

U.S. money manager decides to sell a block of 500,000 shares in a NYSE security. The money manager negotiates a price with a U.S. broker-dealer, who sends the order ticket to its foreign trading desk for execution. In our view, this trade occurred in the United States as much as if the trade had been executed by the broker-dealer at a U.S. trading desk. Under the proposed rule, if the sale agreed to is a short sale in an exchange-listed or Nasdaq NMS security, unless otherwise excepted, it must be effected at a price one cent above the current best bid displayed as part of the consolidated best bid and offer regardless of where it is executed.

Q. What factors should be used to determine whether a trade in a covered security is agreed to in the U.S.? If a trade is agreed to by a broker-dealer located outside the U.S., should the trade be viewed as agreed to outside the U.S., regardless of the location of the seller? Would the requirement that trades agreed to in the U.S. be effected at a price above the current best bid disadvantage U.S. broker-dealers in favor of foreign broker-dealers? If so, please explain.

Q. For trades agreed to in the United States and executed overseas, is the time of agreement a sufficient determinative event for the triggering of the rule?

## XV. Limitations on Short Selling During Significant Market Declines

To protect investors and the markets, the Commission has approved proposals to restrict trading if key market indexes fall by specified amounts. In response to the October, 1987 market break, the Commission approved various exchanges' circuit breaker proposals to permit these brief, coordinated cross-market halts to provide opportunities during a severe market decline to reestablish an equilibrium between buying and selling interests in an orderly fashion, and help to ensure that market participants have a reasonable opportunity to become aware of, and respond to, significant price movements.<sup>221</sup> The coordinated cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the *ad hoc* and destabilizing halts which can occur when market liquidity is exhausted.<sup>222</sup> Currently, all stock exchanges and the NASD have rules or policies to implement coordinated circuit breaker

halts.<sup>223</sup> The options markets also have rules applying circuit breakers.<sup>224</sup> The futures exchanges that trade futures on indexes have adopted circuit breaker halt procedures in conjunction with their price limit rules for index products.<sup>225</sup> Finally, security futures products are required to have cross-market circuit breaker regulatory halt procedures in place.<sup>226</sup>

We note that current short sale regulation focuses on the prices of individual securities rather than market segments or market indexes. Nevertheless, we seek comment on whether short selling should be restricted in the future in response to a severe market decline.

Q. Should short selling be restricted or prevented during a period of significant market decline, such as after circuit breakers have been lifted? If so, at what level should the restrictions take place, *i.e.*, if the market declines 10%, 20% etc.? How long a period of time should the restrictions remain in effect?

Q. Should short selling be restricted or prevented for any particular security if the price of that security declines significantly during the course of a trading day? If so, at what level should the restrictions take place, *i.e.*, if the price of the security declines 10%, 20% etc.? How long a period of time should the restrictions remain in effect?

## XVI. Rule 105 of Regulation M—Short Sales in Connection With a Public Offering

The price of securities in an offering is generally based on a security's closing market price. When market prices are

artificially distorted securities markets are prevented from functioning as independent pricing mechanisms and offering price integrity is eroded. Short sales of securities that depress the market price shortly before an offering is priced can cause (i) the postponement or abandonment of an offering, and (ii) the offering price to be lower than anticipated because artificial forces distort it.<sup>227</sup> The pre-pricing short sales may exert downward pressure on a security's market price causing the market price to decline. Consequently, the offering price is set lower than anticipated because it is now based off an artificially depressed market price. Short sellers who anticipate and receive an offering allocation cover their short sales at the lower, fixed offering price generating a profit. Rule 105 of Regulation M addresses this market abuse.

### A. Scope of Rule 105 of Regulation M

Rule 105 of Regulation M prohibits a short seller from covering short sales with offered securities purchased from an underwriter, broker or dealer participating in the offering if the short sale occurred within the period of five days prior to pricing of the offering securities. The Rule promotes offering prices that are based upon market prices determined by natural market forces instead of prices distorted by artificial forces. Rule 105 of Regulation M applies to offerings of securities for cash pursuant to a registration statement or a notification on Form 1-A filed under the Securities Act of 1933. The Rule prohibits covering a short sale with offering securities purchased from an underwriter or broker or dealer participating in the offering if the short sale occurred during the Rule 105 of Regulation M restricted period, which is the shorter of the period beginning (i) five business days before pricing of the offered securities and ending with such pricing, or (ii) with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing. The Rule excepts shelf offerings filed under Rule 415 and offerings not conducted on a firm commitment basis as well as providing for exemptive relief. The Rule is prophylactic, and prohibits the conduct irrespective of the short seller's intent in effecting the short sale.

<sup>221</sup> See Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637 (October 24, 1988) (approving rules of the Amex, CBOE, NASD, NYSE).

<sup>222</sup> See Circuit Breaker Report by the Staff of the President's Working Group on Financial Markets (August 18, 1998) (Circuit Breaker Report), n. 33.

<sup>223</sup> See Securities Exchange Act Release No. 39846 (April 9, 1998), 63 FR 18477 (April 15, 1998) (order approving proposals by Amex, BSE, CHX, NASD, NYSE, and Phlx). See also *e.g.*, NYSE Rule 80B. The current circuit breaker procedures call for cross-market trading halts when the Dow Jones Industrial Average (DJIA) declines by 10 percent, 20 percent, and 30 percent from the previous day's closing value.

<sup>224</sup> See Amex Rule 950 (applying Amex Rule 117, Trading Halts Due to Extraordinary Market Volatility, to options transactions); CBOE Rule 6.3B; ISE Rule 703; PCX Rule 4.22 (which applies to options contracts through Rules 6.1(a) and (e)); and Phlx Rule 133.

<sup>225</sup> See, *e.g.*, CME Rule 4002.I. The CME will implement a circuit breaker trading halt in SPX Futures if the 10% circuit breaker halt has been imposed in the securities markets and the futures are "locked" at their 10% price limit. Trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50% of the index capitalization. The CME will implement another circuit breaker trading halt in SPX Futures if the 20% circuit breaker halt has been imposed in the securities markets and the futures are locked at their 20% price limit. Once again, trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50% of the index capitalization.

<sup>226</sup> See Securities Exchange Act Release No. 45956 (May 17, 2002), 67 FR 36740 (May 24, 2002).

<sup>227</sup> Concerned about losses in "cold" issues, investors may engage in schemes to guarantee "cold" issue profits by effecting short sales prior to the pricing of an offering (pre-pricing short sales) and covering the short sales with offering securities.