported applying

the short sale rule to after-hours trading.²¹⁶ We believe that the proposed uniform short sale rule should apply to after hours trades in all covered securities, requiring all short sales in covered securities to be effected at a price above the current best bid displayed as part of the consolidated best bid and offer. After the time the consolidated best bid ceases to be calculated and disseminated, the proposed rule would prevent short selling at a price at or below the last published consolidated best bid. We believe that applying the proposed bid test to after hours trades in all covered securities would extend the goals of short sale regulation to the after hours markets.

We solicit comment on this proposed operation of the rule, including, but not limited to, the following issues:

Q. Does the consolidated quote information that is collected and published after hours provide sufficient information to allow short selling after hours at a price above the consolidated best bid, or should the rule impose a fixed reference point above which all short sales must be effected, such as the consolidated best bid at the close of the regular session?

Q. Should the proposed short sale rule allow short selling above the best bid after the time that the consolidated best bid ceases to be collected and disseminated, if reliable quotes are still published?²¹⁷ Would this approach, which would most likely have

²¹⁶ The NYSE and the NASD were among those commentators who recommended extending the short sale rule to cover after hours trading. The NYSE stated that, "With respect to after-hours trading, the Exchange believes that the Rule should apply given the potential for trading abuses in a market environment with lesser trading volume and greater volatility." See Letter from James E. Buck, Senior Vice President and Secretary, NYSE (February 3, 2000). The NASD recommended that short sale regulation be extended to all securities being traded in extended hours sessions, including National Market and SmallCap securities. "The justifications for regulating short-sales—the threats of abusive short-selling, extreme volatility, and reduced liquidity due to the high risk to market-makers—apply with equal, if not greater, force during extended hours trading." See Letter from Richard G. Ketchum, President, NASD, Inc. (February 15, 2000). However, as noted, the NASD subsequently determined not to apply Rule 3350 after-hours, due to the belief that the volume of trading after hours was not sufficient to justify imposing short sale regulation.

²¹⁷ For example, in its comment letter in response to the Concept Release, one commenter urged the Commission to allow short sales to be effected on ATSs based on their respective systems' last trade price when the tape is not operating. It was noted that this option could only be extended to such ATSs that meet certain thresholds relative to the overall trading volume in the after-hours market. See Letter from Orrick, Herrington & Sutcliffe, counsel for MarketXT (December 30, 1999). Island also suggested allowing ATSs operating after-hours to rely on their own bid as a reference point. See Letter from The Island ECN, Inc. (January 21, 2000).

multiple reference points, be a feasible alternative?

B. Off-Shore Trading

In July 1992, the Commission announced that it was undertaking a study of the U.S. equity markets and of the regulatory environment in which those markets operate.²¹⁸ As part of the study, the Commission addressed and sought comment on the practice of U.S. broker-dealers "booking" trades through their foreign desks or foreign affiliates to avoid U.S. transparency requirements, off-board trading restrictions, transaction fees, or limits on short sales. In what is commonly referred to as the "fax market," a U.S. broker-dealer acting as principal for its customer negotiates and agrees to the terms of a trade in the U.S., but transmits or faxes the terms overseas to be "printed" on the books of a foreign office.²¹⁹

Consistent with prior Commission action, we view short sale regulation as applying to trades in reported securities when the trade is agreed to in the United States, even if the trades are "booked" overseas.²²⁰ For example, a

²¹⁸ See Securities Exchange Act Release No. 30920 (July 14, 1992), 57 FR 32587 (July 22, 1992).

²¹⁹ This practice of "booking" trades overseas was analyzed and dealt with in further depth in the Division of Market Regulation's Market 2000 Report. In the Report, the Division estimated that approximately 7 million shares a day in NYSE stocks are faxed overseas, and many of these trades are nominally "executed" in the London over-the-counter market. The Report further stated that off-shore trades generally are not reported publicly. Rather, they are reported for regulatory purposes only to the NYSE and NASD pursuant to NYSE Rule 410 or to the NASD on Form T. See Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (January 1994), Study VII, p. 2.

²²⁰ See, e.g., Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949 (April 30, 1990) (stating that the no-action position exempting certain index arbitrage sales from the tick test provisions of Rule 10a-1 will not apply to an index arbitrage position that was established in an offshore transaction unless the holder acquired the securities from a seller that acted in compliance with Rule 10a-1 or other comparable provision of foreign law); see also Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302 (April 25, 1985) at n. 48 (stating that, "Rule 10a-1 does not contain any exemption for short sales effected in international markets."). The question of whether a particular transaction negotiated in the U.S. but nominally executed abroad by a foreign affiliate is a domestic trade for U.S. regulatory purposes was also addressed in the Commission's Order concerning Wunsch Auction Systems, Inc. (WASI). The Commission stated its belief that "trades negotiated in the U.S. on a U.S. exchange are domestic, not foreign trades. The fact that the trade may be time-stamped in London for purposes of avoiding an SRO rule does not in our view affect the obligation of WASI and BT Brokerage to maintain a complete record of such trades and report them as U.S. trades to U.S. regulatory and self-regulatory authorities and, where applicable, to U.S. reporting systems." See Securities Exchange Act Release No. 28899 (February 20, 1991), 56 FR 8377 (February 28, 1991).

²¹¹ See Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (January 1994), at II-13 and II-14.

²¹² See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001). ArcaEx entered into an agreement with SIAC to extend the operation of the consolidated tape for exchange-listed stocks and Nasdaq NMS stocks from 8 a.m. to 8 p.m. ET.

²¹³ See Securities Exchange Act Release No. 42003 (October 13, 1999), 64 FR 56554 (October 20, 1999). Under the pilot, any Nasdaq market maker that chooses to post quotations and trade during these extended hours is obligated to post firm two-sided quotations when opening and making its market, but may enter or leave the market on the hour or half-hour up to 6:30 p.m. Regardless of an NASD's member's quotation activity, all transactions in Nasdaq National Market, Small Cap, Convertible Debt and OTC transactions in exchange-listed securities executed between the hours of 8 a.m. and 6:30 p.m. must be reported within 90 seconds.

²¹⁴ See NASD Head Trader Alert #2000-55 (August 7, 2000).

²¹⁵ See NASD Rule 3370.