

be designed to avoid possible trade execution delays associated with complying with the "tick test" of Rule 10a-1. Other strategies are intended to avoid aggregation obligations.¹¹ Some strategies may involve the manipulative sale of securities underlying a married put as part of a scheme to drive the market price down and later profit by purchasing the securities at a depressed price.¹²

Most recently, we have become aware of certain strategies in which traders may acquire married puts as part of what may be an effort to circumvent the application of Rule 105. In these schemes traders enter into married put transactions during the restricted period 5 days before (or, sometimes, on the day of) pricing in a "secondary" or "repeat" offering.¹³ Thereafter, the traders aggressively sell the stock portion of the married put as "long" sales, exercise the puts at the end of the day they are obtained, and then use securities obtained in the offering (sometimes obtained at a discount to the closing price) to cover their restricted period sales.

or below the current best (inside) bid displayed in the Nasdaq National Market Execution System when the current best (inside) bid is below the preceding best (inside) bid in the security. With respect to trades executed on or reported to the Alternative Display Facility, Rule 3350 provides that no member shall effect a short sale, for the account of a customer or for its own account, in a NMS Security at or below the current national best (inside) bid when the current national best (inside) bid is below the preceding national best (inside) bid in the security.

¹¹ For example, day-trading firms, where traders generally attempt to derive a profit by executing many intra-day trades to take advantage of small price movements in a stock, may find it difficult to aggregate the positions held by each day trader in calculating the firm's "net long" position under Rule 3b-3. As part of an effort to avoid aggregation, day-trading firms may use married put transactions to execute sales in a stock in a coordinated attempt to maintain a firm-wide "net long" position.

¹² We have previously expressed concern about the use of married put transactions as a part of such strategies. See Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28, 1999) (Short Sale Concept Release). We noted that such strategies often involve the purchase of a married put just prior to, or simultaneous with, the sale of stock associated with the married put transaction. Soon after (*i.e.*, later in the day), the transaction is unwound when the market participant allegedly returns the securities to the facilitator of the married put transaction. In expressing concern about such activity, we concluded "a potential for abuse exists where the trader aggressively sells the 'long' stock position, destabilizing the price of the stock, and soon after repurchases the stock in the market to return to the counter party. This type of strategy may present a heightened potential for manipulation." *Id.*

¹³ The first time an issuer conducts a public offering of its securities, the offering is referred to as an "initial public offering." Subsequent offerings by the issuer are referred to as "repeat" offerings. A "secondary" offering is an offering of securities held by shareholders.

This activity often enables the traders receiving offering shares to profit from the difference between the sales prices and the offering price, where the sales lowered the market price and, as a consequence, the market-based offering price. Not only is this manipulative conduct harmful to the market, but it also may have a substantial impact on the issuer and its shareholders that receive reduced offering proceeds as a result of the lower offering price.¹⁴

We find the use of married put transactions as a part of these strategies particularly troubling because they represent an attempt to facilitate the very kind of abuse that Rules 10a-1 and 105 are designed to prevent. In light of this activity, we have determined that it is necessary to provide notice to traders that, under certain circumstances, the securities underlying married puts will not provide ownership (*i.e.*, a "long" position) under Rule 3b-3.

We are issuing this guidance to address married puts that are used as part of an attempt to create a "long" position for the purpose of circumventing Rules 10a-1 and 105.¹⁵ Such transactions usually have some or all of the following characteristics (or a variation of them):

- the purchase of an at- or in-the-money non-standardized put option with a brief (1 to 5 day) expiration period,
- the contemporaneous purchase of an equivalent number of shares of the same security,
- the contemporaneous sale of the stock acquired with a married put, in essence divorcing the stock position from the put option,¹⁶

¹⁴ This activity impedes the markets from functioning as an independent pricing mechanism, undermines market integrity, and diminishes investor confidence.

¹⁵ The abusive use of married put transactions has also been discussed in the press. For example, see Torres, "Are 'Slam Dunks' on Troubled Stocks a Foul," Wall St. J., (February 1, 1991) (describing married puts as a "new weapon to 'raid' bad-news stocks."); see also Pulliam, "Bullet Strategy Makes Comeback as Trades Find a Way to Skirt Rules on Short Selling," Wall St. J., (October 14, 1998) (describing the married put strategy as a "rapid fire sale of stock that is designed to build on a wave of selling . . . even though the trader may be selling the married-put stock at a loss, the theory is that he will make an even bigger profit on the put option as its value rises based partly on the market impact of the aggressive stock selling.").

¹⁶ Identifying a contemporaneous divorce of the stock position from the put option as an indication of a possible abusive use of married put transactions should not discourage legitimate hedging because such activity is inconsistent with hedging. Separating the securities underlying a married put transaction from the put option eliminates one of the legitimate economic reasons why an investor may enter into a married put transaction, *i.e.*, its use to protect from any losses resulting from the stock price falling below the

• the repeated use of a "facilitator"¹⁷ that sells both the puts and the "long" position (often by selling the stock short to the counterparty),

• the "netting out" of the transaction between the facilitator and the counterparty, often at the end of the day the married put was purchased, and

• the payment of a standardized fee, not calculated in accordance with a standard options pricing model, to the facilitator for the transaction.¹⁸

The net result of these transactions is that there is minimal or no economic risk to the married put purchaser or the party facilitating the married put.¹⁹ These married puts are distinguishable from other paired positions of stock and options where each component is intended to offset the risk of the other. In those cases, both sides of the position are held for a period of time, and the

strike price of the option. Once the stock is divorced from the put option, a married put transaction is converted into a speculative "bearish" position, with the put option used as a substitute for a short position in the stock. This is not consistent with legitimate hedging but rather aligned with a short strategy. Moreover, it is unlikely that a trader anticipating obtaining a "long" position by virtue of an expected allocation of "repeat" or "secondary" offering shares would use a married put transaction as a legitimate hedging instrument. In such an instance, a trader most likely would simply purchase put options in the offering stock rather than purchasing both the stock and the put options.

¹⁷ Often, the married put transactions are structured so the facilitator sells the "long" position at a price equal to the strike price of the puts at the beginning of a trading day. At the end of the day the facilitator repurchases the security from the trader at the strike price charging a per share fee for the service. Other times, the facilitator may sell the put options with an in-the-money strike price, *i.e.*, the strike price is above the current market price, charging higher premiums as payment for the facilitating the married put transactions.

¹⁸ The options are not priced in accordance with a standard options pricing model, *e.g.*, the Black-Scholes option pricing model, that takes into account volatility of a securities return, the level of interest rates, the relationship of the underlying stock's price to the strike price of the option, and the time remaining until the option expires. Instead, the options are priced to ensure that transaction is netted out between the parties with the payment of a flat fee to the facilitator for the service, *i.e.*, a lending fee.

¹⁹ The Commission has previously indicated that where transactions involve no market risk and serve no purpose other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws. See *In the Matter of Shearson Lehman Brothers, Inc.*, Admin. Proc. File No. 3-7853, Exchange Act Release No. 31196 (September 17, 1992). See also *In re Bevil, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557 (D.N.J. 1986) (Whether a particular repurchase agreement is characterized as a securities transaction or as a loan can be determined by the objective intent of the parties. Intent of the parties may be reflected in the terms of the transaction as well as extrinsic evidence of intent, such as books and records of the parties, accounting practices, regulatory treatment of the transactions, and trade custom and usage).