

# **SECURITIES AND EXCHANGE COMMISSION**

## **17 CFR PART 242**

**Release No. 34-61595; File No. S7-08-09**

**RIN 3235-AK35**

### **Amendments to Regulation SHO**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is adopting amendments to Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”). We are adopting a short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold short (“short sale price test” or “short sale price test restriction”). Specifically, the Rule requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan. We believe it is appropriate at this time to adopt a short sale-related circuit breaker because, when triggered, it will prevent short selling, including potentially manipulative or abusive short selling,

from driving down further the price of a security that has already experienced a significant intra-day price decline, and will facilitate the ability of long sellers to sell first upon such a decline. This approach establishes a narrowly-tailored Rule that will target only those securities that are experiencing significant intra-day price declines. We believe that addressing short selling in connection with such declines in individual securities will help address erosion of investor confidence in our markets generally.

In addition, we are amending Regulation SHO to provide that a broker-dealer may mark certain qualifying sell orders “short exempt.” In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.” This “short exempt” marking requirement will aid surveillance by self-regulatory organizations (“SROs”) and the Commission for compliance with the provisions of Rule 201 of Regulation SHO.

**DATES:** Effective Date: [Insert date 60 days after publication in the Federal Register.]

Compliance Date: [Insert date 6 months from Effective Date.]

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**SUPPLEMENTARY INFORMATION:** The Commission is amending Rules 200(g) and 201 of Regulation SHO [17 CFR 242.200(g) and 17 CFR 242.201] under the Exchange Act.

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## **I. Executive Summary**

In July 2007, the Commission eliminated all short sale price test restrictions. Prior to that time, short sale price test restrictions included Rule 10a-1 under the Exchange Act, also known as the “uptick rule” or “tick test” (“former Rule 10a-1”), that applied to exchange-listed securities,<sup>1</sup> and the National Association of Securities Dealers, Inc.’s (“NASD”)<sup>2</sup> bid test, Rule 3350 (“NASD’s former bid test”), that applied to certain Nasdaq securities.<sup>3</sup> The Commission’s removal of short sale price test restrictions followed a careful, deliberative rulemaking process, carried out in multiple stages from 1999 through 2006, and was open to the public at every stage.

The Commission took a number of steps as part of that process, including seeking extensive public comment and conducting a comprehensive staff study to assess whether then-current short sale price test restrictions were appropriate. For example, beginning in 1999, the Commission published a concept release in which it sought comment regarding short sale price test regulation, including comment on whether to eliminate such regulation.<sup>4</sup> In 2004, the Commission initiated a year-long pilot (“Pilot”) to study the removal of short sale price tests for approximately one-third of the largest stocks.<sup>5</sup> Short sale data was made publicly available during this Pilot to allow the public and Commission staff (the “Staff”) to study the effects of eliminating short sale price test restrictions. The findings of third party researchers were

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<sup>1</sup> See infra note 41 and accompanying text.

<sup>2</sup> NASD is now known as the Financial Industry Regulatory Authority, Inc. (“FINRA”).

<sup>3</sup> See infra note 43 and accompanying text.

<sup>4</sup> See Exchange Act Release No. 42037 (Oct. 20, 1999), 64 FR 57996 (Oct. 28, 1999) (“1999 Concept Release”).

<sup>5</sup> See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (Aug. 6, 2004) (“Pilot Release”).

presented and discussed in a public Roundtable in September 2006.<sup>6</sup> In addition, the results of the Staff study of the Pilot data were made publicly available in draft form in September 2006 and in final form in February 2007.<sup>7</sup>

Since then, there has been significant market turmoil. Concurrent with the development of the subprime mortgage crisis and credit crisis in 2007, market volatility, including steep price declines, particularly in the stocks of certain financial services companies, increased markedly in the U.S. and in every major stock market around the world (including markets that continued to operate under short sale price test restrictions).<sup>8</sup> As market conditions continued to worsen, investor confidence eroded, and the Commission received many requests from the public to consider imposing restrictions with respect to short selling, based in part on the belief that such action would help restore investor confidence.<sup>9</sup>

We determined that it was appropriate to re-examine the appropriateness of short sale price test restrictions and seek comment on whether to restore any such restrictions. Thus, in April 2009 we proposed two approaches to restrictions on short selling, one that would apply on a permanent, market-wide basis and another that would apply to a particular security upon a significant decline in the price of that security (the “proposed circuit breaker approach” or “proposed circuit breaker rules”).<sup>10</sup>

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<sup>6</sup> See <http://www.sec.gov/about/economic/shopilottrans091506.pdf> (the “Regulation SHO 2006 Roundtable”).

<sup>7</sup> See [http://www.sec.gov/about/economic/shopilot091506/draft\\_reg\\_sho\\_pilot\\_report.pdf](http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf) and <http://www.sec.gov/news/studies/2007/regshopilot020607.pdf>. See also *infra* notes 48 to 62 and accompanying text (discussing findings of the Staff study).

<sup>8</sup> See Exchange Act Release No. 59748 (Apr. 10, 2009), 74 FR 18042, 18043 (Apr. 20, 2009) (the “Proposal”).

<sup>9</sup> See *id.*

<sup>10</sup> See Proposal, 74 FR 18042.

With respect to the permanent, market-wide approach, we proposed two alternative price tests. The first alternative price test, in many ways similar to NASD's former bid test, would be based on the national best bid (the "proposed modified uptick rule"). The second alternative price test, similar to former Rule 10a-1, would be based on the last sale price (the "proposed uptick rule").

With respect to the proposed circuit breaker approach, we proposed two basic alternatives. First, we proposed a circuit breaker rule that, when triggered by a significant price decline in a particular security, would temporarily prohibit any person from selling short that security, subject to certain exceptions ("proposed circuit breaker halt rule"). Second, we proposed a circuit breaker rule that, when triggered by a significant price decline in a particular security, would trigger a temporary short sale price test for that security. In connection with this alternative, we proposed two short sale price tests. One was the modified uptick rule – that is, we proposed a circuit breaker rule that, when triggered by a significant price decline in a particular security, would temporarily impose the proposed modified uptick rule for that security ("proposed circuit breaker modified uptick rule"). The other was the uptick rule – that is, we proposed a circuit breaker rule that, when triggered by a significant market decline in a particular security, would temporarily impose the proposed uptick rule for that security ("proposed circuit breaker uptick rule").

In addition, in the Proposal we inquired whether a short sale price test restriction that would permit short selling at a price above the current national best bid (the "alternative uptick rule"), would be preferable to the proposed modified uptick rule and the proposed uptick rule.<sup>11</sup> We sought comment regarding the application of the alternative uptick rule as a market-wide

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<sup>11</sup> See Proposal, 74 FR at 18072, 18081, 18082.

permanent short sale price test restriction or in conjunction with a circuit breaker.<sup>12</sup> As a supplement to our request for comment in the Proposal and to help ensure the public had a full opportunity to comment on, among other things, the alternative uptick rule, on August 20, 2009 we re-opened the comment period to the Proposal.<sup>13</sup> In addition, on May 5, 2009, we held a Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions (the “May 2009 Roundtable”).<sup>14</sup> Panelists included representatives of public issuers, investors, financial services firms, SROs and the academic community.<sup>15</sup>

Although in recent months there has been an increase in stability in the securities markets, we remain concerned that excessive downward price pressure on individual securities accompanied by the fear of unconstrained short selling can undermine investor confidence in our markets generally.<sup>16</sup> In addition, we are concerned about potential future market turmoil, including significant increases in market volatility and steep price declines. Thus, as discussed in more detail below, after considering the comments, we have determined that it is appropriate at this time to adopt in Rule 201 a targeted short sale price test restriction that will apply the alternative uptick rule for the remainder of the day and the following day if the price of an

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<sup>12</sup> See id.

<sup>13</sup> See Exchange Act Release No. 60509 (Aug. 17, 2009), 74 FR 42033 (Aug. 20, 2009) (the “Re-Opening Release”).

<sup>14</sup> See Exchange Act Release No. 59855 (May 1, 2009); Press Release No. 2009-101 (agenda and panelists included); Press Release No. 2009-88 (preliminary agenda included).

<sup>15</sup> See <http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.txt> (unofficial transcript of May 2009 Roundtable).

<sup>16</sup> We note that investor confidence may include a number of different elements, such as investor perceptions about fundamental market risk, investor optimism about the economy, or investor trust in the fairness of financial markets as influenced by applicable regulatory protections. Although the latter can be directly influenced by Commission actions, the Commission does not have control over fundamental market risk and economic optimism. Thus, as used here, the term “investor confidence” refers to investor trust in the fairness of financial markets.

individual security declines intra-day by 10% or more from the prior day's closing price for that security as determined by the covered security's listing market.

By not allowing short sellers to sell at or below the current national best bid while the circuit breaker is in effect, the short sale price test restriction in Rule 201 will allow long sellers, who will be able to sell at the bid, to sell first in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long sellers to sell first in a declining market.<sup>17</sup> A short seller that is seeking to profit quickly from accelerated, downward market moves may find it advantageous to be able to short sell at the current national best bid. In addition, by making such bids accessible only by long sellers when a security's price is undergoing significant downward price pressure, Rule 201 will help to facilitate and maintain stability in the markets and help ensure that they function efficiently. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors.

In addition, combining the alternative uptick rule with a circuit breaker will strike the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets,

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<sup>17</sup> See Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62989 (Nov. 6, 2003) ("2003 Regulation SHO Proposing Release"); see also Exchange Act Release No. 30772 (June 3, 1992), 57 FR 24415, 24416 (June 9, 1992) (stating that former Rule 10a-1 was "designed to limit short selling of a security in a declining market, by requiring, in effect, that each successive lower price be established by a long seller").

including the provision of liquidity and price efficiency in the markets.<sup>18</sup> The circuit breaker approach of Rule 201 will help benefit the market for a particular security by allowing participants, when a security is undergoing a significant intra-day price decline, an opportunity to re-evaluate circumstances and respond to volatility in that security. We also believe that a circuit breaker will better target short selling that may be related to potential bear raids<sup>19</sup> and other forms of manipulation that may be used to exacerbate a price decline in a covered security.

At the same time, however, we recognize the benefits to the market of legitimate short selling, such as the provision of liquidity and price efficiency. Thus, by imposing a short sale price test restriction only when an individual security is undergoing significant downward price pressure, the short sale price test restrictions of Rule 201 will apply to a limited number of securities, rather than to all securities all the time. As discussed in more detail below,<sup>20</sup> in response to our request for comment on an appropriate threshold at which to trigger the proposed circuit breaker short sale price test restrictions, commenters submitted estimates of the number of securities that would trigger a circuit breaker rule at a 10% threshold.<sup>21</sup> While commenters'

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<sup>18</sup> Where we use the terms “market efficiency” and “price efficiency” in this adopting release we are using terms of art as used in the economic literature proceeding under the “efficient markets hypothesis,” under which financial prices are assumed to reflect all available information and accordingly adjust quickly to reflect new information. See, e.g., Eugene F. Fama, 1991, Efficient capital markets: II, Journal of Finance, 46: 1575-1617; Eugene F. Fama and Kenneth R. French, 1992, The Cross-Section of Expected Stock Returns, Journal of Finance, 47: 427-465. It should be noted that economic efficiency and price efficiency are not identical with the ordinary sense of the word “efficiency.”

<sup>19</sup> See infra note 36 and accompanying text.

<sup>20</sup> See infra Section III.A.5. (discussing the circuit breaker trigger level).

<sup>21</sup> See, e.g., letter from Mary Lou Von Kaenel, Managing Director, Management Consulting, Jordan & Jordan, dated June 19, 2009 (“Jordan & Jordan”); letter from John C. Nagel, Managing Director and Deputy General Counsel, Citadel Investment Group, John Liftin, Managing Director and General Counsel, The D.E. Shaw Group, and Mark Silber, Executive Vice President, Renaissance Technologies, dated June 19, 2009 (“Citadel et al. (June 2009)”); letter from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, Managed Funds Association, dated June 22, 2009 (“MFA (June 2009)”); letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, dated June 19, 2009 (“SIFMA (June 2009)”); letter from Daniel Mathisson, Managing Director, Credit Suisse Securities (USA), LLC, dated Sept. 21, 2009 (“Credit Suisse (Sept. 2009)”).

analyses (including the facts and assumptions used) and their resulting estimates varied,<sup>22</sup> commenters' estimates reflect that a 10% circuit breaker threshold, on average, should affect a limited percentage of covered securities.<sup>23</sup> Given the variations in the facts and assumptions underlying the estimates submitted by commenters, the Staff also looked at trading data to confirm the reasonableness of those estimates. The Staff found that, during the period covering April 9, 2001 to September 30, 2009,<sup>24</sup> the price test restrictions of Rule 201 would have been triggered, on an average day, for approximately 4% of covered securities.<sup>25</sup> The Staff also found that for a low volatility period, covering January 1, 2004 to December 31, 2006, the 10% trigger level of Rule 201 would have, on an average day, been triggered for approximately 1.3% of covered securities.<sup>26</sup>

Thus, Rule 201 is structured so that the circuit breaker generally will not be triggered for the majority of covered securities at any given time and, thereby, will not interfere with the smooth functioning of the markets for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. If the short sale price test restrictions of Rule 201 apply to a covered security it will be because and when that security is undergoing significant downward price pressure.

In addition, to help ensure the Rule's workability, we are amending Rule 200(g) of Regulation SHO, substantially as proposed, to provide that, once the circuit breaker has been triggered for a covered security, if a broker-dealer chooses to rely on its own determination that

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<sup>22</sup> See infra note 306.

<sup>23</sup> See infra note 307.

<sup>24</sup> See infra note 309.

<sup>25</sup> See infra note 310.

<sup>26</sup> See infra note 311.

it is submitting a short sale order to a trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order “short exempt.”<sup>27</sup> The short sale price test restrictions of Rule 201 generally will apply to a small number of securities for a limited duration, and will continue to permit short selling rather than, for example, halting short selling when the restrictions are in place. As such, we believe that the circumstances under which a broker-dealer may need to mark a short sale order “short exempt” under Rule 201 are limited.

## **II. Background on Short Sale Restrictions**

Short selling involves a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>28</sup> In order to deliver the security to the purchaser, the short seller will borrow the security, usually from a broker-dealer or an institutional investor. Typically, the short seller later closes out the position by purchasing equivalent securities on the open market and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security.<sup>29</sup>

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<sup>27</sup> We note that, as discussed in more detail below, unless a sale order is marked “short exempt,” a trading center’s policies and procedures must be reasonably designed to prevent the execution or display of the order at a price that is less than or equal to the current national best bid.

<sup>28</sup> See 17 CFR 242.200(a).

<sup>29</sup> See, e.g., Exchange Act Release No. 54891 (Dec. 7, 2006), 71 FR 75068, 75069 (Dec. 13, 2006) (“2006 Price Test Elimination Proposing Release”); 2003 Regulation SHO Proposing Release, 68 FR at 62974. In this adopting release, we use the terms “liquidity provider” and “liquidity taker,” and correlative terms, in their technical sense in the literature of market microstructure. See, e.g., Larry Harris, Trading and Exchanges: Market Microstructure for Practitioners, at 70 (2003) (an introductory textbook to the economics of market microstructure). As used therein, a liquidity taker is a buyer or seller (including a short seller) who submits an order designed for immediate execution, such as a market order or a marketable limit order, while a liquidity provider is a more patient buyer or seller (including a short seller) who submits orders that may or may not be executed, and thus provides depth to the market. This usage differs from the usage of the term “liquidity provider” to refer to a bank, central bank, or other financial institution or investor who provides cash financing or otherwise increases the money supply.

### **A. Short Selling and its Market Impact**

Short selling provides the market with important benefits, including market liquidity and pricing efficiency.<sup>30</sup> Market liquidity is often provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the buying and selling interest for securities. Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary imbalance between buying and selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.<sup>31</sup>

Short selling also can contribute to the pricing efficiency of the equities markets.<sup>32</sup> When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security in anticipation that the security's price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because

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<sup>30</sup> See id.; see also Exchange Act Release No. 29278 (June 7, 1991), 56 FR 27280 (June 13, 1991); Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48009 n.6 (Aug. 6, 2004) ("2004 Regulation SHO Adopting Release"); Ekkehart Boehmer and J. Julie Wu, Short Selling and the Informational Efficiency of Prices, Working Paper, Jan. 8, 2009.

<sup>31</sup> See, e.g., 2006 Price Test Elimination Proposing Release, 71 FR at 75069; 2003 Regulation SHO Proposing Release, 68 FR at 62974.

<sup>32</sup> See id.

their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.<sup>33</sup>

Although short selling serves useful market purposes, it also may be used to drive down the price of a security or as a tool to accelerate a declining market in a security.<sup>34</sup> In addition, short selling may be used to illegally manipulate stock prices.<sup>35</sup> One example is the “bear raid” where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest.<sup>36</sup> This unrestricted short selling could exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security’s price is falling for fundamental reasons, when the decline, or the speed of the decline, is being driven by other factors.<sup>37</sup>

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<sup>33</sup> See 2006 Price Test Elimination Proposing Release, 71 FR at 75069 – 75070; 2003 Regulation SHO Proposing Release, 68 FR at 62974. Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions. See id.

<sup>34</sup> See, e.g., Proposal, 74 FR at 18065 (noting that a short selling circuit breaker rule would be designed to target only those securities that experience rapid severe intra-day price declines and, therefore, might help to prevent short selling from being used to drive the price of a security down or to accelerate the decline in the price of those securities).

<sup>35</sup> See, e.g., U.S. v. Russo, 74 F.3d 1383, 1392 (2d Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b-5); S.E.C. v. Gardiner, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. Mar. 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price).

<sup>36</sup> Many people blamed “bear raids” for the 1929 stock market crash and the market’s prolonged inability to recover from the crash. See, e.g., Steve Thel, \$850,000 in Six Minutes – The Mechanics of Securities Manipulation, 79 Cornell L. Rev. 219, 295-296 (1994); Jonathan R. Macey, Mark Mitchell & Jeffry Netter, Restrictions on Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash, 74 Cornell L. Rev. 799, 801-802 (1989).

<sup>37</sup> See 2006 Price Test Elimination Proposing Release, 71 FR at 75070; 2003 Regulation SHO Proposing Release, 68 FR at 62974.

## **B. History of Short Sale Price Test Restrictions in the U.S.**

Section 10(a) of the Exchange Act<sup>38</sup> gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as necessary or appropriate in the public interest or for the protection of investors.<sup>39</sup> After conducting an inquiry into the effects of concentrated short selling during the market break of 1937,<sup>40</sup> the Commission adopted former Rule 10a-1 in 1938 to restrict short selling in a declining market.<sup>41</sup>

The core provisions of former Rule 10a-1 remained virtually unchanged for almost seventy years. Over the years, however, in response to changes in the securities markets, including changes in trading strategies and systems used in the marketplace, the Commission added exceptions to former Rule 10a-1 and granted numerous written requests for relief from the Rule's restrictions. These market changes included decimalization, the increased use of matching systems that execute trades at independently-derived prices during random times within specific time intervals,<sup>42</sup> and the spread of fully automated markets. In addition, market

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<sup>38</sup> 15 U.S.C. 78j(a).

<sup>39</sup> See id.; see also 2006 Price Test Elimination Proposing Release, 71 FR at 75068; 2003 Regulation SHO Proposing Release, 68 FR at 62973.

<sup>40</sup> The study covered two weekly periods, that of September 7-13, 1937, and that of October 18-23, 1937. See Exchange Act Release No. 1548 (Jan. 24, 1938), 3 FR 213 (Jan. 26, 1938) ("Former Rule 10a-1 Adopting Release").

<sup>41</sup> See id. Former Rule 10a-1 provided that, subject to certain exceptions, a listed security could be sold short (i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it was higher than the last different price (zero plus tick).

<sup>42</sup> See, e.g., letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Andre E. Owens, Schiff Hardin & Waite, dated Apr. 23, 2003 (granting exemptive relief from former Rule 10a-1 for trades executed through an alternative trading system ("ATS") that matches buying and selling interest among institutional investors and broker-dealers at various set times during the day).

developments over the years led to the application of different price tests to securities trading in different markets.<sup>43</sup>

In July 2004, the Commission adopted Rule 202T of Regulation SHO,<sup>44</sup> which established procedures for the Commission to temporarily suspend short sale price tests for a prescribed set of securities so that the Commission could study the effectiveness of these tests.<sup>45</sup> Pursuant to the process established in Rule 202T, the Commission issued an order creating the Pilot, which temporarily suspended the tick test of former Rule 10a-1 and any price test of any national securities exchange or national securities association for short sales of certain securities.<sup>46</sup> The Pilot was designed to assist the Commission in assessing whether changes to short sale price test regulation were appropriate at that time in light of then-current market practices and the purposes underlying short sale price test regulation.<sup>47</sup>

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<sup>43</sup> See, e.g., Exchange Act Release No. 55245 (Feb. 5, 2007), 72 FR 6635 (Feb. 12, 2007). Former Rule 10a-1 applied only to short sale transactions in exchange-listed securities. In 1994, the Commission granted temporary approval to NASD to apply its own short sale rule, known as the “bid test,” on a pilot basis that was renewed annually until the Commission repealed short sale price tests. NASD’s former bid test prohibited short sales in Nasdaq Global Market securities (then known as Nasdaq National Market securities) at or below the current (inside) bid when the current best (inside) bid was below the previous best (inside) bid in a security. As a result, until the Commission eliminated former Rule 10a-1, and prohibited any SRO from having a short sale price test in July 2007, Nasdaq Global Market securities traded on Nasdaq or the over-the-counter (“OTC”) market and reported to a NASD facility were subject to a bid test. Nasdaq securities traded on exchanges other than Nasdaq were not subject to any price test. In addition, many thinly-traded securities, such as Nasdaq Capital Market securities and securities quoted on the OTC Bulletin Board and Pink Sheets, were not subject to any price test wherever traded. According to the Staff, in 2005, prior to the start of the Pilot, NASD’s former bid test applied to approximately 2,800 securities, while former Rule 10a-1 applied to approximately 4,000 securities.

<sup>44</sup> 17 CFR 242.202T.

<sup>45</sup> See 17 CFR 242.202T; see also 2004 Regulation SHO Adopting Release, 69 FR at 48012-48013.

<sup>46</sup> See Pilot Release, 69 FR 48032.

<sup>47</sup> See *id.* In the 2004 Regulation SHO Adopting Release, we noted that “the purpose of the [P]ilot is to assist the Commission in considering alternatives, such as: (1) Eliminating a Commission-mandated price test for an appropriate group of securities, which may be all securities; (2) adopting a uniform bid test, and any exceptions, with the possibility of extending a uniform bid test to securities for which there is currently no price test; or (3) leaving in place the current price tests.” 2004 Regulation SHO Adopting Release, 69 FR at 48010.

The Staff gathered the data made public during the Pilot, analyzed the data and provided the Commission with a summary report on the Pilot (“Staff’s Summary Pilot Report”).<sup>48</sup> The Staff’s Summary Pilot Report, which was made public, examined several aspects of market quality including the overall effect of then-current price tests on short selling, liquidity, volatility and price efficiency.<sup>49</sup> The Pilot was also designed to allow the Commission and members of the public to examine whether the effects of the then-current short sale price tests were similar across stocks.<sup>50</sup>

As set forth in the Staff’s Summary Pilot Report, the Staff found little empirical justification at that time for maintaining then-current short sale price test restrictions, especially for actively traded securities. Amongst its results, the Staff found that such short sale price tests did not have a significant impact on daily volatility. However, the Staff also found some evidence that the short sale price tests dampened intra-day volatility for smaller stocks.<sup>51</sup>

In addition, the Staff found that the Pilot data provided limited evidence that then-current price test restrictions distorted a security’s price.<sup>52</sup> The Staff also found that the price test

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<sup>48</sup> See [http://www.sec.gov/about/economic/shopilot091506/draft\\_reg\\_sho\\_pilot\\_report.pdf](http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf) and <http://www.sec.gov/news/studies/2007/regshopilot020607.pdf>.

<sup>49</sup> See Staff’s Summary Pilot Report at 40-47; see also *id.* at 22-24 (discussing the selection of securities included in the Pilot and the control group).

<sup>50</sup> In the 2004 Regulation SHO Adopting Release, the Commission stated its expectation that data on trading during the Pilot would be made available to the public to encourage independent researchers to study the Pilot. See 2004 Regulation SHO Adopting Release, 69 FR at 48009, n.9. Accordingly, nine SROs began publicly releasing transactional short selling data on Jan. 3, 2005. The nine SROs at that time were the Amex, ARCA, BSE, CHX, NASD, Nasdaq, National Stock Exchange, NYSE and Phlx. The SROs agreed to collect and make publicly available trading data on each executed short sale involving equity securities reported by the SRO to a securities information processor (“SIP”). The SROs published the information on a monthly basis on their Internet Web sites.

<sup>51</sup> See Staff’s Summary Pilot Report at 55-56.

<sup>52</sup> On the day the Pilot went into effect, listed Pilot securities underperformed listed control group securities by approximately 24 basis points. The Pilot and control group securities, however, had similar returns over the first six months of the Pilot. See Staff’s Summary Pilot Report at 8.

restrictions resulted in an increase in quote depths.<sup>53</sup> Realized liquidity levels, however, were unaffected by the removal of such short sale price test restrictions.<sup>54</sup> The Pilot data also provided evidence that the short sale price test restrictions reduced the volume of executed short sales to total volume and, therefore, acted as a constraint on short selling.<sup>55</sup> The Staff did not find, however, a significant difference in short interest positions between those securities subject to a short sale price test versus those securities that were not subject to such a test during the Pilot.<sup>56</sup>

In addition, the Commission encouraged outside researchers to examine the Pilot data. In response to this request, the Commission received four completed studies (the “Academic Studies”) from outside researchers that specifically examined the Pilot data.<sup>57</sup> The Commission also held the Regulation SHO 2006 Roundtable<sup>58</sup> that focused on the empirical evidence learned from the Pilot data (the Staff’s Summary Pilot Report, Academic Studies, and Regulation SHO 2006 Roundtable are referred to collectively herein as the “Pilot Results”).<sup>59</sup> The Pilot Results contained a variety of observations, which the Commission considered in determining whether or not to propose removal of then-current short sale price test restrictions and subsequently whether

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<sup>53</sup> See Staff’s Summary Pilot Report at 55.

<sup>54</sup> This conclusion is based on the result that changes in effective spreads were not economically significant (less than a basis point) and that the changes in the bid and ask depth appear not to affect the transaction costs paid by investors. Arguably, the changes in bid and ask depth appeared to affect the intra-day volatility. However, the Staff concluded that overall, the Pilot data did not suggest a deleterious impact on market quality or liquidity. See Staff’s Summary Pilot Report at 40-42, 55.

<sup>55</sup> See Staff’s Summary Pilot Report at 35.

<sup>56</sup> See *id.*

<sup>57</sup> See Karl B. Diether, Kuan Hui Lee and Ingrid M. Werner, 2009, It’s SHO Time! Short-Sale Price-Tests and Market Quality, Journal of Finance 64:37-73; Gordon J. Alexander and Mark A. Peterson, 2008, The Effect of Price Tests on Trader Behavior and Market Quality: An Analysis of Reg. SHO, Journal of Financial Markets 11:84-111; J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006; Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? Rutgers Business Law Journal 5:1-63.

<sup>58</sup> See *supra* note 6.

<sup>59</sup> See *id.*

or not to eliminate such restrictions. For example, one study concluded that former Rule 10a-1 had little or no effect on price efficiency.<sup>60</sup> Another study found no evidence that former Rule 10a-1 negatively impacted price discovery.<sup>61</sup>

Generally, the Pilot Results supported removal of the short sale price test restrictions that were in effect at that time.<sup>62</sup> In addition to the Pilot Results, thirteen other analyses by SEC staff and various third party researchers were conducted between 1963 and 2004 addressing price test restrictions.<sup>63</sup> Among these were several studies that evaluated short sale price tests during times of significant market decline, including the market break of May 28, 1962, the market decline of September and October 1976, the market break of October 19, 1987, and the Nasdaq market decline of 2000-2001. The results of these studies were mixed, but generally the studies found that former Rule 10a-1 did not prevent short sales in extreme down markets and did limit short selling in up markets, and the studies provided additional support for the removal of the permanent, market-wide short sale price test restrictions in existence at that time.

In December 2006, the Commission proposed to eliminate former Rule 10a-1 by removing restrictions on the execution prices of short sales, as well as prohibiting any SRO from having a short sale price test.<sup>64</sup> The Commission received twenty-seven comment letters in response to its proposal to eliminate former Rule 10a-1 and prohibit any SRO from having a short sale price test. The comments in response to the proposed amendments varied. Most commenters (including individual traders, an academic, broker-dealers, SROs and trade

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<sup>60</sup> See J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006.

<sup>61</sup> See Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? Rutgers Business Law Journal 5:1-63.

<sup>62</sup> See 2006 Price Test Elimination Proposing Release, 71 FR at 75072-75075 (discussing the Pilot Results).

<sup>63</sup> See Staff's Summary Pilot Report at 14, 17-22 (discussing the thirteen studies).

<sup>64</sup> See 2006 Price Test Elimination Proposing Release, 71 FR 75068.

associations) advocated removing all short sale price test restrictions.<sup>65</sup> Generally, these commenters believed that short sale price test restrictions were no longer necessary due to increased market transparency and the existence of real-time regulatory surveillance that could monitor for and detect any potential short sale manipulation.<sup>66</sup>

Two commenters (both individual investors) opposed the proposed amendments, noting the need for short sale price tests to prevent “bear raids.”<sup>67</sup> One commenter, although generally in support of removing all short sale price test restrictions, stated the belief that at some level unrestricted short selling should be collared.<sup>68</sup> This commenter supported having a 10% circuit breaker to prevent panic in the event there is a major market collapse.<sup>69</sup> The New York Stock Exchange (“NYSE”) also noted its concern about unrestricted short selling during periods of unusually rapid and large market declines. The NYSE stated that the effects of an unusually

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<sup>65</sup> See, e.g., letter from Howard Teitelman, CSO, Trillium Trading, dated Feb. 6, 2007; letter from S. Kevin An, Deputy General Counsel, E\*TRADE, dated Feb. 9, 2007 (“E\*TRADE (Feb. 2007)”); letter from Carl Giannone, dated Feb. 11, 2007 (“Giannone (Feb. 2007)”); letter from David Schwarz, dated Feb. 12, 2007; letter from John G. Gaine, President, Managed Funds Association, dated Feb. 12, 2007; letter from Lisa M. Utasi, Chairman of the Board, John C. Giese, President and CEO, Security Traders Association, dated Feb. 12, 2007 (“STA (Feb. 2007)”); letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS, dated Feb. 14, 2007 (“UBS (Feb. 2007)”); letter from Mary Yeager, Assistant Secretary, NYSE Euronext, dated Feb. 14, 2007 (“NYSE Euronext (Feb. 2007)”); letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated Feb. 14, 2007; letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, dated Feb. 16, 2007; see also Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348, 36350-36351 (July 3, 2007) (“2007 Price Test Adopting Release”) (discussing the comment letters).

<sup>66</sup> See, e.g., letter from Giannone (Feb. 2007); letter from E\*TRADE (Feb. 2007); letter from STA (Feb. 2007); letter from UBS (Feb. 2007); see also 2007 Price Test Adopting Release, 72 FR at 36350-36351 (discussing the comment letters).

<sup>67</sup> See, e.g., letter from Jim Ferguson, dated Dec. 19, 2006; letter from David Patch, dated Jan. 1, 2007; letter from David Patch, dated Jan. 12, 2007.

<sup>68</sup> See letter from Giannone (Feb. 2007).

<sup>69</sup> See *id.*

rapid and large market decline could not be measured or analyzed during the Pilot because such decline did not occur during the period studied.<sup>70</sup>

Effective July 3, 2007, the Commission eliminated former Rule 10a-1 and added Rule 201 of Regulation SHO, prohibiting any SRO from having a short sale price test.<sup>71</sup> The Commission stated that it determined to eliminate all short sale price test restrictions after reviewing the comments received in response to its proposal to eliminate all short sale price test restrictions, reviewing the Pilot Results, and taking into account the market developments that had occurred in the securities industry since the Commission adopted former Rule 10a-1 in 1938.<sup>72</sup> In addition, the Commission stated its belief that the amendments would bring increased uniformity to short sale regulation, level the playing field for market participants, and remove an opportunity for regulatory arbitrage.<sup>73</sup>

### **C. Proposal to Adopt a Short Sale Price Test Restriction or Circuit Breaker**

On April 8, 2009, following changes in market conditions since the elimination of former Rule 10a-1, we proposed to re-examine and seek comment on whether to impose price test restrictions or circuit breaker restrictions on short selling.<sup>74</sup> In the Proposal, we noted that market volatility had recently increased markedly in the U.S., as well as in every major stock market around the world.<sup>75</sup> We also noted that although we were not aware of specific empirical evidence that the elimination of short sale price tests contributed to the increased volatility in

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<sup>70</sup> See letter from NYSE Euronext (Feb. 2007).

<sup>71</sup> See 2007 Price Test Adopting Release, 72 FR 36348.

<sup>72</sup> See *id.* at 36352.

<sup>73</sup> See *id.*

<sup>74</sup> See Proposal, 74 FR 18042.

<sup>75</sup> See *id.* at 18049.

U.S. markets, many members of the public associate the removal of former Rule 10a-1 with such volatility, including steep declines in some securities' prices, and loss of investor confidence in our markets.<sup>76</sup> Due to the market conditions with which we were faced and the resulting deterioration in investor confidence, we stated in the Proposal that we believed it was appropriate to propose amending Regulation SHO to add a short sale price test or a circuit breaker rule.<sup>77</sup>

In response to the Proposal and the Re-Opening Release, we received over 4,300 unique comment letters.<sup>78</sup> A number of commenters stated that they do not believe that we should reinstate any form of short sale price test restriction, whether in the form of a short sale price test restriction or a circuit breaker rule. For example, a number of commenters noted a lack of empirical evidence suggesting that such restrictions would advance the Commission's goals of restoring investor confidence and preventing short selling, including potentially abusive or manipulative short selling, from driving down the market or being used as a tool to exacerbate a declining market in a security.<sup>79</sup> In response to our specific request for empirical data in the

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<sup>76</sup> See id.

<sup>77</sup> See Proposal, 74 FR at 18047.

<sup>78</sup> See <http://www.sec.gov/comments/s7-08-09/s70809.shtml>.

<sup>79</sup> See, e.g., letter from Daniel Mathisson, Managing Director, Credit Suisse Securities (USA), LLC, dated June 16, 2009 ("Credit Suisse (June 2009)"); letter from Citadel et al. (June 2009); letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT, LLC, dated June 19, 2009 ("EWT (June 2009)"); letter from Stephen Schuler, Managing Member, Daniel Tierney, Managing Member, Global Electronic Trading Company, dated June 19, 2009 ("GETCO (June 2009)"); letter from SIFMA (June 2009); letter from Kimberly Unger, Executive Director, Security Traders Association of New York, Inc., dated June 18, 2009 ("STANY (June 2009)"); letter from Karrie McMillan, General Counsel, Investment Company Institute, dated June 19, 2009 ("ICI (June 2009)"); letter from Megan A. Flaherty, Chief Legal Counsel, Wolverine Trading, LLC, dated June 19, 2009 ("Wolverine"); letter from Eric Swanson, SVP and General Counsel, BATS Exchange, Inc., dated Sept. 21, 2009 ("BATS (Sept. 2009)"); letter from Michael R. Trocchio, Esq. on behalf of Bingham McCutchen, LLP, dated Sept. 30, 2009 ("Bingham McCutchen"); letter from James S. Chanos, Chairman, Coalition of Private Investment Companies, dated Sept. 21, 2009 ("CPIC (Sept. 2009)"); (citing letter from Credit Suisse letter (June 2009)); letter from Luke Fichthorn, Managing Member, John Fichthorn, Managing Member, Dialectic Capital Management, LLC, dated Sept. 21, 2009 ("Dialectic Capital (Sept. 2009)"); letter from Eric W. Hess, General Counsel, Direct Edge Holdings LLC, dated Sept. 21, 2009 ("Direct Edge (Sept. 2009)"); letter from Paul M. Russo, Managing Director and Head of U.S. Equity Trading, Goldman, Sachs & Co., dated Sept. 21, 2009 ("Goldman Sachs (Sept. 2009)"); letter from Suhas Daftuar, Managing Director, Hudson River Trading LLC, dated Sept. 21, 2009 ("Hudson River Trading"); letter from

Proposal, a number of commenters submitted data or referenced studies in support of their position that a short sale price test restriction would not have a positive impact on the market.<sup>80</sup>

In addition, several commenters stated they do not believe that short selling exacerbated market declines during the Fall 2008 financial crisis, and suggested that long sale activity was a more substantial factor in those declines.<sup>81</sup> Other commenters stated that short selling is a small

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Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated Sept. 22, 2009 (“Knight Capital (Sept. 2009)”); letter from Richard Chase, Managing Director and General Counsel, RBC Capital Markets Corporation, dated Sept. 21, 2009 (“RBC (Sept. 2009)”); letter from Peter J. Driscoll, Chairman, John C. Giesea, President and CEO, Security Traders Association, dated Sept. 21, 2009 (“STA (Sept. 2009)”); letter from Barbara Palk, President, TD Asset Management, Inc., dated Sept. 14, 2009 (“TD Asset Management”); letter from George U. Sauter, Managing Director and Chief Investment Officer, The Vanguard Group, Inc., dated Sept. 21, 2009 (“Vanguard (Sept. 2009)”); letter from Chris Concannon, Virtu Financial, LLC, dated Sept. 21, 2009 (“Virtu Financial”); letter from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, Managed Funds Association, dated Oct. 1, 2009 (“MFA (Oct. 2009)”); letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, The Nasdaq OMX Group, Inc., dated Oct. 7, 2009 (“Nasdaq OMX Group (Oct. 2009)”).

<sup>80</sup> See, e.g., letter from Michael D. Lipkin, Adjunct Assistant Professor, Columbia University, dated Apr. 9, 2009 (“Prof. Lipkin”); letter from Eric Swanson, SVP and General Counsel, BATS Exchange, Inc., dated May 14, 2009 (“BATS (May 2009)”); Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009); letter from William J. Brodsky, Chairman and CEO, Edward J. Joyce, President and COO, The Chicago Board Options Exchange, Inc., dated June 19, 2009 (“CBOE (June 2009)”); letter from James S. Chanos, Chairman, Coalition of Private Investment Companies, dated June 19, 2009 (“CPIC (June 2009)”); letter from STANY (June 2009); letter from SIFMA (June 2009); letter from MFA (June 2009); letter from ICI (June 2009); letter from Joan Hinchman, Executive Director, President and CEO, National Society of Compliance Professionals Inc., dated June 19, 2009 (“NSCP”); letter from Mary Richardson, Director of Regulatory and Tax Department, Alternative Investment Management Association, dated June 19, 2009 (“AIMA”); letter from Credit Suisse (June 2009); letter from Rory O’Kane, President, TD Professional Execution, Inc, dated June 19, 2009 (“T.D. Pro Ex”); letter from Citadel et al. (June 2009); letter from William Connell, President and CEO, Allston Trading, LLC, dated June 18, 2009 (“Allston Trading (June 2009)”); letter from Wolverine; letter from Roy J. Katzovicz, Chief Legal Officer, Pershing Square Capital Management L.P., dated June 19, 2009 (“Pershing Square”); letter from GETCO (June 2009); letter from Luke Fichthorn, Managing Member, John Fichthorn, Managing Member, Dialectic Capital Management, LLC, dated June 18, 2009 (“Dialectic Capital (June 2009)”); memorandum of a meeting between representatives of Credit Suisse and the Office of Commissioner Aguilar, dated July 2, 2009, and written materials submitted at the meeting (“Credit Suisse (July 2009)”); letter from CPIC (Sept. 2009); letter from STA (Sept. 2009); letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, dated Sept. 21, 2009 (“SIFMA (Sept. 2009)”); letter from TD Asset Management; letter from Goldman Sachs (Sept. 2009); letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT, LLC, dated Sept. 21, 2009 (“EWT (Sept. 2009)”); letter from Charles M. Jones, Ph.D., Robert W. Lear Professor of Finance and Economics, Columbia Business School, dated Sept. 21, 2009 (“Prof. Jones”). See also *infra* Section II.D. (discussing the data and studies submitted and/or referenced by commenters).

<sup>81</sup> See, e.g., letter from MFA (June 2009); letter from STANY (June 2009); letter from Credit Suisse (June 2009); letter from STA (Sept. 2009) (noting that “[t]he STA believes that long sellers deleveraging and anticipating withdrawals and redemptions were largely responsible for the declines”).

segment of the overall equity marketplace and active short sellers are an even smaller group of participants and, therefore, represented a de minimus amount of the selling pressure that the markets experienced recently.<sup>82</sup> As support for their arguments, commenters referenced, among other things, two recent studies by the Staff that were also discussed in the Proposal.<sup>83</sup> In these studies, the Staff analyzed the impact that a short sale price test might have had during a thirteen day period in September 2008,<sup>84</sup> as well as whether and the extent to which short selling and long selling exerted downward price pressure during a volatile period in early September 2008.<sup>85</sup> The first of these studies noted that, although its data was limited to historical trade and quote data from a period when no short sale price test was in place and the shape of order book and trading sequences might have differed had a short sale price test been in place, a short sale price test would likely have been most restrictive during periods of low volatility, with greatest impact on short selling in lower priced and more active stocks.<sup>86</sup> The second study found that during periods of price declines, the selling pressure was more intense from long sellers than from short sellers. It also found that, on average, short sale volume as a fraction of total volume was highest during periods of positive returns, noting, however, that it was also possible that there were instances in which short selling activity peaked during periods of extreme negative returns.<sup>87</sup>

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<sup>82</sup> See, e.g., letter from STA (Sept. 2009).

<sup>83</sup> See Proposal, 74 FR at 18049.

<sup>84</sup> See Staff, Analysis of a short sale price test using intraday quote and trade data, Dec. 17, 2008 (“Staff Analysis (Dec. 17, 2008)”) at <http://www.sec.gov/comments/s7-08-09/s70809-368.pdf>.

<sup>85</sup> See Staff, Analysis of Short Selling Activity during the First Weeks of September, 2008, Dec. 16, 2008 (“Staff Analysis (Dec. 16, 2008)”) at <http://www.sec.gov/comments/s7-08-09/s70809-369.pdf>.

<sup>86</sup> See Staff Analysis (Dec. 17, 2008).

<sup>87</sup> See Staff Analysis (Dec. 16, 2008).

Some commenters stated that the recent market stability suggests that investor confidence has been restored and, therefore, short sale price test restrictions are not necessary.<sup>88</sup> Several commenters submitted data or referenced studies showing that investor confidence has recently improved.<sup>89</sup> A number of commenters expressed concern that any short sale price test restriction would carry with it the unintended consequences of reduced liquidity and widened bid-ask spreads, resulting in less efficient pricing in the securities markets.<sup>90</sup> One commenter stated its belief that because short sale price test restrictions would weaken and erode benefits of short selling such as liquidity, price discovery and the ability to manage risk, they would also weaken and erode investor confidence.<sup>91</sup> Many commenters stated that the reinstatement of any short sale price test restriction would impose significant costs on market participants and lead to increased transaction costs for investors.<sup>92</sup> In addition, several commenters noted that while the

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<sup>88</sup> See, e.g., letter from Renee M. Toth, President, National Association of Active Investment Managers, dated June 12, 2009 (“NAAIM”); letter from NSCP; letter from RBC (Sept. 2009).

<sup>89</sup> See, e.g., memorandum of meeting between representative of TD Ameritrade and the Office of Commissioner Aguilar, dated June 1, 2009, and written materials submitted at the meeting (“TD Ameritrade”); letter from RBC (Sept. 2009); letter from EWT (Sept. 2009). In addition, one commenter submitted preliminary data on the relationship between short selling and investor confidence and stated that “[w]hile it is too early to draw conclusions from this data, the evidence presented below does not suggest that there is a negative relationship between short selling activity and investor confidence.” See letter from Ingrid M. Werner, Ph.D., Martin and Andrew Murrer Professor of Finance, Fisher College of Business, The Ohio State University, dated June 19, 2009 (“Prof. Werner”). See also infra Section II.D. (discussing data submitted and/or referenced by commenters regarding investor confidence).

<sup>90</sup> See e.g., letter from Jeffrey S. Wecker, CEO, Lime Brokerage LLC, dated June 19, 2009 (“Lime Brokerage (June 2009)”) (noting that “[w]e believe there would be significant unintended consequences of the proposed restrictions, including reduction in overall market liquidity and widening of spreads ...”); letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated June 18, 2009 (“Knight Capital (June 2009)”); letter from MFA (June 2009); see also infra Section II.D. (discussing empirical data regarding the potential impact of short sale price test restrictions).

<sup>91</sup> See letter from AIMA; see also letter from CPIC (June 2009) (stating “investor confidence will not be served in the long term by the adoption of rules that the Commission itself has acknowledged have no sound empirical basis and may decrease market efficiency, limit price discovery, provide less protection against upward stock price manipulations, increase trading costs, reduce liquidity and impose other potential costs on investors”).

<sup>92</sup> See e.g., letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Investments, dated June 22, 2009 (“Fidelity”); letter from MFA (June 2009); letter from Credit Suisse (June 2009); letter from EWT (June 2009); letter from SIFMA (June 2009); letter from Wolverine; letter from T.D. Pro Ex; letter from ICI (June 2009); letter from Simon M. Lorne, Chief Legal Officer, Martin Z. Schwartz, Chief Compliance

Commission is rightly trying to increase investor confidence, current short sale regulations, including Rule 204 of Regulation SHO and Exchange Act Rule 10b-21, are sufficient to address the public's concerns about potentially abusive short selling.<sup>93</sup>

A significant number of commenters, however, continue to urge the Commission to reinstate some form of short sale price test restriction because these commenters believe that such a measure will help to restore investor confidence.<sup>94</sup> One commenter stated that “we

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Officer, Millennium Management LLC, dated June 19, 2009 (“Millennium”); letter from Citadel et al. (June 2009).

<sup>93</sup> See e.g., letter from Tim Belloto, dated May 5, 2009; letter from MFA (June 2009); letter from SIFMA (June 2009); letter from Pershing Square; letter from Paul M. Russo, Managing Director and Head of U.S. Equity Trading, Goldman, Sachs & Co., dated June 19, 2009 (“Goldman Sachs (June 2009)”); letter from CBOE (June 2009); letter from Allston Trading (June 2009); letter from STANY (June 2009); letter from Citadel et al. (June 2009); letter from STA (Sept. 2009); letter from BATS (Sept. 2009).

<sup>94</sup> See, e.g., letter from Herbert C. Roubidoux, dated May 4, 2009; letter from William K. Barnard, CEO, Equity Insight, Inc., dated May 4, 2009 (“Equity Insight”); letter from Henry J. Judd, CEO, Alethium Corp., dated May 6, 2009; letter from John Sook, dated May 6, 2009; letter from Boris Finkelstein, dated May 7, 2009; letter from John E. Detraz, dated May 8, 2009; letter from Joseph Giancola, dated May 8, 2009; letter from John W. Kozak, Chief Financial Officer, Park National Corporation, dated May 19, 2009 (“Park National”); letter from Robert S. Miloszewski, dated June 1, 2009; letter from Dr. George R. Arends, dated June 1, 2009; letter from Kent Hendrickson, dated June 4, 2009; letter from Dennis Nixon, Chairman and Chief Executive Officer, International Bancshares Corporation, dated June 9, 2009 (“IBC”); letter from Brian P. Hendey, dated June 9, 2009; letter from Catherine Mapen, dated June 15, 2009; letter from Jeffrey T. Brown, Senior Vice President, Office of Legislative and Regulatory Affairs, Charles Schwab & Co., Inc., dated June 18, 2009 (“Schwab”); letter from Michael Gitlin, Head of Global Trading, David Oestreicher, Chief Legal Counsel, Christopher P. Hayes, Sr. Legal Counsel, T. Rowe Price Associates, Inc., dated June 18, 2009 (“T. Rowe Price (June 2009)”); letter from Michael R. McAleve, Vice President and Chief Corporate, Securities and Finance Counsel, General Electric Company, dated June 18, 2009 (“GE”); letter from Janet M. Kissane, Senior Vice President, Legal and Corporate Secretary, NYSE Euronext, dated June 19, 2009 (“NYSE Euronext (June 2009)”; letter from Ronald C. Long, Director, Regulatory Affairs, Wells Fargo Advisors, dated June 15, 2009 (“Wells Fargo (June 2009)”). In addition, prior to the Proposal, a number of commenters stated that they believe that reinstatement of some form of price test restriction would help restore investor confidence. See, e.g., letter from Richard F. Vulpi, dated Sept. 24, 2008; letter from Maureen Christensen, dated Oct. 9, 2008; letter from Peter B. Eckle, CEO Associate Arrangements, dated Oct. 11, 2008; letter from Joe Garrett, dated Oct. 15, 2008; letter from Jenna L. Spurrier, dated Oct. 24, 2008; letter from Scotland Settle, dated Oct. 27, 2008; letter from Patrick McQuaid, dated Oct. 29, 2008; letter from Lynn Miller, dated Nov. 13, 2008; letter from David Sheridan, dated Nov. 18, 2008; letter from W. Romain Spell, dated Nov. 19, 2008; letter from Phil Mason, dated Nov. 19, 2008; letter from Jeff Brower, dated Nov. 20, 2008; letter from Mike Abraham, dated Nov. 20, 2008; letter from Marvin Dingott, dated Nov. 20, 2008; letter from Josh Dodson, dated Nov. 21, 2008; letter from J. Geddes Parsons, dated Nov. 21, 2008; letter from Charles Rudisill, dated Nov. 21, 2008; letter from Mike Ryan, dated Nov. 21, 2008; letter from David B. Campbell and Natalie H. Win, dated Nov. 25, 2008; letter from Edward L. Yingling, American Bankers Association, dated Dec. 16, 2008; letter from Robert A. Lee, dated Feb. 10, 2009; letter from Robert Levine, dated Feb. 17, 2009; letter from Karl Findorff, dated Feb. 19, 2009; letter from Robert Lounsbury, dated Feb. 25, 2009; letter from Dr. Bill Daniel, dated Feb. 26, 2009; letter from Glenn A. Webster, dated Feb. 26, 2009; letter from Arleen Golden, dated Mar. 2, 2009; letter from Doug Cameron, dated Mar. 2, 2009; letter from Mike Rogers, dated Mar. 3, 2009; letter from George A. Flagg, dated Mar. 3, 2009; letter from

believe that a price test could have a real impact on investors' and issuers' confidence in the equities market."<sup>95</sup> Some commenters have stated that a lack of price test restrictions makes them question whether they should invest in the stock market.<sup>96</sup> Other commenters have stated that they believe a short sale price test will aid small investors.<sup>97</sup> In addition, some commenters have suggested that restricting the prices at which securities may be sold short will help address steep declines in securities' prices.<sup>98</sup> Some Members of Congress and representatives of one

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Kevin Girard, dated Mar. 4, 2009; letter from Briggs Diuguid, dated Mar. 5, 2009 ("Briggs Diuguid"); letter from Bob Young, dated Mar. 5, 2009; letter from Troy Williams, dated Mar. 6, 2009; letter from Paul Kent, dated Mar. 7, 2009; letter from Chris Baratta, dated Mar. 9, 2009 ("Chris Baratta"); see also letter from Professor Constantine Katsoris, Fordham University School of Law, dated Mar. 4, 2009 (stating that elimination of former Rule 10a-1 "hardly generates confidence on the part of a true investor who is entrusting his or her life's savings...to the current market").

<sup>95</sup> Letter from NYSE Euronext (June 2009).

<sup>96</sup> See, e.g., letter from Phil Koepke, dated May 5, 2009; letter from Joe Wells, dated May 29, 2009; letter from Michael Anderson, dated June 1, 2009 (noting "[i]f the SEC fails to act in the best interest of all investors, then peopel (sic) like myself, will look at other investment alternatives than the Stock Market."); letter from Anton Kleinschmidt, dated June 2, 2009 (noting that he "will not return to the equity markets" until he is "confident that the wide range of market predators such as unregulated short sellers are being effectively controlled"). In addition, prior to (and as cited in) the Proposal, commenters expressed similar concerns regarding a lack of price test restrictions. See, e.g., letter from Jeff Boyd, dated Feb. 10, 2009; letter from Tim Zanni, dated Feb. 19, 2009.

<sup>97</sup> See, e.g., letter from Michael Anderson, dated June 1, 2009; letter from Carl H. Van Hoozier, Jr., dated June 3, 2009; letter from Kevin Adcock, dated June 3, 2009 (noting that "[w]ithout this reinstatement the market will never be judged as fair, balanced or worth the unfair risks created by the SEC removing a tried and tested 70+ year old rule"); letter from Fran Mazenko, dated June 4, 2009; letter from Daniel H. Owings, dated June 4, 2009 (noting "the elimination of the uptick rule...prevented the small investor from equal treatment in the market"); letter from Kathleen Jardine, dated June 4, 2009. In addition, prior to (and as cited in) the Proposal, commenters expressed similar statements regarding short sale price tests aiding small investors. See, e.g., letter from Chris Baratta (noting that while price test restrictions could not reasonably be expected to prevent market downturns, they would, in his opinion, "give the little investor a chance" in the current conditions); see also letter from Paul D. Mendelsohn, President, Windham Financial Services, Inc., dated Mar. 6, 2009 (stating that he believes former Rule 10a-1 "protected" the markets and that "suspension of the uptick rule has opened a security hole into our financial system"); letter from Bob Young, dated Mar. 5, 2009 (suggesting that reinstatement of the uptick rule "will not be a quick or total fix, but it will help").

<sup>98</sup> See, e.g., letter from Grant D. Wieler, dated May 8, 2009; letter from John J. Piccitto, Managing Director, John Piccitto Consulting Ltd., dated May 7, 2009 (noting that "[b]ecause the decline of the value of a stock can be very steep and very fast indeed, the ensuing 'feeding frenzy'... should be addressed by regulators. Slowing the cascade of short selling would create both the fact and the appearance of regulatory control..."); letter from Mucho Balka, Esq., dated May 30, 2009; letter from George A. Mitchell, dated June 1, 2009; letter from Jason Sturm, dated June 1, 2009; letter from Erin Chieffi, dated June 2, 2009; letter from Paul Rivett, Vice President and Chief Legal Officer, Fairfax Financial Holdings Ltd., dated June 17, 2009 ("Fairfax Financial"); letter from GE; letter from Michael Lamanna, dated June 17, 2009; letter from Stanyarne Burrows, dated June 17, 2009; letter from William R. Harker, Senior Vice President, General Counsel and Corporate Secretary, Sears Holdings

SRO have also continued to express support for reinstatement of price test restrictions.<sup>99</sup> One such SRO representative noted that over 95% of its issuers who participated in a survey believed that the market would function better with one of the proposed short sale price test restrictions.<sup>100</sup>

As we noted in the Proposal, some researchers have also indicated that they believe that they have collected data that establishes a possible association between the recent market

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Corporation, dated June 19, 2009 (“Sears”); letter from Glen Shipway, dated Sept. 21, 2009 (“Glen Shipway (Sept. 2009)”). In addition, the American Bankers Association noted that its members, “both large and small, have told us that short sellers were taking advantage of the uptick rule’s absence; that their stock prices were experiencing excessive downward pressure unrelated to actual conditions of the firm . . .” and that its members expressed “that measures needed to be taken, including reinstating the uptick rule in some format, to reduce the avenues for abusive trading practices and to restore investor confidence.” Letter from Sarah A. Miller, Senior Vice President, Center for Securities, Trust and Investments, American Bankers Association, dated July 1, 2009 (“Amer. Bankers Assoc.”); see also letter from Paul Tudor Jones II, Tudor Investment Corporation, dated Oct. 10, 2008 (stating that he believes that one way to “immediately stem the decline” in the stock market would be to reinstate the uptick rule); letter from James F. Kane, Jr., dated Feb. 6, 2009 (stating that he believes that reinstating “the Up-tick Rule will go a long way in preventing speculators from ganging up on a particular stock and forcing it down”); letter from Briggs Diuguid (stating that while short sellers “make efficient markets,” he is nonetheless concerned that short selling may be a tool of manipulators when short sales are “piled on” a particular company).

<sup>99</sup> See e.g., letter to Mary Schapiro, Chairman, from Kirsten Gillibrand, United States Senator, dated June 5, 2009; joint statement of Ted Kaufman, United States Senator, and Johnny Isakson, United States Senator, dated Sept. 29, 2009. In addition, prior to (and as cited in) the Proposal, several current and former Members of Congress have called for reinstatement of short sale price test restrictions. See, e.g., letter to Christopher Cox, Chairman, from Hillary Rodham Clinton, former United States Senator, dated Sept. 17, 2008; letter to Christopher Cox, Chairman, from Bill Sali, Member of Congress, dated Oct. 1, 2008; letter to Christopher Cox, Chairman, from Peter T. King, Member of Congress, dated Oct. 7, 2008; letter to Mary Schapiro, Chairman, from Gary L. Ackerman, Member of Congress, dated Jan. 27, 2009; letter to Mary Schapiro, Chairman, from Rep. Barney Frank and other Members of the House Financial Services Committee, dated Mar. 11, 2009; Proposal, 74 FR at 18046-18047 (noting statements by a Member of Congress and a former U.S. Senator asking the Commission to reinstate former Rule 10a-1 or some other form of short sale price test restriction). See also letter to Mary Schapiro, Chairman, from Carolyn Maloney, Member of Congress and Chairman of the Joint Economic Committee, dated Mar. 23, 2009. We note, however, that other Members of Congress have expressed concerns regarding our adopting a short sale price test restriction. See, e.g., letter to Mary Schapiro, Chairman, from Michael Crapo, United States Senator, Jim Bunning, United States Senator, David Vitter, United States Senator, Michael Enzi, United States Senator, and Mel Martinez, former United States Senator, dated June 17, 2009.

With respect to comments by SRO representatives, see, e.g., letter from Janet M. Kissane, Senior Vice President, Legal and Corporate Secretary, NYSE Euronext, dated Sept. 21, 2009 (“NYSE Euronext (Sept. 2009)”); letter from NYSE Euronext (June 2009); statement of Larry Leibowitz, Group Executive Vice President and Head of Global Technology and US Executions, NYSE Euronext, dated May 5, 2009 (“NYSE Euronext (May 2009)”). In addition, prior to (and as cited in) the Proposal, one senior SRO representative endorsed the reinstatement of a short sale price test restriction. See Edgar Ortega, Short-Sale Rule Undermined as Bernanke Backs Review, Bloomberg News Service, Mar. 4, 2009 (noting comments by Duncan Niederauer, CEO, The NYSE Euronext Group, Inc., that imposing a measure such as former Rule 10a-1, “would go a long way to adding confidence” in our markets).

<sup>100</sup> See letter from NYSE Euronext (June 2009).

downturn and the elimination of former Rule 10a-1.<sup>101</sup> Commenters also submitted data or referenced studies they believe support the contention that a price test restriction would have a positive impact on the market.<sup>102</sup> In addition, there have been reports of significant short selling in connection with the use of credit default swaps (“CDS”), particularly in the securities of significant financial institutions,<sup>103</sup> and it has been suggested that the interaction between and amplifying effects of CDS and short selling may be a reason to reinstate a short sale price test.<sup>104</sup>

Further, as we stated in the Proposal, questions and comments have been raised about the role that short selling, and in particular potentially abusive short selling, may have had in connection with the recent price fluctuations and disruption in our markets.<sup>105</sup> As such, prior to issuing the Proposal, in the latter part of 2008, we took a number of other short sale-related actions aimed at addressing these concerns. For example, due to our concerns that false rumors spread by short sellers regarding financial institutions of significance in the U.S. may have fueled market volatility in the securities of some of these institutions, on July 15, 2008, we issued an

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<sup>101</sup> See Proposal, 74 FR at 18047, n.64; see also letter from Yavni Bar-Yam, New England Complex Systems Institute, dated June 23, 2009 (“Yavni Bar-Yam”); Dion Harmon and Yaneer Bar-Yam, April 2009, Technical Report on SEC Uptick Rule Proposals, New England Complex Systems Institute.

<sup>102</sup> See, e.g., letter from NYSE Euronext (June 2009); letter from Schwab; letter from Richard J. Adler, Managing Director, European Investors, Inc., dated June 19, 2009 (“European Investors (June 2009)”); letter from Richard J. Adler, Managing Director, European Investors, dated Sept. 21, 2009 (“European Investors (Sept. 2009)”); letter from William Furber, High Street Advisors, L.P., dated June 18, 2009 (“High Street Advisors”); letter from Park National; letter from IBC; letter from Daniel P. Amos, Chairman and CEO, Aflac Incorporated, dated June 23, 2009 (“Aflac”); letter from J. Austin Murphy, Ph.D., Professor of Finance at Oakland University, School of Business Administration, dated Apr. 9, 2009 (“Prof. Murphy”); letter from Martin B. Napor, dated June 17, 2009 (“Martin Napor”); see also infra Section II.D. (discussing empirical data submitted in response to the Proposal and the Re-Opening Release).

<sup>103</sup> See Proposal, 74 FR at 18047, n.65 (referring to an article by George Soros, The Game Changer, available at <http://www.ft.com/cms/s/0/49b1654a-ed60-11dd-bd60-0000779fd2ac.html>). Similarly, in response to the Proposal, commenters raised concerns about CDS and short selling. See, e.g., letter from Edward D. Herlihy, Theodore A. Levine, Wachtell, Lipton, Rosen & Katz, dated June 17, 2009 (“Wachtell”); letter from GE.

<sup>104</sup> See Proposal, 74 FR at 18047, n.66 and accompanying text.

<sup>105</sup> See Proposal, 74 FR at 18047-18048.

emergency order (“July Emergency Order”)<sup>106</sup> pursuant to Section 12(k)(2) of the Exchange Act<sup>107</sup> which imposed borrowing and delivery requirements on short sales of the equity securities of certain financial institutions. We noted in the July Emergency Order that false rumors can lead to a loss of investor confidence. Such loss of investor confidence can lead to panic selling, which may be further exacerbated by “naked” short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process.<sup>108</sup> If significant financial institutions are involved, this chain of events can threaten disruption of our markets.<sup>109</sup>

Due to our concerns regarding the impact of short selling on the prices of financial institution securities, on September 18, 2008, we issued another emergency order prohibiting short selling in the publicly traded securities of certain financial institutions.<sup>110</sup> Our concerns, however, were not limited to financial institutions, given the importance of confidence in our markets and the rapid and steep declines in the prices of securities that generally we were seeing at that time.<sup>111</sup> Such rapid and steep price declines can give rise to questions about the underlying financial condition of an institution, which in turn can erode confidence, even without

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<sup>106</sup> See Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379 (July 21, 2008).

<sup>107</sup> 15 U.S.C. 78l(k)(2).

<sup>108</sup> See July Emergency Order, 73 FR 42379.

<sup>109</sup> See *id.*

<sup>110</sup> See Exchange Act Release No. 58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008) (“Short Sale Ban Emergency Order”).

<sup>111</sup> See, e.g., July Emergency Order, 73 FR 42379; Short Sale Ban Emergency Order 73 FR 55169; Exchange Act Release No. 58572 (Sept. 17, 2008), 73 FR 54875 (Sept. 23, 2008) (“September Emergency Order”).

an underlying fundamental basis.<sup>112</sup> This erosion of confidence can impair the liquidity and ultimate viability of an institution, with potentially broad market consequences.<sup>113</sup>

These concerns resulted in our issuance on September 17, 2008 of an emergency order under Section 12(k)(2) of the Exchange Act, in part targeting short selling in all equity securities.<sup>114</sup> Pursuant to the September Emergency Order we imposed enhanced delivery requirements on sales of all equity securities under Rule 204T of Regulation SHO.<sup>115</sup>

Rule 204T, among other things, required participants of a registered clearing agency to close-out fails to deliver resulting from short sales of any equity security by purchasing or borrowing the security by no later than the beginning of trading on the day after the fail to deliver occurred. We adopted the provisions of the September Emergency Order as an Interim Final Temporary Rule in October 2008 because of our continued concern about the potentially negative market impact of large and persistent fails to deliver.<sup>116</sup>

Our adoption of Interim Final Temporary Rule 204T followed a series of other steps aimed at reducing such fails to deliver and addressing potentially abusive short selling. These steps included eliminating the “grandfather” and options market maker exceptions to Regulation SHO’s close-out requirement,<sup>117</sup> and proposing and subsequently adopting a “naked” short

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<sup>112</sup> See Short Sale Ban Emergency Order, 73 FR 55169; September Emergency Order, 73 FR 54875.

<sup>113</sup> See *id.*

<sup>114</sup> See September Emergency Order, 73 FR 54875.

<sup>115</sup> See *id.* In addition, we issued an emergency order, and subsequent Interim Final Temporary Rule, Rule 10a-3T, to require disclosure of short sales and short positions in certain securities. The temporary rule expired on August 1, 2009. See Exchange Act Release No 58591 (Sept. 18, 2008) 73 FR 55175 (Sept. 24, 2008); Exchange Act Release No. 58785 (Oct. 15, 2008), 73 FR 61678 (Oct. 17, 2008).

<sup>116</sup> See Exchange Act Release No. 58773 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) (“Interim Final Temporary Rule 204T”).

<sup>117</sup> See Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007) (eliminating the “grandfather” exception to Regulation SHO’s close-out requirement); September Emergency Order, 73 FR 54875 (eliminating the options market maker exception to Regulation SHO’s close-out requirement).

selling anti-fraud rule, Rule 10b-21.<sup>118</sup> Although we recognize that fails to deliver can occur for legitimate reasons, we remained concerned about the impact of large and persistent fails to deliver on market confidence. Results from Staff analysis indicate that our actions to further reduce fails to deliver are having their intended effect. For example, these results indicate that fails to deliver in all equity securities have declined significantly since the adoption of Interim Final Temporary Rule 204T.<sup>119</sup> To help further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of Interim Final Temporary Rule 204T, as well as other actions taken by the Commission, we adopted the substance of Interim Final Temporary Rule 204T as a permanent rule, Rule 204, in July 2009.<sup>120</sup>

Despite the significant decline in fails to deliver and the more recent stability in the securities markets, concerns persist about rapid and steep price declines in securities and erosion of investor confidence in our markets. Thus, we continued to examine whether there are other actions that the Commission should take, including re-evaluating whether a short sale price test should be reintroduced or a circuit breaker rule should be imposed.

As we stated in the Proposal, when we eliminated all short sale price test restrictions in July 2007, we acknowledged that circumstances may develop that could warrant relief from the

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Following the issuance of the September Emergency Order, we adopted amendments making permanent the elimination of the options market maker exception. See Exchange Act Release No. 58775 (Oct. 14, 2008), 73 FR 61690 (Oct. 17, 2008) (“Options Market Maker Elimination Release”).

<sup>118</sup> See Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008); September Emergency Order, 73 FR 54875; Exchange Act Release No. 57511 (Mar. 17, 2008), 73 FR 15376 (Mar. 21, 2008).

<sup>119</sup> See Memorandum from the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Nov. 4, 2009 at <http://www.sec.gov/spotlight/shortsales/oeamemo110409.pdf> (stating, among other things, that the average daily number of aggregate fails to deliver for all securities decreased from 2.21 billion to 0.25 billion for a total decline of 88.5% when comparing a pre-Rule to post-Rule period); Memorandum from the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Nov. 26, 2008 at <http://www.sec.gov/comments/s7-30-08/s73008-37.pdf>; Memorandum from the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Mar. 20, 2009 at <http://www.sec.gov/comments/s7-30-08/s73008-107.pdf>.

<sup>120</sup> See Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009) (“Rule 204 Adopting Release”). Rule 204 contained some modifications to address commenters’ concerns. See *id.*

prohibition in Rule 201 of Regulation SHO for a short sale price test, including a short sale price test of an SRO, to apply to short sales in any security.<sup>121</sup> Thus, in determining whether or not to propose, and now adopt, a short sale price test rule or circuit breaker rule, we have considered the recent turmoil in the financial sector and steep declines and extreme volatility in securities prices.<sup>122</sup>

As discussed in this adopting release, we remain mindful that short selling provides benefits to the market. For example, legitimate short selling can play an important and constructive functional role in the markets, providing liquidity and price efficiency. Short sellers also play an important role in correcting upward stock price manipulation.<sup>123</sup> Because short sale price test restrictions may lessen some of these benefits, it is important that any short sale price test regulation is designed to limit any potentially unnecessary impact on legitimate short selling.

Thus, as discussed in detail below, we are adopting in Rule 201 a targeted short sale price test restriction that will be based on the current national best bid and that will apply only if the price of an individual security declines intra-day by 10% or more from that security's prior day's closing price on the listing market for that security. We are also amending Rule 200(g) of Regulation SHO to address when a broker-dealer may need to mark certain sell orders "short exempt."

#### **D. Empirical Data Regarding Potential Market Impact of Short Sale Price Test Restrictions Submitted in Response to the Proposal and Re-Opening Release**

In the Proposal, we requested that commenters provide empirical data to support their views and arguments with respect to the proposed short sale price test rules and the proposed

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<sup>121</sup> See Proposal, 74 FR at 18048; see also 2007 Price Test Adopting Release, 72 FR at 36348.

<sup>122</sup> See, e.g., Proposal, 74 FR at 18048 (noting the turbulence in the securities markets at the time we issued the Proposal and during the eighteen months prior thereto).

<sup>123</sup> See, e.g., Staff's Summary Pilot Report at 9.

circuit breaker rules.<sup>124</sup> Overall, the interpretations and results of the analyses submitted were mixed and sometimes conflicted with each other. In addition, the methods used in the empirical analyses submitted ranged from simple plots of data points to carefully constructed econometrics. The Pilot Results, while dated, in our view should continue to inform our decision-making where relevant, and none of the empirical studies discussed below have given us reason to question the rigor or validity of the Pilot Results.

A number of commenters submitted data or referenced studies in support of their position that a short sale price test restriction would not have a positive impact on the market.<sup>125</sup> In contrast, and as we noted in the Proposal, some commenters have indicated that they believe that they have collected data that establishes a possible association between the recent market downturn and the elimination of former Rule 10a-1.<sup>126</sup> Commenters also submitted data or referenced studies in support of the contention that a price test restriction would have a positive

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<sup>124</sup> See, e.g., Proposal, 74 FR at 18049.

<sup>125</sup> See, e.g., letter from BATS (May 2009); Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009); letter from CBOE (June 2009); letter from CPIC (June 2009); letter from STANY (June 2009); letter from SIFMA (June 2009); letter from MFA (June 2009); letter from ICI (June 2009); letter from NSCP; letter from AIMA; letter from Credit Suisse (June 2009); letter from T.D. Pro Ex; letter from Citadel et al. (June 2009); letter from Allston Trading (June 2009); letter from Knight Capital (June 2009); letter from Wolverine; letter from Pershing Square; letter from GETCO (June 2009); letter from Dialectic Capital (June 2009); letter from Hudson River Trading; memorandum regarding meeting with Credit Suisse (July 2009); letter from CPIC (Sept. 2009); letter from STA (Sept. 2009); letter from SIFMA (Sept. 2009); letter from TD Asset Management; letter from Goldman Sachs (Sept. 2009); letter from EWT (Sept. 2009); letter from Prof. Jones; see also letter from NAAIM; letter from Prof. Werner; memorandum regarding meeting with TD Ameritrade; letter from Adam V. Reed, Julian Price Associate Professor of Finance, University of North Carolina at Chapel Hill, dated Sept. 21, 2009 (“Prof. Reed”); letter from RBC (Sept. 2009); letter from Daniel Mathisson, Managing Director, Credit Suisse Securities (USA), LLC, dated Mar. 30, 2009 (“Credit Suisse (Mar. 2009)”); Ana Avramovic, What Happened When Traders’ Shorts Were Pulled Down?, Credit Suisse Market Commentary (Sept. 2008) (“Avramovic (Sept. 2008)”).

<sup>126</sup> See Proposal, 74 FR at 18047, n.64; see also letter from Yavni Bar-Yam; Dion Harmon and Yaneer Bar-Yam, April 2009, Technical Report on SEC Uptick Rule Proposals, New England Complex Systems Institute.

impact on the market.<sup>127</sup> We summarize below findings from these studies and discuss our views with respect to the studies.

Several commenters cited empirical evidence showing that short selling contributes to market liquidity, price discovery, and market efficiency and that restrictions on short selling, particularly bans on short selling, may impede liquidity, price discovery, and market efficiency.<sup>128</sup> While we agree with commenters that short selling contributes to market liquidity, price discovery and market efficiency and while these studies provide relevant information with respect to the effects of a short selling ban, they do not address the effects of a short sale price test restriction, or more specifically for purposes of Rule 201, a circuit breaker that, when triggered, imposes the alternative uptick rule.<sup>129</sup> In fact, because Rule 201 does not impose a ban

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<sup>127</sup> See, e.g., letter from Jeff Wang, dated May 7, 2009 (“Jeff Wang”); letter from NYSE Euronext (June 2009); letter from Schwab; letter from European Investors (June 2009); letter from European Investors (Sept. 2009); letter from High Street Advisors; letter from Park National; letter from IBC; letter from Aflac; letter from GE; letter from Michael R. Grupe, Executive Vice President, Research & Investor Outreach, National Association of Real Estate Investment Trusts, dated June 19, 2009 (“NAREIT”); letter from Kurt N. Schacht, Managing Director, Linda L. Rittenhouse, Director, Capital Markets Policy, CFA Institute Centre for Financial Market Integrity, dated Aug. 21, 2009 (“CFA”); letter from Martin Napor.

<sup>128</sup> See, e.g., letter from BATS (May 2009); letter from AIMA; letter from CBOE (June 2009); letter from CPIC (June 2009); letter from Credit Suisse (June 2009); letter from GETCO (June 2009); letter from ICI (June 2009); letter from NSCP; letter from TD Asset Management; letter from T.D. Pro Ex; letter from STANY (June 2009); letter from Hudson River Trading; letter from Allston Trading (June 2009); letter from Knight Capital (June 2009); letter from Pershing Square; letter from Wolverine; letter from Citadel et al. (June 2009) (referencing Lawrence E. Harris, Ethan Namvar and Blake Phillips, Price Inflation and Wealth Transfer during the 2008 SEC Short-Sale Ban, (Apr. 2009)); Matthew Clifton and Mark Snape, The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange (Dec. 19, 2008); Recent Trends in Trading Activity, Short Sales and Failed Trades and Study on the Impact of the Prohibition on the Short Sale of Inter-Listed Financial Sector Issuers by Investment Industry Regulatory Organization of Canada (IIROC) (February 2009); See Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009); memorandum regarding meeting with Credit Suisse (July 2009); see also letter from Credit Suisse (Mar. 2009).

<sup>129</sup> See id. In addition, several commenters cited research showing that short selling may be beneficial to price discovery and market efficiency, but that did not address the effect of a short sale price test restriction on price discovery or market efficiency. See letter from CPIC (June 2009) (citing Jonathan Karpoff and Xiaoxia Lou, Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions, Working paper, 2008); letter from Goldman Sachs (Sept. 2009) (citing Jonathan Karpoff and Xiaoxia Lou, Short Sellers and Financial Misconduct, Working paper, 2009); letter from Pershing Square (citing Jonathan Karpoff and Xiaoxia Lou, Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions, Working paper, 2008); letter from CPIC (Sept. 2009) (citing Jonathan Karpoff and Xiaoxia Lou, Short Sellers and Financial Misconduct, Working paper, 2009). Another commenter submitted a study showing that short sellers trade after news stories

on short selling but instead continues to allow short selling (although at a price above the national best bid) when the short sale price test restriction has been triggered, the Rule's structure will help preserve the benefits of short selling.

Some commenters cited a study (the "Pre-Borrow Study") which did not find a relationship between changes in short interest and changes in trading volume, and which concluded that "short sales do not have a significant effect on market liquidity: Other factors drive liquidity."<sup>130</sup> We note, however, that the correlation between changes in short interest and changes in trading volume may not be an accurate measure of the impact of short sales on liquidity. Economic theory does not tend to support using changes in trading volume as a measure of liquidity.<sup>131</sup> Trading volume itself, as opposed to changes in trading volume, is considered a measure of liquidity, though other measures, such as effective spreads and price impact, are considered by many to be better measures of liquidity and are more commonly used for measuring the liquidity of equities.<sup>132</sup> In addition, changes in short interest do not necessarily measure the volume of short selling. In fact, short interest is a "snapshot" variable, so the change

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and that short sellers effectively process publicly available information. See letter from Prof. Reed. While this study uses short selling volume data to support its conclusion that short sellers do not disproportionately engage in information-based manipulation, it does not directly examine the impact of a short sale price test restriction, and, therefore, has limited utility for purposes of evaluating the potential market impact of Rule 201.

<sup>130</sup> See, e.g., letter from Patrick M. Byrne, Chairman and CEO, Overstock.com, Inc., dated May 29, 2009 ("Overstock.com (May 2009)") (citing Robert J. Shapiro and Nam D. Pham, The Impact of a Pre-Borrow Requirement for Short Sales on Failures-to-Deliver and Market Liquidity, Apr. 2009; letter from Brian D. Pardo, Chairman and CEO, Life Partners Holding, Inc., dated May 28, 2009 ("Life Partners Holding") (citing the Pre-Borrow Study).

<sup>131</sup> The reason why we cannot interpret a change in trading volume as a measure of liquidity can be illustrated by the following example: A less liquid stock can experience an increase (positive change) in trading volume and a more liquid stock can experience a decrease in trading volume. Measuring liquidity by changes in trading volume will mischaracterize the less liquid stock as more liquid and the more liquid stock as less liquid.

<sup>132</sup> See, e.g., Tarun Chordia, Richard Roll, and Avanidhar Subrahmanyam, 2001, Market Liquidity and Trading Activity, Journal of Finance, 34: 501-530; Joel Hasbrouck and Duane J. Seppi, 2001, Common Factors in Prices, Order Flows and Liquidity, Journal of Financial Economics, 59: 383-411; Yakov Amihud, 2002, Illiquidity and stock returns: cross-section and time-series effects, Journal of Financial Markets, 5: 31-56.

in short interest does not necessarily measure correctly the volume of short selling, which is what the Pre-Borrow Study is trying to examine. Thus, we do not believe that the results in the Pre-Borrow Study cited by commenters should be interpreted to suggest that short sales are unimportant for liquidity. We also note that the Pre-Borrow study does not reconcile its results to a large body of conflicting evidence, including (but not restricted to) analyses in the comments mentioned above, showing that short selling contributes to market liquidity and that restrictions on short selling, particularly bans on short selling, may impede liquidity.<sup>133</sup>

Several commenters provided analyses showing that short interest initially fell immediately after the repeal of former Rule 10a-1 and that either short interest or short selling volume fell for specific stocks over periods leading up to the Short Sale Ban Emergency Order.<sup>134</sup> Overall, these analyses show that the negative returns of financial securities in the weeks both before and during the Short Sale Ban Emergency Order are unlikely to be the result of short selling activities.<sup>135</sup> We note that, although these studies create some doubt about whether certain price declines during that time period were caused by short sellers, because the analyses provided are specific to the Short Sale Ban Emergency Order and to a time period during which there was significant market turmoil, the analyses are less relevant regarding the potential impact on returns of the circuit breaker approach of Rule 201.

Several other commenters stated that the absence of a short sale price test restriction has been detrimental to prices and provided information on share prices, volume and/or short interest

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<sup>133</sup> See supra note 128 (referencing, among others, empirical evidence cited by commenters as showing that short selling contributes to market liquidity).

<sup>134</sup> See, e.g., letter from Dialectic Capital (June 2009); letter from MFA (June 2009); letter from STA (Sept. 2009); Avramovic (Sept. 2008).

<sup>135</sup> See Avramovic (Sept. 2008); letter from Credit Suisse (June 2009).

that they believe support this statement.<sup>136</sup> We note that, while some of the noted price changes coincide with changes in short selling activity, some do not.<sup>137</sup> Moreover, because these studies look at a long horizon (e.g., months instead of minutes), it is not clear that the evidence provided is relevant to support such conclusion. Thus, it is difficult to conclude from these analyses that the absence of a short sale price test restriction and the actions of short sellers resulted in issuer prices falling below their fundamental values.

One commenter cited a study that used intra-day short selling transaction data to examine the impact of short selling on volatility and found that the removal of former Rule 10a-1 did not exacerbate volatility.<sup>138</sup> We note that, while the study analyzed a period prior to and after the removal of former Rule 10a-1, it analyzed only a six-week period following the elimination of former Rule 10a-1, which may minimize the study's statistical significance. We also note that although the Staff found, in the Staff's Summary Pilot Report presenting the Staff's analysis of the data made public during the Pilot, that short sale price tests in effect at that time did not have a significant impact on daily volatility, the Staff also found some evidence that the short sale price tests dampened intra-day volatility for smaller stocks.<sup>139</sup>

In contrast, other commenters submitted data showing an increase in volatility from July 2007 through November 2008 to support the conclusion that the absence of a short sale price test

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<sup>136</sup> See, e.g., letter from Park National; letter from GE; letter from Aflac; letter from IBC; letter from Jeff Wang; letter from Martin Napor.

<sup>137</sup> For example, some of the noted price declines coincide with increases in short interest. See letter from Aflac; letter from IBC. Other noted price changes do not correlate with changes in short interest or short selling activity. See letter from Dialectic Capital (June 2009); letter from MFA (June 2009); letter from Peter J. Driscoll, Chairman, John C. Giese, President and CEO, Security Traders Association, dated June 19, 2009 ("STA (June 2009)"); Avramovic (Sept. 2008).

<sup>138</sup> See letter from Citadel et al. (June 2009) (citing Ekkehart Boehmer, Charles M. Jones, and Xioayan Zhang, Unshackling Short Sellers: The Repeal of the Uptick Rule (Nov. 2008)).

<sup>139</sup> See Staff's Summary Pilot Report at 55.

restriction caused an increase in market volatility.<sup>140</sup> As discussed above and in the Proposal,<sup>141</sup> concurrent with the subprime mortgage crises and credit crisis in 2007, U.S. markets experienced increased volatility and steep price declines, particularly in the stocks of certain financial issuers. We are not aware, however, of any empirical evidence that the elimination of short sale price test restrictions contributed to the increased volatility in the U.S. markets. In addition, the data showing an increase in volatility since the elimination of former Rule 10a-1 submitted by commenters in response to the Proposal does not address the extent to which other factors may have influenced the increased volatility. Moreover, because these studies look at a long horizon (e.g., months instead of minutes), it is not clear that the evidence provided is relevant to support such conclusion. Thus, the relationship between the elimination of short sale price test restrictions and the increased volatility remains unclear.

Several commenters submitted data on the percentage of short sales that might be affected by a short sale price test restriction.<sup>142</sup> One commenter submitted data indicating that the alternative uptick rule, adopted on a permanent, market-wide basis, could affect up to 37% of short sale orders.<sup>143</sup> As acknowledged by this commenter, however, this number does not indicate how severely the short sellers would be affected, how the number might change in different market conditions, or whether the number would result in changes in market quality.<sup>144</sup>

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<sup>140</sup> See, e.g., letter from NAREIT; letter from High Street Advisors; letter from European Investors (June 2009); letter from European Investors (Sept. 2009).

<sup>141</sup> See Proposal, 74 FR at 18043.

<sup>142</sup> See letter from Prof. Jones; letter from BATS (May 2009) (stating that, on its own market during May, June, September and October 2008, 12% to 13% of all executions were short sellers trading at a price less than the last execution price).

<sup>143</sup> See letter from Prof. Jones (stating that, during the period from July 6, 2007 through the end of August 2007, an average of 37% of submitted short sale orders in NYSE-listed Russell 3000 stocks were either market orders or marketable limit orders).

<sup>144</sup> See *id.*

In addition, as acknowledged by the commenter, the number also does not account for how order submission strategies would differ based on the alternative uptick rule.<sup>145</sup>

In addition, as discussed in more detail below,<sup>146</sup> in response to our request for comment on an appropriate threshold at which to trigger the proposed circuit breaker short sale price restrictions, commenters submitted estimates of the number of securities that would trigger a circuit breaker rule at a 10% threshold.<sup>147</sup> While commenters' analyses (including the facts and assumptions used) and their resulting estimates varied,<sup>148</sup> commenters' estimates reflect that a 10% circuit breaker threshold, on average, should affect a limited percentage of covered securities.<sup>149</sup> Given the variations in the facts and assumptions underlying the estimates submitted by commenters, the Staff also looked at trading data to confirm the reasonableness of those estimates. The Staff found that, during the period covering April 9, 2001 to September 30, 2009,<sup>150</sup> the price test restrictions of Rule 201 would have been triggered, on an average day, for approximately 4% of covered securities.<sup>151</sup> The Staff also found that for a low volatility period, covering January 1, 2004 to December 31, 2006, the 10% trigger level of Rule 201 would have, on an average day, been triggered for approximately 1.3% of covered securities.<sup>152</sup> Thus, we believe that the short sale price test restriction of Rule 201 is structured so that generally it will not be triggered for the majority of covered securities at any given time and, thereby, will not

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<sup>145</sup> See id.

<sup>146</sup> See infra Section III.A.5. (discussing the circuit breaker trigger level).

<sup>147</sup> See supra note 21.

<sup>148</sup> See infra note 306.

<sup>149</sup> See infra note 307.

<sup>150</sup> See infra note 309.

<sup>151</sup> See infra note 310.

<sup>152</sup> See infra note 311.

interfere with the provision of market benefits such as liquidity and price efficiency for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising.

Several commenters submitted data on indexes of investor confidence to argue that investor confidence has been restored and, therefore, short sale price test restrictions are not necessary.<sup>153</sup> In addition, one commenter submitted preliminary data, drawn in part from investor confidence indexes, on the relationship between short selling and investor confidence and stated that “[w]hile it is too early to draw conclusions from this data, the evidence presented . . . does not suggest that there is a negative relationship between short selling activity and investor confidence.”<sup>154</sup> Another commenter submitted a survey showing that its clients put more money into the markets between Fall 2008 and Spring 2009 and that many of its clients do not believe that an overhaul of financial services regulation would restore investor confidence.<sup>155</sup>

We also note that some other commenters submitted surveys showing that reinstituting a short sale price test restriction would improve investor confidence.<sup>156</sup> One commenter submitted a survey showing that over 95% of the issuers participating in the survey believed that the market would function better with a short sale price test restriction and stated that this data “suggests that a price test would boost confidence.”<sup>157</sup>

While the analyses of investor confidence indexes submitted by commenters do contain measures of investor confidence, we believe that the investor confidence indexes cited are

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<sup>153</sup> See, e.g., letter from RBC (Sept. 2009); letter from EWT (Sept. 2009); letter from CPIC (June 2009); see also letter from NAAIM (citing press articles as evidence of increased investor confidence).

<sup>154</sup> Letter from Prof. Werner.

<sup>155</sup> See memorandum regarding meeting with TD Ameritrade.

<sup>156</sup> See, e.g., letter from NYSE Euronext (June 2009); letter from CFA; see also letter from Schwab.

<sup>157</sup> Letter from NYSE Euronext (June 2009).

designed to capture elements of investor confidence not directly affected by regulatory changes. Investor confidence indexes often capture measures of systematic risk or optimism about the economy, as opposed to measures of investor confidence related to regulation designed to provide investor protections. In addition, in light of the surveys that were submitted in support of a short sale price test restriction as a means to restore investor confidence,<sup>158</sup> we do not believe that the surveys submitted to argue that a short sale price test restriction would not improve investor confidence<sup>159</sup> provide strong evidence on this point.

Although in recent months there has been an increase in stability in the securities markets, we remain concerned that excessive downward price pressure on individual securities accompanied by the fear of unconstrained short selling can undermine investor confidence in our markets generally. Further, we are concerned about potential future market turmoil, including significant increases in market volatility and significant price declines, and the impact of any such future market turmoil on investor confidence. Thus, we believe it is appropriate to adopt the targeted short sale price test restrictions contained in Rule 201.

In summary, we have reviewed the empirical data, analyses and studies submitted and carefully considered them in connection with our determination that it is appropriate at this time to adopt in Rule 201 a short sale price test restriction combined with a circuit breaker approach.

### **III. Discussion of Rule 201 of Regulation SHO**

In the Proposal, we proposed two approaches to restrictions on short selling: one that would apply on a market-wide and permanent basis and one that would apply only to a particular security during a significant market decline in the price of that security (i.e., a circuit breaker

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<sup>158</sup> See, e.g., letter from Schwab; letter from NYSE Euronext (June 2009); letter from CFA.

<sup>159</sup> See, e.g., memorandum regarding meeting with TD Ameritrade.

approach).<sup>160</sup> With respect to the permanent, market-wide approach, we proposed two alternative short sale price tests: the proposed modified uptick rule, based on the current national best bid, and the proposed uptick rule, based on the last sale price. With respect to the circuit breaker approach, we proposed two alternative circuit breaker tests: one that would temporarily prohibit short selling in a particular security when there is a significant decline in the price of that security and one that would temporarily impose either the proposed modified uptick rule or the proposed uptick rule on short sales in a particular security when there is a significant decline in the price of that security.

In addition, in the Proposal we inquired whether a short sale price test restriction that would permit short selling at a price above the current national best bid, i.e., the alternative uptick rule, would be preferable to the proposed modified uptick rule and the proposed uptick rule.<sup>161</sup> We sought comment regarding the application of the alternative uptick rule as a market-wide permanent price test restriction or in conjunction with a circuit breaker.<sup>162</sup> We received two comment letters regarding applying the alternative uptick rule on a permanent, market-wide basis<sup>163</sup> and seven comment letters with respect to applying the alternative uptick rule in combination with a circuit breaker.<sup>164</sup> To allow us to further consider the alternative uptick rule,

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<sup>160</sup> See Proposal, 74 FR 18042.

<sup>161</sup> See Proposal, 74 FR at 18072, 18081, 18082.

<sup>162</sup> See id.

<sup>163</sup> See letter from William Hartley, dated May 8, 2009; letter from Glen Shipway, dated June 19, 2009 (“Glen Shipway (June 2009)”).

<sup>164</sup> See letter from BATS (May 2009); letter from Johnny Peters, ChFC, dated May 20, 2009; letter from Credit Suisse (June 2009); letter from SIFMA (June 2009); letter from Goldman Sachs (June 2009); letter from NYSE Euronext (June 2009); letter from Eric W. Hess, General Counsel, Direct Edge Holdings LLC, dated June 23, 2009 (“Direct Edge (June 2009)”). In addition, in connection with the May 2009 Roundtable, panelists expressed support for the alternative uptick rule. See statement from NYSE Euronext (May 2009); opening remarks of James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated May 5, 2009. We also note that prior to the Proposal, four exchanges, NYSE Euronext, Nasdaq OMX Group, BATS, and National Stock Exchange, submitted a comment letter

on August 20, 2009, we re-opened the comment period to the Proposal.<sup>165</sup> In addition, on May 5, 2009, we held the May 2009 Roundtable<sup>166</sup> at which panelists discussed the proposed short sale price test restrictions and circuit breaker rules.

As noted above, we received over 4,300 unique comment letters in response to the Proposal and Re-Opening Release.<sup>167</sup> In discussing the provisions of Rule 201, we highlight and address below the main issues, concerns, and suggestions raised by commenters.

#### **A. Operation of the Circuit Breaker Plus Alternative Uptick Rule**

We are adopting in Rule 201 a circuit breaker approach combined with the alternative uptick rule. Specifically, Rule 201(b)(1) provides that “[a] trading center shall establish, maintain, and enforce written policies and procedures reasonably designed to: (i) Prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day; and (ii) Impose the requirements of paragraph (b)(1)(i) of this section for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.”<sup>168</sup>

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recommending a circuit breaker combined with a price test that would allow short selling only at an increment above the current national best bid. See letter from National Stock Exchange, NYSE Euronext, Nasdaq OMX Group, and BATS, dated Mar. 24, 2009 (“National Stock Exchange et al.”). NYSE Euronext, in its subsequent comments, stated that it supported the proposed modified uptick rule applied on a permanent and market-wide basis rather than the position expressed in the earlier March 24, 2009 letter. See statement from NYSE Euronext (May 2009); letter from NYSE Euronext (June 2009).

<sup>165</sup> See Re-Opening Release, 74 FR 42033.

<sup>166</sup> See supra note 14.

<sup>167</sup> See supra note 78.

<sup>168</sup> Rule 201(b).

Thus, Rule 201 will require a trading center<sup>169</sup> to have policies and procedures reasonably designed to prevent it from executing or displaying any short sale order, absent an exception, at a price that is equal to or below the national best bid if the price of that security decreases by 10% or more from the security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>170</sup> As discussed in more detail below, we believe that such a Rule will help prevent short sellers from using short selling as a tool to exacerbate a declining market in a security.

### **1. Covered Securities**

Consistent with the proposed permanent, market-wide short sale price test restrictions and proposed circuit breaker rules, Rule 201 will apply to any “covered security.” As proposed and as adopted, Rule 201 defines “covered security” to mean any “NMS stock” as defined under Rule 600(b)(47) of Regulation NMS.<sup>171</sup> Rule 600(b)(47) of Regulation NMS defines an “NMS stock” as “any NMS security other than an option.”<sup>172</sup> Rule 600(b)(46) of Regulation NMS defines an “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”<sup>173</sup> Thus,

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<sup>169</sup> Consistent with the Proposal, Rule 201(a)(9) states that the term “trading center” shall have the same meaning as in Rule 600(b)(78). Rule 600(b)(78) of Regulation NMS defines a “trading center” as “a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.” See 17 CFR 242.600(b)(78). The definition encompasses all entities that may execute short sale orders. Thus, Rule 201 will apply to any entity that executes short sale orders.

<sup>170</sup> Any such execution or display will also need to be in compliance with applicable rules regarding minimum pricing increments. See 17 CFR 242.612. See also *infra* Section III.A.2.

<sup>171</sup> See Rule 201(a)(1).

<sup>172</sup> 17 CFR 242.600(b)(47).

<sup>173</sup> 17 CFR 242.600(b)(46).

Rule 201 will apply to any security or class of securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. As a result, Rule 201 generally will cover all securities, except options, listed on a national securities exchange whether traded on an exchange or in the OTC market.<sup>174</sup> As discussed further below, it will not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market.

In response to our requests for comment, some commenters stated that any short sale price test adopted by the Commission for NMS stocks should also apply to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market.<sup>175</sup> One commenter indicated that failure to apply a short sale price test restriction applicable to NMS stocks to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market would cause investors to have inappropriately negative views about the OTC market and the firms whose securities are quoted there.<sup>176</sup> This commenter and another commenter also stated that not including non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market in a short sale price test restriction could have a negative impact on the ability of firms whose securities are quoted OTC to raise capital.<sup>177</sup> Commenters noted that many issuers of securities

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<sup>174</sup> We note that there may be securities that are listed on a national securities exchange but that are not NMS stocks because they do not meet the definition of “NMS stock.” Thus, these securities will not be subject to the short sale price test restrictions of Rule 201.

<sup>175</sup> See letter from Peter J. Chepucavage, General Counsel, Plexus Consulting LLC, The International Association of Small Broker Dealers and Advisors, dated Apr. 21, 2009; letter from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets, Inc., dated May 26, 2009 (“Pink OTC”); letter from STANY (June 2009); letter from Michael L. Crowl, Managing Director and Global General Counsel, Barclays Global Investors, dated June 19, 2009 (“Barclays (June 2009)”).

<sup>176</sup> See letter from Pink OTC.

<sup>177</sup> See letter from Pink OTC; letter from STANY (June 2009).

that are quoted OTC are “small, emerging growth companies,”<sup>178</sup> that may have a particular need to raise capital in the equity markets.<sup>179</sup> One commenter noted that “less liquid stocks and the stock of less capitalized firms that trade in the OTC markets are in need of as much, if not more, protection from manipulative behavior than NMS stocks”<sup>180</sup> while another stated that “OTC Bulletin Board and Pink Sheet securities would appear to be prime targets for manipulative shorting practices.”<sup>181</sup> Commenters also noted that applying a price test rule uniformly to NMS stocks and to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market could reduce the costs of such a rule because market participants would need only one set of programs and systems designed to ensure compliance with the rule, rather than different programs and systems for securities covered by the rule and securities not covered by the rule.<sup>182</sup>

Several commenters, however, expressed support for the application of a price test only to NMS stocks.<sup>183</sup> Several commenters noted that the current national best bid and offer are not currently collected, consolidated and disseminated for non-NMS stocks quoted on the OTC

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<sup>178</sup> Letter from Pink OTC.

<sup>179</sup> See letter from Pink OTC; letter from Alan F. Eisenberg, Executive Vice President, Emerging Companies and Business Development, Biotechnology Industry Organization, dated June 29, 2009 (“BIO”). BIO requested that biotechnology companies, many of which BIO stated are emerging companies that are “very dependent on capital, including using the public markets as a source of financing,” be covered by any short sale price test restriction. Letter from BIO. We also note that one commenter requested that the Commission adopt a short sale price test or circuit breaker halt restriction specifically applicable to financial sector stocks. See letter from IBC. However, another commenter stated, “Restrictions on short selling in only the issues of financial services providers is perhaps the least valuable of all the ideas to be discussed during the short sale debate.” See letter from STA (June 2009). Another commenter noted that it is not possible to anticipate which industry sectors may be impacted by potentially manipulative short selling in the future. See letter from T. Rowe Price (June 2009). Given the lack of a widespread call for industry specific short selling restrictions, and the additional complexities that an industry specific restriction would raise, such as identifying and defining the industry or sector to be covered, we have determined not to apply an industry specific short selling restriction at this time.

<sup>180</sup> Letter from STANY (June 2009).

<sup>181</sup> Letter from T. Rowe Price (June 2009).

<sup>182</sup> See letter from Pink OTC; letter from STANY (June 2009).

<sup>183</sup> See, e.g., letter from Wells Fargo (June 2009); letter from T. Rowe Price (June 2009); letter from STA (June 2009); letter from Credit Suisse (Sept. 2009).

Bulletin Board or elsewhere in the OTC market.<sup>184</sup> Further, although one commenter indicated that the Commission should plan to phase in application of a price test rule to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market,<sup>185</sup> another commenter expressed concerns that the OTC market is not “robust enough to withstand” such regulation.<sup>186</sup>

At this time, we are not applying Rule 201 to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market because a national best bid and offer currently is not required to be collected, consolidated, and disseminated for such securities.<sup>187</sup> Rule 201 is based on the current national best bid and its implementation requires that the national best bid is collected, consolidated and disseminated to market participants. Although several commenters indicated that it would be possible for non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market to join or create a national plan for disseminating consolidated national best bid information for such stocks,<sup>188</sup> we are concerned that this would be a significant undertaking that would add greatly to the implementation time and cost of Rule 201, particularly in light of comments that the implementation process may be complex even for those securities for which the national best bid is currently collected, consolidated, and disseminated.<sup>189</sup>

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<sup>184</sup> See letter from Pink OTC; letter from T. Rowe Price (June 2009).

<sup>185</sup> See letter from T. Rowe Price (June 2009).

<sup>186</sup> Letter from STA (June 2009).

<sup>187</sup> As noted above, former Rule 10a-1 also did not apply to non-exchange listed securities quoted on the OTC Bulletin Board or elsewhere in the OTC market. See supra note 43.

<sup>188</sup> See, e.g., letter from Pink OTC; letter from STANY (June 2009); letter from T. Rowe Price (June 2009). The comment letter from Pink OTC indicates that it “would be willing to join the current Tape C UTP network or work with FINRA to create an OTC/UTP Plan including the best bid and offer prices for securities quoted on OTCBB and our Pink Quote Inter-Dealer Quotation System.” Letter from Pink OTC.

<sup>189</sup> See infra Section VII. (discussing implementation time) and Sections X.B.1.b. and X.B.2.b. (discussing implementation costs).

We recognize commenters' concerns, however, regarding not applying Rule 201 to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. Thus, at a later time, we may reconsider whether applying Rule 201 to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market may be appropriate.

In response to our requests for comment, a number of commenters expressed concerns about the application of a short sale price test to equity securities without also addressing derivative securities.<sup>190</sup> Several commenters indicated that the ability of market participants to create "synthetic" short positions that are the economic equivalent of a short sale through the use of derivative securities would undermine the effectiveness of a short sale price test<sup>191</sup> and/or result in an increased use of derivative products to create "synthetic" short positions.<sup>192</sup> Some commenters indicated that the Commission should apply some sort of restriction to derivative

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<sup>190</sup> See, e.g., letter from Gregory Bloom, dated Apr. 10, 2009; letter from Peter J. Driscoll, Chairman, John C. Giese, President and CEO, Security Traders Association, dated Apr. 16, 2009 ("STA (Apr. 2009)"); letter from Jeffrey D. Morgan, President and CEO, National Investor Relations Institute, dated May 29, 2009 ("NIRI"); letter from Douglas Engmann, President, Engmann Options, Inc., dated June 1, 2009 ("Engmann Options"); letter from Dale W.R. Rosenthal, Assistant Professor of Finance, College of Business Administration, University of Illinois at Chicago, dated June 2, 2009 ("Prof. Rosenthal"); letter from Leslie Seff, President, Matthew B. Management, Inc., dated June 5, 2009 ("Matthew B. Management"); letter from Patrick J. Healy, Issuer Advisory Group, dated June 30, 2009 ("IAG"); letter from Barclays (June 2009); letter from Jesse J. Greene, Jr., Vice President, Financial Management and Chief Financial Risk Officer, International Business Machines Corporation, dated June 19, 2009 ("IBM"); letter from Katherine Tew Darras, General Counsel, Americas, International Swaps and Derivatives Association, Inc., dated June 19, 2009 ("ISDA"); letter from STA (June 2009); letter from George U. Sauter, Managing Director and Chief Investment Officer, The Vanguard Group, Inc., dated June 19, 2009 ("Vanguard (June 2009)"); letter from GE; letter from Knight Capital (June 2009); letter from Wachtell; letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association, dated July 8, 2009 ("Amer. Bar Assoc. (July 2009)"); letter from Jeffrey S. Wecker, CEO, Lime Brokerage LLC, dated Sept. 21, 2009 ("Lime Brokerage (Sept. 2009)"); letter from Jonathan E. Johnson III, President, Overstock.com, dated Sept. 24, 2009 ("Overstock.com (Sept. 2009)"); letter from Kevin Holley, dated Sept. 29, 2009 ("Kevin Holley"); see also letter from Eric W. Hess, General Counsel, Direct Edge Holdings LLC, dated Mar. 30, 2009 ("Direct Edge (Mar. 2009)").

<sup>191</sup> See, e.g., letter from Prof. Rosenthal; letter from STA (Apr. 2009); letter from Overstock.com (Sept. 2009); letter from Lime Brokerage (Sept. 2009).

<sup>192</sup> See, e.g., letter from Matthew B. Management; letter from Prof. Rosenthal; letter from Barclays (June 2009); letter from STA (June 2009); letter from Vanguard (June 2009); letter from Lime Brokerage (Sept. 2009).

securities with respect to “synthetic” short sales,<sup>193</sup> while others suggested that the Commission should require disclosure of “synthetic” short positions created with derivative securities.<sup>194</sup> Several commenters noted concerns with respect to practical difficulties related to addressing derivative securities and short selling issues, and that the Commission may not have the necessary legislative authority to address certain areas.<sup>195</sup>

As indicated in the Proposal and our requests for comment,<sup>196</sup> we recognize that the ability to obtain a short position through the use of derivative products such as options, futures, contracts for differences, warrants, CDS or other swaps (so-called “synthetic short sales”) or other instruments (such as inverse leveraged exchange traded funds) may undermine our goals for adopting short sale price test restrictions. We are also concerned that synthetic short positions may increase as a result of the adoption of Rule 201. Rule 201, however, like former Rule 10a-1 and NASD’s former bid test, which also did not apply to derivative securities, is formulated with the specific structure of the equity markets in mind and not for the substantially different market structure applicable to many derivatives securities. In addition, we believe that applying a Rule 201-type rule to derivatives securities would significantly complicate the implementation process. Thus, we have determined at this time not to modify the definition of “covered security” from that proposed and, therefore, the scope of securities to which Rule 201 will apply.

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<sup>193</sup> See, e.g., letter from IAG; letter from ISDA; letter from STA (June 2009); letter from Wachtell; letter from Matthew B. Management; letter from James L. Rothenberg, dated Sept. 20, 2009 (“James Rothenberg”).

<sup>194</sup> See, e.g., letter from IAG; letter from GE; letter from Wachtell; see also letter from Direct Edge (Mar. 2009).

<sup>195</sup> See letter from Barclays (June 2009); letter from GE; letter from NIRI; letter from Amer. Bar Assoc. (July 2009). Two commenters stated that the Commission should seek authority from Congress to regulate derivative securities where authority is currently lacking. See letter from GE; letter from NIRI.

<sup>196</sup> See Proposal, 74 FR at 18071, 18078.

We note, however, that short sales in the equity markets to hedge derivatives transactions are subject to Rule 201. In addition, because we are concerned that the ability to create a short position through the use of derivative securities may undermine the goals of short sale price test restrictions, we may reconsider, at a later time, whether additional regulation of derivative securities and the use of “synthetic” short positions may be appropriate.

The securities covered by Rule 201 will overlap with the securities covered by former Rule 10a-1. Former Rule 10a-1 applied to securities registered on, or admitted to unlisted trading privileges on, a national securities exchange, if trades of the security were reported pursuant to an effective transaction reporting plan and information regarding such trades was made available in accordance with such plan on a real-time basis to vendors of market transaction information. All securities that would have been subject to former Rule 10a-1 will also be subject to Rule 201. In addition, certain securities, *i.e.*, securities traded on Nasdaq prior to its regulation as an exchange, that were not subject to former Rule 10a-1 will be subject to Rule 201.<sup>197</sup>

As we discussed in the Proposal,<sup>198</sup> market information for NMS stocks, including quotes, is disseminated pursuant to three different national market system plans.<sup>199</sup> The national

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<sup>197</sup> When Nasdaq became a national securities exchange in 2006, absent an exemption from former Rule 10a-1, all Nasdaq securities would have been subject to former Rule 10a-1. The Commission provided Nasdaq with an exemption from the application of the provisions of former Rule 10a-1 to securities traded on Nasdaq because the Pilot was already in progress, and the Commission believed it was necessary and appropriate to maintain the status quo for short sale price tests during the Pilot and to ensure that market participants would not be burdened with costs associated with implementing a price test that might be temporary. *See* Exchange Act Release No. 53128 (Jan. 13, 2006), 71 FR 3550 (Jan. 23, 2006) (order approving application of Nasdaq for registration as a national securities exchange); *see also* letter from James A. Brigagliano Acting Associate Director, Division of Market Regulation, SEC, to Marc Menchel, Executive Vice President and General Counsel, NASD, Inc., dated June 26, 2006.

<sup>198</sup> *See* Proposal, 74 FR at 18050 – 18051.

<sup>199</sup> The three joint-industry plans are (1) the Consolidated Tape Association Plan (“CTA Plan”), which disseminates transaction information for securities primarily listed on an exchange other than Nasdaq, (2) the Consolidated Quotation Plan (“CQ Plan”), which disseminates consolidated quotation information for securities

securities exchanges and FINRA participate in these joint-industry plans (“Plans”).<sup>200</sup> The Plans establish three separate networks to disseminate market information for NMS stocks.<sup>201</sup> These networks are designed to ensure that, among other things, consolidated bids from the various trading centers that trade NMS stocks are continually collected and disseminated on a real-time basis, in a single stream of information. Thus, all market participants will have access to the consolidated bids for all the securities that will be subject to Rule 201.<sup>202</sup> As discussed in further detail below, however, we note that the national best bid can change rapidly and repeatedly and potentially there might be latencies in obtaining data regarding the national best bid.<sup>203</sup>

## **2. Pricing Increment**

Rule 201(b) provides that a trading center shall establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In Rule 201 we have determined not to specify at what price a trading center may execute or display a short sale order of a covered security provided it is not at a price

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primarily listed on an exchange other than Nasdaq, and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq.

<sup>200</sup> Rule 603(b) of Regulation NMS provides that every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, for NMS stocks. See 17 CFR 242.603(b).

<sup>201</sup> These networks can be categorized as follows: (1) Network A — securities primarily listed on the NYSE; (2) Network B — securities listed on exchanges other than the NYSE and Nasdaq; and (3) Network C — securities primarily listed on Nasdaq.

<sup>202</sup> See Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37503 (June 29, 2005) (“Regulation NMS Adopting Release”).

<sup>203</sup> See infra Section III.A.7.

that is less than or equal to the current national best bid. As we stated in the Proposal, however, any such execution or display must be in compliance with applicable rules regarding minimum pricing increments.<sup>204</sup>

In the Proposal and Re-Opening Release, we did not propose a specific increment above the national best bid or last sale price at which short selling would be permissible. In response to our requests for comment regarding pricing increments, however, a number of commenters stated that any increment should be greater than one cent in order to make a price test more restrictive or effective or to address decimal pricing concerns.<sup>205</sup> Several commenters noted, however, that the higher the increment, the more restrictive such an increment could be on short selling and, if high enough, could even be tantamount to a ban on short selling.<sup>206</sup> A study by the Staff found that even moderate changes in bid increments can have a big impact on the constraints imposed on short selling activity and that, for practical purposes, high bid increments, such as five or ten cents, might be equivalent to a ban on short selling in some stocks, especially during periods when prices are not changing rapidly.<sup>207</sup>

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<sup>204</sup> See Proposal, 74 FR at 18050, n.99, 101 (referencing 17 CFR 242.612).

<sup>205</sup> See, e.g., letter from Franco A. Mortarotti, Managing Director, Zermatt Capital Management, dated Apr. 10, 2009 (“Zermatt”); letter from Neal E. Schear, President, Schear Capital, Inc., dated Apr. 28, 2009 (“Schear”); letter from Dale T. Forte, dated Apr. 14, 2009; letter from Arthur Colman, dated May 4, 2009; letter from Joseph Leegan, dated Mar. 25, 2009; letter from John H. Happke, dated May 7, 2009; letter from Louis G. Marozsan, Jr., dated May 8, 2009; letter from S. Buford Scott, Chairman, Walter S. Robertson, III, President and CEO, John Sherman, Jr., Past President and CEO, William P. Schubmehl, Past President and CEO, Scott & Stringfellow LLC, dated May 14, 2009 (“Scott & Stringfellow”); letter from Martin Napor; letter from Michael Sigmon, Chairman, Sigmon Wealth Management, dated June 10, 2009 (“Sigmon Wealth Management (June 2009)”); letter from Christopher Ailman, Chief Investment Officer, California State Teachers’ Retirement System, dated June 17, 2009; letter from IBM; letter from Stan Ryckman, dated June 19, 2009.

<sup>206</sup> See, e.g., letter from Citadel et al. (June 2009); letter from SIFMA (June 2009); letter from STA (June 2009)); see also letter from Credit Suisse (Mar. 2009).

<sup>207</sup> See Staff Analysis (Dec. 17, 2008).

Several commenters supported an increment of one trading unit, or one cent,<sup>208</sup> while another commenter suggested that the increment should be consistent with the minimum pricing increments specified in Rule 612 of Regulation NMS.<sup>209</sup> One commenter stated that the Commission should not specify a minimum increment and should permit trades to be executed at the mid-point between the best bid and best offer, even if the price were less than one cent above the best bid.<sup>210</sup> Another commenter expressed concerns that a short sale price test might advantage subpenny executions if, for example, certain trading venues were permitted to comply with the test by executing transactions at less than one cent above the national best bid.<sup>211</sup>

After considering the comments, we have determined at this time to not specify in Rule 201 a particular increment above the national best bid at which a covered security may be sold short. We believe that the goals we are seeking to advance by adopting Rule 201 will be achieved by requiring that when a covered security becomes subject to the short sale price test restrictions of Rule 201, all short selling must be at a price above the current national best bid. As discussed above, a goal of Rule 201 is to help prevent short selling from being used as a tool to exacerbate a declining market in a security. Thus, the price test restriction of Rule 201 does not permit short selling at or below the current national best bid. In addition to achieving this goal, however, we also recognize the need to minimize market disruption as well as the need for the price test restriction in Rule 201 to not be unduly restrictive. We believe that restricting short selling to a price above the current national bid for a particular security when the circuit breaker

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<sup>208</sup> See, e.g., letter from Citadel et al. (June 2009); letter from STA (June 2009).

<sup>209</sup> 17 CFR 242.612. See letter from NYSE Euronext (Sept. 2009).

<sup>210</sup> See letter from Howard Meyerson, General Counsel, Liquidnet, Inc., dated June 18, 2009 (“Liquidnet”).

<sup>211</sup> See letter from Alec Hanson, dated Sept. 19, 2009.

has been triggered for that security, without specifying at what price such short sales may occur, will best achieve these goals.<sup>212</sup>

### **3. Alternative Uptick Rule**

We have determined to adopt in Rule 201(b) the alternative uptick rule such that when triggered, short selling will be permitted only at a price above the current national best bid. Specifically, Rule 201(b) will require a trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>213</sup> As noted above, we have determined to adopt in Rule 201(b) a circuit breaker trigger combined with the alternative uptick rule. Thus, while this Section III.A.3. focuses on the alternative uptick rule in the context of comments received about the different price tests that we proposed, the alternative uptick rule operates in conjunction with the circuit breaker approach and should not be considered as an isolated provision.

In the Proposal and the Re-Opening Release, we sought comment on three alternative types of short sale price test restrictions that could be applied on a permanent, market-wide basis or in combination with a circuit breaker: the proposed uptick rule, the proposed modified uptick rule, and the alternative uptick rule.<sup>214</sup> The alternative uptick rule is similar to the proposed modified uptick rule in that it will use the current national best bid, rather than the last sale price,

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<sup>212</sup> As noted above, any execution or display of a short sale order must be in compliance with applicable rules of Regulation NMS regarding minimum pricing increments. See supra note 204 and accompanying text.

<sup>213</sup> See Rule 201(b).

<sup>214</sup> See Proposal, 74 FR 18042; Re-Opening Release, 74 FR 42033.

as a reference point for short sale orders. Unlike the proposed modified uptick rule and the proposed uptick rule, the alternative uptick rule will not allow short selling at the current national best bid or last sale price. Instead, the alternative uptick rule will only permit short selling at an increment above the current national best bid, unless an applicable exception applies.

In response to the Proposal and the Re-Opening Release, we received a number of comment letters supporting and opposing the alternative uptick rule. Those that opposed the alternative uptick rule stated, among other things, that because it will allow short selling only at a price above the current national best bid or last sale price, rather than at the current national best bid or last sale price, it will be more disruptive to the market than the proposed modified uptick rule or proposed uptick rule.<sup>215</sup> Some commenters stated that the alternative uptick rule will decrease liquidity, widen bid-ask spreads, decrease pricing efficiency, create inefficiencies in the routing and execution of short sale orders, increase intra-day volatility, and result in higher costs to investors.<sup>216</sup> Some commenters expressed concerns that the alternative uptick rule will exacerbate downward price movements because market participants may perceive the presence of short limit orders as a negative view of a security, causing buyers to withdraw their bids.<sup>217</sup>

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<sup>215</sup> See, e.g., letter from William E. McDonnell, Jr., Chief Compliance Officer, Atherton Lane Advisers, LLC, dated Sept. 9, 2009 (“Atherton Lane”); letter from Michael J. Simon, Secretary, International Securities Exchange LLC, dated Sept. 21, 2009 (“ISE (Sept. 2009)”); letter from John Nagel, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C., John Liftin, Managing Director and General Counsel, The D.E. Shaw Group, Mark Silber, Executive Vice President, Renaissance Technologies, dated Sept. 21, 2009 (“Citadel et al. (Sept. 2009)”); letter from Bingham McCutchen; letter from Vanguard (Sept. 2009); letter from STA (Sept. 2009).

<sup>216</sup> See, e.g., letter from Karrie McMillan, General Counsel, Investment Company Institute, dated Sept. 21, 2009 (“ICI (Sept. 2009)”); letter from CPIC (Sept. 2009); letter from STA (Sept. 2009); letter from Kimberly Unger, Executive Director, Security Traders Association of New York, Inc., dated Sept. 21, 2009 (“STANY (Sept. 2009)”); letter from RBC (Sept. 2009); letter from EWT (Sept. 2009); letter from MFA (Oct. 2009); letter from Knight Capital (Sept. 2009).

<sup>217</sup> See, e.g., letter from John Gilmartin, Co-CEO and Ben Londergan, Co-CEO, Group One Trading, L.P., dated Sept. 14, 2009 (“Group One Trading (Sept. 2009)”); letter from STANY (Sept. 2009); letter from Glen Shipway (Sept. 2009); letter from Michael L. Crawl, Managing Director, Global General Counsel, Barclays Global Investors, dated Sept. 21, 2009 (“Barclays (Sept 2009)”); letter from Knight Capital (Sept. 2009); letter from MFA (Oct. 2009).

Other commenters stated that, although easier to implement, the alternative uptick rule would have a more disruptive effect on the market than the proposed modified uptick rule or the proposed uptick rule.<sup>218</sup>

The alternative uptick rule, like former Rule 10a-1 and the proposed uptick rule and proposed modified uptick rule, when triggered will affect all short selling, including some legitimate short selling, as well as abusive or manipulative short selling. The alternative uptick rule is by definition more restrictive than the proposed modified uptick rule, but differences between the operation of the proposed uptick rule and the alternative uptick rule mean that one approach or the other would be more restrictive in particular circumstances.<sup>219</sup> The empirical evidence regarding former Rule 10a-1 tends to demonstrate that it did not have a negative effect on market liquidity and price efficiency.<sup>220</sup> We similarly believe that the alternative uptick rule will have a minimal, if any, negative effect on market liquidity or price efficiency.<sup>221</sup>

In contrast to those commenters opposed to the alternative uptick rule, several commenters expressed support for the alternative uptick rule, stating that the alternative uptick rule is preferable to the proposed modified uptick rule or the proposed uptick rule because it will eliminate sequencing issues, will be easier and less costly to implement, will be more effective in decreasing price pressure on a security,<sup>222</sup> and will reduce the ability of market participants to

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<sup>218</sup> See, e.g., letter from ISE (Sept. 2009); letter from ICI (Sept. 2009).

<sup>219</sup> See, e.g., *infra* note 242 and accompanying text (discussing automated trade matching systems).

<sup>220</sup> See, e.g., the Pilot Results.

<sup>221</sup> See *infra* Section X.B.1.a. (discussing the impact of Rule 201 on market liquidity and price efficiency).

<sup>222</sup> See, e.g., letter from Direct Edge (Sept. 2009); letter from BATS (Sept. 2009); letter from Ronald C. Long, Director, Regulatory Affairs, Wells Fargo Advisors, dated Sept. 17, 2009 (“Wells Fargo (Sept. 2009)”); see also letter from SIFMA (Sept. 2009) (stating that a circuit breaker coupled with the alternative uptick rule “would limit instances where a security is the subject of severe downward pressure”); letter from Hudson River Trading (expressing support for the alternative uptick rule in conjunction with a circuit breaker as opposed to other proposed price tests in conjunction with a circuit breaker).

use short selling as a market manipulation tool.<sup>223</sup> Some commenters stated that because the alternative uptick rule will most effectively prevent short selling from proactively driving the price of a security lower, it will also be the most effective of the proposed short sale price test restrictions at achieving the Commission’s goal of helping to restore investor confidence.<sup>224</sup> In discussing the alternative uptick rule, one commenter stated that “[n]ot only does it faithfully replicate the old uptick rule it improves upon it by making each and every short sale a liquidity providing transaction.”<sup>225</sup> Another commenter, in supporting the alternative uptick rule, stated that it will “likely be more restrictive on short selling than the original Rule 10a-1 ‘uptick rule’.”<sup>226</sup>

We have determined to adopt the alternative uptick rule in combination with a circuit breaker because we believe the alternative uptick rule will be more effective at meeting our goals than the other proposed rules. Because the alternative uptick rule, when triggered, will generally permit short selling only at a price above the current national best bid, the alternative uptick rule will not allow short sales to get immediate execution at the bid.<sup>227</sup> In other words, short sellers will not be permitted to act as liquidity takers when the alternative uptick rule applies, but will participate, if at all, as liquidity providers (unless an exception applies), adding depth to the market. Put another way, short sale orders will be executed only when purchasers arrive willing

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<sup>223</sup> See letter from BATS (Sept. 2009); letter from Wells Fargo (Sept. 2009); letter from Glen Shipway (Sept. 2009).

<sup>224</sup> Letter from Michael Gitlin, Head of Global Trading, David Oestreicher, Chief Legal Counsel, Christopher P. Hayes, Sr. Legal Counsel, T. Rowe Price Associates, Inc., dated Sept. 21, 2009 (“T. Rowe Price (Sept. 2009)”).

<sup>225</sup> Letter from Glen Shipway (Sept. 2009).

<sup>226</sup> Letter from Virtu Financial.

<sup>227</sup> As noted by some commenters, there may be situations in which a short seller could get immediate execution, such as where an order is executed in a facility that provides executions at the mid-point of the national best bid and offer. See, e.g., letter from ISE (Sept. 2009); see also letter from BATS (Sept. 2009).

to buy at prices above the national best bid. In addition, by not allowing short sellers to sell at the current national best bid, the alternative uptick rule will generally allow long sellers, by selling at the bid, to sell first and, thereby, take liquidity in a declining market for a security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long sellers to sell first in a declining market.<sup>228</sup> A short seller that is seeking to profit quickly from market moves may find it advantageous to be able to short sell at the current national best bid. By placing long sellers ahead of short sellers in the execution queue under certain circumstances, Rule 201 will help promote capital formation, since investors should be more willing to hold long positions if they know that they may have a preferred position over short sellers when they wish to sell.

In addition, by making bids accessible only by long sellers when a security's price is undergoing significant downward price pressure, Rule 201 will help to facilitate and maintain stability in the markets and help ensure that they function efficiently. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors.

As we stated in the Proposal, short sale price test restrictions, whether a permanent, market-wide restriction or in combination with a circuit breaker, might help prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, and causing successively lower prices to be established by long sellers.<sup>229</sup> Because the alternative

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<sup>228</sup> See supra note 17.

<sup>229</sup> See Proposal, 74 FR at 18050, 18053, 18059, 18061, 18065, 18069; see also Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1<sup>st</sup> Sess., at 251 (1963).

uptick rule will only permit short selling at a price above the current national best bid, unless an exception applies, we believe it will be more effective than the proposed uptick rule or the proposed modified uptick rule at helping to prevent short selling, including potentially abusive or manipulative short selling, from being used as a tool to exacerbate a decline in the price of a security by exhausting all remaining bids at one price level.

A number of commenters favored the proposed circuit breaker halt rule, stating, among other things, that they believe it would be the least disruptive of the proposed rules with respect to market functioning, while still achieving the Commission's underlying goals,<sup>230</sup> and would be the easiest of the proposed rules to implement.<sup>231</sup> We are concerned, however, that, as expressed by other commenters, the proposed circuit breaker halt rule could harm the market by preventing short sellers from being able to provide benefits such as liquidity and price efficiency to the impacted security during the duration of the halt or that it could harm investor confidence.<sup>232</sup> We note that in severe conditions, stocks tend to be less liquid. Thus, as a rule that permits short

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<sup>230</sup> See, e.g., letter from Lime Brokerage (Sept. 2009); see also letter from Lime Brokerage (June 2009) (stating that "[i]mplementing a 'cooling off' period after a steep decline in a given security's price will give market participants a chance to absorb the situation and possibly reassess their desire to continue short selling"); letter from Credit Suisse (June 2009); letter from T.D. Pro Ex.

<sup>231</sup> See, e.g., letter from SIFMA (June 2009); letter from Credit Suisse (June 2009); letter from Liquidnet; letter from Manisha Kimmel, Executive Director, Financial Information Forum, dated June 19, 2009 ("FIF (June 2009)"); letter from Lime Brokerage (Sept. 2009). Some commenters also stated that they believe that the proposed circuit breaker halt rule would be effective at preventing bear raids, reducing volatility in the market, and helpful in restoring investor confidence. See, e.g., letter from Matthew Samelson, Principal, Woodbine Associates, dated May 15, 2009 ("Woodbine"); letter from Credit Suisse (June 2009); letter from IBC; letter from Sigmon Wealth Management (June 2009); letter from Wachtell.

<sup>232</sup> See, e.g., letter from BATS (May 2009); letter from Citadel *et al.* (June 2009); letter from Direct Edge (June 2009); letter from Wolverine; letter from Amer. Bankers Assoc.. Other commenters viewed the proposed circuit breaker halt rule as too restrictive. See, e.g., letter from BATS (May 2009); letter from Direct Edge (June 2009). Some commenters argued that the proposed circuit breaker halt rule could harm investor confidence, by reducing volume and increasing bid-ask spreads during the effective period of the halt. See, e.g., letter from ICI (June 2009); letter from Amer. Bankers Assoc.; letter from Citadel *et al.* (June 2009). Other commenters expressed opposition to the concept of short sale halts and bans as a general matter, perceiving such actions as harmful to the markets, citing prior regulatory halts and short sale bans as evidence. See, e.g., letter from Josh Galper, Managing Principal, Finadium LLC, dated Apr. 13, 2009 ("Finadium"); letter from Barclays (June 2009); letter from Citadel *et al.* (June 2009); letter from Dialectic Capital (June 2009); letter from Knight Capital (June 2009); letter from MFA (June 2009).

selling only at a price above the national best bid, the alternative uptick rule will require that during the period of time when a covered security is subject to the rule, short sellers in the security must act as liquidity providers, not liquidity takers, in that security.<sup>233</sup> In addition, by restricting the ability of short sellers to take liquidity when a covered security is undergoing significant price pressure, it will allow long sellers to access available liquidity by being able to sell at the current national best bid. This, in turn, may result in an increase in investor confidence during times of crisis as long sellers will have preferred access to bids for a security because when the circuit breaker has been triggered for a covered security, Rule 201 generally will allow only long sellers to sell at the bid.<sup>234</sup>

We have also determined to adopt the alternative uptick rule because, unlike the proposed uptick rule, it will be based on the current national best bid rather than the last sale price. As we stated in the Proposal, we believe that a short sale price test based on the national best bid is more suitable to today's markets than a short sale price test based on the last sale price.<sup>235</sup>

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<sup>233</sup> See supra note 29 (discussing the terms “liquidity provider” and “liquidity taker”).

<sup>234</sup> Too much investor confidence may also be detrimental to investors because it can lead to investors making inappropriate decisions. Investor over-confidence, however, is less likely during times of crisis. See, e.g., Brad M. Barber and Terrance Odean, 2000, Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors, *Journal of Finance*, 55: 773-806.

<sup>235</sup> See Proposal, 74 FR at 18053. In response to our requests for comment in the Proposal and the Re-Opening Release, a number of commenters to the Proposal and Re-Opening Release expressed support for a price test restriction based on the national best bid rather than the last sale price, stating that it would be more suitable to today's markets. See, e.g., letter from BATS (May 2009); letter from SIFMA (June 2009); letter from NYSE Euronext (June 2009); letter from Goldman Sachs (June 2009); letter from Direct Edge (June 2009); letter from GE; letter from Bingham McCutchen; letter from Citadel et al. (June 2009); letter from Amer. Bar Assoc. (July 2009); letter from Barry Friedman, Llewellyn Jones, and Derrick Kaiser, Founding Members, Qtrade Capital Partners LLC, dated Sept. 21, 2009 (“Qtrade”); letter from MFA (Oct. 2009). We also note supporting statements made by Larry Leibowitz, Group Executive Vice President at NYSE Euronext, at our May 5, 2009 Roundtable, stating that the proposed uptick rule would be ineffective in today's market “due to improper price sequencing caused by permitted reporting delays and the potential for manipulation.” Statement of NYSE Euronext (May 2009). Available at: <http://www.sec.gov/comments/4-581/4581-86.pdf>.

We note, however, that a number of commenters offered support for a price test restriction based on the last sale price. See, e.g., letter from Zermatt; letter from Bruce Lueck, Managing Partner, Zephyr Unicorn Funds, dated Apr. 10, 2009; letter from Walter Cruttenden, Cruttenden Partners, dated Apr. 14, 2009; letter from Larry Chlebina, President, Chlebina Capital Management, LLC, dated Apr. 15, 2009 (“Chlebina (Apr. 2009)”); letter

Although we recognize that a quotation proposes a transaction, whereas the last trade price reflects an actual trade, we note that pursuant to Commission and SRO rules, quotations for all covered securities must be firm.<sup>236</sup> By requiring that quotations be firm, the Commission intended to ensure that quotations provide reliable information to the marketplace to assist broker-dealers in satisfying their best execution obligations to their customers and to assist customers in making informed investment decisions.<sup>237</sup> Moreover, quotation information has significant value to the marketplace because it reflects the various factors affecting the market, including current levels of buying and selling interest.<sup>238</sup> Both retail and institutional investors rely on quotation information to understand the market forces at work at a given time and to assist in the formulation of investment strategies.<sup>239</sup>

Further, we believe that bids generally are a more accurate reflection of current prices for a security because changes in bids are more accurately timed than transactions. Transactions may be reported within a 90 second window, which can easily result in “stale” reports. Even transactions that are executed and reported automatically may be out of sequence if they occur in different trading centers, which can detract from the accuracy and reliability of the last sale. For example, trade reporting for covered securities can involve multiple trading centers reporting

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from Chad McCurdy, Managing Partner, Marlin Capital Partners, dated Apr. 20, 2009; letter from David Wagner, CEO, Active Investment Management, LLC, dated Apr. 22, 2009; letter from Bradley Kelly, President, Magnum Opus Financial, dated Apr. 29, 2009; letter from Equity Insight; letter from Tony Wyan, CEO, Tony Wyan and Company, dated May 5, 2009; letter from Aaron Shafter, President, Great Mountain Capital Management, LLC, dated May 5, 2009; letter from Richard Casey, Chairman and CEO, Casey Securities, LLC, dated May 8, 2009; letter from Scott & Stringfellow; letter from Donald Rembert Sr., President, Rembert Pendelton and Jackson, dated May 28, 2009; letter from Sigmon Wealth Management (June 2009); letter from Sears.

<sup>236</sup> See, e.g., 17 CFR 242.602.

<sup>237</sup> See, e.g., Exchange Act Release No. 43085 (July 28, 2000), 65 FR 47918, 47924 – 47925 (Aug. 4, 2000).

<sup>238</sup> See id. at 47925.

<sup>239</sup> See id.

trades in the same stock from different locations using different means of reporting. Thus, for those covered securities for which a significant amount of trading occurs manually, or in multiple trading centers, a price test based on the national best bid will be a more accurate and effective means of regulating short selling than a test based on the last sale price because the manner in which trades are reported may create up-ticks and down-ticks that may not accurately reflect actual price movements in the security for the purpose of a test based on the last sale price.

We also note that the national best bid is nearly always a protected bid for the trade-through rule of Rule 611 of Regulation NMS,<sup>240</sup> with which every trading center must comply. Because trading centers' execution procedures must incorporate protected bids, they will also usually include the national best bid. Market participants will also be familiar with using the current national best bid as a reference point because NASD's former bid test, which was in existence from 1994 to mid-2007, was based on the current national best bid.<sup>241</sup>

In addition, another advantage of the alternative uptick rule is that it accommodates trading systems and strategies used in the marketplace today, such as the automated trade matching systems that offer price improvement based on the national best bid and offer. These passive pricing systems often effect trades at an independently-derived price, such as at the mid-point of the bid-offer spread. Such pricing would often not satisfy the tick test of former Rule 10a-1 because matches could potentially occur at a price below the last reported sale price.

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<sup>240</sup> See 17 CFR 242.611.

<sup>241</sup> NASD's former bid test referenced the national best bid and was designed to help prevent short selling at or below the current national best bid in a declining market. See *supra* note 43 (discussing NASD's former bid test).

Thus, we provided a limited exception from former Rule 10a-1 for these trading systems.<sup>242</sup> In response to the Proposal and Re-Opening Release, commenters noted that a short sale price test restriction based on the current national best bid is preferable to a restriction based on the last sale price because it would not impede mid-point and similar derived price trading.<sup>243</sup> One such commenter noted that mid-point trading is beneficial to the markets because it provides price improvement to both sides of the trade.<sup>244</sup> The short sale price test restrictions of Rule 201 will accommodate matching systems that execute trades at an independently-derived price because such systems are designed so that matches occur above the current national best bid.

We have also determined to adopt the alternative uptick rule rather than the proposed uptick rule or the proposed modified uptick rule because it will not require monitoring of the sequence of bids or last sale prices (i.e., whether the current national best bid or last sale price is above or below the previous national best bid or last sale price) and, therefore, will likely be easier to implement and monitor. As we noted in the Re-Opening Release, commenters had stated that the alternative uptick rule would likely be easier to monitor, could likely be implemented more quickly and with less cost, and would be easier to program into trading and surveillance systems than the proposed modified uptick rule or the proposed uptick rule because it would not require bid sequencing.<sup>245</sup> In response to the Re-Opening Release, several

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<sup>242</sup> See, e.g., supra note 42; letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, SEC, to Alan J. Reed, Jr., First Vice President and Director of Compliance, Instinet Group, LLC, dated June 15, 2006 (granting Instinet modified exemptive relief from Rule 10a-1 for certain transactions executed through Instinet's Intra-day Crossing System).

<sup>243</sup> See letter from Liquidnet; letter from GE.

<sup>244</sup> See letter from Liquidnet.

<sup>245</sup> See Re-Opening Release, 74 FR at 42034.

commenters made similar statements in comparing the alternative uptick rule to the proposed modified uptick rule and proposed uptick rule.<sup>246</sup>

The requirements of Rule 201 will also not result in the type of disparate short sale regulation that existed under former Rule 10a-1.<sup>247</sup> Rule 201 will apply a uniform rule to trades in the same securities that can occur in multiple, dispersed, and diverse markets. To further this goal of having a uniform short sale price test, consistent with the Proposal, subsection (e) of Rule 201 provides that no SRO shall have any rule that is not in conformity with, or conflicts with, Rule 201.<sup>248</sup> One of the reasons for the elimination of former Rule 10a-1 and the prohibition on any SRO from having a short sale price test in July 2007 was that the application of short sale price tests had become disjointed, with different price tests applying to the same securities trading in different markets. One commenter noted that a rule that does not cover all market centers would result in an unlevel playing field,<sup>249</sup> while another stated that the Commission should not adopt a rule that would create an opportunity for regulatory arbitrage.<sup>250</sup> For this same reason, this commenter supported a prohibition on any SRO having a rule that is not in conformity with or conflicts with Rule 201.<sup>251</sup> We believe that a uniform rule will reduce

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<sup>246</sup> See, e.g., letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from John McCarthy, General Counsel, Global Electronic Trading Company, dated Sept. 21, 2009 (“GETCO (Sept. 2009)”); letter from Hudson River Trading. Some commenters, however, expressed disagreement that a price test restriction that will require sequencing of bids or last sale prices is not technologically feasible. See, e.g., letter from Bingham McCutchen; letter from ISE (Sept. 2009); letter from EWT (Sept. 2009); letter from Vincent Florack and Steve Crutchfield, Matlock Capital LLC, dated Sept. 18, 2009 (“Matlock Capital (Sept. 2009)”); letter from Gary E. Shugrue, President, Ascendant Capital Partners, dated May 11, 2009 (“Ascendant Capital”); letter from Robert P. Porter, President, Paladin Investment LLC, dated May 8, 2009 (“Paladin Investment”).

<sup>247</sup> See Proposal, 74 FR at 18044 – 18045 (discussing the history of short sale price test restrictions).

<sup>248</sup> See Rule 201(e).

<sup>249</sup> See letter from Wells Fargo (June 2009).

<sup>250</sup> See letter from STA (June 2009).

<sup>251</sup> See id.

compliance and surveillance costs because systems and surveillance mechanisms will have to be programmed to consider a single price test based on the national best bid, rather than different tests for different markets. In addition, a uniform test will reduce opportunities for regulatory arbitrage. Accordingly, under Rule 201, all covered securities, wherever traded, will be subject to one short sale price test, the alternative uptick rule.

#### **4. Circuit Breaker Approach Generally**

Under Rule 201(b), the alternative uptick rule will apply only if the price of a covered security has declined by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>252</sup> In the Proposal, we proposed a permanent, market-wide approach to short sale price test restrictions that would result in the proposed uptick rule or proposed modified uptick rule applying to all covered securities all the time.<sup>253</sup> We also proposed a circuit breaker approach, either as an addition or an alternative to a permanent, market-wide approach, which would temporarily result in either a halt on short selling in a specific security or the proposed modified uptick rule or the proposed uptick rule applying to a specific security if there was a significant decline in the price of that security.<sup>254</sup> In addition, in the Re-Opening Release, we stated that the alternative uptick rule could be implemented market-wide or in combination with a short selling circuit breaker.<sup>255</sup>

A number of commenters stated that if we determined to adopt a short sale price test restriction, it should be in combination with a circuit breaker rather than on a permanent, market-

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<sup>252</sup> See Rule 201(b).

<sup>253</sup> See Proposal, 74 FR 18042.

<sup>254</sup> See id.

<sup>255</sup> See Re-Opening Release, 74 FR 42033.

wide basis.<sup>256</sup> For example, one commenter urged us to adopt a circuit breaker approach because it would be more narrowly-tailored to address our concerns about the effects of short selling in a market subject to a significant downturn.<sup>257</sup> This commenter noted that in such a market, circuit breakers likely would be triggered for a large number of securities.<sup>258</sup> Another commenter stated that a circuit breaker is preferable because it “permits normal market activity while a stock is trading in a natural range and short selling is more likely to benefit the market (by, for example, increasing price discovery and liquidity). Conversely, a Circuit Breaker will restrict short selling when prices begin to decline substantially and short selling becomes more likely to be abusive and potentially harmful.”<sup>259</sup> One commenter stated that “[a] circuit breaker would better target situations that could result from . . . potential bear raids and other forms of manipulation that may be used to drive down or accelerate the decline in the price of a stock.”<sup>260</sup>

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<sup>256</sup> See, e.g., statement of Justin Schack, Vice President, Market Structure Analysis, Rosenblatt Securities, Inc., at SEC Roundtable on Short Selling (May 5, 2009) (“Rosenblatt Securities”); letter from Richard T. Chase, Managing Director and General Counsel, RBC Capital Markets Corporation, dated June 19, 2009 (“RBC (June 2009)”); letter from Michael J. Simon, Secretary, International Securities Exchange LLC, dated June 19, 2009 (“ISE (June 2009)”); memorandum of a meeting between representatives of Penson Worldwide, Inc., and the Division of Trading and Markets, dated July 21, 2009, and written materials submitted at the meeting (“Penson”); letter from Direct Edge (June 2009); letter from BATS (May 2009); letter from SIFMA (June 2009); letter from MFA (June 2009); letter from ICI (June 2009); letter from Barclays (June 2009); letter from Vanguard (June 2009); letter from Goldman Sachs (June 2009); letter from Credit Suisse (June 2009); letter from Dialectic Capital (June 2009); letter from Allston Trading (June 2009); letter from Knight Capital (June 2009); letter from GETCO (June 2009); letter from Citadel et al. (June 2009); letter from William Connell, President and CEO, Allston Trading, LLC, dated Sept. 21, 2009 (“Allston Trading (Sept. 2009)”); letter from GETCO (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from ICI (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from RBC (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from BATS (Sept. 2009); letter from SIFMA (Sept. 2009); letter from MFA (Oct. 2009); letter from AIMA; letter from IAG; letter from Fidelity; letter from T.D. Pro Ex; letter from Finadium; letter from Matthew B. Management; letter from Millennium; letter from Liquidnet; letter from Qtrade; letter from Hudson River Trading; letter from Virtu Financial; see also letter from Credit Suisse (Mar. 2009).

<sup>257</sup> See letter from Citadel et al. (Sept. 2009).

<sup>258</sup> See id.

<sup>259</sup> Letter from Nasdaq OMX Group (Oct. 2009); see also letter from Goldman Sachs (June 2009); letter from MFA (June 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Virtu Financial.

<sup>260</sup> Letter from Hudson River Trading; see also letter from MFA (June 2009).

Other commenters stated that implementing price test restrictions on a permanent, market-wide basis, rather than in combination with a circuit breaker, would substantially diminish the benefits that short sellers bring to the markets.<sup>261</sup> One commenter stated that a price test restriction should be adopted with a circuit breaker because prior empirical studies did not necessarily include times of severe market events.<sup>262</sup> One commenter stated that a circuit breaker approach was preferable because it would be easier to implement than a permanent, market-wide rule.<sup>263</sup>

Other commenters were not supportive of a circuit breaker approach.<sup>264</sup> One such commenter stated that a permanent, market-wide price test restriction would be preferable to a circuit breaker approach because it is “more predictable for market participants and issuers alike, would raise fewer implementation complexities, and is less likely to have a ‘magnet effect’ on the pricing of a security as it approaches a circuit breaker trigger point.”<sup>265</sup> This commenter stated that a circuit breaker is “unlikely to be perceived as a timely or effective remedy against abusive short selling, since restrictions would only take effect after there had already been a significant intraday price decline in a security.”<sup>266</sup> Further, this commenter stated that “[c]ircuit breakers may also undermine investor confidence because they introduce an element of uncertainty in the pricing of securities: at a certain point, the price of a declining security would begin to reflect not the fundamental value of the security, but rather the likelihood that a security

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<sup>261</sup> See, e.g., letter from Direct Edge (Sept. 2009); letter from Credit Suisse (Sept. 2009).

<sup>262</sup> See letter from Virtu Financial.

<sup>263</sup> See letter from SIFMA (June 2009).

<sup>264</sup> See, e.g., letter from Glen Shipway (June 2009); letter from T. Rowe Price (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from EWT (Sept. 2009).

<sup>265</sup> Letter from NYSE Euronext (Sept. 2009).

<sup>266</sup> Id.

will trigger the circuit breaker. This ‘magnet effect’ could undermine investor confidence, resulting in less buying interest in securities nearing the circuit breaker if there is a perception that professional traders could use sophisticated pricing models to profit from this anomaly while public investors, lacking access to such tools, could not.”<sup>267</sup>

Another commenter stated that it believes that a circuit breaker approach is unworkable because it “may exacerbate market dislocations by suddenly and unexpectedly altering the regulatory regime and liquidity characteristics of a particular security, precisely when it is under duress.”<sup>268</sup> One commenter stated that it did not support a circuit breaker approach because it “would still allow abusive short sellers to drive down the price of a stock at least 10% on any given day even before the circuit breaker would kick in.”<sup>269</sup> This commenter also stated that it was concerned that during periods of extreme volatility, “circuit breakers could potentially impact far too many stocks on any given day and damage the benefits of short selling.”<sup>270</sup>

Another commenter stated that it did not support a circuit breaker approach because, among other things, it would add “an additional element of trading risk that could result in a decrease in certain market participant’s [sic] willingness to supply liquidity in securities perceived to be potentially subject to triggering of a circuit breaker.”<sup>271</sup>

In line with the Commission’s position that market impediments should be minimized, we believe the short selling circuit breaker approach of Rule 201 will benefit the market as a narrowly-

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<sup>267</sup> Id.; see also letter from Amer. Bankers Assoc. (referencing the “stigmatizing effect” on stocks subject to a circuit breaker); letter from T. Rowe Price (Sept. 2009) (expressing support for the alternative uptick rule that would apply on a permanent, market-wide basis).

<sup>268</sup> Letter from EWT (Sept. 2009).

<sup>269</sup> Letter from Atherton Lane.

<sup>270</sup> Id.

<sup>271</sup> Letter from NYSE Euronext (June 2009).

tailored response to severe circumstances.<sup>272</sup> As discussed above, due to the changes in market conditions and erosion of investor confidence that occurred recently, investors have become increasingly concerned about sudden and excessive declines in prices that appear to be unrelated to issuer fundamentals.<sup>273</sup> We believe that a circuit breaker that is triggered by a significant intra-day decline in price of an individual security is a targeted response to address these concerns. Although a permanent, market-wide approach that would apply to all covered securities all the time may, as one commenter stated,<sup>274</sup> provide an element of predictability, we believe that the circuit breaker approach of Rule 201 is appropriate because it provides a balance between achieving our goals for adopting a short sale price test restriction and limiting impediments to the normal operations of the market.

As noted above, some commenters expressed concerns regarding the effectiveness and workability of a circuit breaker approach because the price test restriction will apply only after there has already been a significant intra-day price decline in a security, and because it may exacerbate market dislocations when a security is under duress. The Commission has previously noted that circuit breakers may benefit the market by allowing participants an opportunity to re-evaluate circumstances and respond to volatility.<sup>275</sup> Unlike a price test restriction that would apply on a permanent, market-wide basis, Rule 201 will restrict short selling for an individual covered security for a specified period of time. As we stated in the Proposal, in discussing a short selling circuit breaker, one commenter noted that such a measure could address the issue of “bear raids”

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<sup>272</sup> See Exchange Act Release No. 39846 (Apr. 9, 1998), 63 FR 18477 (Apr. 15, 1998) (order approving proposals by Amex, BSE, CHX, NASD, NYSE, and Phlx) (“1998 Release”).

<sup>273</sup> See supra Section II.C. (discussing investor confidence); see also Proposal, 74 FR at 18046 – 18049.

<sup>274</sup> See letter from NYSE Euronext (Sept. 2009).

<sup>275</sup> See 1998 Release, 63 FR 18477.

while limiting the market impact that may arise from other forms of short sale price test restrictions.<sup>276</sup> In addition, although we agree that a circuit breaker combined with a halt on short selling may cause or exacerbate market dislocations, we do not believe that the circuit breaker approach of Rule 201 will have the same impact because it will continue to allow short selling, although at a price above the national best bid, even when the price test restriction is in effect. Further, to the extent that the circuit breaker approach results in market dislocations, we believe any such dislocations are justified by the benefits provided by the Rule.

We have designed the alternative uptick rule implemented through a circuit breaker to strike the appropriate balance between our goal of preventing potential short sale abuse and the need to limit impediments to the normal operations of the market. The Commission has long held the view that circuit breakers may help restore investor confidence during times of substantial uncertainty.<sup>277</sup> We believe that the requirements of Rule 201 will produce similar benefits. By imposing the alternative uptick rule once a security's price is experiencing a significant intra-day price decline, the short selling circuit breaker rule in Rule 201(b) is designed to target only those securities that experience such declines and, therefore, will help to prevent short selling from being used as a tool to exacerbate a declining market in a security. This approach establishes a narrowly-tailored Rule that will target only those securities experiencing such a decline. We believe that addressing short selling in connection with such a decline in an individual security will help restore investor confidence in the markets generally.

As discussed above, short selling is an important tool in price discovery and the provision of liquidity to the market, and we recognize that imposition of a short selling circuit breaker that when

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<sup>276</sup> See Proposal, 74 FR at 18067, n.252 (noting a letter from Peter Brown, dated Dec. 12, 2008).

<sup>277</sup> See, e.g., 1998 Release, 63 FR 18477; see also Proposal, 74 FR at 18067.

triggered imposes the alternative uptick rule could restrict otherwise legitimate short selling activity during periods of significant volatility. To the extent that the alternative uptick rule may negatively impact the ability of short sellers to provide liquidity to the markets and contribute to price efficiency, we believe any such negative impact is justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline.

In addition, we believe that any such negative impact will be limited both in duration and reach. First, the circuit breaker will apply for a limited period of time, that is, through the end of the day on which it is triggered and the following day. Second, because the restrictions of Rule 201 will apply only when the price of a covered security has experienced a significant intra-day price decline, the circuit breaker approach of Rule 201 will preserve the potential benefits of short selling, such as the provision of liquidity and price efficiency, for those securities for which prices are undergoing minimal downward pressure, or are stable or rising.<sup>278</sup> To the extent that the markets are experiencing periods of extreme volatility, we expect that the circuit breaker will be triggered for more securities than during periods of low volatility. We believe this is an appropriate result of Rule 201 because it is designed to impose restrictions on short selling when individual securities are undergoing significant intra-day price declines. Because Rule 201 does not impose a halt on short selling, however, short selling will be possible even when the circuit breaker has been triggered, although it will be limited to a price above the current national best bid. A circuit breaker approach will also allow regulatory, supervisory and compliance resources

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<sup>278</sup> In addition, as discussed above, based on the empirical evidence regarding former Rule 10a-1 that tends to demonstrate that it did not have an effect on market liquidity and price efficiency, we similarly believe that the alternative uptick rule will have a minimal, if any, effect on market liquidity or price efficiency. See supra note 220 and accompanying text.

to focus on, and address, those situations where a specific security is experiencing significant downward price pressure.<sup>279</sup>

As we stated in the Proposal, we understand that there are concerns about a potential “magnet effect” that could arise as an unintended consequence of a circuit breaker that imposes a short selling price test restriction.<sup>280</sup> This “magnet effect” could result in short sellers driving down the price of an equity security in a rush to execute short sales before the circuit breaker is triggered. We are also concerned about short selling demand building until the circuit breaker is lifted. In response to our requests for comments, several commenters stated that a short sale circuit breaker could exacerbate downward pressure on stocks as their value reached the threshold level.<sup>281</sup> Commenters also discussed the possibility that short selling demand could be built up until the short selling restriction is lifted.<sup>282</sup> Other commenters, however, discounted the possibility or impact of a “magnet effect,”<sup>283</sup> including some commenters who cited empirical studies that question whether a circuit breaker would result in artificial pressure on the price of individual securities.<sup>284</sup>

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<sup>279</sup> See letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>280</sup> See, e.g., Proposal, 74 FR at 18067.

<sup>281</sup> See, e.g., letter from Vincent Florack and Steve Crutchfield, Matlock Capital LLC, dated May 26, 2009 (“Matlock Capital (May 2009)”); letter from Schwab; letter from Lime Brokerage (June 2009); letter from STA (June 2009); letter from Glen Shipway (June 2009); letter from NYSE Euronext (June 2009); letter from Wolverine; letter from Direct Edge (June 2009); letter from Amer. Bankers Assoc.; letter from NYSE Euronext (Sept. 2009); see also letter from SIFMA (June 2009) (indicating that an “on/off” circuit breaker trigger could dampen any magnet effect); letter from Direct Edge (Mar. 2009).

<sup>282</sup> See letter from STA (June 2009); letter from Wolverine.

<sup>283</sup> See letter from BATS (May 2009); letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); letter from Hudson River Trading; letter from Virtu Financial; see also letter from Credit Suisse (Mar. 2009).

<sup>284</sup> See letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); see also letter from Credit Suisse (Mar. 2009); letter from Nasdaq OMX Group (Oct. 2009).

After considering the comments, including studies cited by commenters, we do not believe that the evidence is clear regarding a “magnet effect.” In fact, many academic studies that have analyzed circuit breakers in other contexts found no evidence of such trading patterns.<sup>285</sup> We recognize, however, that some of these studies were conducted in markets dissimilar from the highly automated markets currently existing in the United States and, therefore, that limits their utility in this context. Overall, however, the most relevant studies fail to demonstrate a magnet effect and we believe that adopting the circuit breaker approach best serves our goals.

## **5. Circuit Breaker Trigger Level and Duration**

In the Proposal, we proposed that if the price of a covered security declined by at least 10% from the prior day’s closing price for that covered security, as measured by the closing price of the covered security on the consolidated system, then all short selling in the covered security would be subject to a halt or a price test restriction for the remainder of the trading day.<sup>286</sup> To avoid market disruption that might occur if a circuit breaker were triggered late in the trading day, the circuit breaker rules, as proposed, would not have been triggered if the specified market decline threshold was reached in a covered security within thirty minutes of the end of regular trading hours.<sup>287</sup>

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<sup>285</sup> See, e.g., letter from Credit Suisse (June 2009); see also David Abad and Roberto Pascual, On the Magnet Effect of Price Limits, *European Financial Management*, 13:833 – 852 (2007) (studying the Spanish stock exchange); Chan et al., Price limit performance: Evidence from transactions data and the limit order book, *Journal of Empirical Finance*, 12: 269 – 290 (2005) (studying the Kuala Lumpur Stock Exchange); Anthony D. Hall and Paul Korfman, Limits to linear price behavior: futures prices regulated by limits, *Journal of Futures Markets*, 21: 463 – 488 (2001) (studying five agriculture futures contracts); Henk Berkman and Onno Steenbeek, The influence of daily price limits on trading in Nikkei futures, *Journal of Futures Markets*, 18: 265 – 279 (1998) (studying futures contracts on the Osaka Securities Exchange); Marcelle Arak and Richard E. Cook, Do daily price limits act as magnets? The case of treasury bond futures, *Journal of Financial Services Research*, 12: 5 – 20 (1997) (studying treasury bond futures).

<sup>286</sup> See Proposal, 74 FR at 18066.

<sup>287</sup> See *id.*

In Rule 201(b), we are adopting a 10% trigger level measured from the closing price determined by the covered security's listing market as of the end of regular trading hours on the prior day.<sup>288</sup> This differs from the Proposal, under which the price decline would have been measured from the covered security's last price reported in the consolidated system during regular trading hours on the prior day.<sup>289</sup> In addition, we are modifying the proposed duration of the price test restriction once the circuit breaker is triggered. Under Rule 201(b), as adopted, once the circuit breaker has been triggered, the price test restriction will remain in place for the remainder of the day and for the following day.<sup>290</sup> In addition, as discussed in more detail below, because the price test restriction will remain in place for the remainder of the day and for the following day, we are not adopting in Rule 201 a provision that the short sale price test restriction of the Rule will not be triggered if the 10% trigger level is reached in a covered security within thirty minutes of the end of regular trading hours.

In the Proposal, we noted our preliminary belief that a 10% decline in a security's price from the prior day's closing price would be an appropriate level at which to trigger the proposed circuit breaker rules.<sup>291</sup> We also noted that a 10% threshold would be consistent with current SRO rules that restrict or halt trading if key market indexes fall by specified amounts ("SRO Circuit

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<sup>288</sup> "Regular trading hours" is defined in Rule 201 to have the same meaning as in Rule 600(b)(64) of Regulation NMS. See Rule 201(a)(7). Rule 600(b)(64) provides that "Regular trading hours means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to §242.605(a)(2)." 17 CFR 242.600(b)(64).

<sup>289</sup> See Proposal, 74 FR at 18066.

<sup>290</sup> Rule 201(b). We note that if the price of a covered security declines intra-day by at least 10% on a day on which the security is already subject to the short sale price test restriction of Rule 201, the restriction will be re-triggered and, therefore, will continue in effect for the remainder of that day and the following day. For example, if on Monday, the price of XYZ security declines intra-day by at least 10%, XYZ security will be subject to the alternative uptick rule for the remainder of Monday and for the following day, Tuesday. If then on Tuesday, the price of XYZ security again declines intra-day by at least 10%, the circuit breaker will be re-triggered for that security such that the alternative uptick rule will apply for the following day, i.e., Wednesday, as well as for the remainder of the day on Tuesday.

<sup>291</sup> See Proposal, 74 FR at 18066, 18069.

Breakers’’) <sup>292</sup> and had been recommended by certain commenters. <sup>293</sup> The Commission solicited comment on whether a 10% decline from the prior day’s closing price would be an appropriate threshold at which to trigger the proposed circuit breaker short sale price restrictions. <sup>294</sup> We noted that the threshold level would affect the balance of the costs and benefits of the Rule; a low trigger level could result in more securities being subject to the proposed short sale price test restrictions, or subject to them more frequently, and a high trigger level could result in securities facing more significant declines before the benefits of the short sale price test restrictions applied. <sup>295</sup>

In response to our request for comment, several commenters expressed support for a 10% trigger level. <sup>296</sup> One commenter did not specifically object to the 10% threshold, but stated that 10% should be the minimum trigger level considered. <sup>297</sup> One commenter expressed support for a lower, 5% trigger level. <sup>298</sup>

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<sup>292</sup> See Proposal, 74 FR at 18065-18066. To protect investors and the markets, the Commission has approved proposals to restrict or halt trading if key market indexes fall by specified amounts. Currently, all stock exchanges and FINRA have rules or policies to implement coordinated circuit breaker halts. See 1998 Release, 63 FR 18477; see also NYSE Rule 80B. The circuit breaker procedures call for cross-market trading halts when the Dow Jones Industrial Average (“DJIA”) declines by 10%, 20%, and 30% from the previous day’s closing value. See, e.g., BATS Exchange Rule 11.18. The options markets also have rules applying circuit breakers. 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; NYSE Arca Options Rule 7.5; and Phlx Rule 133. The futures exchanges that trade index futures contracts have adopted circuit breaker halt procedures in conjunction with their price limit rules for index products. See, e.g., CME Rule 35102.I. The CME will implement a trading halt on S&P 500 Index futures contracts if a NYSE Rule 80B trading halt is imposed in the primary securities market. Trading of S&P 500 Index futures contracts will resume upon lifting of the NYSE Rule 80B trading halt. Finally, security futures products are required to have cross-market circuit breaker regulatory halt procedures in place. See Exchange Act Release No. 45956 (May 17, 2002), 67 FR 36740 (May 24, 2002).

<sup>293</sup> See Proposal, 74 FR at 18066.

<sup>294</sup> See Proposal, 74 FR at 18066, 18069, 18070.

<sup>295</sup> See Proposal, 74 FR at 18079, 18081.

<sup>296</sup> See, e.g., letter from BATS (May 2009); letter from Allston Trading (June 2009); letter from IBC.

<sup>297</sup> See letter from Direct Edge (June 2009).

<sup>298</sup> See letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated Sept. 21, 2009 (“Prof. Angel (Sept. 2009)”).

Several commenters expressed support for a trigger level higher than 10%.<sup>299</sup> Several of these commenters stated that a circuit breaker threshold of 10% would be too narrow or restrictive.<sup>300</sup> Other commenters indicated that a circuit breaker should only be triggered in extraordinary circumstances and asked that we consider a trigger level higher than 10% due to concerns that a 10% trigger level would capture “normal” trading activity.<sup>301</sup> Several commenters indicated that a higher trigger level would be particularly important for lower priced securities because a 10% trigger level would likely be reached frequently even in the absence of abnormal activity for such securities.<sup>302</sup> Other commenters indicated that, in addition to price, the trigger level should factor in other characteristics of individual securities, such as volume and volatility.<sup>303</sup> One commenter stated that a higher trigger level would be especially important for a circuit breaker in conjunction with the alternative uptick rule because the alternative uptick rule is more restrictive than the other proposed price tests.<sup>304</sup>

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<sup>299</sup> See, e.g., letter from MFA (June 2009); letter from Goldman Sachs (June 2009); letter from ISDA; letter from ISE (June 2009); letter from SIFMA (June 2009); letter from Citadel et al. (June 2009); letter from Dialectic Capital (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from ISE (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Virtu Financial; letter from Nasdaq OMX Group (Oct. 2009).

<sup>300</sup> See, e.g., letter from MFA (June 2009); letter from ISDA; letter from ISE (June 2009); letter from Virtu Financial; letter from Jordan & Jordan; letter from Credit Suisse (June 2009).

<sup>301</sup> See, e.g., letter from MFA (June 2009); letter from Citadel et al. (June 2009); letter from Goldman Sachs (June 2009); letter from ISDA; letter from ISE (June 2009); letter from SIFMA (June 2009); letter from Dialectic Capital (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Virtu Financial.

<sup>302</sup> See, e.g., letter from Barclays (June 2009); letter from ISDA; letter from SIFMA (June 2009); letter from SIFMA (Sept. 2009).

<sup>303</sup> See letter from Direct Edge (June 2009); letter from Barclays (June 2009); letter from Goldman Sachs (June 2009); letter from Lime Brokerage (June 2009); letter from Direct Edge (Sept. 2009); letter from Goldman Sachs (Sept. 2009).

<sup>304</sup> See letter from ISE (Sept. 2009).

In addition, several commenters submitted estimates of the number of securities that would trigger a circuit breaker rule at a 10% threshold.<sup>305</sup> While commenters' analyses (including the facts and assumptions used) and their resulting estimates varied,<sup>306</sup> commenters' estimates reflect that a 10% circuit breaker threshold, on average, should affect only a limited percentage of covered securities.<sup>307</sup> For example, one commenter submitted an estimate that slightly more than 5% of a universe of 4,800 NMS common stocks would have "tripped the 10% threshold on average each day" during roughly the first half of 2009.<sup>308</sup> In determining that a 10% threshold is appropriate, we considered other thresholds and the data presented by commenters regarding the numbers of securities that they believed would be subject to a short sale price test restriction at those different thresholds. Given the variations in the facts and assumptions underlying the estimates submitted by commenters, the Staff also looked at trading data to confirm the reasonableness of those estimates. The Staff found that, over the period covering April 9, 2001 to September 30, 2009,<sup>309</sup> the 10% trigger level of Rule 201 would have,

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<sup>305</sup> See, e.g., letter from Jordan & Jordan; letter from Citadel et al. (June 2009); letter from MFA (June 2009); letter from SIFMA (June 2009); letter from Credit Suisse (Sept. 2009).

<sup>306</sup> See, e.g., letter from Jordan & Jordan (providing estimated percentages of exchange listed stocks impacted by a 10% circuit breaker threshold on sample days); letter from MFA (June 2009) (providing the average daily number and percentage of Russell 3000 stocks impacted by a 10% circuit breaker threshold over a ten year period); letter from Credit Suisse (Sept. 2009) (providing the number of times, by month, a circuit breaker with a 10% threshold would have been triggered for S&P 500 stocks and for Russell 2000 stocks); letter from SIFMA (June 2009) (referencing two member firms' estimates, one that provided the average number of stocks out of 4,800 NMS common stocks that would have triggered the 10% threshold during roughly the first half of 2009 and another that measured the average number of Russell 3000 stocks per day that declined by 10% from their opening price from November 2008 to March 2009).

<sup>307</sup> See, e.g., letter from MFA (June 2009) (reflecting that approximately 5% of Russell 3000 stocks would have been impacted at any one time by a circuit breaker with a 10% threshold during the period of October 1998 to September 2008); letter from SIFMA (June 2009) (reflecting that approximately 3% of Russell 3000 stocks trading above \$10 and 16.5% of Russell 3000 stocks trading below \$10 would have been impacted by a 10% threshold measured from the security's opening price during the period of November 2008 through March 2009); but cf letter from Jordan & Jordan. We note that the sample of days in the data reflected in the letter from Jordan & Jordan is not representative of typical trading.

<sup>308</sup> Letter from SIFMA (June 2009).

<sup>309</sup> This time period constitutes the period after full implementation of decimal increments.

on an average day, been triggered for approximately 4% of covered securities.<sup>310</sup> The Staff also found that for a low volatility period, covering January 1, 2004 to December 31, 2006, the 10% trigger level of Rule 201 would have, on an average day, been triggered for approximately 1.3% of covered securities.<sup>311</sup>

After considering the comments, we believe that a 10% decline in a security's price, as measured from the security's closing price on the prior day, is an appropriate level at which to trigger a circuit breaker. As discussed in the Proposal, the circuit breaker short sale price test restrictions were designed to target a security experiencing a significant intra-day price decline, where the concerns about the potential harmful effects of short selling would be greatest. In this way, they would be tailored to help prevent short selling, including potentially abusive or manipulative short selling, from being used as a tool to exacerbate the declining market in those securities experiencing a significant intra-day decline and, thereby, help stabilize the market in those securities and help address concerns about the erosion in investor confidence.<sup>312</sup> At the same time, we explained, the proposed circuit breaker price test restrictions would not impact

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<sup>310</sup> The Staff estimates that on the average day during this period, approximately 6.0% of stocks would have been impacted by the Rule, which is comprised of 3.4% of stocks that would have triggered the circuit breaker on a given day, plus an additional 2.6% of stocks that would have been affected as a result of having triggered the circuit breaker on the previous day. We note that the actual percentage of stocks affected by the Rule in the future could be different from the historical average, particularly under different market conditions. In particular, the percentage of stocks affected by the Rule is likely to be higher under crisis conditions. For example, the Staff estimates that on October 10, 2008 approximately 68.1% of stocks would have traded under a short sale price test during part or all of the day while on November 24, 2006 approximately 0.6% of stocks would have traded under a short sale price test during part or all of the day. The S&P 500 Index was down nearly 15% on October 10, 2008 from the closing price two days earlier while the S&P 500 Index was nearly flat on November 24, 2006 from the closing price two days earlier. The estimates are calculated based on data from CRSP US Stock Database ©2009 Center for Research in Security Prices (CRSP), The University of Chicago Booth School of Business.

<sup>311</sup> The period from 2004 to 2006 exhibited low daily volatility as measured by the S&P 500 index. The estimates are calculated based on data from CRSP US Stock Database ©2009 Center for Research in Security Prices (CRSP), The University of Chicago Booth School of Business.

<sup>312</sup> See, e.g., Proposal, 74 FR at 18065, 18069.

trading in the majority of securities, and so would preserve the benefits of legitimate short selling, such as the provision of liquidity and price efficiency, in those securities.<sup>313</sup>

Although we recognize commenters' concerns that a 10% trigger level may capture some "normal" trading activity, commenters' estimates and the Staff's analysis show that a 10% circuit breaker threshold generally should affect only a limited percentage of covered securities. This supports the conclusion that Rule 201 provides a tailored approach that reaches a limited subset of covered securities that are experiencing a significant intra-day price decline, while generally not restricting short selling in the majority of covered securities. Thus, by including a 10% trigger level in Rule 201, the Rule will not interfere with trading in the majority of securities most of the time, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. In addition, we note that a circuit breaker approach is more targeted than applying a short sale price test restriction on a permanent, market-wide basis, and that any circuit breaker approach needs to have a line drawn.

Further, we are concerned that setting a trigger level higher than 10% would undermine our goals of helping to prevent short selling from being used as a tool to exacerbate a price decline in a particular security and of increasing investor confidence because so few securities would, on average, trigger a threshold higher than 10%.<sup>314</sup> The 10% threshold for a circuit breaker that, when triggered, results in all short selling in a covered security being subject to the alternative uptick rule strikes a balance between the need to restrict short selling in moments of significant intra-day price declines in a covered security and the market participant's expectation that its short selling strategy will normally be available in an efficient and open marketplace. Thus,

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<sup>313</sup> See, e.g., Proposal, 74 FR at 18065, 18069; see also Proposal, 74 FR at 18104 ("By targeting only those securities that experience severe intraday declines, all three proposed circuit breaker rules would be narrowly tailored so that most stocks would not fall under any new short sale restrictions.").

<sup>314</sup> See supra notes 305 to 311 (discussing the limited number of securities that would, on an average day, trigger a circuit breaker with a 10% threshold).

we have determined that a 10% trigger level strikes the right balance among our goals of facilitating the smooth functioning of the markets, preserving investor confidence, and preventing abusive market practices.

Although we recognize commenters' concerns that a 10% trigger level may be reached more frequently for lower priced securities, at this time we have determined not to set a higher trigger level for lower priced securities, or to base the trigger on other characteristics of a security. Varying the trigger level according to characteristics of individual securities would complicate and increase costs with respect to implementation of, compliance with, and regulatory oversight of, Rule 201. Moreover, contrary to the concerns of commenters, we believe that having a trigger level that is reached more frequently for lower priced stocks may be beneficial. As stated in the Staff's Summary Pilot Report, during the Pilot, the Staff found some evidence that short sale price tests dampened intra-day volatility in the smallest market capitalization stocks, which tend to have lower share prices than larger market capitalization stocks.<sup>315</sup> Thus, a trigger level that is reached more frequently for lower priced stocks may impose the alternative uptick rule in those situations where it is more likely to dampen volatility and achieve our goals in adopting short sale price test restrictions.

In response to our request for comment,<sup>316</sup> some commenters asked that we clarify how to determine the official price from which to measure a price decline and to designate from where that price will come.<sup>317</sup> In addition, a number of commenters expressed concerns that measuring the trigger level from the prior day's closing price for a security would result in a short selling restriction being applied as the result of a price change caused by the overnight

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<sup>315</sup> See Staff's Summary Pilot Report at 55-56, 81.

<sup>316</sup> See Proposal, 74 FR at 18066, 18079.

<sup>317</sup> See, e.g., letter from SIFMA (June 2009).

release of material news or other significant events outside of trading hours.<sup>318</sup> Several commenters asked that the percentage decline be measured from the covered security's opening price rather than the prior day's closing price.<sup>319</sup> One commenter specified that the opening price should be the official opening price distributed by a SIP,<sup>320</sup> while other commenters stated that it should be the opening price on the covered security's primary market.<sup>321</sup> One commenter stated that the opening print should not be included in the measurement of the trigger level.<sup>322</sup> Other commenters, however, supported our proposal to measure the decline from the previous day's closing price.<sup>323</sup> One commenter noted that measuring the trigger level from the previous day's closing price might be easier to implement in connection with a policies and procedures approach.<sup>324</sup>

As discussed in more detail in Section III.A.6. below, Rule 201(b)(3) provides that the listing market for each covered security must determine whether a covered security's price has declined by 10% or more such that it is subject to the short sale price test restrictions of Rule 201

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<sup>318</sup> See, e.g., letter from Citadel et al. (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); letter from Lime Brokerage (June 2009); letter from SIFMA (June 2009); letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); letter from Hudson River Trading; letter from Virtu Financial; see also letter from CBOE (June 2009) (stating that the opening price would take into account after hours news and avoid disorderly openings, particularly on options settlement dates).

<sup>319</sup> See, e.g., letter from Knight Capital (June 2009); letter from Citadel et al. (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); letter from Lime Brokerage (June 2009); letter from SIFMA (June 2009); letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from Hudson River Trading.

<sup>320</sup> See letter from Virtu Financial.

<sup>321</sup> See, e.g., letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009).

<sup>322</sup> See letter from SIFMA (June 2009).

<sup>323</sup> See, e.g., letter from IBC; letter from Nasdaq OMX Group (Oct. 2009).

<sup>324</sup> See letter from SIFMA (June 2009); see also letter from Glen Shipway (June 2009) (noting that basing the trigger level on the previous day's closing price "certainly would be a price mechanism easier to track and to comprehend by market participants").

and such information must be disseminated to the trading centers via the applicable single plan processor.<sup>325</sup>

As set forth in Rule 201(b)(1), we have determined that it is appropriate to measure the price decline from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In the proposed circuit breaker rules, we proposed that the decline in a covered security's price would be measured from the security's last price as reported in the consolidated system during regular trading hours on the prior day.<sup>326</sup> After considering the comments, we believe that the closing price as determined by the covered security's listing market as of the end of regular trading hours on the prior day will provide a more accurate price from which to measure a decline in price than the last price reported in the consolidated system. We believe that the last price reported in the consolidated system is more likely to reflect an anomalous trade, e.g., a trade that is not consistent with the current market due to, for example, the 90 second reporting window, or an uncorrected error. Listing markets generally have in place specific procedures designed to ensure the accuracy and reliability of their closing prices.<sup>327</sup> Thus, we believe it is appropriate to use the more accurate closing price as determined by the covered security's listing market rather than the last price reported in the consolidated system.

We also believe that the price decline in a covered security under Rule 201(b)(1)(i) should be measured from the covered security's closing price reported on the prior day rather

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<sup>325</sup> See Rule 201(b)(3); see also infra Section III.A.6. Rule 201(a)(6) provides that "[t]he term plan processor shall have the same meaning as in §242.600(b)(55)." Rule 600(b)(55) of Regulation NMS states: "Plan processor means any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan." The single plan processors are "exclusive processors" as defined under Section 3(a)(22) of the Exchange Act. 17 CFR 242.600(b)(55). See 15 U.S.C. 78c(a)(22).

<sup>326</sup> See Proposal, 74 FR at 18110 – 18113.

<sup>327</sup> See, e.g., NYSE Rule 116.40; NYSE Rule 123C(3).

than from each day's opening price for the covered security because the closing price provides a clearly discernible price and time from which to measure the decline. The closing price of a covered security will be known by or shortly after the end of regular trading hours such that the listing markets will have a price on the following day from which to determine if a covered security is subject to the short sale price test restrictions of Rule 201. An opening price, on the other hand, is established only if there is opening interest for a security, which, for thinly traded securities, may present issues. In addition, as noted by one commenter, we believe that measuring the price decline from the closing price on the prior day is preferable because it should be easier to implement than a requirement to measure the decline from the covered security's opening price.<sup>328</sup> For example, should any uncertainties in price occur, using the closing price as a measurement will provide time to resolve any such uncertainties before the requirements of Rule 201 will potentially apply. If the Rule required that the decline must be measured from the opening price, any uncertainties would have to be resolved in real time, so that if a 10% or more price decline were to occur, the short sale price test restrictions of Rule 201 could be applied that day in accordance with the Rule.

As noted above, under Rule 201(b), once the circuit breaker has been triggered, the price test restriction will remain in place for the remainder of the day and for the following day. This requirement differs from the proposed circuit breaker rules that would have applied a short selling halt or short sale price test restriction for the remainder of the day only.

In response to our request for comment on the duration of the proposed circuit breaker rules, comments were mixed. For example, one commenter suggested that the Commission should consider extending the duration of the short selling restriction through the close of trading

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<sup>328</sup> See letter from SIFMA (June 2009).

on the trading day following the triggering of the circuit breaker to allow sufficient time to achieve the Commission's intended purpose of "halting or slowing a price decline in a security."<sup>329</sup> Some commenters supported the proposed period for the circuit breaker of the remainder of the trading day<sup>330</sup> for various reasons, including that the limited duration would mitigate the potential adverse impact of a short selling restriction.<sup>331</sup> In addition, several commenters supported a circuit breaker with a duration of less than the remainder of the trading day.<sup>332</sup>

One commenter, however, stated that the circuit breaker should not be in effect for multiple days, but also that it should not be in effect for a matter of hours because "frequent changes in the status of a security would create more disruption."<sup>333</sup> Several commenters who supported a circuit breaker with a duration of less than the remainder of the trading day stated that the circuit breaker should be lifted if the security's price has recovered and the price decline is less than 10% before the end of the trading day.<sup>334</sup> These commenters stated, among other things, that such a recovery may be a common occurrence<sup>335</sup> and that lifting the circuit breaker

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<sup>329</sup> See letter from RBC (June 2009); see also letter from Credit Suisse (Mar. 2009).

<sup>330</sup> See, e.g., letter from Direct Edge (June 2009) (stating that the circuit breaker should be limited in duration to the end of the trading day with respect to the proposed circuit breaker halt rule); letter from AIMA; letter from Goldman Sachs (June 2009).

<sup>331</sup> See, e.g., letter from AIMA; see also letter from Direct Edge (June 2009) (opposing a circuit breaker duration beyond one trading day specifically with respect to a circuit breaker triggering a short selling halt); letter from Barclays (June 2009); letter from Goldman Sachs (June 2009).

<sup>332</sup> See letter from Barclays (June 2009); letter from Citadel et al. (June 2009); letter from SIFMA (June 2009); see also letter from Jordan & Jordan (providing data regarding the extent to which securities with an "on/off" trigger recovered by the end of trading).

<sup>333</sup> Letter from Goldman Sachs (June 2009).

<sup>334</sup> See letter from Barclays (June 2009); letter from SIFMA (June 2009).

<sup>335</sup> See letter from SIFMA (June 2009).

would take into account the resilience of the markets.<sup>336</sup> Another commenter stated that the circuit breaker should only be in effect long enough to re-establish equilibrium between buying and selling interests and further noted that the duration of the circuit breaker should depend on the time of day when the threshold is triggered.<sup>337</sup>

Some commenters supported the Commission's proposal that a circuit breaker would not be triggered if the 10% trigger level were reached in a covered security within thirty minutes of the end of regular trading hours.<sup>338</sup> Other commenters, however, stated that the last thirty minutes of the day has become the most volatile part of the day and that this is exactly the time that a rule that would slow short selling and reduce volatility would be most needed.<sup>339</sup>

After considering the comments, we believe it is appropriate to apply the alternative uptick rule, when triggered, for the remainder of the day and the day following the day on which the circuit breaker is triggered. We believe that a circuit breaker that is in effect for the remainder of the day and the following day will have the advantage of being more effective at preventing short selling from being used as a tool to exacerbate a security's decline in price. As we, and several commenters, have noted, because the alternative uptick rule will permit short selling only at a price above the current national best bid, it will likely be the most effective of the proposed price tests at preventing short selling from driving down further a security's price or from exacerbating a price decline.<sup>340</sup> A circuit breaker that will impose a short selling

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<sup>336</sup> See letter from Barclays (June 2009).

<sup>337</sup> See letter from Citadel et al. (June 2009).

<sup>338</sup> See letter from Barclays (June 2009); letter from Citadel et al. (June 2009).

<sup>339</sup> See, e.g., letter from Jibralta Merrill, dated May 5, 2009; letter from Arthur Porcari, dated May 11, 2009; letter from IBC; letter from STA (June 2009).

<sup>340</sup> See letter from Wells Fargo (Sept. 2009); letter from STA (Sept. 2009); letter from Glen Shipway (Sept. 2009); letter from BATS (Sept. 2009).

restriction for only the remainder of the trading day, or as some commenters suggested, for less than the remainder of the trading day, may not allow sufficient time for the short selling restriction to have its desired effect. To the extent that short selling is causing or contributing to downward price pressure, a longer duration will provide additional time during which the security will be subject to reduced downward price pressure from short selling. In addition, we note that the circuit breaker could be triggered at any point during regular trading hours. Further, as noted by one commenter, we are concerned that if the circuit breaker is triggered late in the day, such that it would be in effect for only a short period of time, this would in fact create more disruption rather than achieving our goals with respect to short sale price test restrictions for that security.<sup>341</sup> By applying the short sale price test restriction for the day following the day on which it is triggered, the time period will help ensure that there is not unnecessary disruption caused by the triggering of the circuit breaker.

As discussed above, the Commission has previously noted that circuit breakers may benefit the market by allowing participants an opportunity to re-evaluate circumstances and respond to volatility.<sup>342</sup> We believe that imposing a short selling restriction for the remainder of the day and the following day will help ensure that market participants have a reasonable opportunity to become aware of, and respond to, a significant decline in a security's price, and will provide sufficient time to re-establish market efficiency in the individual security. Although, for the reasons discussed above, we believe it is necessary to impose the short sale price test restriction of Rule 201 for longer than the remainder of the day, we do not believe it is appropriate to extend the duration beyond the time period specified in Rule 201 because we believe that the duration specified in Rule 201 strikes

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<sup>341</sup> See supra note 333 and accompanying text.

<sup>342</sup> See supra note 275 and accompanying text.

the appropriate balance between achieving our goals in adopting Rule 201 and not causing unnecessary market disruption.

In the Proposal, we stated that to avoid market disruption that may occur if a circuit breaker is triggered late in the trading day, the proposed circuit breaker rules would not be triggered if the specified market decline threshold is reached in a covered security within thirty minutes of the end of regular trading hours.<sup>343</sup> As noted above, because the short sale price test restriction of Rule 201 will remain in place for the remainder of the day and the following day, we have determined not to include a provision in Rule 201 stating that the Rule's restrictions will not be triggered if the 10% trigger level is reached in a covered security within thirty minutes of the end of regular trading hours. We believe it is appropriate to apply Rule 201 during the last thirty minutes of regular trading hours because, due to potential volatility during this period, it is a time period when a covered security's price may experience a significant decline.

Consistent with the Proposal, we have determined to apply the price test restriction, if triggered, during periods when the national best bid is calculated and disseminated on a current and continuing basis by a plan processor.<sup>344</sup> As discussed above and as we discussed in the Proposal,<sup>345</sup> market information for quotes in covered securities is disseminated pursuant to two different national market system plans, the CQ Plan and Nasdaq UTP Plan.<sup>346</sup> Quotation information is made available pursuant to the CQ Plan between 9:00 a.m. and 6:30 p.m. ET,

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<sup>343</sup> See Proposal, 74 FR at 18066.

<sup>344</sup> See Rule 201(b).

<sup>345</sup> See Proposal, 74 FR at 18060, 18064-18065.

<sup>346</sup> See *supra* note 199 and accompanying text. See also 17 CFR 242.603(b). Rule 603 of Regulation NMS requires that every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks.

while one or more participants is open for trading. In addition, quotation information is made available pursuant to the CQ Plan during any other period in which any one or more participants wish to furnish quotation information to the Plan.<sup>347</sup> Quotation information is made available by the Nasdaq UTP Plan between 9:30 a.m. and 4:00 p.m. ET. The Nasdaq UTP Plan also collects, processes, and disseminates quotation information between 4:00 a.m. and 9:30 a.m. ET, and after 4:00 p.m. when any participant is open for trading, until 8:00 p.m. ET.<sup>348</sup> During the time periods in which these Plans do not operate, real-time quote information is not collected, calculated and disseminated.

In response to our request for comment,<sup>349</sup> one commenter stated that any price test restriction should be applied during regular trading hours only because the period when the current national best bid is calculated, collected and disseminated “can vary depending on whether a participant in the particular national market system governing quote consolidation for a security decides to pay the consolidator to extend the hours of the calculation of the bid.”<sup>350</sup> In contrast, other commenters stated that the proposed price test restrictions should apply at all times during after-hours trading.<sup>351</sup> Because the short sale price test restrictions of Rule 201 are based on the current national best bid, we believe that the restrictions should apply at all times when the current national best bid is collected, calculated and disseminated even though this period can vary depending on whether a participant in the particular national market system

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<sup>347</sup> See <http://www.nyxdata.com/cta>.

<sup>348</sup> See [http://www.utpdata.com/docs/UTP\\_PlanAmendment.pdf](http://www.utpdata.com/docs/UTP_PlanAmendment.pdf).

<sup>349</sup> See, e.g., Proposal, 74 FR at 18060.

<sup>350</sup> Letter from Credit Suisse (Sept. 2009); see also letter from SIFMA (June 2009); letter from Goldman Sachs (June 2009); letter from T. Rowe Price (June 2009).

<sup>351</sup> See, e.g., letter from Michael Sigmon, Chairman, Sigmon Wealth Management, dated Apr. 14, 2009; letter from IBC.

governing quote consolidation for a security decides to pay the consolidator to extend the hours of the calculation of the bid.<sup>352</sup> Thus, the price test restrictions of Rule 201 will apply at times when quotation information and, therefore, the national best bid, is collected, processed, and disseminated pursuant to a national market system plan. We note, however, that at a later time we may reconsider whether any changes to Rule 201 would be necessary to also apply the Rule to short selling during times when the national best bid is not collected, calculated and disseminated, in light of any new information on short selling activity during these times.

## **6. Determination Regarding Securities Subject to Rule 201 and Dissemination of Such Information**

In the Proposal, we requested comment regarding who should be responsible for monitoring the price declines of individual securities to determine if they trigger the short selling circuit breaker, such as broker-dealers or SROs, how such information should be disseminated to the market, and who should be responsible for disseminating the information.<sup>353</sup> In response to our request for comment, some commenters stated that if we were to adopt a circuit breaker rule, securities subject to the Rule should be tracked and disseminated by the SIP for the covered security in question, noting that SIPs currently track and disseminate percentage moves<sup>354</sup> and that such a role would be consistent with the responsibilities of a SIP to collect, process, distribute and publish information with respect to transactions in, or quotations for, any security for which it acts as a SIP

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<sup>352</sup> We note that currently, the period during which the current national best bid is collected, calculated and disseminated can vary depending on whether a participant in the particular national market system governing quote consolidation for a security has decided to pay the consolidator to extend the hours of the calculation of the bid.

<sup>353</sup> See Proposal, 74 FR at 18078.

<sup>354</sup> See, e.g., letter from Virtu Financial (also stating that the SIPs would add a flag to their data feeds that would announce when the circuit breaker is in effect).

on a current and continuing basis.<sup>355</sup> One commenter stated that it would be inappropriate to allow each market to perform its own calculation or to impose the responsibility on a particular market due to the importance of ensuring that triggering of a circuit breaker is communicated to all markets and market participants on a fair, impartial and timely basis.<sup>356</sup> Other commenters stated that the listing market for a covered security should communicate the triggering of the circuit breaker to the SIP for the covered security, which would then redistribute such information to the market.<sup>357</sup> Another commenter stated that the exchanges should be required to develop and maintain “a centralized real-time list of all securities subject to the circuit breaker price test.”<sup>358</sup> This commenter stated that it believes this centralization “would ensure consistent treatment of orders and help reduce the costs of compliance for market participants.”<sup>359</sup> One commenter stated that as an alternative to the listing market notifying the SIP for a covered security when the circuit breaker has been triggered, trading centers could arrange to receive this information directly from the listing market.<sup>360</sup>

After considering the comments, we have determined that the listing market for each covered security must determine whether that covered security is subject to Rule 201.<sup>361</sup> Rule 201(a)(3) defines the term “listing market” to have the same meaning as the term “listing

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<sup>355</sup> See letter from NYSE Euronext (Sept. 2009); see also letter from SIFMA (June 2009) (stating that some of its member firms “believe that exchange-controlled SIPs should monitor prices and disseminate information flags when a security is in short sale mode . . .”).

<sup>356</sup> See letter from NYSE Euronext (Sept. 2009).

<sup>357</sup> See, e.g., letter from Direct Edge (June 2009); letter from Liquidnet; letter from FIF (June 2009); letter from Manisha Kimmel, Executive Director, Financial Information Forum, dated Sept. 23, 2009 (“FIF (Sept. 2009)”).

<sup>358</sup> Letter from RBC (June 2009).

<sup>359</sup> Id.

<sup>360</sup> See letter from Liquidnet.

<sup>361</sup> See Rule 201(b)(3).

market” as defined in the effective transaction reporting plan for the covered security.<sup>362</sup>

Because the definition of “listing market” is a currently-used definition, we believe users of the Rule will not have difficulty identifying for a security which entity is its listing market.

Currently, there are two effective transaction reporting plans, the CTA Plan, which disseminates transaction information for securities primarily listed on an exchange other than Nasdaq, and the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq.<sup>363</sup> Each of these Plans includes a definition of “listing market,” which definitions we are incorporating by reference into Rule 201. We have determined to incorporate by reference into Rule 201 the definition of “listing market,” as that term is defined in the CTA Plan and the Nasdaq UTP Plan,<sup>364</sup> to provide the markets with uniformity with respect to decisions regarding trading restrictions for individual NMS stocks because the listing markets are already familiar with making determinations regarding, and imposing trading restrictions on, individual NMS stocks. For example, listing markets already

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<sup>362</sup> Rule 201(a)(2). Rule 201(a)(2) provides that “[t]he term effective transaction reporting plan for a covered security shall have the same meaning as in §242.600(b)(22).” Rule 201(a)(2).

<sup>363</sup> See supra note 199 (discussing the joint-industry plans).

<sup>364</sup> We note that although the definition of a “listing market” in the CTA Plan and Nasdaq UTP Plan is similar, the Plans differ with respect to how they treat dually listed securities. The CTA Plan states that “the ‘listing market’ for any Eligible Security shall be that exchange Participant on which the Eligible Security is listed. If an Eligible Security is dually listed, ‘listing market’ shall be that exchange Participant on which the Eligible Security was originally listed.” The Nasdaq UTP Plan states that “‘Listing Market’ for an Eligible Security means the Participant’s Market on which the Eligible Security is listed. If an Eligible Security is dually listed, Listing Market shall mean the Participant’s Market on which the Eligible Security is listed that also has the highest number of the average of the reported transactions and reported share volume for the preceding 12-month period. The Listing Market for dually-listed Eligible Securities shall be determined at the beginning of each calendar quarter.” Although there are differences between how each of the Plans determines the listing market for dually listed securities, we do not believe this difference will impact the rule operationally because participants are already familiar with determining the applicable listing market for a covered security.

have rules or policies in place to coordinate trading suspensions or halts in individual NMS stocks.<sup>365</sup>

In addition, requiring the listing market for a covered security to determine whether the security has become subject to the short sale price test restrictions of Rule 201 will help ensure consistency for each covered security with respect to such determinations as only the listing market for that covered security will be making the determination. In addition, we believe that listing markets will be in the best position to respond to anomalous or unforeseeable events that may impact a covered security's price, such as an erroneous trade, because the listing markets generally have in place specific procedures designed to address such events.

As discussed above, in response to our request for comment,<sup>366</sup> some commenters provided comments regarding how information that a covered security has become subject to the short sale price test restrictions of Rule 201 should be disseminated to the markets.<sup>367</sup> In order that all market participants receive information regarding when a security has become subject to Rule 201 on a fair, impartial and timely basis, after considering the comments we have determined to provide in Rule 201(b)(3) that once the listing market has determined that a security has become subject to the requirements of Rule 201, the listing market shall immediately notify the single plan processor responsible for consolidation of information for the covered security in accordance with Rule 603(b) of Regulation NMS<sup>368</sup> of the fact that a covered

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<sup>365</sup> See, e.g., Nasdaq Rule 4120 (relating to trading halts in Nasdaq-listed securities); NYSE Rule 123D (relating to delayed openings and trading halts in NYSE-listed securities).

<sup>366</sup> See supra note 353 and accompanying text.

<sup>367</sup> See, e.g., letter from Direct Edge (June 2009); letter from FIF (June 2009); letter from Liquidnet; letter from RBC (June 2009); letter from SIFMA (June 2009); letter from FIF (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from Virtu Financial.

<sup>368</sup> Rule 603(b) of Regulation NMS provides that "Every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on

security has become subject to the short sale price test restriction of Rule 201. The plan processor must then disseminate this information.<sup>369</sup>

As discussed above, the CTA Plan disseminates transaction information for securities primarily listed on an exchange other than Nasdaq and the Nasdaq UTP Plan disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq. In accordance with Rule 603(b) of Regulation NMS, these plans, together with the CQ Plan, provide for the dissemination of all consolidated information for individual NMS stocks through a single plan processor. The single plan processors currently receive information from listing markets regarding trading restrictions (i.e., Regulatory Halts as defined in those plans) on individual securities and disseminate such information. Thus, the requirements of Rule 201(b)(3) are similar to existing obligations on plan processors pursuant to the requirements of Regulation NMS, the CTA and CQ Plans and the Nasdaq UTP Plan.

We recognize that the requirements of Rule 201(b)(3) may require changes to systems currently supported by the single plan processors.<sup>370</sup> Thus, in considering the appropriate implementation period for Rule 201, we have factored into our considerations time to allow the single plan processors to determine any changes to their systems requirements and to make any necessary changes.

## **7. Policies and Procedures Approach**

In the Proposal, we stated that the proposed price test restrictions could be applied in combination with a policies and procedures approach, a prohibition approach, or a combination

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quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.” 17 CFR 242.603(b).

<sup>369</sup> See Rule 201(b)(3); 17 CFR 242.603(b).

<sup>370</sup> See letter from FIF (June 2009).

thereof.<sup>371</sup> We have determined to adopt a policies and procedures approach in Rule 201(b). Rule 201(b) will require trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of the security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>372</sup> In addition, such policies and procedures must be reasonably designed to impose the short sale price test restriction in Rule 201(b)(1) for the remainder of the day on which it is triggered and on the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>373</sup>

Several commenters stated that any short sale price test restriction should be implemented through a policies and procedures approach.<sup>374</sup> One such commenter stated that a policies and procedures approach “would help promote compliance by all affected parties, distribute compliance and monitoring responsibility, allow flexibility to address inadvertent violations (thus likely resulting in fewer cancellations and trade breaks), and conserve the enforcement resources of agencies and other self-regulatory organizations.”<sup>375</sup> Another commenter noted the

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<sup>371</sup> See Proposal, 74 FR at 18049.

<sup>372</sup> See Rule 201(b)(1)(i).

<sup>373</sup> See Rule 201(b)(1)(ii).

<sup>374</sup> See, e.g., letter from SIFMA (June, 2009); letter from Goldman Sachs (June 2009); letter from NYSE Euronext (June 2009); letter from T. Rowe Price (June 2009); letter from RBC (June 2009); letter from Schwab; letter from BATS (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Virtu Financial; letter from Goldman Sachs (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from Qtrade; letter from Citadel et al. (Sept. 2009); letter from MFA (Oct. 2009).

<sup>375</sup> Letter from Citadel et al. (Sept. 2009); see also letter from AIMA.

“smooth implementation” and “successful operation” of Regulation NMS, which also uses a policies and procedures approach, and stated that a policies and procedures approach for Rule 201 will “allow for a smoother transition into full implementation as well as a more flexible rule where triggers based on circuit breakers are being contemplated.”<sup>376</sup>

Some commenters stated that any short sale price test restriction should be implemented with a policies and procedures approach as well as a straight prohibition approach.<sup>377</sup> In supporting this combination approach, one such commenter noted that a policies and procedures approach would be consistent with Regulation NMS, permit trading centers the flexibility to tailor such policies and procedures to their particular markets, and permit broker-dealers to manage their order flow. At the same time, this commenter stated that a prohibition approach would be familiar to market participants and will give the Commission direct enforcement authority over violations.<sup>378</sup>

In contrast, some commenters stated that a short sale price test restriction, if adopted, should be implemented with a straight prohibition approach only. For example, one commenter stated that a straight prohibition approach is preferable because “[v]ariations in policies and procedures would lead some to believe certain market participants are less vigilant than others.”<sup>379</sup> Another said a straight prohibition approach would be easier for market participants

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<sup>376</sup> Letter from Virtu Financial; see also letter from MFA (Oct. 2009) (stating that it believes that “implementation concerns would be minimized if executing market centers (or any broker using an intermarket sweep order) surveil for compliance as they could leverage existing architecture developed to comply with the order protection rule in Reg. NMS (Rule 611)”).

<sup>377</sup> See, e.g., letter from GE; letter from Wachtell; letter from Amer. Bankers Assoc.

<sup>378</sup> See letter from GE; see also letter from Wachtell.

<sup>379</sup> Letter from Wells Fargo (Sept. 2009).

to implement and understand.<sup>380</sup> In addition, several commenters expressed support for a rule that would “prohibit” short selling on a down-bid (or down-tick)<sup>381</sup> or expressed that they did not support a policies and procedures approach.<sup>382</sup>

We recognize some commenters’ preference that a short sale price test restriction be adopted with a straight prohibition approach or in combination with a straight prohibition approach because it is the approach taken under former Rule 10a-1 and, therefore, is familiar to market participants. Further, some commenters noted there can be variations in policies and procedures. As discussed in more detail below, however, we have determined to adopt in Rule 201(b)(1) a policies and procedures approach rather than a straight prohibition approach (or a combination thereof) because this alternative is similar to the policies and procedures approach under Regulation NMS and, therefore, market participants are familiar with a policies and procedures approach and can build on such policies and procedures in implementing Rule 201. In addition, a policies and procedures approach provides flexibility to trading centers and their customers in managing order flow because it allows trading centers, together with their customers, to determine how to handle orders that are not immediately executable or displayable by the trading center because the order is impermissibly priced. This flexibility potentially allows for the more efficient functioning of the securities markets than a rule that applies a straight prohibition approach.

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<sup>380</sup> See, e.g., letter from Amer. Bankers Assoc. We note that this commenter also expressed support for a policies and procedures requirement for trading centers.

<sup>381</sup> See, e.g., letter from Sigmon Wealth Management (June 2009); letter from James V. Kelly, President, Kelly Capital Management, LLC, dated June 2, 2009 (“Kelly Capital”); letter from Larry Chlebina, President, Ryan Stine, VP Portfolio Strategist, Chlebina Capital Management, LLC, dated May 29, 2009.

<sup>382</sup> See, e.g., letter from Theresa Kinley, dated May 14, 2009; see also letter from James Rothenberg.

In addition, we note that the Commission and SROs will carefully monitor whether trading centers' policies and procedures are reasonably designed to prevent short selling in violation of Rule 201. To the extent that a trading center's policies and procedures permit any execution or display of a short sale order not in accordance with the requirements of the Rule, such trading center's policies and procedures may not be reasonable and could subject the trading center to enforcement action. Further, any conduct by trading centers, or other market participants, that facilitates short sales in violation of Rule 201 could also lead to liability for aiding and abetting or causing a violation of Regulation SHO, as well as potential liability under the anti-fraud and anti-manipulation provisions of the federal securities laws, including Sections 9(a), 10(b), and 15(c) of the Exchange Act, and Rule 10b-5 thereunder.

Under Rule 201(b)(1), a trading center will be required to have written policies and procedures reasonably designed to prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid when the price of a covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In addition, such policies and procedures must be reasonably designed to impose the short sale price test restriction of Rule 201(b)(1)(i) for the remainder of the day and the following day. Thus, a trading center's policies and procedures must require that a trading center be able to determine when a covered security is subject to the short sale price test restriction of Rule 201. As discussed above, due to the importance of ensuring that the triggering of the requirements of Rule 201 is communicated to all market participants on a fair, impartial and timely basis, we believe it is appropriate for the listing market for the covered security to determine whether that security is subject to the requirements of Rule 201 and, if it is, for such information to be

disseminated to the market by the single plan processor. Thus, a trading center's policies and procedures must be reasonably designed so that the trading center is able to obtain such information from the single plan processor if the covered security becomes subject to the Rule's requirements.

Upon receipt of a short sale order for a covered security that is subject to the Rule's requirements, a trading center's policies and procedures must ensure that the trading center is able to determine whether or not the short sale order can be executed or displayed in accordance with the provisions of Rule 201(b)(1). If the order is marketable at a permissible price, the trading center may present the order for immediate execution or, if not immediately marketable, hold it for execution later at its specified price.

Rule 201(b)(1) permits a trading center to display an order provided it is permissibly priced at the time the trading center displays the order. If an order is impermissibly priced, the trading center could, in accordance with policies and procedures reasonably designed to prevent the execution or display of a short sale order at a price that is less than or equal to the current national best bid, re-price the order upwards to the lowest permissible price and hold it for later execution at its new price or better.<sup>383</sup> As quoted prices change, in accordance with Rule 201(b)(1), a trading center may repeatedly re-price and display an order at the lowest permissible price down to the order's original limit order price (or, if a market order, until the order is filled).

In addition, paragraph (b)(1)(iii)(A) of Rule 201 requires a trading center's policies and procedures to be reasonably designed to permit a trading center to execute a displayed short sale order at a price that is less than or equal to the current national best bid provided that, at the time the order was initially displayed by the trading center it was permissibly priced, i.e., not at a

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<sup>383</sup> For example, if a trading center receives a short sale order priced at \$47.00 when the current national best bid in the security is \$47.00, the trading center could re-price the order at the permissible offer price of \$47.01, and display the order for execution at this new limit price.

price that was less than or equal to the then-current national best bid.<sup>384</sup> As discussed in the Proposal, this exception for properly displayed short sale orders will help avoid a conflict between Rule 201 and the “Quote Rule” under Rule 602 of Regulation NMS.<sup>385</sup> The Quote Rule requires that, subject to certain exceptions, the broker-dealer responsible for communicating a quotation shall be obligated to execute any order to buy or sell presented to him, other than an odd lot order, at a price at least as favorable to such buyer or seller as the responsible broker-dealer’s published bid or published offer in any amount up to his published quotation size.<sup>386</sup> Thus, pursuant to this exception, a trading center will be able to comply with the “firm quote” requirement of Rule 602 of Regulation NMS by executing a presented order to buy against its displayed offer to sell as long as the displayed offer to sell was permissibly priced under Rule 201 at the time it was first displayed, even if the execution of the transaction will be at a price that is less than or equal to the current national best bid at the time of execution.<sup>387</sup>

Because a trading center can re-price and display a previously impermissibly priced short sale order, the policies and procedures approach of Rule 201, as noted by one commenter,<sup>388</sup>

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<sup>384</sup> See Rule 201(b)(1)(iii)(A).

<sup>385</sup> See Proposal, 74 FR at 18051.

<sup>386</sup> See 17 CFR 242.602(b)(2). We note that to the extent that a short sale order is un-displayed, Rule 201 will prevent the trading center from executing the order unless at the time of execution, the execution price complies with the Rule.

<sup>387</sup> We note that such a conflict between the Quote Rule and Rule 201 should be relatively infrequent. If a displayed order to sell shares is at a price that is less than or equal to the national best bid, this would result in a crossed or locked market. In accordance with Rule 610(d) of Regulation NMS, each national securities exchange and national securities association must establish, maintain, and enforce written rules that require its members reasonably to avoid: displaying quotations that lock or cross any protected quotation in an NMS stock; displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan; are reasonably designed to assure reconciliation of locked or crossed quotations in an NMS stock; and prohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotation, or other quotation, in an NMS stock, unless an exception in such rules applies. See 17 CFR 242.610(d).

<sup>388</sup> See, e.g., letter from Citadel *et al.* (Sept. 2009) (noting that a policies and procedures approach is favorable to a strict prohibition approach in that it “would help promote compliance” and “address inadvertent violations” of Rule 201).

potentially allows for the more efficient functioning of the markets than a rule that applies a straight prohibition approach. Another commenter noted that while a prohibition approach could provide “bright lines” as to the acceptability of trades, such an approach would result in an “inordinate number” of trades being cancelled by trading centers.<sup>389</sup> Because trading centers will not have to reject or cancel impermissibly priced orders unless instructed to do so by the trading center’s customer submitting the short sale order, we believe that the policies and procedures approach of Rule 201 will provide more flexibility to trading centers and their customers and result in more efficient markets. We recognize, however, that some trading centers might not want to re-price an impermissibly priced short sale order. Thus, re-pricing is not a requirement under Rule 201.

In addition, as noted by commenters, Rule 201 will provide trading centers and their customers with flexibility in determining how to handle orders that are not immediately executable or displayable by the trading center because the order is impermissibly priced. For example, trading centers can offer their customers various order types regarding the handling of impermissibly priced orders such that a trading center can either reject an impermissibly priced order or re-price the order upwards to the lowest permissible price until the order is filled.

As proposed and as adopted, Rule 201(b)(2) requires trading centers to regularly surveil to ascertain the effectiveness of the policies and procedures required by Rule 201(b)(1) and to take prompt action to remedy deficiencies in such policies and procedures.<sup>390</sup> As one commenter noted, this provision places trading centers in the position of determining whether an execution complies with the requirements of Rule 201(b)(1).<sup>391</sup> Thus, short sale orders executed or

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<sup>389</sup> Letter from STA (June 2009).

<sup>390</sup> See Rule 201(b)(2).

<sup>391</sup> See letter from Wolverine.

displayed at impermissible prices will require the trading center that executed or displayed the short sales to take prompt action to remedy any deficiencies.

The policies and procedures requirements of Rule 201(b)(1) are similar to those set forth under Regulation NMS.<sup>392</sup> In accordance with Regulation NMS, trading centers must have in place written policies and procedures in connection with that Regulation's Order Protection Rule.<sup>393</sup> Thus, as we stated in the Proposal, trading centers are already familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.<sup>394</sup> Several commenters agreed with the Commission's view that this familiarity should reduce the implementation time and costs of the Rule on trading centers.<sup>395</sup>

As discussed in the Proposal,<sup>396</sup> similar to the requirements under Regulation NMS in connection with the Order Protection Rule, at a minimum, a trading center's policies and procedures must enable a trading center to monitor, on a real-time basis, the national best bid, so as to determine the price at which the trading center may execute or display a short sale order. In addition, as proposed, a trading center must have policies and procedures reasonably designed to permit the execution or display of a short sale order of a covered security marked "short exempt" without regard to whether the order is at a price that is less than or equal to the current national

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<sup>392</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also 17 CFR 242.611.

<sup>393</sup> See id.

<sup>394</sup> See Proposal, 74 FR at 18051 – 18052.

<sup>395</sup> See, e.g., letter from Amer. Bankers Assoc.; letter from Schwab; letter from Credit Suisse (Sept. 2009); letter from GE; letter from Goldman Sachs (June 2009); letter from NYSE Euronext (June 2009); letter from SIFMA (June 2009); letter from T. Rowe Price (June 2009); letter from Virtu Financial (noting familiarity with the policies and procedures approach of Regulation NMS should reduce the implementation costs of Rule 201).

<sup>396</sup> See Proposal, 74 FR at 18052.

best bid.<sup>397</sup> A trading center's policies and procedures will not, however, have to include mechanisms to determine on which provision a broker-dealer is relying in marking an order "short exempt" in accordance with paragraph (c) or (d) of Rule 201.<sup>398</sup> We note that we did not receive comments that specifically discussed a trading center's policies and procedures with respect to the monitoring, on a real-time basis, of the national best bid, or its policies and procedures related to orders marked "short exempt."

As discussed in the Proposal,<sup>399</sup> a trading center must also take such steps as will be necessary to enable it to enforce its policies and procedures effectively. For example, trading centers may establish policies and procedures that include regular exception reports to evaluate their trading practices. If a trading center's policies and procedures include exception reports, any such reports will need to be examined by the trading center to affirm that a trading center's policies and procedures have been followed by its personnel and properly coded into its automated systems and, if not, promptly identify the reasons and take remedial action. In addition, we note that one commenter stated, and we agree, that as a means for developing an effective set of policies and procedures for compliance with the provisions of Rule 201, trading centers should conduct "regular post-trade analysis."<sup>400</sup> Another commenter stated that significant oversight of policies and procedures is necessary to prevent trades from being directed toward venues that become known for lax supervision regarding compliance with Rule 201.<sup>401</sup>

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<sup>397</sup> See Rule 201(b)(1)(iii)(B); see also *infra* Section III.B. (discussing short sale orders marked "short exempt").

<sup>398</sup> See *infra* Section III.B.; see also Rules 201(c) and 201(d)

<sup>399</sup> See Proposal, 74 FR at 18052.

<sup>400</sup> See letter from Jordan & Jordan.

<sup>401</sup> See letter from STA (June 2009). We note that to the extent that a trading center is lax with respect to its supervision regarding Rule 201, such trading center could be subject to enforcement action. In addition, the

To help ensure compliance with Rule 201, as discussed in the Proposal,<sup>402</sup> trading centers may also have policies and procedures that will enable a trading center to have a record identifying the current national best bid at the time of execution or display of a short sale order. Such “snapshots” of the market will aid SROs in evaluating a trading center’s written policies and procedures and compliance with Rule 201. In addition, such snapshots will aid trading centers in verifying that a short sale order was priced in accordance with the provisions of proposed Rule 201(b)(1) if bid “flickering,” i.e., rapid and repeated changes in the current national best bid during the period between identification of the current national best bid and the execution or display of the short sale order, creates confusion regarding whether or not the short sale order was executed or displayed at a permissible price. Snapshots of the market at the time of execution or display of an order will also aid trading centers in dealing with time lags in receiving data regarding the national best bid from different data sources. A trading center’s policies and procedures will be required to address latencies in obtaining data regarding the national best bid. In addition, to the extent such latencies occur, a trading center’s policies and procedures will need to implement reasonable steps to monitor such latencies on a continuing basis and take appropriate steps to address a problem should one develop.

Some commenters requested clarification regarding whether, in determining the current national best bid, trading centers and/or broker-dealers, as applicable, may rely on the current national best bid as disseminated by proprietary feeds as well as the current national best bid disseminated by SIPs.<sup>403</sup> In addition, several commenters indicated that trading centers and/or

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Commission and SROs will monitor whether trading centers adequately monitor their compliance with Rule 201 as part of their examinations.

<sup>402</sup> See Proposal, 74 FR at 18052.

<sup>403</sup> See, e.g., letter from Glen Shipway (Sept. 2009); see also letter from Credit Suisse (June 2009); letter from FIF (June 2009); letter from Goldman Sachs (June 2009); letter from Lime Brokerage (June 2009); letter from RBC

broker-dealers should be required to rely on one source of the national best bid,<sup>404</sup> such as the current national best bid disseminated by SIPs.<sup>405</sup> One commenter stated that “[s]uch centralization would ensure consistent treatment of orders,”<sup>406</sup> and another commenter stated that it would “eliminate redundant effort across broker-dealers and maintain uniformity across exchanges.”<sup>407</sup> Other commenters, however, questioned whether a unitary data feed would be beneficial, stating that “[e]ven utilizing a unitary data feed would be problematic, however, given the ‘flickering’ that occurs,”<sup>408</sup> and that latencies in the receipt of data by market participants is of concern, “even if they are working with the same SIP or exchange feed.”<sup>409</sup> Another commenter noted concerns with respect to market disruption as a result of a single mandated data feed, stating that “the entire market could be disrupted significantly by a single point of failure at the aggregator.”<sup>410</sup>

We recognize commenters’ concerns regarding the potential impact that receiving national best bid information from different data feeds might have on the application of Rule 201, including latencies that may occur in receiving such information from different data feeds.<sup>411</sup> We do not believe, however, that it is appropriate to mandate that the receipt of the

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(June 2009); letter from SIFMA (June 2009); letter from Direct Edge (June 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Lime Brokerage (Sept. 2009); letter from Qtrade.

<sup>404</sup> See, e.g., letter from FIF (June 2009); letter from RBC (June 2009); letter from NYSE Euronext (Sept. 2009).

<sup>405</sup> See, e.g., letter from FIF (June 2009); letter from NYSE Euronext (Sept. 2009); see also letter from Direct Edge (June 2009).

<sup>406</sup> Letter from RBC (June 2009).

<sup>407</sup> Letter from FIF (June 2009).

<sup>408</sup> Letter from Direct Edge (June 2009).

<sup>409</sup> Letter from Lime Brokerage (June 2009); see also letter from Lime Brokerage (Sept. 2009).

<sup>410</sup> Letter from Credit Suisse (June 2009).

<sup>411</sup> See infra Section X.B.1.b.i. and Section X.B.1.b.ii. (discussing the potential impact of not mandating receipt of the current national best bid from one particular data feed on the implementation costs of Rule 201).

current national best bid must be from any one particular data feed because a policies and procedures approach that provides for a “snapshot” of the applicable current national best bid will allow trading centers to deal with time lags in receiving data regarding the national best bid from different data sources. Thus, Rule 201 does not require modifications to how data feeds are currently received.

As discussed in the Proposal, trading centers will be required to conduct regular surveillance of their policies and procedures under Rule 201. Specifically, Rule 201(b)(2) provides that a trading center must regularly surveil to ascertain the effectiveness of the policies and procedures required under the Rule and must take prompt action to remedy deficiencies in such policies and procedures.<sup>412</sup> This provision will reinforce the requirement of Rule 201(b)(1) to maintain and enforce policies and procedures by explicitly assigning an affirmative responsibility to trading centers to surveil to ascertain the effectiveness of their policies and procedures.<sup>413</sup> Thus, under the Rule, trading centers may not merely establish policies and procedures that may be reasonable when created and assume that such policies and procedures will continue to satisfy the requirements of Rule 201(b). Rather, trading centers will be required to regularly assess the continuing effectiveness of their policies and procedures and take prompt action when needed to remedy deficiencies. In particular, trading centers will need to engage in regular and periodic surveillance to determine whether executions or displays of short sale orders on impermissible bids are occurring without an applicable exception and whether the trading center has failed to implement and maintain policies and procedures that would have reasonably prevented such impermissible executions or displays of short sale orders. We note that, although

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<sup>412</sup> See Rule 201(b)(2).

<sup>413</sup> We note that Rule 611(a)(2) of Regulation NMS contains a similar provision for trading centers. See 17 CFR 242.611(a)(2).

discussed in the Proposal, we did not receive comments that specifically addressed the requirement that trading centers must conduct regular surveillance of their policies and procedures under Rule 201.

## **B. “Short Exempt” Provisions of Rule 201**

In the Proposal, we proposed that a trading center’s policies and procedures must be reasonably designed to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order otherwise met the short sale price test restrictions.<sup>414</sup> In addition, we included provisions in the Proposal that set out circumstances under which a broker-dealer could mark a sale order as “short exempt.”<sup>415</sup>

After considering the comments and consistent with the Proposal, we have determined to include in Rule 201(b)(1)(iii)(B) a requirement that a trading center’s policies and procedures must be reasonably designed to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.<sup>416</sup> We have also determined to include in Rule 201(c) and (d) provisions that specify the circumstances under which a broker-dealer may mark certain sale orders as “short exempt” so that a trading center may execute or display such orders without regard to whether they are priced in accordance with the requirements of Rule 201(b).<sup>417</sup> The

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<sup>414</sup> See, e.g., Proposal, 74 FR at 18107, 18111.

<sup>415</sup> See, e.g., Proposal, 74 FR at 18108, 18111-18112. We note that we proposed provisions relating to when a broker-dealer may mark a sale order as “short exempt.” In discussing the “short exempt” marking provisions in paragraphs (c) and (d) of Rule 201, we set forth below how and why the provisions, as adopted, differ from the provisions as set forth in the proposed circuit breaker with modified uptick rule because that rule most closely resembles Rule 201, as adopted. To that end, we note that the circumstances under which a sale order may be marked as “short exempt” are contained in paragraphs (c) and (d) of Rule 201, as adopted, whereas such circumstances were contained in paragraphs (d) and (e) of the proposed circuit breaker with modified uptick rule.

<sup>416</sup> See Rule 201(b)(1)(iii)(B).

<sup>417</sup> See Rule 201(c); 201(d).

provisions contained in paragraphs (c) and (d) of Rule 201 are designed to promote the workability of the Rule, while at the same time furthering the Commission's goals.

The provisions contained in paragraph (d) of Rule 201 parallel exceptions to former Rule 10a-1 and exemptive relief granted pursuant to that rule.<sup>418</sup> These exceptions and exemptions from former Rule 10a-1 had been in place for several years. As we noted in the Proposal, we believe that the rationales underlying these exceptions and exemptions from former Rule 10a-1 still hold true today.<sup>419</sup> Moreover, due to the limited scope of these exceptions and exemptions, we do not believe that including them will undermine the Commission's goals for adopting Rule 201. To the extent that commenters addressed our inclusion of these exceptions and exemptions, we discuss such comments below.

A number of commenters stated that if we were to adopt a form of short sale price test restriction, it should include exceptions beyond those that we proposed in the Proposal and Re-Opening Release, particularly if we were to adopt a short sale price test restriction based on the alternative uptick rule.<sup>420</sup> Some commenters stated that the exceptions included in the Proposal and the Re-Opening Release were insufficient, stating that broader and/or additional exceptions would be necessary to, among other things, provide stability and liquidity to the market<sup>421</sup> and so as not to impair price discovery.<sup>422</sup> For example, commenters requested exceptions for activity

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<sup>418</sup> See Proposal, 74 FR at 18054 (discussing how the "short exempt" marking provisions of the proposed modified uptick rule would parallel exceptions to former Rule 10a-1 and exemptive relief granted pursuant to that rule).

<sup>419</sup> See Proposal, 74 FR at 18054-18059.

<sup>420</sup> See, e.g., letter from SIFMA (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from EWT (Sept. 2009); letter from GETCO (Sept. 2009).

<sup>421</sup> See, e.g., letter from SIFMA (June 2009); letter from NYSE Euronext (June 2009).

<sup>422</sup> See, e.g., letter from NYSE Euronext (June 2009).

excepted from, or necessary to comply with, Regulation NMS.<sup>423</sup> Commenters also requested an exception for exchange traded funds (“ETFs”) and similar broad-based indices and baskets of stocks.<sup>424</sup> Some commenters requested exceptions for short sales in connection with the facilitation of capital raising transactions, through stock issuances and convertible instruments, by issuers and selling shareholders.<sup>425</sup> In connection with convertible instruments, commenters stated that there needs to be an exception from any short sale price test restriction to allow investors purchasing a convertible instrument to hedge their long exposure.<sup>426</sup> Other exceptions requested relate to automated electronic buy-side trading,<sup>427</sup> bona fide hedging generally,<sup>428</sup> “exchange for physicals” transactions,<sup>429</sup> index expirations,<sup>430</sup> and market on open<sup>431</sup> and market on close orders.<sup>432</sup>

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<sup>423</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); letter from Goldman Sachs (June 2009). We note that where a broker-dealer is routing an inter-market sweep order (“ISO”) solely to facilitate its execution of a customer’s long sale in compliance with Rule 611, such ISOs may be marked as “short exempt.” This will allow the destination trading centers to execute the orders against better-priced protected quotations without regard to the short sale price test restrictions of Rule 201. Such ISOs must not be marked as “long.”

<sup>424</sup> See, e.g., letter from SIFMA (June 2009); letter from NYSE Euronext (June 2009); letter from MFA (June 2009); letter from RBC (June 2009); letter from ICI (June 2009); letter from Citadel *et al.* (June 2009); letter from Credit Suisse (June 2009); letter from ISDA; letter from NYSE Euronext (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from Knight Capital (Sept. 2009); letter from Virtu Financial; letter from EWT (Sept. 2009).

<sup>425</sup> See, e.g., letter from SIFMA (June 2009); see also letter from ISDA.

<sup>426</sup> See, e.g., letter from SIFMA (June 2009).

<sup>427</sup> See, e.g., letter from MFA (June 2009).

<sup>428</sup> See, e.g., letter from MFA (June 2009); letter from Credit Suisse (June 2009); letter from ISDA; letter from John K. Robinson, General Counsel, P. Schoenfeld Asset Management LP, dated July 2, 2009 (“P. Schoenfeld Asset Management”).

<sup>429</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009).

<sup>430</sup> See, e.g., letter from SIFMA (June 2009).

<sup>431</sup> See, e.g., letter from RBC (June 2009); letter from Goldman Sachs (June 2009); letter from Goldman Sachs (Sept. 2009).

<sup>432</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); letter from Credit Suisse (June 2009); letter from EWT (Sept. 2009); letter from Goldman Sachs (June 2009); letter from Goldman Sachs (Sept. 2009). We also note that some commenters stated that we should include a marking error exception in connection with

In addition, as discussed in more detail in Section III.B.9. below, commenters requested an exception for short sales by market makers engaged in bona fide market making activities, including market makers in OTC and listed derivatives, options, convertibles and ETFs, and block positioners.<sup>433</sup>

Several commenters, however, stated that the Commission should be cautious of adopting numerous exceptions and discussed problems that may arise from adopting a short sale price test restriction with many or complex exceptions, such as additional implementation difficulties, greater compliance costs, lack of uniformity that may cause unfair application of the rule, increased opportunities for gaming and abuse, and, overall, a less effective rule that only applies

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any short sale price test restriction we adopt. See, e.g., letter from RBC (June 2009); letter from SIFMA (June 2009). In connection with the proposed uptick rule, we proposed an exception for any sale by a broker-dealer of a covered security for an account in which it has no interest, pursuant to an order marked “long.” See Proposal, 74 FR at 18109. This exception would have applied where a broker-dealer effects a sale of an order marked “long” by another broker-dealer, but the order was mis-marked such that it should have been marked as a short sale order. We do not believe that a similar exception is necessary under Rule 201 because Rule 201, unlike the proposed uptick rule, is based on a policies and procedures approach rather than a straight prohibition approach. Thus, if a trading center’s written policies and procedures are reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid, it is unlikely that such trading center’s participation in any violation of the Rule due to a mis-marking by a broker-dealer could be knowing or reckless. See Proposal, 74 FR at 18063. As we stated in the Proposal, knowledge may be inferred where a broker-dealer has previously accepted orders marked “long” from the same counterparty that required borrowed shares for delivery or that resulted in a “fail to deliver.” See Proposal, 74 FR at 18063 n.212; see also 2004 Regulation SHO Adopting Release, 69 FR at 48019, n.111 (stating that “[i]t may be unreasonable for a broker-dealer to treat a sale as long where orders marked ‘long’ from the same customer repeatedly require borrowed shares for delivery or result in ‘fails to deliver.’ A broker-dealer also may not treat a sale as long if the broker-dealer knows or has reason to know that the customer borrowed shares being sold.”).

<sup>433</sup> See, e.g., letter from SIFMA (June 2009); letter from NYSE Euronext (June 2009); letter from Knight Capital (June 2009); letter from EWT (June 2009); letter from STANY (June 2009); letter from Credit Suisse (June 2009); letter from CBOE (June 2009); letter from RBC (June 2009); letter from Citadel et al. (June 2009); letter from NYSE Euronext (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from Virtu Financial; letter from EWT (Sept. 2009); letter from Credit Suisse (Sept. 2009). Some commenters also asked for an exception for, or clarification that, a short sale price test restriction would not apply to short sales pursuant to all options assignments and exercises. See, e.g., letter from SIFMA (June 2009); letter from CBOE (June 2009); letter from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, Nasdaq Options Market, Nasdaq OMX PHLX, NYSE Amex, NYSE Arca and The Options Clearing Corporation, dated June 22, 2009 (“Boston Options Exchange et al. (June 2009)”; letter from RBC (June 2009). We note that because short sales pursuant to options exercises and assignments (whether or not automatic) are unrelated to the current national best bid, Rule 201 does not apply to such sales.

to a limited numbers of short sales.<sup>434</sup> Commenters stated that a short sale price test restriction with numerous exceptions will create loopholes and a rule that is easy to circumvent, thus resulting in a rule that applies to little trading activity and fails to serve the purpose for which it was adopted.<sup>435</sup> One commenter stated that emphasis should first be placed on “a sales price restriction on short sales, its possible effects on helping restore a measure of price continuity, and its possible deleterious effects on informational efficiency . . . with exceptions to be evolved as time goes by and as the industry petitions for them.”<sup>436</sup> Another commenter noted that a short sale price test restriction with many exceptions will impose additional burdens on the Commission’s inspection staff, which will be tasked with “retracing transactions to discern which were eligible for exceptions, which were not, and if any were disguised.”<sup>437</sup>

In addition, one commenter noted that the exceptions that accompany any price test restriction will be driven by the approach adopted.<sup>438</sup> This commenter noted that a permanent, market-wide approach may necessitate more exceptions than one triggered by a temporary circuit

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<sup>434</sup> See, e.g., letter from Paladin Investment; letter from Douglas M. Branson, W. Edward Sell Professor of Business Law, University of Pittsburgh School of Law, dated June 10, 2009 (“Prof. Branson”); letter from Wells Fargo (June 2009); letter from CPIC (June 2009); letter from IAG; letter from IBC; letter from Jordan & Jordan; letter from Kelly Capital; letter from Lime Brokerage (June 2009); letter from Millennium; letter from Hudson River Trading; letter from Lime Brokerage (Sept. 2009); letter from Glen Shipway (Sept. 2009); letter from Qtrade.

<sup>435</sup> See, e.g., letter from Paladin Investment; letter from Prof. Branson; letter from CPIC (June 2009); letter from Wells Fargo (June 2009); letter from IBC (June 2009); letter from Jordan & Jordan; letter from Lime Brokerage (June 2009); letter from Millennium.

<sup>436</sup> Letter from Prof. Branson.

<sup>437</sup> Letter from CPIC (June 2009).

<sup>438</sup> See, e.g., letter from ICI (June 2009).

breaker.<sup>439</sup> This commenter further noted that “a circuit breaker short sale ban may necessitate more or different exceptions than a circuit breaker that still permits short selling to occur.”<sup>440</sup>

Although, as noted above, commenters requested a variety of exceptions in addition to those set forth in the Proposal, at this time, we have determined to include in Rule 201(c) and (d) only the “short exempt” marking provisions that we proposed. We believe that these limited provisions will help ensure the smooth functioning of the markets while at the same time not undermining our goals for adopting Rule 201.

In addition, we note that a number of commenters that discussed the need for additional and/or broader exceptions referenced the absence of some of the requested exceptions during the Short Sale Ban Emergency Order<sup>441</sup> and the effect on market quality of the Short Sale Ban Emergency Order in the absence of such exceptions.<sup>442</sup> These commenters noted the absence from the Short Sale Ban Emergency Order of exceptions for certain convertible arbitrage or hedging activities<sup>443</sup> and for automated electronic buy-side trading.<sup>444</sup> We note, however, that unlike the Short Sale Ban Emergency Order, which halted all short selling in the securities subject to the emergency order for its three-week duration, the short sale restrictions of Rule 201 will apply for a limited duration and will only apply to a covered security if such security has experienced a significant intra-day price decline (of 10% or more). Thus, Rule 201 will not

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<sup>439</sup> See letter from ICI (June 2009).

<sup>440</sup> Letter from ICI (June 2009).

<sup>441</sup> See supra Section II.C. (discussing the Short Sale Ban Emergency Order).

<sup>442</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); letter from CPIC (June 2009); letter from Goldman Sachs (June 2009); letter from MFA (June 2009).

<sup>443</sup> See, e.g., letter from RBC (June 2009) (attaching and discussing letter from Philip Taylor and Scott DeCanio, Directors, RBC Capital Markets Corp., dated Sept. 25, 2008); letter from CPIC (June 2009); letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009); letter from MFA (June 2009).

<sup>444</sup> See, e.g., letter from MFA (June 2009).

impact trading in the vast majority of covered securities on an average day.<sup>445</sup> If a covered security becomes subject to the short sale price test restrictions of Rule 201 it will occur because that security's price is experiencing extreme downward price pressure and it is these securities that Rule 201 is designed to address by helping to prevent short selling from being used as a tool to exacerbate its price decline. If, as requested by commenters, we were to expand the scope of short selling activities that would not be subject to Rule 201, we are concerned such exceptions could undermine this goal of Rule 201.

In addition, although short selling will be restricted if the price of a covered security decreases by 10% or more, in contrast to securities subject to the Short Sale Ban Emergency Order, Rule 201 will still permit short selling in the covered security even when the restriction is in place, although at a price above the current national best bid. Thus, short sellers engaged in the various activities for which commenters are requesting additional or expanded exceptions will continue to be able to sell short even when the price test restriction is in effect. In addition, the restriction on short selling will be in place for a limited duration, that is, the remainder of the day on which the circuit breaker level is triggered and the following day, further reducing the need for additional exceptions.

We also note that with respect to ETFs, although under former Rule 10a-1 the Commission issued limited exemptive relief for certain ETFs via authority delegated to the Staff, that relief was issued on a case-by-case basis for a permanent, market-wide short sale price test rule.<sup>446</sup> Since the elimination of former Rule 10a-1, there has been a significant growth in ETF

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<sup>445</sup> See supra Section III.A.5. (discussing analyses regarding the number of securities that will trigger the circuit breaker on an average day).

<sup>446</sup> See, e.g., letter from Racquel L. Russell, Esq., Branch Chief, Office of Trading Practices and Processing, Division of Market Regulation, to George T. Simon, Esq., Foley & Lardner LLP, dated June 21, 2006; letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to Claire P. McGrath, Vice President and Special Counsel, Amex, dated Aug. 17, 2001. We note that each of the approvals for relief under

trading volume and an expansion in different structures of ETF products.<sup>447</sup> Commenters who opposed an exception for these products noted the growth in ETF trading volume and new ETF products among the reasons not to provide an exception for ETFs from any short sale price test restriction.<sup>448</sup> We do not believe that a general ETF exception is necessary because the circuit breaker approach of Rule 201 will generally result in the majority of ETFs not being subject to its short sale price test restrictions because ETFs are generally diversified, whereas single stocks are not. If such securities do become subject to its restrictions, the restrictions will be in place for a limited duration and will continue to permit short selling even when in place.

For the reasons discussed above, at this time we believe it is appropriate to limit the scope and number of circumstances under which a broker-dealer may mark a sell order as “short exempt.” We recognize, however, the concerns raised by commenters and note that to help ensure the future workability of Rule 201, or for other reasons, we may reconsider whether certain exceptions or exemptions are warranted.

### **1. Broker-Dealer Provision**

After the 10% circuit breaker is triggered for a covered security, Rule 201(c) will permit a broker-dealer submitting a short sale order for the covered security to a trading center to mark the order “short exempt” if the broker-dealer identifies the order as being at a price above the

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former Rule 10a-1 was conditioned on the ETF meeting certain enumerated conditions, either specific to certain products or included as part of a broader “class exemption.”

<sup>447</sup> See, e.g., Investment Company Institute, 2009 Investment Company Fact Book, (49 ed.); National Stock Exchange, NSX Announces Record January ETF Trading Volume Surpasses \$2.2 Trillion, News & Views, Feb. 14, 2008 available at <http://www.nsx.com/content/news/story/90>.

<sup>448</sup> See, e.g., letter from Robert E. Koza, dated May 4, 2009; letter from Robert W. Angove, President, Santiam Mountain Investment, dated May 5, 2009; letter from David Tarrell, dated May 6, 2009; letter from Mitchel Schlesinger, Principal, FBB Capital Partners, dated May 8, 2009; letter from Paladin Investment; letter from Shelby Frisch, dated May 15, 2009; letter from Robert Cannataro, dated June 5, 2009; letter from High Street Advisors; letter from European Investors (June 2009); letter from Ascendant Capital; letter from Kelly Capital; letter from European Investors (Sept. 2009); letter from NAREIT.

current national best bid at the time of submission.<sup>449</sup> We have modified this provision from the Proposal to clarify that a broker-dealer may only mark an order as “short exempt” after the circuit breaker has been triggered for a covered security.<sup>450</sup> In addition, consistent with the Proposal, Rule 201(c) requires any broker-dealer relying on this provision to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the incorrect identification of orders as being priced in accordance with the requirements of Rule 201(c) and requires the broker-dealer regularly to surveil to ascertain the effectiveness of these policies and procedures, and to take prompt action to remedy deficiencies.<sup>451</sup>

As discussed above, in response to our request for comment,<sup>452</sup> several commenters stated that if we were to adopt a short sale price test restriction, it should include a broker-dealer provision.<sup>453</sup> One commenter stated that the broker-dealer provision is necessary to prevent contradictory requirements for broker-dealers under Regulation NMS and Regulation SHO.<sup>454</sup>

Other commenters disagreed, stating that they do not think that the broker-dealer provision is necessary. One commenter pointed to problems that may arise from the provision, such as increasing the potential for confusion in the marketplace, creating an unlevel playing field, and penalizing participants who have the most efficient market data infrastructures.<sup>455</sup>

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<sup>449</sup> See Rule 201(c).

<sup>450</sup> We have also made technical modifications to Rule 201(c) to reflect that it is the broker-dealer submitting the order that must also mark the order as “short exempt” and to reflect the difference in operation of the alternative uptick rule from the proposed circuit breaker with modified uptick rule.

<sup>451</sup> See Rule 201(c).

<sup>452</sup> See Proposal, 74 FR at 18073-18074.

<sup>453</sup> See, e.g., letter from SIFMA (June 2009); letter from BATS (May 2009); letter from EWT (Sept. 2009); letter from Qtrade.

<sup>454</sup> See letter from EWT (Sept. 2009).

<sup>455</sup> See letter from Lime Brokerage (June 2009).

Commenters also noted that the broker-dealer provision has the potential to greatly increase costs to the industry and to adversely impact the ability of smaller broker-dealers to compete.<sup>456</sup> One commenter stated that, what it termed a “requirement,” that broker-dealers maintain “snapshots,” may impose significant costs, including costs associated with technology, data storage, and surveillance and review and that the Commission’s cost estimates of over \$100,000 per broker-dealer “seem to underestimate the cost to large, full service broker-dealers, since the volume of orders handled by these firms are likely to lead to significantly greater technology and storage costs alone as well as more frequent reviews.”<sup>457</sup> We note that, as discussed in the Proposal and in more detail below, we believe that “snapshots” of the market could aid broker-dealers in complying with Rule 201(c), but Rule 201 does not “require” such snapshots.<sup>458</sup>

Another commenter expressed the belief that a majority of broker-dealer participants that service customer orders will want to take advantage of the provision to remain competitive and to ensure that client orders receive the best possible execution, which will result in many non-trading center participants becoming subject to market data “snapshotting” and other compliance-related changes.<sup>459</sup>

After considering the comments, as discussed above, we have determined to include in Rule 201(c) a provision to permit a broker-dealer submitting a short sale order for a covered security to a trading center after the circuit breaker is triggered for a covered security, to mark the order “short exempt” if the broker-dealer identifies the order as being at a price above the

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<sup>456</sup> See letter from STANY (June 2009); letter from Lime Brokerage (June 2009); letter from NSCP.

<sup>457</sup> Letter from NSCP.

<sup>458</sup> See Proposal, 74 FR at 18054 – 18055.

<sup>459</sup> See letter from Lime Brokerage (June 2009).

current national best bid at the time of submission.<sup>460</sup> Rule 201(c) will provide broker-dealers with the option to manage their order flow, rather than having to always rely on their trading centers to manage their order flow on their behalf.

Although we recognize commenters' concerns, including regarding potential increased costs to the industry with respect to technology, data storage and surveillance, we note that most broker-dealers may already have developed "snapshot" capability in connection with Regulation NMS's Order Protection Rule. We also agree that "snapshot" capability will require data storage by broker-dealers; however, as noted by one commenter,<sup>461</sup> because the alternative uptick rule does not require sequencing of the national best bid, the data storage requirements under the alternative uptick rule are lower than they would be under the proposed modified uptick rule or the proposed uptick rule. In addition, we believe that the costs of a policies and procedures approach that provides for a snapshot of the applicable current national best bid of the security are justified because snapshot capability will aid broker-dealers in dealing with time lags in receiving data regarding the national best bid from different data sources and facilitate verification of whether a short sale order was executed or displayed at a permissible price.

In addition, we note that this provision will not undermine our goals for short sale regulation because any broker-dealer marking an order "short exempt" in accordance with this provision must have mechanisms in place to enable the broker-dealer to identify the short sale order as priced in accordance with the provisions of Rule 201(c). In accordance with Rule 201(c)(1), these mechanisms must include written policies and procedures reasonably designed to prevent the incorrect identification of orders as being permissibly priced in accordance with

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<sup>460</sup> See Rule 201(c).

<sup>461</sup> See letter from STA (Sept. 2009).

the provisions of 201(c).<sup>462</sup> Thus, although a broker-dealer relying on this provision in marking an order “short exempt” will not need to identify the order as permissibly priced to the trading center, it will need to have written policies and procedures in place reasonably designed to enable it to identify that an order was permissibly priced at the time of submission of the order to a trading center.<sup>463</sup> We believe these policies and procedures will further our goals by helping to ensure that short sale orders are not incorrectly marked as “short exempt,” and, thereby, helping to preclude impermissible short sales from being executed when the price test restriction has been triggered.<sup>464</sup>

At a minimum, a broker-dealer’s policies and procedures must be reasonably designed to enable a broker-dealer to monitor, on a real-time basis, the national best bid, so as to determine the price at which the broker-dealer may submit a short sale order to a trading center in compliance with the provisions of Rule 201(c). To ensure compliance with Rule 201(c), a broker-dealer may also have policies and procedures that will enable it to have a record identifying the current national best bid at the time of submission of a short sale order. Such “snapshots” of the market will also aid SROs in evaluating a broker-dealer’s written policies and procedures and compliance with Rule 201(c). In addition, such snapshots will aid broker-dealers in verifying that a short sale order was priced in accordance with the provisions of Rule 201(c) if bid flickering during the period between identification of the current national best bid and the submission of the short sale order to a trading center creates confusion regarding whether or not the short sale order was submitted at a permissible price. Snapshots of the market at the time of

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<sup>462</sup> See Rule 201(c)(1).

<sup>463</sup> Such policies and procedures should be similar to those required for trading centers complying with paragraph (b) of Rule 201.

<sup>464</sup> We also note that it would be a violation of Rule 200(g) to mark a short sale order as “short exempt” when a security is not subject to the alternative uptick rule.

submission of an order will also aid broker-dealers in dealing with time lags in receiving data regarding the national best bid from different data sources. Under Rule 201(c)(2), latencies in obtaining data regarding the national best bid will need to be addressed.<sup>465</sup> In addition, to the extent such latencies occur, a broker-dealer's policies and procedures will need to implement reasonable steps to monitor such latencies on a continuing basis and take appropriate steps to address a problem should one develop.

Surveillance will be a required part of a broker-dealer's satisfaction of its legal obligations. Rule 201(c)(2) provides that a broker-dealer must regularly surveil to ascertain the effectiveness of the policies and procedures required under Rule 201(c)(1) and must take prompt action to remedy deficiencies in such policies and procedures.<sup>466</sup> This provision will reinforce the on-going maintenance and enforcement requirements of Rule 201(c) by explicitly assigning an affirmative responsibility to broker-dealers to surveil to ascertain the effectiveness of their policies and procedures.<sup>467</sup> Thus, under paragraphs (c)(1) and (c)(2) of Rule 201, broker-dealers may not merely establish policies and procedures that may be reasonable when created and assume that such policies and procedures will continue to satisfy the requirements of the Rule. Rather, broker-dealers will be required to regularly assess the continuing effectiveness of their procedures and take prompt action when needed to remedy deficiencies. In particular, each broker-dealer will need to engage in regular and periodic surveillance to determine whether it is submitting short sale orders marked "short exempt" without complying with the requirements of

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<sup>465</sup> See Rule 201(c)(2).

<sup>466</sup> See id.

<sup>467</sup> We note that Rule 611(a)(2) of Regulation NMS contains a similar surveillance provision. See 17 CFR 242.611(a)(2).

Rule 201(c) and whether the broker-dealer has failed to implement and maintain policies and procedures that would have reasonably prevented such impermissible submissions.

A broker-dealer will also need to take such steps as will be necessary to enable it to enforce its policies and procedures effectively.<sup>468</sup> For example, broker-dealers may establish policies and procedures that include regular exception reports to evaluate their trading practices. If a broker-dealer's policies and procedures include exception reports, any such reports will need to be examined to affirm that a broker-dealer's policies and procedures have been followed by its personnel and properly coded into its automated systems and, if not, promptly identify the reasons and take remedial action.

## **2. Seller's Delay in Delivery<sup>469</sup>**

We are adopting Rule 201(d)(1) without modification to provide that a broker-dealer may mark an order "short exempt" if the broker-dealer has a reasonable basis to believe that the seller owns the security being sold and that the seller intends to deliver the security as soon as all restrictions on delivery have been removed.<sup>470</sup> Specifically, Rule 201(d)(1) provides that a broker-dealer may mark a short sale order "short exempt" if the broker-dealer has a reasonable basis to believe the short sale order of a covered security is by a person that is "deemed to own"

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<sup>468</sup> See Rule 201(c)(2).

<sup>469</sup> We note that we have modified paragraph (d) of Rule 201 from that provision as proposed to reflect that a broker-dealer may only mark an order as "short exempt" pursuant to the provisions in paragraph (d) after the circuit breaker has been triggered for a covered security.

<sup>470</sup> Subsection (e)(1) of former Rule 10a-1 contained an exception relating to a seller's delay in the delivery of securities. The provision in Rule 201(d)(1) parallels the exception in former Rule 10a-1(e)(1).

the covered security pursuant to Rule 200 of Regulation SHO,<sup>471</sup> provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed.<sup>472</sup>

Rule 200(g)(1) of Regulation SHO provides that a sale can be marked “long” only if the seller is deemed to own the security being sold and either (i) the security is in the broker-dealer’s physical possession or control; or (ii) it is reasonably expected that the security will be in the broker-dealer’s possession or control by settlement of the transaction.<sup>473</sup> Thus, even where a seller owns a security, if delivery will be delayed, such as in the sale of formerly restricted securities pursuant to Rule 144 of the Securities Act of 1933,<sup>474</sup> or where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date, such sales must be marked “short.” As a result, Rule 201(d)(1) is necessary to allow for sales of securities that, although owned, are subject to the provisions of Regulation SHO governing short sales due solely to the seller being unable to deliver the covered security to its broker-dealer prior to settlement based on

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<sup>471</sup> See 17 CFR 242.200(a) – (f) (defining the term “deemed to own”).

<sup>472</sup> See Rule 201(d)(1). This provision is also consistent with Rule 203(b)(2)(ii) and Rule 204(a)(2) of Regulation SHO. Rule 203(b)(2)(ii) provides an exception from the “locate” requirement of Rule 203(b)(1) of Regulation SHO for “[a]ny sale of a security that a person is deemed to own pursuant to §242.200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed...”. Rule 204(a)(2) provides additional time to close out fails to deliver “[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security resulting from a sale of a security that person is deemed to own pursuant to §242.200 and that such person intends to deliver as soon as all restrictions on delivery have been removed, the participant shall, by no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.” We note that to the extent that an exception to Regulation SHO’s locate requirement applies to a short sale order, such order must be marked “short” in accordance with Rule 200(g) of Regulation SHO unless the order can be marked “short exempt” pursuant to Rule 200(g)(2) of Regulation SHO.

<sup>473</sup> See 17 CFR 242.200(g)(1).

<sup>474</sup> 17 CFR 230.144.

circumstances outside the seller's control. In response to our request for comment, commenters that specifically addressed this provision were supportive of it.<sup>475</sup>

After considering the comments, we believe it is appropriate to adopt Rule 201(d)(1) as proposed. This provision is consistent with the goals of Rule 201 and with other provisions of Regulation SHO related to sales of securities that although owned are subject to the provisions of Regulation SHO governing short sales. Thus, we are adopting Rule 201(d)(1) such that the provision will apply to the sale of any covered securities that a seller is deemed to own pursuant to Rule 200 of Regulation SHO and cannot deliver by settlement date based on circumstances outside the seller's control, provided the seller intends to deliver the securities as soon as all restrictions on delivery have been removed.<sup>476</sup>

### **3. Odd Lot Transactions**

We are adopting in Rule 201(d)(2), without modification, the ability for a broker-dealer to mark a short sale order as "short exempt" if the broker-dealer has a reasonable basis to believe

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<sup>475</sup> See, e.g., letter from BATS (May 2009); letter from SIFMA (June 2009); letter from Jesse D. Hill, Director of Regulatory Relations, Office of Regulatory Counsel, Edward Jones, dated Sept. 21, 2009 ("Edward Jones"); letter from NYSE Euronext (Sept. 2009).

<sup>476</sup> Such circumstances could include the situation where a convertible security, option or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date. See Regulation SHO Adopting Release, 69 FR at 48015; see also 17 CFR 242.200(b) (defining when a person shall be "deemed to own" a security). In addition, we understand that sellers that own restricted equity securities that wish to sell such securities pursuant to an effective registration statement pursuant to Rule 415 under the Securities Act of 1933 experience similar types of potential settlement delays as those persons selling Rule 144 securities. Thus sales of such securities pursuant to Rule 415 may be marked "short exempt" in accordance with Rule 201(d)(1) if the securities subject to the sale are outstanding at the time they are sold, and the sale occurs after the registration statement has become effective. In addition, and as noted by one commenter, we understand that sales made pursuant to broker-dealer assisted cashless exercises of compensatory options to purchase a company's securities may result in potential settlement delays that would otherwise require the seller to mark such sales "short" pursuant to the definition under Rule 200(g) of Regulation SHO. Such sales may be marked "short exempt" pursuant to Rule 201(d)(1). See Rule 204 Adopting Release, 74 FR at 38277, n.141; see also 17 CFR 230.415.

that the short sale order is by a market maker to offset a customer odd-lot<sup>477</sup> order or to liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading.<sup>478</sup> In response to our request for comment, commenters that specifically addressed this provision were supportive of inclusion of this provision in any short sale price test restriction.<sup>479</sup>

Under former Rule 10a-1, an exception for certain odd-lot transactions was created in an effort to reduce the burden and inconvenience that short sale restrictions would place on odd-lot transactions. In 1938, the Commission found that odd-lot transactions played a very minor role in potential manipulation by short selling.<sup>480</sup> Initially, sales of odd-lots were not subject to the restrictions of former Rule 10a-1.<sup>481</sup> However, the Commission became concerned over the volume of odd-lot transactions, which possibly indicated that the exception was being used to circumvent the rule. As a result, the exception was changed to include the two odd lot exceptions described below.<sup>482</sup>

Former Rule 10a-1(e)(3) contained a limited exception that allowed short sales by odd-lot dealers registered in the security and by third market makers of covered securities to fill

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<sup>477</sup> Rule 201(a)(5) provides that the term "odd lot" shall have the same meaning as in 17 CFR 242.600(b)(49). Rule 600(b)(49) defines an "odd lot" as "an order for the purchase or sale of an NMS stock in an amount less than a round lot." 17 CFR 242.600(b)(49).

<sup>478</sup> See Rule 201(d)(2). SRO rules define a "unit of trading" or "normal unit of trading," and the term generally means 100 shares, *i.e.*, a round lot. For example, FINRA Rule 6320A(a)(7) defines a "normal unit of trading" to mean "100 shares of a security unless, with respect to a particular security, FINRA determines that a normal unit of trading shall constitute other than 100 shares." NYSE Rule 55 states that "[t]he unit of trading in stocks shall be 100 shares, except that in the case of certain stocks designated by the Exchange the unit of trading shall be such lesser number of shares as may be determined by the Exchange, with respect to each stock so designated. . . ."

<sup>479</sup> See, *e.g.*, letter from BATS (May 2009); letter from SIFMA (June 2009); letter from NYSE Euronext (Sept. 2009).

<sup>480</sup> See Former Rule 10a-1 Adopting Release, 3 FR 213.

<sup>481</sup> The Commission initially adopted three exceptions for odd-lot transactions. While the first one, excepting all odd-lot transactions, seemed to make other odd-lot exceptions unnecessary, the 1938 adopting release included all three exceptions without discussion. See Former Rule 10a-1 Adopting Release, 3 FR 213.

<sup>482</sup> See Exchange Act Release No. 11030 (Sept. 27, 1974), 39 FR 35570 (Oct. 2, 1974) ("1974 Release").

customer odd lot orders. Former Rule 10a-1(e)(4) provided an exception under the rule for any sale to liquidate an odd-lot position by a single round lot sell order that changed the broker-dealer's position by no more than a unit of trading.

Rule 201(d)(2), as proposed and adopted, generally parallels the exceptions in subsections (e)(3) and (e)(4) of former Rule 10a-1. In addition, however, as proposed, we are extending the provision to cover all market makers acting in the capacity of an odd-lot dealer. When former Rule 10a-1 was adopted, odd-lot dealers dealt exclusively with odd-lot transactions, and were so registered. Today, market makers registered in a security typically also act as odd-lot dealers of the security. Thus, as proposed, we are broadening the provision in Rule 201(d)(2) to all broker-dealers acting as “market makers” in odd lots.<sup>483</sup>

We believe that a provision that will allow a broker-dealer to mark a short sale order “short exempt” if it has a reasonable basis to believe that the short sale order is by a market maker to offset a customer odd-lot order or liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading, will continue to be of utility under Rule 201 and will not be in conflict with the goals of the Rule.

Because odd-lot transactions by market makers to facilitate customer orders are not of a size that could facilitate a downward movement in the particular security, we do not believe that Rule 201(d)(2) will adversely affect the goals of short sale regulation that Rule 201 seeks to advance. Thus, we believe that a broker-dealer should be able to mark such orders “short exempt” so that those acting in the capacity of a “market maker,” with the commensurate negative and positive obligations, will be able to offset a customer odd-lot order and liquidate an

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<sup>483</sup> Section 3(a)(38) of the Exchange Act defines the term “market maker,” and includes specialists. See 15 U.S.C. 78c(a)(38).

odd-lot position without a trading center's policies and procedures preventing the execution or display of such orders at a price that is less than or equal to the current national best bid.

#### **4. Domestic Arbitrage**

We are adopting in Rule 201(d)(3) without modification the ability for a broker-dealer to mark as “short exempt” short sale orders associated with certain bona fide domestic arbitrage transactions. Although commenters generally stated that a domestic arbitrage provision should be included in any short sale price test restriction, some commenters also stated that the provision, as proposed, should be expanded to cover more trading scenarios.<sup>484</sup> However, one commenter stated that arbitrage activities are not unique in contributing to market efficiency and any short sale price test restriction that the Commission adopts should require few, if any, exceptions to maintain market quality.<sup>485</sup>

As discussed above, the short sale price test restriction adopted in Rule 201(b) will apply to a covered security only after the security has experienced a significant intra-day price decline, will remain in place for a limited period of time, and will continue to permit short selling at a price above the national best bid (rather than, for example, halting all short selling in that security). As such, we do not believe it is appropriate at this time to broaden the scope of the

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<sup>484</sup> See, e.g., letter from SIFMA (June 2009) (stating that the exception should cover convertible arbitrage strategies); letter from AIMA (stating that the provisions relating to domestic and international arbitrage are too narrow in scope, and that they should be broadened to include: (1) bona fide strategies and risk management tools that provide necessary market liquidity and efficiency, and (2) other forms of convertible securities that differ from standard American-style convertibles); letter from Credit Suisse (June 2009); letter from Citadel *et al.* (June 2009) (stating that the exception should be broadened to cover any transaction in connection with domestic arbitrage, even if not contemporaneous in time); letter from RBC (June 2009) (stating that the exception should accommodate convertible arbitrage strategies as well as arbitrage strategies that do not meet the contemporaneous requirement of this provision); letter from MFA (June 2009) (stating that we should broaden the domestic arbitrage provision to include “bona fide hedging transactions,” such as risk arbitrage and statistical arbitrage transactions).

<sup>485</sup> See letter from Hudson River Trading; *see also* letter from Liquidnet (expressing concern regarding the complexity of the arbitrage and other exceptions to a short sale price test restriction and concern that the exceptions could result in different rules applying to different industry participants).

domestic arbitrage provision. Due to the already limited scope and applicability of Rule 201, we believe that expanding the domestic arbitrage provision to cover more trading scenarios would undermine our goals in adopting Rule 201. Thus, we are adopting the provision as proposed.

Subsection (e)(7) of former Rule 10a-1 contained an exception related to domestic arbitrage.<sup>486</sup> That exception applied to bona fide arbitrage undertaken to profit from a current difference in price between a convertible security and the underlying common stock.<sup>487</sup> The term “bona fide arbitrage” describes an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to lock in a gross profit or spread resulting from a current differential in pricing of two related securities.<sup>488</sup> For example, a person may sell short securities to profit from a current price differential based upon a convertible security that entitles him to acquire a number of securities equivalent to the securities sold short. We continue to believe that bona fide arbitrage activities are beneficial to the markets because they tend to reduce pricing disparities between related securities and, thereby, promote market efficiency.<sup>489</sup>

Rule 201(d)(3) parallels the exception in former Rule 10a-1(e)(7). Specifically, Rule 201(d)(3) provides that a broker-dealer may mark a short sale order of a covered security “short

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<sup>486</sup> See Exchange Act Release No. 1645 (Apr. 8, 1938).

<sup>487</sup> See 1999 Concept Release, 64 FR 57996.

<sup>488</sup> 1999 Concept Release, 64 FR at 58001, n.54 and accompanying text (discussing the domestic arbitrage exception under former Rule 10a-1). See also Section 220.6(b) of Regulation T, which states that the term “bona fide arbitrage” means: “(1) A purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets; or (2) A purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities.” 12 CFR 220.6(b). See also Exchange Act Release No. 15533 (Jan. 29, 1979), 44 FR 6084 (Jan. 31, 1979) (“1979 Release”) (interpretation concerning the application of Exchange Act Section 11(a)(1) to bona fide arbitrage).

<sup>489</sup> See 1979 Release, 44 FR 6084.

exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is “for a good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities of the issuer.”<sup>490</sup>

The domestic arbitrage exception in former Rule 10a-1 was intended to be consistent with the arbitrage provision of Regulation T.<sup>491</sup> Thus, consistent with that provision, former Rule 10a-1(e)(7) referred to a “special arbitrage account” and not a “good faith account.”<sup>492</sup> The Federal Reserve Board amended Regulation T in 1998 to eliminate the “special arbitrage account” and to allow the functions formerly effected in that account to be effected in a “good faith account.” Consistent with that language, Rule 201(d)(3) refers to a “good faith account.”

Because allowing domestic arbitrage at a price that is less than or equal to the current national best bid will potentially promote market efficiency, we have included in Rule 201 a limited provision to allow broker-dealers to mark short sale orders “short exempt” where the broker-dealer has a reasonable basis to believe that the conditions in proposed Rule 201(d)(3) have been met. Thus, Rule 201 is designed to permit the execution or display of such orders in connection with bona fide arbitrage transactions involving convertible, exchangeable, and other rights to acquire the securities sold short, where such rights of acquisition were originally

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<sup>490</sup> Rule 201(d)(3).

<sup>491</sup> See 12 CFR 220.6.

<sup>492</sup> See Proposal, 74 FR at 18056.

attached to, or represented by, another security, or were issued to all the holders of any such class of securities of the issuer.

## **5. International Arbitrage**

We are adopting Rule 201(d)(4) without modification to allow a broker-dealer to mark as “short exempt” short sale orders associated with certain international arbitrage transactions. In response to our request for comment, commenters were generally supportive of this provision relating to international arbitrage.<sup>493</sup> Some commenters, however, stated that they believe that the provision should be expanded to cover more trading scenarios.<sup>494</sup>

As discussed above, the short sale price test restriction of Rule 201(b) will apply to a covered security only after the security has experienced a significant intra-day price decline, will remain in place for a limited period of time, and will continue to permit short selling at a price above the current national best bid (rather than, for example, halting all short selling in that security). As such, we do not believe it is appropriate at this time to broaden the scope of the international arbitrage provision. Due to the already limited scope and applicability of Rule 201, we believe that expanding the scope of the international arbitrage provision to cover more trading scenarios would undermine our goals in adopting Rule 201 because its scope would be even further limited, thereby risking not achieving our goals in adopting Rule 201. Thus, we are adopting the provision as proposed.

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<sup>493</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); letter from NYSE Euronext (Sept. 2009); letter from STANY (Sept. 2009).

<sup>494</sup> See, e.g., letter from RBC (June 2009) (stating that the exception should accommodate convertible arbitrage strategies as well as arbitrage strategies that do not meet the contemporaneous requirement of this provision); letter from Credit Suisse (June 2009); see also supra note 484 (discussing comments regarding the domestic arbitrage provision).

Former Rule 10a-1(e)(8) included an international arbitrage exception that was adopted in 1939.<sup>495</sup> In adopting the exception, the Commission stated that it was necessary to facilitate “transactions which are of a true arbitrage nature, namely, transactions in which a position is taken on one exchange which is to be immediately covered on a foreign market.”<sup>496</sup> We believe likewise that such transactions will have utility under Rule 201. As discussed above in connection with domestic arbitrage, bona fide arbitrage transactions promote market efficiency because they equalize prices at an instant in time in different markets or between relatively equivalent securities.

Rule 201(d)(4) parallels the exception contained in former Rule 10a-1(e)(8). Specifically, Rule 201(d)(4) provides that a broker-dealer may mark a short sale order of a covered security “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is “for a good faith account and submitted to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States, provided that the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it was made.”<sup>497</sup>

In Rule 201(d)(4), we have simplified the language of former Rule 10a-1(e)(8) to make it more understandable.<sup>498</sup> In addition, we have changed the reference in former Rule 10a-1(e)(8)

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<sup>495</sup> See Exchange Act Release No. 2039 (Mar. 10, 1939), 4 FR 1209 (Mar. 14, 1939).

<sup>496</sup> See id.

<sup>497</sup> Rule 201(d)(4).

<sup>498</sup> Former Rule 10a-1(e)(8) provided that the short sale price test restrictions of that rule shall not apply to: “Any sale of a security registered on, or admitted to unlisted trading privileges on, a national securities exchange effected for a special international arbitrage account for the bona fide purpose of profiting [sic] from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on a securities market subject to the jurisdiction of the United States; provided the seller at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe

from a “special international arbitrage account” to a “good faith account.” As discussed above in connection with the domestic arbitrage provision of Rule 201(d)(3), this revision will make the provision consistent with the arbitrage provision in Regulation T.

In addition, as proposed, we have incorporated language from the exception in former Rule 10a-1(e)(12) that provided that, for purposes of the international arbitrage exception, a depository receipt for a security shall be deemed to be the same security represented by the receipt. This language was originally included in the Commission’s 1939 release adopting the international arbitrage exception, but was incorporated separately in former Rule 10a-1(e)(12).<sup>499</sup> Although we requested comment in the Proposal regarding whether a depository receipt for a security should be deemed to be the same security represented by the receipt, we did not receive comments specific to this request.<sup>500</sup> As proposed, we are incorporating in Rule 201(d)(4) the language from the exception in former Rule 10a-1(e)(12).<sup>501</sup>

As with the exception in former Rule 10a-1(e)(8), Rule 201(d)(4) will apply only to bona fide arbitrage transactions. Thus, this provision will only be applicable if at the time of the short sale there is a corresponding offer in a foreign securities market, so that the immediate covering purchase will have the effect of neutralizing the short sale. We believe Rule 201(d)(4) is necessary to facilitate arbitrage transactions in which a position is taken in a security in the U.S.

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that an offer enabling him to cover such sale is then available to him in such foreign securities market and intends to accept such offer immediately.”

<sup>499</sup> See supra note 495.

<sup>500</sup> See Proposal, 74 FR at 18057.

<sup>501</sup> To the extent that the short sale is of a depository receipt and the seller intends to purchase the same security represented by the depository receipt to immediately cover the short sale of the depository receipt, the sale may be marked “short exempt” provided that the seller reasonably believes at the time of the sale that it will be able to convert the security to be purchased into the depository receipt and deliver the depository receipt by settlement date for the sale.

market, and which is to be immediately covered in a foreign market.<sup>502</sup> Thus, we do not believe that permitting broker-dealers to mark these orders “short exempt” will undermine our goals for adopting Rule 201, and, as described above, we believe facilitating or permitting these transactions has utility in terms of promoting market and pricing efficiency.

## **6. Over-Allotments and Lay-Off Sales**

We have determined to adopt without modification in Rule 201(d)(5) a provision that will permit a broker-dealer to mark as “short exempt” short sale orders by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any short sale orders for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment.<sup>503</sup> In response to our request for comment, commenters were generally supportive of inclusion of this provision relating to certain syndicate activity.<sup>504</sup> Some commenters, however, asked that we expand this provision beyond over-allotment and lay-off sales.<sup>505</sup>

As discussed above, the short sale price test restriction of Rule 201(b) will apply to a covered security only after the security has experienced a significant intra-day price decline, will remain in place for a limited period of time, and will continue to permit short selling at a price above the national best bid (rather than, for example, halting all short selling in that security). As such, we do not believe it is appropriate at this time to broaden the scope of the provision relating to over-allotment and lay-off sales. Due to the already limited scope and applicability of

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<sup>502</sup> We note that the requirement that the transaction be “immediately” covered on a foreign market requires the foreign market to be open for trading at the time of the transaction. See Proposal, 74 FR at 18057, n.166; see also 2003 Regulation SHO Proposing Release, 68 FR at 62986, n.119.

<sup>503</sup> See Rule 201(d)(5).

<sup>504</sup> See, e.g., letter from BATS (May 2009); letter from SIFMA (June 2009); letter from NYSE Euronext (Sept. 2009).

<sup>505</sup> See, e.g., letter from SIFMA (June 2009).

Rule 201, we believe that expanding the scope of this provision to cover other sales effected in connection with a distribution would undermine our goals in adopting Rule 201 because it would further limit the scope of the Rule, thereby risking not achieving our goals in adopting Rule 201. Thus, we are adopting the provision as proposed. In addition, we note that we are including a “short exempt” marking provision for syndicate and lay-off sales in part because, as discussed further below, we have historically excepted such activity from short sale rules.

Former Rule 10a-1(e)(10) contained an exception for over-allotment and lay-off sales.<sup>506</sup> Although the exception was not adopted until 1974, the Commission’s approval of the concept of excepting over-allotments and lay-off sales from short sale rules is long-standing.<sup>507</sup> In addition, we note that recently we excepted these sales from the July Emergency Order, which among other things required that short sellers borrow or arrange to borrow securities prior to effecting a short sale, stating that it was not necessary for the Order to cover such sales because such activity is covered by Regulation M under the Exchange Act,<sup>508</sup> an anti-manipulation rule.<sup>509</sup> In accordance with the long-standing Commission position regarding these sales, we are including in Rule 201(d)(5) a provision to permit broker-dealers to mark as “short exempt” short sale orders in connection with over-allotment and lay-off sales, which provision also parallels the exception in former Rule 10a-1(e)(10).

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<sup>506</sup> See 1974 Release, 39 FR 35570.

<sup>507</sup> See, e.g., Exchange Act Release No. 3454 (July 6, 1946), in which the Commission approved the NYSE’s special offering plan, which permitted short sales in the form of over-allotments to facilitate market stabilization.

<sup>508</sup> 17 CFR 242.100 et seq.

<sup>509</sup> See Exchange Act Release No. 58190 (July 18, 2008), 73 FR 42837 (July 23, 2008) (amending the July Emergency Order to include exceptions for certain short sales).

## 7. Riskless Principal Transactions

We have determined to adopt without modification in Rule 201(d)(6) a provision that will permit a broker-dealer to mark as “short exempt” short sale orders where broker-dealers are facilitating customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal.<sup>510</sup> In response to our request for comment, commenters that specifically addressed this provision supported its inclusion.<sup>511</sup>

As discussed in the Proposal,<sup>512</sup> in 2005, the Commission, via authority delegated to the Staff, granted exemptive relief under former Rule 10a-1 for any broker-dealer that facilitates a customer buy or long sell order on a riskless principal basis.<sup>513</sup> In granting the relief, the Commission noted representations made in the letter requesting relief that, in the situation where the amount of securities that the broker-dealer purchases for the customer may not be sufficient to give the broker-dealer an overall net “long” position, former Rule 10a-1 would constrain the ability of the broker-dealer to fill the customer buy order. Further, the Commission noted representations in the letter requesting relief that, because such short sales would be effected only in response to a customer buy order, this should vitiate any concerns about such sales having a depressing impact on the security’s price.<sup>514</sup>

In addition, the Commission noted representations made in the letter requesting relief that where a broker-dealer is facilitating a customer long sale order in a riskless principal transaction,

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<sup>510</sup> See Rule 201(d)(6).

<sup>511</sup> See, e.g., letter from BATS (May 2009); letter from SIFMA (June 2009); letter from Credit Suisse (June 2009); letter from NYSE Euronext (Sept. 2009).

<sup>512</sup> See Proposal, 74 FR at 18057-18058.

<sup>513</sup> See letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Ira Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated July 18, 2005 (“Riskless Principal Letter”).

<sup>514</sup> See id.

because the ultimate seller is long the shares being sold, these transactions present none of the potential abuses that former Rule 10a-1 was designed to address.<sup>515</sup> The Commission also noted representations that the application of former Rule 10a-1 to riskless principal transactions involving a customer long sale can inhibit the broker-dealer's ability to provide timely (or any) execution to such customer long sale. Specifically, if the broker-dealer has a net short position, the broker-dealer will be restricted from executing its own principal trade to complete the first leg of the riskless principal transaction.<sup>516</sup> Thus, compliance with former Rule 10a-1 would adversely affect a broker-dealer's ability to provide best execution to a customer order.<sup>517</sup>

Taken together, Rules 201(a)(8) and (d)(6) parallel the conditions for relief in the Riskless Principal Letter.<sup>518</sup> Consistent with the relief granted in the Riskless Principal Letter, we believe that including a provision to permit a broker-dealer to mark "short exempt" short sale orders in connection with riskless principal transactions is appropriate and will not undermine our goals in adopting short sale price test regulation. In particular, we note that such a provision will facilitate a broker-dealer's ability to provide best execution to customer orders. In addition, such provision will apply only where the customer is selling long.

Rule 201(a)(8) defines the term "riskless principal" to mean "a transaction in which a broker or dealer, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee, or, after having received an order to

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<sup>515</sup> See id.

<sup>516</sup> See id.

<sup>517</sup> See id.

<sup>518</sup> These conditions are also consistent with the definition of "riskless principal transactions" under Rule 10b-18 of the Exchange Act. See 17 CFR 240.10b-18(a)(12).

sell, sells the security as principal at the same price to satisfy the order to sell, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee.”<sup>519</sup>

Rule 201(d)(6) provides that a broker-dealer may mark a short sale order “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is to effect the execution of a customer purchase or the execution of a customer “long” sale on a riskless principal basis.<sup>520</sup> In addition, Rule 201(d)(6) requires the broker-dealer, if it marks an order “short exempt” under this provision, to have written policies and procedures in place to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision.<sup>521</sup>

We believe that Rule 201(d)(6) will provide broker-dealers with additional flexibility to facilitate customer orders and provide best execution. In addition, we believe that the conditions

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<sup>519</sup> Rule 201(a)(8). In addition to being consistent with the conditions in the Riskless Principal Letter and Rule 10b-18(a)(12) of the Exchange Act, this definition is consistent with the definition of “riskless principal” in FINRA Rule 6642. See FINRA Rule 6642(d). We note that Rule 201(a)(8), as adopted, is slightly modified from the definition in the Proposal in that we have added language to clarify that the term “same price” shall be exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee. This language is consistent with the conditions in the Riskless Principal Letter and Rule 10b-18(a)(12). It is also consistent with FINRA’s trade reporting rules which require a riskless principal transaction in which both legs are executed at the same price to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee. See FINRA Rule 6380A(d)(3)(B).

<sup>520</sup> See Rule 201(d)(6). Due to the modification to the definition of “riskless principal” in Rule 201(a)(8), we have not included in Rule 201(d)(6) the proposed language that stated that the purchase or sell order must be given the same per-share price at which the broker-dealer sold or bought shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee. See also supra note 519.

<sup>521</sup> See Rule 201(d)(6). We note that we determined to adopt, as proposed, in Rule 201(d)(6) an explicit requirement that broker-dealers must establish policies and procedures for handling such transactions to be consistent with the conditions in the Riskless Principal Letter and Rule 10b-18(a)(12), which also contain such a requirement.

set forth in Rule 201(d)(6) will provide a mechanism for the surveillance of the provision's use by linking it to specific incoming orders and executions, and by requiring broker-dealers to establish procedures for handling such transactions. These requirements will help ensure that broker-dealers are complying with Rule 201(d)(6).

## **8. Transactions on a Volume-Weighted Average Price Basis**

We have determined to adopt in Rule 201(d)(7) without modification the ability for a broker-dealer to mark as “short exempt” certain short sale orders executed on a volume-weighted average price (“VWAP”) basis. In response to the Proposal, commenters to this provision were supportive of the provision. Some commenters, however, requested that we expand this provision to, for example, cover all benchmark orders, similar to the exception in Rule 611 of Regulation NMS.<sup>522</sup> As discussed above, the short sale price test restriction of Rule 201(b) will apply to a covered security only after the security has experienced a significant intra-day price decline, will remain in place for a limited period of time, and will continue to permit short selling at a price above the current national best bid (rather than, for example, halting all short selling in that security). As such, we do not believe it is appropriate at this time to broaden the scope of the provision relating to transactions on a VWAP basis. Due to the already limited scope and applicability of Rule 201, we believe that expanding the scope of this provision to cover other transactions would undermine our goals in adopting Rule 201 because it would further limit the scope of the Rule, thereby risking not achieving our goals in adopting Rule 201. Thus, we are adopting the provision as proposed.

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<sup>522</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); see also letter from Goldman Sachs (June 2009); letter from ICI (June 2009) (stating that a broadened exception would be necessary to facilitate execution of the types of large orders executed by institutional investors and that such benchmark orders do not raise concerns of manipulation or negative market effects that a short sale price test restriction would be designed to prevent); letter from Credit Suisse (Sept. 2009) (positing that the exception should be extended to cover any orders executed on a similar formulaic basis as VWAP orders).

Under former Rule 10a-1, the Commission, via authority delegated to the Staff, granted limited relief from that rule in connection with short sales executed on a VWAP basis.<sup>523</sup> The relief was limited to VWAP transactions that are arranged or “matched” before the market opens at 9:30 a.m., but are not assigned a price until after the close of trading when the VWAP value is calculated. The Commission granted the exemptions based, in part, on the fact that these VWAP short sale transactions appeared to pose little risk of facilitating the type of market effects that former Rule 10a-1 was designed to prevent.<sup>524</sup> In particular, the Commission noted that the pre-opening VWAP short sale transactions do not participate in or affect the determination of the VWAP for a particular security.<sup>525</sup> Moreover, the Commission stated that all trades used to calculate the day’s VWAP would continue to be subject to former Rule 10a-1.<sup>526</sup>

Consistent with the relief granted under former Rule 10a-1 and with the Proposal, we are providing that a broker-dealer may mark as “short exempt” certain short sale orders executed at the VWAP. Rule 201(d)(7) differs from the relief granted under former Rule 10a-1, however, in that it is not limited to VWAP transactions that are arranged or “matched” before the market opens at 9:30 a.m., or that are not assigned a price until after the close of trading when the VWAP value is calculated. As noted in the Proposal, we believe this restriction is not necessary because VWAP short sale transactions appear to pose little risk of facilitating the type of market

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<sup>523</sup> See e.g., letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Associate General Counsel, Phlx, dated Mar. 24, 1999; letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Soo J. Yim, Wilmer, Cutler & Pickering, dated Dec. 7, 2000; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Andre E. Owens, Schiff Hardin & Waite, dated Mar. 30, 2001; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Sam Scott Miller, Esq., Orrick, Herrington & Sutcliffe LLP, dated May 12, 2001; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to William W. Uchimoto, Esq., Vie Institutional Services, dated Feb. 12, 2003.

<sup>524</sup> See id.

<sup>525</sup> See id.

<sup>526</sup> See id.

effects that a short sale price test restriction is designed to prevent. In addition, in contrast to the Proposal, we have not included in Rule 201 the requirement that no short sale orders marked “short exempt” may be used to calculate the VWAP. We have not incorporated this condition into Rule 201(d)(7) because the information used to calculate the VWAP will not contain information regarding whether an order was marked “short exempt.”

Thus, pursuant to Rule 201(d)(7), a broker-dealer may mark a short sale order of a covered security “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is for the sale of a covered security at the VWAP that meets the following conditions:<sup>527</sup> (1) the VWAP for the covered security is calculated by: calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (2) the transactions are reported using a special VWAP trade modifier; (3) the VWAP matched security qualifies as an “actively-traded security” (as defined under Rules 101(c)(1) and 102(d)(1) of Regulation M), or where the subject listed security is not an “actively-traded security,” the proposed short sale transaction will be permitted only if it is conducted as part of a basket transaction of twenty or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (4) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; and (5) a broker or dealer will act as principal on the contra-side to fill customer short sale orders only if the broker-dealer’s position in the covered security, as committed by the broker-dealer during the pre-opening period of a trading

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<sup>527</sup> See Rule 201(d)(7).

day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the covered security's relevant average daily trading volume, as defined in Regulation M.<sup>528</sup>

Except as discussed above, the conditions set forth in Rule 201(d)(7) parallel the conditions contained in the exemptive relief from former Rule 10a-1 granted for VWAP short sale transactions. We believe that these conditions worked well in restricting the exemptive relief to situations that generally would not raise the harms that short sale price tests are designed to prevent. We believe they will be similarly effective in serving that function today and, therefore, we have incorporated them into Rule 201(d)(7).

**9. Decision Not to Adopt a Provision that a Broker-Dealer may Mark an Order “Short Exempt” in Connection with Bona Fide Market Making Activity**

As discussed in the Proposal, former Rule 10a-1(e)(5) provided a limited exception from the restrictions of that rule for “[a]ny sale . . . by a registered specialist or registered exchange market maker for its own account on any exchange with which it is registered for such security, or by a third market maker for its own account over-the-counter, (i) Effected at a price equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan . . . . Provided, however, That any exchange, by rule, may prohibit its registered specialist and registered exchange market makers from availing themselves of the exemption afforded by this paragraph (e)(5) if that exchange determines that such action is necessary or appropriate in its market in the public interest or for the protection of investors.”<sup>529</sup> Unless prohibited by exchange rule, this exception was intended to permit registered specialists or

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<sup>528</sup> See Rule 201(d)(7); 17 CFR 242.100(b) (defining average daily trading volume), 242.101(c)(1), 242.102(d)(1).

<sup>529</sup> See Proposal, 74 FR at 18059.

market makers to protect customer orders against transactions in other markets in the consolidated system by allowing them to sell short at a price equal to the last trade price reported to the consolidated system, even if that sale was on a minus or zero-minus tick.<sup>530</sup> Although former Rule 10a-1 included this exception for market makers, exchanges adopted rules that prohibited their registered specialists and market makers from availing themselves of this exception.<sup>531</sup> In addition, former Rule 10a-1 did not contain a general exception for short selling in connection with bona fide market making activities.<sup>532</sup>

In the Proposal, in connection with one proposed rule, the proposed circuit breaker halt rule, we included a provision that would permit a broker-dealer to mark a short sale order “short exempt” in connection with certain bona fide market making activities. None of the other proposed rules contained a “short exempt” marking provision with respect to bona fide market making activities. In connection with the proposed circuit breaker halt rule, we included an exception for equity and options market makers engaged in bona fide market making

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<sup>530</sup> See 1974 Release, 39 FR 35570. Former Rule 10a-1(a)(1)(i) referenced the last sale price reported to an effective transaction reporting plan, but former Rule 10a-1(a)(2) also permitted an exchange to make an election to use the last sale price reported in that exchange market. Certain exchanges, such as the NYSE, implemented short sale price test rules consistent with former Rule 10a-1(a)(2). See, e.g., former NYSE Rule 440B.

<sup>531</sup> See 1974 Release, 39 FR 35570.

<sup>532</sup> We note, however, that NASD’s former bid test contained an exception for short sales executed by qualified market makers in connection with bona fide market making. Although the NASD’s former bid test contained an exception for short sales executed by qualified market makers in connection with bona fide market making activity, we understand that market makers relied on the exception a small percentage of the time. For example, a 1997 study indicates that during a sample month in 1997, market maker short sales at or below the inside bid accounted for only 2.41% of their total share volume. See D. Timothy McCormick and Bram Zeigler, The Nasdaq Short Sale Rule: Analysis of Market Quality Effects and The Market Maker Exemption, NASD Economic Research, (August 7, 1997) at 27; see also 2003 Regulation SHO Proposing Release, 68 FR at 62989. In addition, we note that when the Commission approved NASD’s former bid test and the market maker exception to the bid test, it noted concerns that the market maker exception could create opportunities for abusive short selling. See Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994). See also supra note 43 (discussing NASD Rule 3350).

activities.<sup>533</sup> We also included in the proposed circuit breaker halt rule an exception related to bona fide market making in derivatives.<sup>534</sup>

In response to our decision not to provide in the Proposal for most of the proposed alternatives that a broker-dealer may mark an order “short exempt” in connection with bona fide market making activity, we received a wide variety of comments both supporting and opposing such a provision. Many commenters stated that any short sale price test restriction adopted by the Commission must include an exception for market makers due to the large amount of liquidity that they provide to the markets; although comments varied with respect to the necessity of such an exception to the various proposed price test restrictions and circuit breaker rules and to whom such an exception should apply.<sup>535</sup> Commenters stated that the lack of a market maker exception to any short sale price test restriction could result in, among other things, reduced

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<sup>533</sup> See Proposal, 74 FR at 18110. Proposed Rule 201(d)(1) of the proposed circuit breaker halt rule provided that the short selling halt would not apply to “[a]ny sale of a covered security by a registered market maker, block positioner, or other market maker obligated to quote in the over-the-counter market, in each case that are selling short a covered security as part of bona fide market making in such covered security.” Id.

<sup>534</sup> See id. Proposed Rule 201(d)(4) of the proposed circuit breaker halt rule provided that the short selling halt would not apply to “[a]ny sale of a covered security by any person that is a market maker, including an over-the-counter market maker, if the sale is part of a bona fide market making and hedging activity related directly to bona fide market making in: (i) Derivative securities based on that covered security; or (ii) exchange traded funds and exchange traded notes of which that covered security is a component.” Id.

<sup>535</sup> See, e.g., roundtable statement of Rosenblatt Securities; letter from BATS (May 2009); letter from Matlock Capital (May 2009); letter from Pink OTC; letter from Direct Edge (June 2009); letter from Engmann Options; letter from Prof. Rosenthal; letter from Credit Suisse (June 2009); letter from John Gilmartin, Co-CEO and Ben Londergan, Co-CEO, Group One Trading, L.P., dated June 17, 2009 (“Group One Trading (June 2009)”); letter from Allston Trading (June 2009); letter from Knight Capital (June 2009); letter from STANY (June 2009); letter from AIMA; letter from Barclays (June 2009); letter from Citadel et al. (June 2009); letter from EWT (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); letter from ICI (June 2009); letter from NYSE Euronext (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from STA (June 2009); letter from T.D. Pro Ex; letter from Vanguard (June 2009); letter from Direct Edge (Sept. 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Group One Trading (Sept. 2009); letter from Allston Trading (Sept. 2009); letter from Knight Capital (Sept. 2009); letter from STANY (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from EWT (Sept. 2009); letter from GETCO (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from William J. Brodsky, Chairman and CEO, The Chicago Board Options Exchange, Inc., dated Sept. 21, 2009 (“CBOE (Sept. 2009)”); letter from Edward Jones; letter from Virtu Financial.

liquidity, increased bid-ask spreads, increased volatility, increased barriers to entry for new market makers, reduced competition among market makers, and increased costs to market makers and investors.<sup>536</sup> Some commenters stated that the Commission should consider exceptions that would permit high frequency traders<sup>537</sup> and other market makers to continue to provide the same level of liquidity to the markets.<sup>538</sup>

Some commenters stated that an exception for options market makers, in particular, would be necessary for any short sale price test restriction, citing the important role that short selling plays in an options market maker's ability to hedge risk and the negative impact that a short sale price test restriction would have on options market quality, liquidity, bid-ask spreads, quote size, and investor costs.<sup>539</sup> One commenter noted that although former Rule 10a-1 did not contain an options market maker exception, the NASD's former bid test contained an exception that "allowed options market makers to provide liquidity and depth for listed options by allowing

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<sup>536</sup> See, e.g., letter from SIFMA (June 2009); letter from Knight Capital (June 2009); letter from EWT (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); letter from EWT (Sept. 2009); letter from Virtu Financial; but cf. letter from Dr. Jim DeCosta, dated Sept. 14, 2009 ("Dr. Jim DeCosta") (noting that there are currently few barriers to entry for market makers and abuse can arise from small market makers, who are in need of business, being willing to misuse a bona fide market maker exemption in exchange for order flow).

<sup>537</sup> See letter from Bingham McCutchen.

<sup>538</sup> See, e.g., roundtable statement of Rosenblatt Securities; letter from MFA (June 2009); see also letter from Credit Suisse (Mar. 2009).

<sup>539</sup> See, e.g., roundtable statement of Rosenblatt Securities; letter from BATS (May 2009); letter from Matlock Capital (May 2009); letter from Direct Edge (June 2009); letter from Engmann Options; letter from Prof. Rosenthal; letter from Credit Suisse (June 2009); letter from Group One Trading (June 2009); letter from STANY (June 2009); letter from John Favia, Blue Capital Group LLC, dated June 19, 2009 ("Blue Capital"); letter from Goldman Sachs (June 2009); letter from ISE (June 2009); letter from NYSE Euronext (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from STA (June 2009); letter from T.D. Pro Ex; letter from Boston Options Exchange et al. (June 2009); letter from Direct Edge (Sept. 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Group One Trading (Sept. 2009); letter from Knight Capital (Sept. 2009); letter from STANY (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from ISE (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, Nasdaq Options Market, Nasdaq OMX PHLX, NYSE Amex, NYSE Arca and The Options Clearing Corporation, dated Sept. 22, 2009 ("Boston Options Exchange et al. (Sept. 2009)"); letter from CBOE (Sept. 2009).

them to hedge,” but that also had “limited definitions and scope.”<sup>540</sup> Another commenter recognized the risk of a transference effect resulting from an options market maker exception, namely that an exception may facilitate short selling by buying puts from or selling calls to market makers, but stated that there was no empirical evidence showing that the risk is more than theoretical.<sup>541</sup>

Some commenters stated that a market maker exception should include market makers in listed and OTC derivatives.<sup>542</sup> Other commenters stated that a market maker exception should cover block positioners.<sup>543</sup> In addition, some commenters stated that a market maker exception should include market makers in convertibles and warrants.<sup>544</sup> Several commenters stated that an exception for market makers in ETFs should be included in any price test restriction adopted by the Commission.<sup>545</sup>

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<sup>540</sup> Letter from CBOE (June 2009); see also letter from Boston Options Exchange et al. (June 2009); letter from ISE (June 2009); letter from Citadel et al. (June 2009); letter from STANY (June 2009); letter from GETCO (June 2009).

<sup>541</sup> See letter from Blue Capital; but cf. letter from John H. Frazer, Jr., dated May 4, 2009 (“Frazer”) (stating that if options market makers are not subject to the short sale price test restriction, then “short sellers will simply purchase Puts knowing that Options Market Makers will simply sell the stock short without restriction.”).

<sup>542</sup> See, e.g., letter from Direct Edge (June 2009); letter from Credit Suisse (June 2009); letter from STANY (June 2009); letter from Barclays (June 2009); letter from Goldman Sachs (June 2009); letter from ICI (June 2009); letter from NYSE Euronext (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from ISDA; letter from Direct Edge (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from STANY (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009).

<sup>543</sup> See letter from Credit Suisse (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from SIFMA (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from RBC (Sept. 2009).

<sup>544</sup> See, e.g., letter from Credit Suisse (June 2009); letter from SIFMA (June 2009); letter from Credit Suisse (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from SIFMA (Sept. 2009).

<sup>545</sup> See, e.g., letter from Credit Suisse (June 2009); letter from Allston Trading (June 2009); letter from STANY (June 2009); letter from Goldman Sachs (June 2009); letter from ICI (June 2009); letter from SIFMA (June 2009); letter from SIFMA (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from STANY (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from Direct Edge (Sept. 2009).

In addition, some commenters stated that to not include an exception for bona fide market making activities is inconsistent with the Commission's short sale-related emergency orders issued in mid- to late-2008, which included various forms of exceptions for bona fide market making activities.<sup>546</sup> Commenters also noted that since its adoption in 2004, Regulation SHO has included an exception for bona fide market making activities from the "locate" requirement of Rule 203(b)(1).<sup>547</sup> Several commenters also noted that fails to deliver resulting from certain bona fide market making activity are provided additional time to be closed out under Regulation SHO's close-out requirements.<sup>548</sup>

Several commenters, however, discussed the importance of limiting a market maker exception to bona fide market making activity and requested that the Commission define the term strictly so as to eliminate the possibility for gaming.<sup>549</sup> Moreover, some commenters stated that a market maker exception may not be necessary. For example, commenters noted that equity market makers will usually sell at their offer quote, which would not be inhibited by any price test restriction.<sup>550</sup> One commenter stated that if we were to adopt a circuit breaker

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<sup>546</sup> See, e.g., letter from SIFMA (June 2009); letter from RBC (June 2009); letter from CBOE (June 2009); letter from Boston Options Exchange *et al.* (June 2009); letter from ISE (June 2009); letter from Citadel *et al.* (June 2009); letter from Goldman Sachs (June 2009); see also *supra* Section II.C. (discussing the Commission's emergency orders).

<sup>547</sup> See, e.g., letter from SIFMA (June 2009); letter from CBOE (June 2009); letter from Boston Options Exchange *et al.* (June 2009); letter from Goldman Sachs (June 2009); letter from GETCO (June 2009); see also 17 CFR 242.203(b)(2)(iii).

<sup>548</sup> See, e.g., letter from Goldman Sachs (June 2009); letter from Wolverine; letter from Boston Options Exchange *et al.* (June 2009); letter from GETCO (Sept. 2009); letter from Virtu Financial; letter from Nasdaq OMX Group (Oct. 2009); see also 17 CFR 242.204(a)(3).

<sup>549</sup> See letter from Pink OTC; letter from SIFMA (June 2009); letter from STA (June 2009); letter from SIFMA (Sept. 2009); see also letter from NYSE Euronext (June 2009); letter from NYSE Euronext (Sept. 2009) (stating that the definition should contain some obligation to the market).

<sup>550</sup> See letter from CBOE (June 2009); letter from GETCO (June 2009). Although GETCO stated that a market maker typically should not need an exception because the market maker will be able to sell short on the offer when providing liquidity, this commenter also noted that market makers such as GETCO "often employ market making strategies that sometimes include removing liquidity on the bid as part of the overall strategy, which

approach with the alternative uptick rule, an equity market making exception may not be as critical because equity market makers generally post their offers one price increment above the national best bid.<sup>551</sup> This commenter stated that “[i]n a market characterized by the kind of decline that would trigger a circuit breaker, remaining above the [national best bid] will tend to be the natural norm.”<sup>552</sup>

Other commenters stated that there should not be an exception for market makers in any short sale price test restriction that the Commission adopts.<sup>553</sup> One commenter noted that the activities of market makers “are not unique in contributing to market efficiency; all market participants, regardless of trading frequency or professional expertise, improve market quality by their very participation, whether or not their trading activity is arbitrage or professional market making . . . the Commission’s goal should be to implement rules that are sufficiently focused and require few, if any, exceptions to maintain market quality.”<sup>554</sup> In addition, as discussed in Section III.B. above, several commenters cautioned against the Commission adopting numerous exceptions and discussed problems that may arise from adopting a short sale price test restriction with many or complex exceptions, such as additional implementation difficulties, greater compliance costs, lack of uniformity that may cause unfair application of the rule, increased

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may include short selling.” GETCO stated that such strategies result in tighter spreads, more liquidity and potentially lower costs to investors. See letter from GETCO (June 2009).

<sup>551</sup> See letter from Direct Edge (Sept. 2009).

<sup>552</sup> Letter from Direct Edge (Sept. 2009).

<sup>553</sup> See, e.g., letter from David G. Furr, dated Apr. 20, 2009; letter from R. Skinner, dated Apr. 21, 2009; letter from Frazer; letter from IBC; letter from Vitus Lask, dated June 20, 2009; letter from Stephen R. Porpora, dated Sept. 10, 2009; letter from Hudson River Trading; letter from David Furr, dated Nov. 3, 2009.

<sup>554</sup> Letter from Hudson River Trading.

opportunities for gaming and abuse, and, overall, a less effective rule that only applies to a limited numbers of short sales.<sup>555</sup>

At this time, we believe that including a provision to permit broker-dealers to mark as “short exempt” short sale orders in connection with market making activity in the equity or options markets is not necessary and would not advance the goals of our adopting a short sale price test restriction. We recognize that there are distinct differences between options market making and market making in the equity markets and that Rule 201 may impact these markets differently. In addition, we recognize commenters’ concerns regarding the potential negative market impact of not including an exception for market making activity in the equity or options markets. Due to the reasons discussed below, however, we believe such impact, if any, would be limited. In addition, we believe that the potential costs of not including exceptions for equity and options market makers are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline.

We believe that the potential negative market impact from not including an equity or options market maker exception to Rule 201 will be limited, in large part, because Rule 201 is a narrowly-tailored Rule that will impose a short sale price test restriction only if the price of a covered security declines by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In addition, once triggered, the short sale price test restriction will apply for a limited period of time – the remainder of the day on which the circuit breaker has been triggered and the following day. Thus, unlike NASD’s former bid test or former Rule 10a-1 (which also did not include an exception for bona fide market making activity), Rule 201 does not impose a

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<sup>555</sup> See supra note 434.

short sale price test restriction that will apply all the time to all covered securities. Nor does Rule 201 impose a halt on short selling. Instead, Rule 201 is a targeted Rule that will not impact trading in the majority of covered securities. As discussed in more detail above,<sup>556</sup> in response to our request for comment on an appropriate threshold at which to trigger the proposed circuit breaker short sale price restrictions, commenters submitted estimates of the number of securities that would trigger a circuit breaker rule at a 10% threshold<sup>557</sup> and the estimates reflect that a 10% circuit breaker threshold, on average, should result in a limited percentage of covered securities triggering the threshold.<sup>558</sup> In addition, following its review of trading data, the Staff found that, during the period covering April 9, 2001 to September 30, 2009, the price test restrictions of Rule 201 would have, on an average day, been triggered for approximately 4% of covered securities.<sup>559</sup> The Staff also found that for a low volatility period, covering January 1, 2004 to December 31, 2006, the 10% trigger level of Rule 201 would have, on an average day, been triggered for approximately 1.3% of covered securities.<sup>560</sup>

In addition, we believe that any negative market impact due to the lack of a bona fide market making exception for equity market makers will be limited, if any, because as noted by some commenters, for the most part, equity market makers sell at their offer quote.<sup>561</sup> Thus, the price test restriction of Rule 201, that requires short selling at a price above the national best bid and only if the circuit breaker has been triggered, is consistent with equity market making

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<sup>556</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level).

<sup>557</sup> See, e.g., letter from Jordan & Jordan; letter from Citadel et al. (June 2009); letter from MFA (June 2009); letter from SIFMA (June 2009); letter from Credit Suisse (Sept. 2009).

<sup>558</sup> See supra notes 305 to 308 and accompanying text.

<sup>559</sup> See supra note 310 and accompanying text.

<sup>560</sup> See supra note 311 and accompanying text.

<sup>561</sup> See, e.g., letter from CBOE (June 2009); letter from GETCO (June 2009).

strategies because these market makers generally post their offer quotes at a price above the national best bid.<sup>562</sup> In addition, because equity market makers typically provide liquidity on the opposite side of the market, if a covered security is experiencing significant downward price pressure such that it is subject to Rule 201, market makers will tend to be buying not selling the security. Thus, equity market makers will continue to be able to provide liquidity in that security.

Although a number of commenters expressed concerns regarding the lack of an options market maker exception from a price test restriction, we do not believe that such an exception under Rule 201 is necessary because, unlike with a ban on short selling, options market makers will be able to sell short to hedge their positions even when the restriction is in place.<sup>563</sup> In addition, not all covered securities have options traded on them (“optionable covered securities”). As discussed above, data provided by commenters and Staff analysis indicate that, on an average day, a limited number of all covered securities would trigger a 10% circuit breaker level.<sup>564</sup> Thus, an even more limited number of optionable covered securities would trigger a 10% circuit breaker, thereby further reducing the need for an options market maker exception to the Rule’s requirements. To the extent that an optionable covered security is subject to Rule 201, we recognize this may result in a delay in an options market maker’s ability to sell short to hedge a position.<sup>565</sup> Such delay, and the resulting uncertainty options market makers may face

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<sup>562</sup> See letter from Direct Edge (Sept. 2009).

<sup>563</sup> We note that some commenters, in stating that a short sale price test restriction should include an options market maker exception, provided support for their arguments by referencing the impact of the Short Sale Ban Emergency Order that halted short selling in the securities subject to the emergency order, rather than imposing a short sale price test restriction that would continue to allow short selling while the restriction is in effect. See, e.g., letter from CBOE.

<sup>564</sup> See supra note 310 and 311 and accompanying text.

<sup>565</sup> We note that one commenter stated that “[options market makers] need immediacy in their hedges, which means selling at lower than the inside offer quote.” See letter from CBOE (June 2009). Rule 201, if triggered,

(including as the price of an optionable covered security approaches the circuit breaker) regarding their ability to obtain immediate execution of their short sale hedging transactions, may have a negative impact on the options markets, such as the widening of options quote spreads.

We believe, however, that this potential negative market impact and any resulting costs to options market makers will be limited and are justified by the benefits of the Rule. As discussed above, we believe these costs will be limited because, among other things, due to the Rule's circuit breaker approach, the Rule's restrictions will not apply to most optionable covered securities most of the time. In addition, even when a security is experiencing excessive downward price pressure such that the short sale price test restriction of Rule 201 has been triggered for a particular security, we expect there will be purchasers in the market willing to buy the security at the offer or at a price between the current national best bid and offer. Thus, for securities that are subject to Rule 201, there will be buying interest in the market that will result in execution of short sale hedging transactions.

We have also determined not to include an options market maker exception because we are concerned about creating an un-level playing field between options market makers and market makers in other derivatives that sell short to hedge their positions in the derivative.<sup>566</sup> For the reasons discussed above and below, we do not believe that any market maker exception is necessary.

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limits short selling to a price above the current national best bid. Thus, it does not prevent short selling at a price between the current national best bid and offer.

<sup>566</sup> We also note that, as discussed in Section III.A.1. above, we, as well as some commenters, are concerned about the ability to obtain a short position through the use of derivative products and that synthetic short positions may increase as a result of the adoption of a short sale price test restriction. We are concerned that inclusion of an exception in Rule 201 for short sale hedging transactions would make such an increase even more likely. See supra Section III.A.1.

We are also concerned that the inclusion of an exception for equity or options market makers may create an opportunity for potential misuse. Whether from misuse or proper use, if a large volume of short selling were excepted from the short sale price test restrictions of the Rule, such an exception could potentially undermine our goals for adopting the Rule.<sup>567</sup> We are also concerned that the inclusion of an exception could result in significant additional surveillance and compliance costs necessary to help to determine whether market participants are validly claiming the applicable exception and to prevent any misuse. In determining not to include such an exception, we also considered these additional costs.

Although some commenters noted that the NASD's former bid test contained exceptions for equity and options market makers, as noted above, former Rule 10a-1, which was in place for almost seventy years, and applied on a permanent, market-wide basis, did not contain any such exceptions. We are not aware of any negative impact on market quality or any significant costs to investors arising from the lack of such exceptions. In addition, we note that although Regulation SHO currently contains a limited exception from its locate requirement<sup>568</sup> and an additional two days to close out fails to deliver under its close-out requirement for certain market making activity,<sup>569</sup> these exceptions relate to the ability to obtain shares in time to make delivery by settlement date rather than to downward price pressure and potential price manipulation

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<sup>567</sup> See, e.g., Ekkehart Boehmer, Charles M. Jones and Xiaoyan Zhang, 2009, Shackling Short Sellers: The 2008 Shorting Ban. This study on the Short Sale Ban Emergency Order found that “[d]uring the shorting ban (19 Sep through 8 Oct), [NYSE-executed] short sales are 7.72% of overall trading volume for stocks on the original ban list, compared to 19.32% of overall trading volume over the same time interval for the matching set of non-banned stocks.” The authors of the study attributed the on-going short sales in the banned stocks to market makers selling short as part of their market making and hedging activity, as such activity was excepted from the Short Sale Ban Emergency Order. See *id.* While short sale volume decreased in the banned stocks, based on this study’s results and its comparison of ban and non-ban stocks, approximately 40% of the short sale trading volume would be expected to be exempt short selling. This short selling may have occurred as a result of market making exceptions.

<sup>568</sup> See 17 CFR 242.203(b)(2)(iii).

<sup>569</sup> See 17 CFR 242.204(a)(3).

resulting from short selling. Thus, although commenters noted these exceptions as support for an exception from a short sale price test restriction, we do not agree that the inclusion of such exceptions to Regulation SHO's locate and close-out requirements necessitates the inclusion of such an exception in Rule 201.

Moreover, we note that we recently eliminated an exception to Regulation SHO's close-out requirement relating to fails to deliver resulting from options market making activity because, as we noted in the Options Market Maker Elimination Release, a substantial level of fails to deliver continued to persist in threshold securities, and it appeared that a significant number of the fails were as a result of the options market maker exception.<sup>570</sup> In addition, in adopting that amendment, we noted that although we acknowledged commenters' concerns regarding the potential impact of the elimination of the options market maker exception on market making risk, quote depths, spread widths, and market liquidity, we believed that these potential effects were justified by the benefits of requiring such fails to deliver to be closed out within specific time-frames rather than being allowed to persist indefinitely.<sup>571</sup>

Similarly, although we recognize commenters' concerns about the potential impact of the lack of an options market maker exception or a general equity market maker exception on market liquidity, volatility, spread widths, and investor costs, we believe, for the reasons discussed, that these potential costs are justified by the benefits of requiring that when a covered security's price is undergoing significant downward price pressure, short selling in the security by market makers

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<sup>570</sup> See Options Market Maker Elimination Release, 73 FR at 61696. In addition, as we stated in the Options Market Maker Elimination Release, preliminary analysis by the Staff indicated that there was a significant increase in fails to deliver in threshold securities with options traded on them following elimination of the grandfather exception to Regulation SHO's close-out requirement. See *id.* at 61693.

<sup>571</sup> See *id.* at 61696. As discussed above and as noted by several commenters to the Proposal and Re-Opening Release, since the elimination of the options market maker exception to Regulation SHO's close-out requirement, among other Commission actions, data from the Staff indicates there has been a significant reduction in fails to deliver. See *supra* note 119 (discussing the recent reduction in fails to deliver).

generally is restricted. Moreover, as discussed above, because the short sale price test restriction of Rule 201(b) will apply to a covered security only after the security has experienced a significant intra-day price decline, will remain in place for a limited period of time, and will continue to permit short selling at a price above the current national best bid (rather than, for example, halt all short selling in that security) even when the restriction is in place, we believe that the negative market impact, if any, when the restriction is in place, will be limited.<sup>572</sup>

For the reasons discussed above, rather than provide an exception for short selling in connection with bona fide market making activity, whether in the equity or options markets, we have determined to limit the extent to which market makers will be permitted to sell short without restriction under Rule 201. We note, however, as discussed above, Rule 201 permits broker-dealers to mark short sale orders as “short exempt” in connection with riskless principal transactions. We also note that under Rule 201, a trading center’s policies and procedures will be designed to permit the execution or display of short sale orders at the offer. As discussed above, and as noted by some commenters, equity market makers typically will sell at their offer quote.<sup>573</sup> Thus, Rule 201 generally will not restrict short selling by equity market makers engaged in bona fide market making activity. Moreover, in connection with both equity and options market makers, because most covered securities and, to an even greater extent, most optionable covered securities, will not be subject to the short sale price test restriction of Rule 201, these market makers will be able to continue to provide liquidity and hedge positions, as applicable, by selling short at or below the national best bid in most securities most of the time. For all these reasons, at this time we do not believe it is necessary to provide that a broker-dealer

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<sup>572</sup> See supra Sections III.A.3. and III.A.4. (discussing, among other things, the market impact of the alternative uptick rule in combination with a circuit breaker approach); see also infra Sections X.B.1.a. and X.B.2.a. (discussing the market impact of the alternative uptick rule and the circuit breaker approach).

<sup>573</sup> See supra notes 550, 561, and 562 and accompanying text.

may mark an order “short exempt” where the short sale order is in connection with bona fide market making activity, whether in the equity or options markets.<sup>574</sup>

#### **IV. Order Marking**

In the Proposal, we proposed amending Rule 200(g) of Regulation SHO to add a “short exempt” marking requirement.<sup>575</sup> Rule 200(g) of Regulation SHO provides that a broker-dealer must mark all sell orders of any security as “long” or “short.”<sup>576</sup> As initially adopted, Regulation SHO included an additional marking requirement of “short exempt” applicable to short sale orders if the seller was “relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association.”<sup>577</sup> We adopted amendments to Rule 200(g) of Regulation SHO to remove the “short exempt” marking requirement in conjunction with our elimination of former Rule 10a-1.<sup>578</sup>

In conjunction with the adoption of Rule 201 of Regulation SHO to add a short sale circuit breaker rule, we are amending Rule 200(g) of Regulation SHO, substantially as proposed, to again impose a “short exempt” marking requirement.<sup>579</sup> Specifically, Rule 200(g), as amended, provides that “[a] broker or dealer must mark all sell orders of any equity security as

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<sup>574</sup> We note, however, as discussed in more detail below, we have instructed the Staff to assess the impact of the Rule on the options markets and to provide a written assessment of the impact. See infra Section VIII.

<sup>575</sup> See Proposal, 74 FR at 18082-18083.

<sup>576</sup> See 17 CFR 242.200(g).

<sup>577</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48030.

<sup>578</sup> See 2007 Price Test Adopting Release, 72 FR 36348.

<sup>579</sup> In connection with Rule 200(g), we note that we have made one technical modification to Rule 200(g)(2) from the language in the proposed circuit breaker with modified uptick rule. Specifically, we have specified the subsections of Rule 201 – subsections (c) and (d) – that set forth the circumstances under which a short sale order may be marked “short exempt.”

“long,” “short,” or “short exempt.”<sup>580</sup> In addition, Rule 200(g)(2) provides that a sale order shall be marked “short exempt” only if the provisions of paragraph (c) or (d) of Rule 201 are met.<sup>581</sup>

In response to our requests for comment, several commenters noted that a new “short exempt” marking requirement would require adjustments to front end systems, that many firms have multiple front end systems, and that such costs would be multiplied for firms with correspondent clearing operations because each correspondent firm can have its own front end system.<sup>582</sup> Commenters also stated that market participants would need to make adjustments to reporting systems, including blue sheets, OATS, and OTS reporting systems,<sup>583</sup> in addition to order entry and routing applications.<sup>584</sup>

In contrast, several commenters indicated that requiring broker-dealers to mark all sell orders “long,” “short,” or “short exempt” would provide valuable information to the Commission<sup>585</sup> and that such information would be worth the costs of requiring such marking.<sup>586</sup> One commenter indicated that the information provided by a “short exempt” marking requirement would provide the Commission with data on the extent to which exceptions are being used to circumvent the requirements of Rule 201.<sup>587</sup> In addition, with respect to implementation periods, one commenter stated that the “short exempt” marking requirement

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<sup>580</sup> Rule 200(g).

<sup>581</sup> See Rule 200(g)(2).

<sup>582</sup> See letter from RBC (June 2009); letter from NSCP; see also letter from FIF (June 2009).

<sup>583</sup> See letter from RBC (June 2009); letter from NSCP; letter from FIF (June 2009).

<sup>584</sup> See letter from FIF (June 2009).

<sup>585</sup> See, e.g., letter from CFA; letter from STA (June 2009).

<sup>586</sup> See, e.g., letter from STA (June 2009).

<sup>587</sup> See id.

would require coding for new fields in order records, which should be accomplished in approximately three months.<sup>588</sup>

After considering the comments, we have determined to adopt the proposed “short exempt” marking requirement, including the requirement that a sale order shall be marked “short exempt” only if the provisions of paragraph (c) or (d) of Rule 201 are met. The “short exempt” marking requirement will provide a record that a broker-dealer is availing itself of one of the provisions of paragraph (c) or (d) of Rule 201. The records provided pursuant to the “short exempt” marking requirements of Rule 200(g) will also aid surveillance by SROs and the Commission for compliance with the provisions of Rule 201. In addition, under the policies and procedures approach required by Rule 201, the “short exempt” marking requirement will indicate to a trading center whether it must execute or display a short sale order without regard to whether the short sale order is at a price that is less than or equal to the current national best bid.

We recognize that the “short exempt” marking requirement will increase implementation and compliance costs, including costs related to adjusting front-end systems, reporting systems, and order entry and routing applications.<sup>589</sup> We believe, however, that these costs are justified by the benefit of the information that the “short exempt” marking requirement will provide. In addition, to allow sufficient time to make any necessary systems changes, we are providing for a six month implementation period for the “short exempt” marking requirement of Rule 200(g) such that market participants will have to comply with this requirement six months following the effective date of these amendments. We believe that a six month implementation period will provide market participants with sufficient time in which to modify their systems and procedures

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<sup>588</sup> See id.

<sup>589</sup> See infra Section X.A.3. and Section X.B.4. (discussing the benefits and costs of the “short exempt” order marking requirement).

in order to comply with the proposed marking requirements. In addition, the six month implementation period is consistent with the implementation period for Rule 201.

## **V. Exemptive Procedures**

Consistent with the provisions proposed, Rule 201(f) as adopted includes provisions establishing procedures for the Commission, upon written request or its own motion, to grant an exemption from the Rule's provisions, either unconditionally or on specified terms and conditions, if the Commission determines that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.<sup>590</sup> Pursuant to this provision, we will consider and act upon appropriate requests for relief from the provisions of Rule 201 and will consider the particular facts and circumstances relevant to each such request and any appropriate conditions to be imposed as part of the exemption.

In response to our request for comment, one commenter stated that "it is important for the Commission to have detailed procedures for granting exemptions," but that exemptions can decrease overall compliance with the rule by encouraging other market participants to tailor their situation to qualify for an exemption.<sup>591</sup> The commenter stated that the Commission "must set the bar high for those seeking exemptive relief."<sup>592</sup>

We have determined to include in Rule 201 a provision related to granting exemptions from the Rule's provisions in order to provide clear procedures for requests and grants of exemptions. As stated above, we will consider requests for relief and grant exemptions from Rule 201 if the Commission determines that an exemption is necessary or appropriate in the public interest and is consistent with the protection of investors, taking into account the

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<sup>590</sup> See Rule 201(f).

<sup>591</sup> Letter from STA (June 2009).

<sup>592</sup> Id.

particular facts and circumstances relevant to each such request and any appropriate conditions to be imposed in connection with the exemption.

## **VI. Overseas Transactions**

In connection with former Rule 10a-1, the Commission consistently took the position that the rule applied to trades in securities subject to that rule where the trade was “agreed to” in the U.S., but booked overseas.<sup>593</sup> In addition, in the 2004 Regulation SHO Adopting Release we stated that any broker-dealer using the United States jurisdictional means to effect short sales in securities traded in the United States would be subject to Regulation SHO, regardless of whether the broker-dealer is registered with the Commission or relying on an exemption from registration.<sup>594</sup> For example, a U.S. money manager decides to sell a block of 500,000 shares in a covered 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 was agreed to in the United States and occurred in the United States as much as if the trade had been executed by

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<sup>593</sup> See Exchange Act Release No. 27938 (Apr. 23, 1990), 55 FR 17949 (Apr. 30, 1990) (stating that the no-action position exempting certain index arbitrage sales from former Rule 10a-1 would 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 former Rule 10a-1 or other comparable provision of foreign law). See also Exchange Act Release No. 21958 (Apr. 18, 1985), 50 FR 16302, 16306, n.48 (Apr. 25, 1985) (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 rule 390 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 Exchange Act Release No. 28899 (Feb. 20, 1991), 56 FR 8377, 8381 (Feb. 28, 1991). 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. This practice of “booking” trades overseas was analyzed in depth in the Division of Market Regulation’s Market 2000 Report. In the Report, the Division estimated that at that time approximately seven million shares a day in NYSE stocks were faxed overseas, and many of these trades were nominally “executed” in the London over-the-counter market. See Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994), Study VII, p. 2.

<sup>594</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48014, n.54.

the broker-dealer at a U.S. trading desk. Consistent with these prior statements, we stated in the Proposal that if a short sale is agreed to in the United States, it must be effected in accordance with the requirements of the proposed rules, unless otherwise excepted.<sup>595</sup>

In response to our request for comment, one commenter stated that “[g]enerally speaking, the Commission has taken the position that the provisions of Regulation SHO apply to transactions in covered securities ‘agreed to’ in the United States, but sent to a foreign market for execution. Notwithstanding, there has been on-going confusion in this area. The Commission should use this opportunity to clarify the applicability of the restrictions (and Regulation SHO generally) to transactions in covered securities executed on overseas markets.”<sup>596</sup> Consistent with our prior statements, we note that Rule 201 applies to any short sale effected using the United States jurisdictional means, regardless of the jurisdiction in which the short sale is executed.

## **VII. Rule 201 Implementation Period**

In the Proposal and Re-Opening Release, we proposed a three-month and two-month implementation period, respectively, and requested comment regarding these implementation periods.<sup>597</sup> We are adopting in Rule 201 a six-month implementation period, such that trading centers will have to comply with Rule 201 six months following the effective date of Rule 201. We believe that this implementation period will provide trading centers, broker-dealers and other market participants with sufficient time in which to modify their systems, policies and procedures in order to comply with the requirements of Rule 201.

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<sup>595</sup> See Proposal, 74 FR at 18083-18084.

<sup>596</sup> Letter from RBC (June 2009).

<sup>597</sup> See Proposal, 74 FR at 18042; Re-Opening Release, 74 FR at 42036.

In response to our request for comment, commenters indicated that a circuit breaker rule triggering the alternative uptick rule will require an implementation period of between three and twelve months.<sup>598</sup> Several commenters noted that because the alternative uptick rule, unlike the other proposed price tests, would not require sequencing of bids or last sale prices, the alternative uptick rule could be implemented more quickly than the other proposed price tests and could be implemented within three to six months.<sup>599</sup> One commenter noted that implementation concerns with respect to a short sale price test restriction could be minimized, provided that trading centers “could leverage existing architecture developed to comply with the Order Protection Rule in Reg NMS (Rule 611).”<sup>600</sup> Another commenter noted that implementation of a circuit breaker triggering the alternative uptick rule would be easier to implement, “provided that the Commission permits firms to leverage the numerous systems changes made to facilitate compliance with Regulation NMS (including the use of internal market data rather than consolidated data supplied by the industry plans).”<sup>601</sup> Other commenters noted that adopting the alternative uptick rule in conjunction with a circuit breaker, rather than as a permanent, market-wide rule, would not add significantly to the implementation time required.<sup>602</sup>

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<sup>598</sup> See, e.g., letter from FIF (Sept. 2009); letter from Citadel *et al.* (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from EWT (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from MFA (Oct. 2009); letter from Amer. Bankers Assoc.; see also letter from NSCP; letter from RBC (June 2009); letter from STA (June 2009).

<sup>599</sup> See, e.g., letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); letter from STA (Sept. 2009); letter from FIF (Sept. 2009).

<sup>600</sup> Letter from MFA (Oct. 2009).

<sup>601</sup> Letter from Goldman Sachs (Sept. 2009).

<sup>602</sup> See, e.g., letter from Credit Suisse (Sept. 2009); letter from Nasdaq OMX Group (Oct. 2009).

Several commenters, however, did not agree that the absence of a sequencing requirement would shorten the implementation time required for the alternative uptick rule.<sup>603</sup> In addition, several commenters did not agree that previous implementation of Regulation NMS might allow for quicker implementation of a price test.<sup>604</sup> Other commenters stated that adopting the alternative uptick rule in conjunction with a circuit breaker would add to the implementation time.<sup>605</sup> Some commenters expressed concerns that allowing for certain exceptions could affect the implementation time.<sup>606</sup>

We believe that a six month implementation period is appropriate.<sup>607</sup> This implementation period, which is longer than the implementation periods proposed in the Proposal and the Re-opening Release, takes into consideration commenters' concerns that implementation of a price test could be complex. We do not believe that a longer implementation time is warranted because Rule 201 will not require monitoring of the sequence of bids or last sale prices, unlike other proposed price tests, and because Rule 201 will require the implementation of policies and procedures similar to those required for trading centers under Regulation NMS. In addition, market participants will be able to leverage the numerous systems changes made and current architecture developed to facilitate compliance with Regulation NMS. These factors should reduce implementation time.

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<sup>603</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009).

<sup>604</sup> See, e.g., letter from NSCP; letter from RBC (June 2009).

<sup>605</sup> See letter from Direct Edge (Sept. 2009) (stating that adopting the alternative uptick rule with a circuit breaker would add approximately four to six weeks to the development process); letter from NYSE Euronext (Sept. 2009).

<sup>606</sup> See letter from Goldman Sachs (Sept. 2009); letter from FIF (Sept. 2009).

<sup>607</sup> We note that, in effect, market participants will have approximately eight months from publication in the Federal Register to implement Rule 201. Rule 201 will not become effective until sixty days following publication in the Federal Register and the Compliance Date for Rule 201 is six months following the Rule's Effective Date.

In addition, we believe the six month implementation period will allow sufficient time to address any complexities implementing the circuit breaker and the “short exempt” order marking requirement.<sup>608</sup> We note that broker-dealers are already familiar with and have experience implementing a “short exempt” marking requirement as Regulation SHO, as originally adopted, included such a requirement.<sup>609</sup> The “short exempt” marking requirement was eliminated together with the elimination of all short sale price test restrictions in July 2007.<sup>610</sup> In addition, we note that broker-dealers were able to make significant systems changes to de-program the “short exempt” marking requirement from their systems in less than 90 days from the compliance date for elimination of the requirement.<sup>611</sup> Thus, we believe that a six month implementation period should be sufficient.

We also believe that a six month implementation period is appropriate for any systems changes that must be made by listing markets and single plan processors to comply with Rule 201. As discussed above, the single plan processors currently receive information from listing markets regarding trading restrictions (i.e. Regulatory Halts as defined in those plans) on individual securities and disseminate such information. Thus, the requirements of Rule 201(b)(3) are similar to existing obligations on plan processors pursuant to the requirements of Regulation NMS, the CTA and CQ Plans and the Nasdaq UTP Plan. Due to this similarity, we believe that a six month implementation period is appropriate.

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<sup>608</sup> See supra Section III.B. (discussing the “short exempt” marking provisions of Rule 201) and supra Section IV. (discussing the “short exempt” marking requirement of Rule 200(g)).

<sup>609</sup> See 2004 Regulation SHO Adopting Release, 69 FR 48008.

<sup>610</sup> See 2007 Price Test Adopting Release, 72 FR 36348.

<sup>611</sup> See letter from Josephine J. Tao, Assistant Director, Division of Market Regulation, SEC, to Ira Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, dated July 2, 2007.

## VIII. Decision Not to Implement Rule 201 on a Pilot Basis

In the Proposal, we requested comment regarding whether, before determining whether to adopt a short sale price test restriction or circuit breaker rule on a permanent basis, we should adopt a rule that would apply on a pilot basis to specified securities.<sup>612</sup> In response to our request for comment, a number of commenters stated that any price test restriction should be adopted on a pilot basis.<sup>613</sup> A number of commenters indicated that a pilot study should be conducted prior to adoption of a price test on a permanent basis in order to gather empirical evidence on the effectiveness and/or market impact of a price test.<sup>614</sup> Some commenters stated that adopting a price test on a pilot basis only would limit any negative market impact to the subset of securities subject to the price test.<sup>615</sup> Another commenter stated that a pilot study would allow the Commission to gather data on the effects of a price test as compared to a control group not

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<sup>612</sup> See, e.g., Proposal, 74 FR at 18071.

<sup>613</sup> See, e.g., letter from BATS (May 2009); letter from IAG; letter from BIO; letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated June 19, 2009 (“Prof. Angel (June 2009)”); letter from Barclays (June 2009); letter from Citadel *et al.* (June 2009); letter from EWT (June 2009); letter from NSCP; letter from RBC (June 2009); letter from STA (June 2009); letter from NYSE Euronext (June 2009); letter from Knight Capital (June 2009); letter from STANY (June 2009); letter from T. Rowe Price (June 2009); letter from Credit Suisse (June 2009); memorandum regarding meeting with Penson; letter from CFA; letter from Knight Capital (Sept. 2009); letter from Prof. Angel (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from EWT (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from Qtrade; letter from RBC (Sept. 2009); letter from STANY (Sept. 2009); letter from Virtu Financial.

<sup>614</sup> See, e.g., letter from BATS (May 2009); letter from BIO; letter from Prof. Angel (June 2009); letter from Credit Suisse (June 2009); letter from Knight Capital (June 2009); letter from NSCP; letter from RBC (June 2009); letter from STANY (June 2009); memorandum regarding meeting with Penson; letter from CFA; letter from Prof. Angel (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from EWT (Sept. 2009); letter from Knight Capital (Sept. 2009); letter from Qtrade; letter from RBC (Sept. 2009); letter from STANY (Sept. 2009); *see also* letter from Park National (stating that a review of a price test based on the national best bid should be conducted six months after implementation to ensure effectiveness). We also note that a number of commenters indicated that the Commission should gather empirical evidence through further study, though not necessarily in the form of a pilot study, prior to adopting a price test. See, e.g., letter from BATS (May 2009); letter from Citadel *et al.* (June 2009); letter from Dialectic Capital (June 2009); letter from Geoffrey F. Foisie, Investments Manager, Shawbrook, dated June 16, 2009; letter from Amer. Bar Assoc. (July 2009); letter from Jeffrey W. Rubin, Chair, Committee on Federal Regulation of Securities, American Bar Association, dated Sept. 30, 2009 (“Amer. Bar Assoc. (Sept. 2009)”); letter from Goldman Sachs (Sept. 2009).

<sup>615</sup> See, e.g., letter from Credit Suisse (June 2009); letter from STA (June 2009).

subject to a price test.<sup>616</sup> One commenter noted that a pilot study would allow the Commission to observe the effects of a price test under current market conditions,<sup>617</sup> while another stated that the Commission should study a price test in the context of severe market conditions.<sup>618</sup> Another commenter stated that a pilot study is particularly important for the alternative uptick rule because it has not been in effect in the market previously and would be more restrictive than other proposed price tests.<sup>619</sup> Other commenters noted that a pilot study could provide data regarding the impact or need for various exceptions to a price test.<sup>620</sup> Several commenters indicated that pilot study data should be made publicly available to permit third parties to analyze the results of the pilot study.<sup>621</sup>

In contrast, several commenters stated that the Commission should not adopt a price test restriction on a pilot basis.<sup>622</sup> Several of these commenters expressed concerns regarding the costs to implement a price test on a pilot basis,<sup>623</sup> with some stating that such costs would outweigh the benefits of a pilot study.<sup>624</sup> One commenter stated that a price test should be implemented as soon as possible, without a pilot study, because a pilot study would produce little

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<sup>616</sup> See letter from Citadel et al. (June 2009).

<sup>617</sup> See letter from NYSE Euronext (June 2009).

<sup>618</sup> See letter from Virtu Financial.

<sup>619</sup> See letter from STANY (Sept. 2009).

<sup>620</sup> See, e.g., letter from T. Rowe Price (June 2009); letter from Direct Edge (Sept. 2009); see also letter from Wells Fargo (June 2009) (noting that additional study regarding an exception for bona fide market making activity would be needed if the Commission adopted a circuit breaker rule).

<sup>621</sup> See letter from BATS (May 2009); letter from STA (June 2009).

<sup>622</sup> See, e.g., letter from Amer. Bankers Assoc.; letter from SIFMA (June 2009); letter from IBC.

<sup>623</sup> See, e.g., letter from Amer. Bankers Assoc.; letter from NYSE Euronext (June 2009); letter from SIFMA (June 2009); letter from STA (June 2009).

<sup>624</sup> See, e.g., letter from Amer. Bankers Assoc.; letter from SIFMA (June 2009).

or no benefit.<sup>625</sup> Several commenters expressed support for a “sunset” provision allowing the Commission to more easily remove a price test restriction if it was determined that the restriction was not meeting the Commission’s goals or was harming the market.<sup>626</sup>

We have determined not to adopt Rule 201 on a pilot basis. We believe that adopting the rule on a temporary pilot basis and/or only for a subset of securities will not advance the goals of our adopting Rule 201. For example, one goal in adopting Rule 201 is to address erosion of investor confidence in our markets. We believe that adopting Rule 201 on a pilot basis, such that the Rule would apply for the duration of the pilot only, could undermine this goal because, among other things, investors would know that the Rule is in place for a limited period of time rather than on a permanent basis and, therefore, may believe that any benefits that result from the Rule could be temporary.

In addition, we note that unlike the Pilot, which removed then-existing short sale price test restrictions for a subset of securities, undertaking a pilot study in connection with Rule 201 would require market participants to undertake as much time, effort and expense as full implementation of the new rule. As noted by one commenter, the implementation cost would be the same whether the Rule is adopted on a pilot or a permanent basis.<sup>627</sup> We also do not believe a “sunset” provision would advance our goal of restoring investor confidence because, as with a pilot, investors would know that the Rule is in place for a limited period of time rather than on a

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<sup>625</sup> See letter from IBC.

<sup>626</sup> See, e.g., letter from SIFMA (June 2009); letter from Dialectic Capital (June 2009). One commenter also cited easier removal of the price test restriction as an argument for a pilot study. See letter from STANY (June 2009).

<sup>627</sup> See letter from STA (June 2009). We note that a number of commenters expressed concerns regarding the implementation costs of a price test. See *infra* Sections X.B.1.b. and X.B.2.b. (discussing implementation costs).

permanent basis and, therefore, may believe that any benefits that result from the Rule could be temporary.

We encourage researchers, however, to provide the Commission with their own empirical analyses regarding the impact of the Rule on the options markets, and on market quality in general. We will, moreover, carefully monitor the operation of the Rule to assess its impact and effectiveness, including the Rule's impact on market quality, to determine whether any modifications to the Rule are warranted. In addition, we have instructed the Staff to assess the impact of the Rule on the options markets and to provide us with a written report of their assessment within the shortest time practicable for completing a meaningful study, which we expect, in any event, will not exceed two years from the Compliance Date.

To the extent that we determine at any time that any of the current parameters of Rule 201, such as the exceptions to the Rule, the 10% trigger level, the duration of the price test restriction if triggered, the basing of the trigger level on the prior day's closing price as determined by the covered security's listing market, or changed market conditions, result in Rule 201 not adequately addressing our concerns or meeting our goals in adopting Rule 201, we will consider whether to amend Rule 201, or grant relief thereunder, as appropriate at that time.

## **IX. Paperwork Reduction Act**

### **A. Background**

Certain provisions of the amendments to Regulation SHO contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>628</sup> We submitted the collection of information to the Office of Management and Budget ("OMB") for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR

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<sup>628</sup> 44 U.S.C. 3501 et seq.

1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is “Rules 201 and 200(g)” and the OMB control number for the collection of information is 3235-0651.

We are adopting amendments to Rules 201 and 200(g) of Regulation SHO under the Exchange Act. The amendments to Rule 201 impose a short sale-related circuit breaker that, if triggered, will impose a short sale price test restriction on a particular security for a limited period of time. Specifically, Rule 201 requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>629</sup> In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>630</sup> In addition, we are adopting amendments to Rule 200(g) of Regulation SHO to provide that a broker-dealer may mark certain qualifying sell orders “short exempt.” In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to

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<sup>629</sup> Rule 201(b). See also supra Section III.A.7. (discussing the policies and procedures approach).

<sup>630</sup> Id.

the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>631</sup>

## **B. Summary**

As detailed below, several provisions under the amendments to Regulation SHO impose a new “collection of information” within the meaning of the PRA.

### **1. Policies and Procedures Requirement under Rule 201**

Rule 201 imposes a new “collection of information” within the meaning of the PRA. Rule 201 requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>632</sup> In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan. Thus, a trading center’s policies and procedures must be reasonably designed to permit the trading center to be able to obtain information from the single plan processor regarding whether a covered security is subject to the short sale price test restriction of Rule 201; if the covered security is subject to the short sale price test restriction of Rule 201, to determine whether or not the short sale order is priced in

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<sup>631</sup> See Rules 200(g) and 200(g)(2); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>632</sup> Rule 201(b). See also supra Section III.A.7. (discussing the policies and procedures approach).

accordance with the provisions of Rule 201(b); and to recognize when an order is marked “short exempt” such that the trading center’s policies and procedures do not prevent the execution or display of such orders at a price that is less than or equal to the current national best bid, even if the covered security is subject to the short sale price test restriction of Rule 201.<sup>633</sup>

At a minimum, a trading center’s policies and procedures must enable a trading center to monitor, on a real-time basis, the national best bid, so as to determine the price at which the trading center may execute or display a short sale order. As mentioned above, a trading center must have policies and procedures reasonably designed to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.<sup>634</sup>

A trading center must also take such steps as will be necessary to enable it to enforce its policies and procedures effectively. A trading center must regularly surveil to ascertain the effectiveness of the policies and procedures required under the Rule and must take prompt action to remedy deficiencies in such policies and procedures.<sup>635</sup> The nature and extent of the policies and procedures that a trading center must establish to comply with these requirements will depend upon the type, size, and nature of the trading center.

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<sup>633</sup> Id.

<sup>634</sup> Rule 200(g)(2). The broker-dealer marking the order “short exempt” will have responsibility for being able to identify on which provision of Rule 201 it was relying in marking the order “short exempt.”

<sup>635</sup> This provision will reinforce the on-going maintenance and enforcement requirements of Rule 201(b)(1) by explicitly assigning an affirmative responsibility to trading centers to surveil to ascertain the effectiveness of their policies and procedures. See Rule 201(b)(2). We note that Rule 611(a)(2) of Regulation NMS contains a similar provision for trading centers. See 17 CFR 242.611(a)(2).

## **2. Policies and Procedures Requirement under the Broker-Dealer and Riskless Principal Provisions**

Rule 201 contains a broker-dealer provision that requires a new “collection of information” under the PRA. Rule 201(c) permits a broker-dealer submitting a short sale order for the covered security to a trading center to mark the order “short exempt” if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission.<sup>636</sup> This provision requires a new collection of information in that a broker-dealer marking an order “short exempt” under Rule 201(c) must identify a short sale order as priced in accordance with the requirements of Rule 201(c); establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being priced in accordance with the requirements of Rule 201(c); regularly surveil to ascertain the effectiveness of these policies and procedures, and to take prompt action to remedy deficiencies.<sup>637</sup>

Rule 201 also contains a riskless principal provision that requires a new “collection of information” under the PRA. Specifically, Rule 201(d)(6) permits a broker-dealer to mark as “short exempt” short sale orders where broker-dealers are facilitating customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal, provided certain conditions are satisfied.<sup>638</sup> This provision requires a new collection of information in that it requires a broker-dealer marking an order “short exempt”

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<sup>636</sup> See Rule 201(c). As a result, a trading center’s policies and procedures will need to be reasonably designed to permit the execution or display of such orders without regard to whether the order is at a price that is less than or equal to the current national best bid. See Rule 201(b)(1)(iii).

<sup>637</sup> See Rules 201(c)(1) and 201(c)(2).

<sup>638</sup> See Rule 201(d)(6). As a result, a trading center’s policies and procedures will need to be reasonably designed to permit the execution or display of such orders without regard to whether the order is at a price that is less than or equal to the current national best bid. See Rule 201(b)(1)(iii).

under this provision to have written policies and procedures in place to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision.<sup>639</sup>

### **3. Marking Requirements**

While the current marking requirements in Rule 200(g) of Regulation SHO, which require broker-dealers to mark all sell orders of any equity security as either “long” or “short,”<sup>640</sup> remain in effect, the amendments to Rule 200(g) add a new marking requirement of “short exempt.”<sup>641</sup> In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>642</sup> The new “short exempt” marking requirements impose a new collection of information.

## **C. Use of Information**

### **1. Policies and Procedures Requirement under Rule 201**

The information collected under Rule 201’s written policies and procedure requirement<sup>643</sup> will help ensure that the trading center does not execute or display any impermissibly priced

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<sup>639</sup> See Rule 201(d)(6).

<sup>640</sup> 17 CFR 242.200(g).

<sup>641</sup> See Rule 200(g); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>642</sup> See Rule 200(g)(2).

<sup>643</sup> See Rule 201(b).

short sale orders, unless an order is marked “short exempt,” in accordance with the Rule’s requirements. This written policies and procedures requirement will also provide trading centers with flexibility in determining how to comply with the requirements of Rule 201. The information collected also will aid the Commission and SROs that regulate trading centers in monitoring compliance with the Rule’s requirements. In addition, it will aid trading centers and broker-dealers in complying with the Rule’s requirements.

## **2. Policies and Procedures Requirement under the Broker-Dealer and Riskless Principal Provisions**

The broker-dealer provision in Rule 201(c) permits a broker-dealer submitting a short sale order for the covered security to a trading center to mark the order “short exempt” if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission.<sup>644</sup> This provision includes a policies and procedures requirement that is designed to help prevent incorrect identification of orders for purposes of Rule 201(c)’s broker-dealer provision. The information collected will also enable the Commission and SROs to examine for compliance with the requirements of the exception.

Moreover, the information collected under the written policies and procedures requirement in the riskless principal exception in Rule 201(d)(6)<sup>645</sup> will help assure that broker-dealers comply with the requirements of this provision. The information collected will also enable the Commission and SROs to examine for compliance with the requirements of the exception.

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<sup>644</sup> See Rule 201(c).

<sup>645</sup> See Rule 201(d)(6).

### **3. Marking Requirements**

The amendments to Rule 200(g) add a new marking requirement of “short exempt.”<sup>646</sup> In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>647</sup> The purpose of the information collected is to enable the Commission and SROs to monitor whether a person entering a sell order covered by Rule 201 is acting in accordance with one of the provisions contained in paragraph (c) or (d) of the Rule. In particular, the “short exempt” marking requirement will provide a record that will aid in surveillance for compliance with the provisions of Rule 201. It also will provide an indication to a trading center regarding whether or not it must execute or display a short sale order in accordance with the Rule’s provisions. In addition, it will help a trading center determine whether its policies and procedures are reasonable and whether its surveillance is effective.

#### **D. Respondents**

As discussed below, the Commission has considered each of the following respondents for the purposes of calculating the reporting burdens under the amendments to Rules 200(g) and 201 of Regulation SHO.

#### **1. Policies and Procedures Requirement under Rule 201**

Rule 201 requires each trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid during the

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<sup>646</sup> See Rule 200(g); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>647</sup> See Rule 200(g)(2).

period when the circuit breaker is in effect, unless an exception applies.<sup>648</sup> A “trading center” is defined as “a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.”<sup>649</sup> Because Rule 201 applies to any trading center that executes or displays a short sale order in a covered security, the Rule applies to 10 registered national securities exchanges that trade covered securities (or “SRO trading centers”),<sup>650</sup> and approximately 407 broker-dealers (including ATs) registered with the Commission (or “non-SRO trading centers”).<sup>651</sup>

## **2. Policies and Procedures Requirement under the Broker-Dealer and Riskless Principal Provisions**

The collection of information required in connection with the broker-dealer provision in Rule 201(c) and in connection with the riskless principal provision in Rule 201(d)(6) applies to all registered brokers-dealers submitting short sale orders in reliance on these provisions. While not all broker-dealers likely will enter sell orders in securities covered by the amendments to Rules 200(g) and 201 in a manner that will subject them to this collection of information, we

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<sup>648</sup> See Rule 201(b).

<sup>649</sup> See Rule 201(a)(9); see also 17 CFR 242.600(b)(78).

<sup>650</sup> Currently, there are 10 national securities exchanges (BX, BATS, CBOE, CHX, ISE, Nasdaq, NSX, NYSE, NYSE Amex, and NYSE Arca) that operate an SRO trading facility for covered securities and thus will be subject to the Rule. The Proposal indicated that one national securities association (FINRA) would also be subject to the Rule. See Proposal, 74 FR at 18086, n.334. However, FINRA operates an SRO display-only facility for covered securities, rather than an SRO trading facility, and thus is not subject to the Rule.

<sup>651</sup> This number includes the approximately 357 firms that were registered equity market makers or specialists at year-end 2008 (this number was derived from annual FOCUS reports and discussion with SRO staff), as well as the 50 ATs that operate trading systems that trade covered securities. The Commission believes it is reasonable to estimate that in general, firms that are block positioners - i.e., firms that are in the business of executing orders internally - are the same firms that are registered market makers (for instance, they may be registered as a market maker in one or more Nasdaq stocks and carry on a block positioner business in exchange-listed stocks), especially given the amount of capital necessary to carry on such a business.

estimate, for purposes of the PRA, that all of the approximately 5,178<sup>652</sup> registered broker-dealers will do so.

### **3. Marking Requirements**

The collection of information that is required pursuant to the “short exempt” marking requirements of Rule 200(g) applies to all registered brokers-dealers submitting short sale orders marked “short exempt” in accordance with the provisions contained in paragraph (c) or (d) of Rule 201. While not all broker-dealers likely will enter sell orders in securities covered by the amendments to Rules 200(g) and 201 in a manner that will subject them to this collection of information, we estimate, for purposes of the PRA, that all of the approximately 5,178<sup>653</sup> registered broker-dealers will do so.

#### **E. Total Annual Reporting and Recordkeeping Burdens**

##### **1. Policies and Procedures Requirement under Rule 201**

Rule 201 requires each trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid during the period when the circuit breaker is in effect.<sup>654</sup> Thus, trading centers must develop written policies and procedures reasonably designed to permit the trading center to be able to obtain information from the single plan processor regarding whether a covered security is subject to the short sale price test restriction of Rule 201; if the covered security is subject to the short sale price test restriction of Rule 201, to determine whether or not the short sale order is priced in

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<sup>652</sup> This number is based on a review of 2008 FOCUS Report filings reflecting registered broker-dealers, including introducing broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

<sup>653</sup> Id.

<sup>654</sup> See Rule 201(b)(1).

accordance with the provisions of Rule 201(b); and to recognize when an order is marked “short exempt” such that the trading center’s policies and procedures do not prevent the execution or display of such orders at a price that is less than or equal to the current national best bid, even if the covered security is subject to the short sale price test restriction of Rule 201.

In the Proposal, we provided estimates of the reporting and recordkeeping burdens for trading centers under the proposed short sale price test restrictions, both on a permanent, market-wide basis and in conjunction with a circuit breaker.<sup>655</sup> We also requested comment, in the Proposal and the Re-Opening Release, as to whether the proposed burden estimates were appropriate or whether such estimates should be increased or reduced, and if so, for which entities and by how much.<sup>656</sup>

One commenter provided a cost estimate, including costs for “development man-hours” of \$500,000 per firm for implementation of a new short sale price test restriction by trading centers, either on a permanent, market-wide basis, or in conjunction with a circuit breaker.<sup>657</sup> One commenter stated that a new short sale price test restriction would involve “significant implementation costs” and “the generation and retention of voluminous compliance reports” but did not provide a specific estimate of the cost or hours that would be involved.<sup>658</sup> Several commenters expressed general concerns regarding the time and cost that would be imposed for implementation and on-going monitoring and surveillance of a new short sale price test

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<sup>655</sup> See Proposal, 74 FR at 18087.

<sup>656</sup> See Proposal, 74 FR at 18088; Re-Opening Release, 74 FR at 42036.

<sup>657</sup> Letter from Wolverine. Wolverine provided an estimate of \$500,000 per firm for implementation costs, which it applied to both non-SRO trading centers and other registered broker-dealers.

<sup>658</sup> Letter from EWT (Sept. 2009).

restriction, including a policies and procedures requirement, but did not provide specific estimates of such time and cost.<sup>659</sup>

We considered these comments in reviewing the burden estimates for trading centers that we proposed with respect to the collection of information requirements in Rule 201. We believe that the cost and time required for implementation of Rule 201 will be lower than some commenters' stated estimates<sup>660</sup> because we believe that the implementation and on-going monitoring and surveillance costs of the alternative uptick rule will be lower than the implementation and on-going monitoring and surveillance costs that would be associated with adoption of the proposed modified uptick rule or the proposed uptick rule. Unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price (i.e., whether the current national best bid or last sale price is above or below the previous national best bid or last sale price), the alternative uptick rule references only the current national best bid.

A number of commenters stated that because the alternative uptick rule would not require monitoring of the sequence of bids or last sale prices, implementing the alternative uptick rule would be less costly<sup>661</sup> or easier than implementing the proposed modified uptick rule or the

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<sup>659</sup> See, e.g., letter from RBC (June 2009); letter from STANY (June 2009); letter from CPIC (June 2009); letter from EWT (Sept. 2009); letter from RBC (Sept. 2009). We received time estimates only with respect to the Commission's proposed implementation time and did not receive comments regarding estimated PRA burden hours. See supra Section VII. (discussing comments on implementation time).

<sup>660</sup> We received comments expressing concerns about the implementation and on-going monitoring and compliance costs of a short sale price test restriction that were not specific to the alternative uptick rule. See, e.g., letter from RBC (June 2009); letter from STANY (June 2009); letter from CPIC (June 2009); letter from Wolverine.

<sup>661</sup> See, e.g., letter from BATS (May 2009); letter from Michael L. Crawl, Managing Director, Global General Counsel, Barclays Global Investors, dated Sept. 21, 2009 ("Barclays (Sept. 2009)"); letter from BATS (Sept. 2009); letter from GETCO (Sept. 2009); letter from ICI (Sept. 2009); letter from Glen Shipway (Sept. 2009); letter from STA (Sept. 2009). In addition, several commenters acknowledged that implementation of the alternative uptick rule will likely be less costly, without referencing the sequencing issue. See, e.g., letter from Atherton Lane; letter from STANY (Sept. 2009).

proposed uptick rule.<sup>662</sup> In addition, several commenters stated that the alternative uptick rule would be easier to program into trading and surveillance systems than the proposed modified uptick rule or the proposed uptick rule.<sup>663</sup> Another commenter stated, with respect to the alternative uptick rule, that “actual implementation costs in terms of time and capital expenditure would be negligible when compared to those involved in implementing either the uptick rule or modified uptick rule.”<sup>664</sup>

Several commenters indicated that implementation of the alternative uptick rule would not be easier or less costly than implementation of the proposed modified uptick rule or the proposed uptick rule.<sup>665</sup> However, we note that some of these commenters presented concerns that were not directly related to the alternative uptick rule<sup>666</sup> or to implementation costs or difficulties.<sup>667</sup> Additionally, one commenter did not provide the reasoning for its belief that the alternative uptick rule would not be easier or less costly to implement.<sup>668</sup>

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<sup>662</sup> See, e.g., letter from Credit Suisse (June 2009); letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009); letter from Glen Shipway (Sept. 2009); letter from SIFMA (Sept. 2009). In addition, one commenter acknowledged that implementation of the alternative uptick rule will likely be easier, without referencing the sequencing issue. See letter from Allston Trading (Sept. 2009).

<sup>663</sup> See, e.g., letter from BATS (May 2009); letter from Goldman Sachs (June 2009); letter from Glen Shipway (Sept. 2009); letter from ICI (Sept. 2009); see also letter from National Stock Exchange et al.

<sup>664</sup> Letter from BATS (Sept. 2009).

<sup>665</sup> See, e.g., letter from Matlock Capital (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from Knight Capital (Sept. 2009).

<sup>666</sup> See, e.g., letter from NYSE Euronext (Sept. 2009) (stating that implementation of the alternative uptick rule would be more difficult on the basis that the alternative uptick rule would be paired with a circuit breaker and attributing implementation difficulties to the circuit breaker approach, not the alternative uptick rule); letter from RBC (Sept. 2009) (expressing concern about the implementation cost of any short sale price test restriction in general).

<sup>667</sup> See, e.g., letter from Knight Capital (Sept. 2009) (characterizing a potential increase in friction, confusion, or inefficiency in the market as an implementation difficulty that may arise from the alternative uptick rule).

<sup>668</sup> See letter from Matlock Capital (Sept. 2009).

Several commenters indicated that their belief that other commenters' estimates regarding the difficulty or costs of implementing and monitoring the proposed modified uptick rule and the proposed uptick rule were exaggerated.<sup>669</sup> We recognize that some commenters' estimates of the costs of the proposed modified uptick rule or the proposed uptick rule may have been conservative. We also believe that because the alternative uptick rule does not include a sequencing requirement, the implementation and on-going monitoring and surveillance costs of the alternative uptick rule will be less than such costs would be with respect to the other proposed short sale price test restrictions.

In addition, as noted in the Proposal, while we have based our burden estimates, in part, on the burden estimates provided in connection with the adoption of Regulation NMS,<sup>670</sup> we believe that these estimates may be on the high end because trading centers have already had to establish policies and procedures in connection with that Regulation's Order Protection Rule, which could help form the basis for the policies and procedures for Rule 201. Several commenters agreed, stating that previous experience with the policies and procedures required under Regulation NMS might reduce the implementation and on-going monitoring and compliance burdens on trading centers.<sup>671</sup> In contrast, some commenters indicated that the Commission overstated the benefit of such previous experience,<sup>672</sup> because, for example, "systems re-written and architected for Reg NMS ... did not include any short sale restrictions,"<sup>673</sup> or because such systems will require modifications in order to be used in the

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<sup>669</sup> See, e.g., letter from Matlock Capital (Sept. 2009); letter from ISE (Sept. 2009); letter from Bingham McCutchen.

<sup>670</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087.

<sup>671</sup> See, e.g., letter from EWT (Sept. 2009); letter from MFA (Oct. 2009).

<sup>672</sup> See, e.g., letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009).

<sup>673</sup> Letter from FIF (June 2009); see also letter from RBC (June 2009).

context of a short sale price test restriction.<sup>674</sup> However, we considered these issues when considering the impact of previous experience with the policies and procedures requirement of Regulation NMS's Order Protection Rule. We continue to believe that because most trading centers already have in place systems and written policies and procedures to comply with Regulation NMS's Order Protection Rule, most trading centers will already be already familiar with establishing, maintaining, and enforcing trading-related policies and procedures, which will mitigate the burden of implementation of the policies and procedures requirement under Rule 201. We realize, however, that the exact nature and extent of the policies and procedures that a trading center is required to establish likely will vary depending upon the type, size, and nature of the trading center. Thus, our estimates take into account different types of trading centers and we realize that these estimates may be on the low-end for some trading centers while they may be on the high-end for other trading centers.

We considered whether our estimates of the burdens associated with the collection of information requirements for trading centers with respect to the proposed modified uptick rule included in the Proposal<sup>675</sup> would change under the circuit breaker approach of Rule 201, but, as discussed below, concluded that these estimates continue to represent reasonable estimates under the circuit breaker approach in combination with the alternative uptick rule.

Despite some commenters' concerns regarding the implementation costs of a circuit breaker rule,<sup>676</sup> we believe that the circuit breaker approach will result in largely the same implementation

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<sup>674</sup> See letter from NSCP; letter from RBC (June 2009).

<sup>675</sup> See Proposal, 74 FR at 18087.

<sup>676</sup> See, e.g., letter from T. Rowe Price (June 2009); letter from Glen Shipway (June 2009); see also letter from STANY (June 2009) (stating that costs savings of a circuit breaker approach would be reduced if the circuit breaker triggered a short sale price test restriction); letter from NYSE Euronext (Sept. 2009) (stating that "a circuit breaker approach raises significant implementation complexities"); letter from SIFMA (June 2009) (including a survey reflecting implementation costs of a circuit breaker triggering a short sale price test based

costs as we estimated would be incurred if we adopted a permanent, market-wide short sale price test restriction.<sup>677</sup> As one commenter stated “[o]nce the price test is in place, there is minimal incremental effort required to add a Circuit Breaker that controls the application of the price test.”<sup>678</sup> Similarly, another commenter stated that “[t]he additional coding required to implement a circuit breaker is minimal...”<sup>679</sup> We believe that there will be only minimal, if any implementation costs for a circuit breaker approach in addition to the costs we estimated previously for the implementation of a permanent, market-wide short sale price test rule because trading centers would need to establish written policies and procedures to implement the short sale price test restriction regardless of whether the short sale price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker. Several other commenters agreed, stating that the costs of the circuit breaker approach would be similar to, or only incrementally higher than, the costs of a permanent, market-wide approach.<sup>680</sup>

In addition, with respect to on-going monitoring and surveillance costs of the circuit breaker approach, we recognize, as noted by one commenter,<sup>681</sup> that trading centers will need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the circuit breaker approach, the alternative uptick rule is time limited and

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on the national best bid). We note that one commenter indicated that adoption of a circuit breaker approach would add approximately four to six weeks to the implementation time of the alternative uptick rule. See letter from Direct Edge (Sept. 2009); see also supra Section VII. (discussing comments on implementation time).

<sup>677</sup> See Proposal, 74 FR at 18087.

<sup>678</sup> Letter from Nasdaq OMX Group (Oct. 2009).

<sup>679</sup> Letter from Credit Suisse (Sept. 2009).

<sup>680</sup> See, e.g., letter from STA (June 2009).

<sup>681</sup> See letter from Glen Shipway (June 2009).

will only apply on a stock by stock basis, which will reduce our previously estimated costs for on-going monitoring and surveillance. This is because trading centers only need to monitor and surveil for compliance with the alternative uptick rule during the limited period of time that the circuit breaker is in effect with respect to a specific security. As such, the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure. As noted by one commenter, a circuit breaker “is particularly efficient in stable and rising markets because it avoids imposing continuous monitoring and compliance costs where there is little or no corresponding risk of abusive short selling.”<sup>682</sup>

Further, although, under the circuit breaker approach, market participants will need to monitor whether a stock is subject to Rule 201, we believe that familiarity with a circuit breaker approach may help mitigate such compliance costs. As discussed in the Proposal, currently, all stock exchanges and FINRA have rules or policies to implement coordinated circuit breaker halts.<sup>683</sup> Moreover, SROs have rules or policies in place to coordinate individual security trading halts corresponding to significant news events.<sup>684</sup>

On balance, we believe that the estimates of the burdens associated with the collection of information requirements for trading centers included in the Proposal<sup>685</sup> are appropriate with respect to Rule 201. Thus, our estimates have not changed from the Proposal, except to the

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<sup>682</sup> Letter from Nasdaq OMX Group (Oct. 2009); see also letter from SIFMA (Sept. 2009).

<sup>683</sup> See supra note 292.

<sup>684</sup> See, e.g., FINRA Rule 6120; see also Proposal, 74 FR at 18065-18066 (discussing the background on circuit breakers).

<sup>685</sup> See Proposal, 74 FR at 18087.

extent that total burden estimates have changed because we have updated the estimated number of trading centers.<sup>686</sup>

Although the exact nature and extent of the policies and procedures that a trading center must establish likely will vary depending upon the nature of the trading center (e.g., SRO vs. non-SRO, full service broker-dealer vs. market maker), we estimate that it initially will, on average, take an SRO trading center approximately 220 hours<sup>687</sup> of legal, compliance, information technology and business operations personnel time,<sup>688</sup> and a non-SRO trading center approximately 160 hours<sup>689</sup> of legal, compliance, information technology and business operations personnel time,<sup>690</sup> to develop the required policies and procedures.

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<sup>686</sup> The Proposal indicated that there were approximately 372 non-SRO trading centers, including approximately 325 firms that were registered equity market makers or specialists at year-end 2007 (this number was derived from annual FOCUS reports and discussion with SRO staff), as well as 47 ATSs that operate trading systems that trade NMS stocks. See Proposal, 74 FR at 18086. We now estimate that there are approximately 407 non-SRO trading centers, including approximately 357 firms that were registered equity market makers or specialists at year-end 2008 (this number was derived from annual FOCUS reports and discussion with SRO staff), as well as 50 ATSs that operate trading systems that trade covered securities. See supra note 651. We also note that the number of SRO trading centers has changed from 11 in the Proposal to 10. See supra note 650.

<sup>687</sup> For purposes of this adopting release, we are basing our estimates on the burden hour estimates provided in connection with the adoption of Regulation NMS because the policies and procedures developed in connection with that Regulation's Order Protection Rule are in many ways similar to what a trading center will need to do to comply with Rule 201. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087. We note, however, that these estimates may be on the high end because trading centers have already had to establish similar policies and procedures to comply with Regulation NMS.

<sup>688</sup> Based on experience and estimates provided in connection with Regulation NMS, we anticipate that of the 220 hours we estimate will be spent to establish the required policies and procedures, 70 hours will be spent by legal personnel, 105 hours will be spent by compliance personnel, 20 hours will be spent by information technology personnel and 25 hours will be spent by business operations personnel of the SRO trading center.

<sup>689</sup> For purposes of this adopting release, we are basing our estimates on the burden hour estimates provided in connection with the adoption of Regulation NMS because the policies and procedures developed in connection with that Regulation's Order Protection Rule are in many ways similar to what a trading center will need to do to comply with the Rule 201. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087. We note, however, that these estimates may be on the high end because trading centers have already had to establish similar policies and procedures to comply with Regulation NMS.

<sup>690</sup> Based on experience and the estimates provided in connection with Regulation NMS, we anticipate that of the 160 hours we estimate will be spent to establish policies and procedures, 37 hours will be spent by legal personnel, 77 hours will be spent by compliance personnel, 23 hours will be spent by information technology personnel and 23 hours will be spent by business operations personnel of the non-SRO trading center.

In addition to these estimates (of 220 hours for SRO respondents and 160 hours for non-SRO respondents), we expect that SRO and non-SRO respondents will incur one-time external costs for outsourced legal services. While we recognize that the amount of legal outsourcing utilized to help establish written policies and procedures may vary widely from entity to entity, we estimate that on average, each trading center will outsource 50 hours of legal time in order to establish policies and procedures in accordance with the amendments.<sup>691</sup>

We estimate that there will be an initial one-time burden of, on average, 220 (not including the outsourced 50 hours of legal time) burden hours per SRO trading center or 2,200 hours,<sup>692</sup> and, on average, 160 (not including the outsourced 50 hours of legal time) burden hours per non-SRO trading center or 65,120 hours,<sup>693</sup> for a total of 67,320 burden hours to establish the required written policies and procedures.<sup>694</sup> We estimate a cost of, on average, approximately \$8,340,000 for both SRO and non-SRO trading centers resulting from outsourced legal work.<sup>695</sup>

Once a trading center has established the required written policies and procedures, we estimate that, on average, it will take an SRO and non-SRO trading center each approximately two hours per month of on-going internal legal time and three hours of on-going internal compliance time to ensure that its written policies and procedures are up-to-date and remain in

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<sup>691</sup> As discussed above, we base our burden estimate of 50 hours of outsourced legal time on the burden estimate used for Regulation NMS because the policies and procedures developed in connection with that Regulation's Order Protection Rule are in many ways similar to what a trading center will need to do to comply with Rule 201. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087.

<sup>692</sup> The estimated 2,200 burden hours necessary for SRO trading centers to establish policies and procedures are calculated by multiplying 10 times 220 hours (10 x 220 hours = 2,200 hours).

<sup>693</sup> The estimated 65,120 burden hours necessary for non-SRO trading centers to establish policies and procedures are calculated by multiplying 407 times 160 hours (407 x 160 hours = 65,120 hours).

<sup>694</sup> See Rule 201(b).

<sup>695</sup> This figure was calculated as follows: (50 legal hours x \$400 x 10 SRO trading centers) + (50 legal hours x \$400 x 407 non-SRO trading centers) = \$8,340,000. Based on industry sources, we estimate that the average hourly rate for outsourced legal services in the securities industry is \$400.

compliance with the amendments to Rule 201, or a total of 60 hours annually per respondent.<sup>696</sup>

In addition, we estimate that, on average, it will take an SRO and non-SRO trading center each approximately 16 hours per month of on-going compliance time, 8 hours per month of on-going information technology time, and 4 hours per month of on-going legal time associated with on-going monitoring and surveillance for and enforcement of trading in compliance with Rule 201, or a total of 336 hours annually per respondent.<sup>697</sup>

## **2. Policies and Procedures Requirement under the Broker-Dealer and Riskless Principal Provisions**

To rely on the broker-dealer provision of Rule 201(c), a broker-dealer marking a short sale order in a covered security “short exempt” under Rule 201(c) must identify the order as being at a price above the current national best bid at the time of submission to the trading center and must establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the incorrect identification of orders as being submitted to the trading center at a permissible price.<sup>698</sup> At a minimum, the broker-dealer’s policies and procedures must be reasonably designed to enable a broker-dealer to monitor, on a real-time basis, the national best bid so as to determine the price at which the broker-dealer may submit a short sale order to a trading center in compliance with the requirements of Rule 201(c). In addition, a broker-dealer

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<sup>696</sup> This figure was calculated as follows: (2 legal hours x 12 months) + (3 compliance hours x 12 months) = 60 hours annually per respondent. As discussed above, this burden estimate of 60 hours is based on experience and what was estimated for Regulation NMS to ensure that written policies and procedures were up-to-date and remained in compliance. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087.

<sup>697</sup> This figure was calculated as follows: (16 compliance hours x 12 months) + (8 information technology hours x 12 months) + (4 legal hours x 12 months) = 336 hours annually per respondent. As discussed above, this burden estimate of 336 hours is based on experience and what was estimated for Regulation NMS regarding similarly required on-going monitoring and surveillance for and enforcement of trading in compliance with that regulation’s policies and procedures requirement.

<sup>698</sup> See Rule 201(c).

must take such steps as necessary to enable it to enforce its policies and procedures effectively.<sup>699</sup>

To rely on the riskless principal provision under Rule 201(d)(6) a broker-dealer must have written policies and procedures in place to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision.<sup>700</sup>

In the Proposal, we provided estimates of the reporting and recordkeeping burdens for broker-dealers to implement, monitor and surveil on an on-going basis the policies and procedures required to rely on the broker-dealer provision of Rule 201(c) or the riskless principal provision under Rule 201(d)(6).<sup>701</sup> We also requested comment, in the Proposal and the Re-Opening Release, as to whether the proposed burden estimates were appropriate or whether such estimates should be increased or reduced, and if so, for which entities and by how much.<sup>702</sup> The following discussion of comments on the proposed burden estimates for broker-dealers includes comments that were discussed above with respect to the burden estimates for trading centers<sup>703</sup>

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<sup>699</sup> This will include the requirement that broker-dealers regularly surveil to ascertain the effectiveness of their policies and procedures and take prompt remedial steps. This provision is intended to reinforce the on-going maintenance and enforcement requirements of the provision contained in Rule 201(c)(1) by explicitly assigning an affirmative responsibility to broker-dealers to surveil to ascertain the effectiveness of their policies and procedures. See Rule 201(c)(2).

<sup>700</sup> See Rule 201(d)(6).

<sup>701</sup> See Proposal, 74 FR at 18088-18089.

<sup>702</sup> See Proposal, 74 FR at 18089; Re-Opening Release, 74 FR at 42036.

<sup>703</sup> See supra Section IX.E.1. (discussing reporting and recordkeeping burdens for trading centers).

because, in some cases, commenters provided comments and estimates on the costs of establishing and monitoring policies and procedures under the proposed short sale price tests without distinguishing between costs that would be applicable to trading centers as opposed to broker-dealers.

One commenter provided a cost estimate, including costs for “development man-hours” of \$500,000 per firm for implementation of Rule 201 by broker-dealers.<sup>704</sup> One commenter stated that a new short sale price test restriction would involve “significant implementation costs” and “the generation and retention of voluminous compliance reports” but did not provide a specific estimate of the cost or hours that would be involved.<sup>705</sup> Several commenters expressed general concerns regarding the time and cost that would be imposed on market participants for implementation and on-going monitoring and surveillance of a new short sale price test restriction, including a policies and procedures requirement but did not provide specific estimates of such time and cost.<sup>706</sup>

In addition, several commenters noted that implementation and on-going monitoring and surveillance of the requirements of the broker-dealer provision would impose significant costs on broker-dealers, but did not provide an estimate of such costs.<sup>707</sup> Several commenters stated that

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<sup>704</sup> Letter from Wolverine. Wolverine provided an estimate of \$500,000 per firm for implementation costs, which it applied to both non-SRO trading centers and other registered broker-dealers.

<sup>705</sup> Letter from EWT (Sept. 2009). EWT also did not specify whether this comment on our estimated annual reporting and recordkeeping burdens with respect to provisions of the proposed rules that would require a new “collection of information” was specific to the provisions applicable to trading centers or to the provisions applicable to broker-dealers.

<sup>706</sup> See, e.g., supra note 659. These commenters’ concerns regarding implementation costs either were expressed with respect to market participants generally or included references to obligations that would be imposed on, or changes that would have to be made by, broker-dealers.

<sup>707</sup> See, e.g., letter from Credit Suisse (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from NSCP; letter from STANY (June 2009); letter from EWT (Sept. 2009).

the costs of the broker-dealer provision could be particularly burdensome for smaller broker-dealers, but did not provide a time or cost estimate of such burdens.<sup>708</sup>

We considered these comments in reviewing the burden estimates for broker-dealers that we proposed with respect to the collection of information requirements in Rule 201. We believe that the cost and time required for implementation and on-going monitoring and surveillance of the policies and procedures required to rely on the broker-dealer provision of Rule 201(c) will be lower than some commenters' stated estimates<sup>709</sup> because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price.<sup>710</sup> Because the alternative uptick rule does not require sequencing of the national best bid, we believe that the policies and procedures required in order to rely on the broker-dealer provision under the alternative uptick rule, which are similar to those required for non-SRO trading centers in complying with paragraph (b) of Rule 201, will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick

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<sup>708</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP; letter from T.D. Pro Ex. We received time estimates on the Commission's proposed implementation time, but did not receive comments with respect to the estimated PRA burden hours. See supra Section VII. (discussing comments on implementation time).

<sup>709</sup> We received comments expressing concerns about the implementation and on-going monitoring and compliance costs to broker-dealers of a short sale price test restriction that were not specific to the alternative uptick rule. See, e.g., letter from Credit Suisse (June 2009); letter from RBC (June 2009); letter from STANY (June 2009); letter from CPIC (June 2009); letter from Wolverine; letter from T.D. Pro Ex; letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from NSCP.

<sup>710</sup> We also note that it is possible that some smaller broker-dealers that determine to rely on the broker-dealer provision may determine that it is cost-effective for them to outsource certain functions necessary to comply with Rule 201(c) to larger broker-dealers, rather than performing such functions in house, to remain competitive in the market. This may help mitigate costs associated with implementing and complying with Rule 201(c). Additionally, they may decide to purchase order management software from technology firms. Order management software providers may integrate changes imposed by Rules 200(g) and 201 into their products, thereby providing another cost-effective way for smaller broker-dealers to comply with the requirement of Rule 201(c).

rule.<sup>711</sup> We note that one of the commenters that expressed concerns about the implementation cost of the broker-dealer provision also acknowledged that a rule “that would not require data centralization and sequencing would be significantly less complex and faster to implement.”<sup>712</sup>

We disagree with several commenters who stated that, although implementation and on-going monitoring and surveillance of the alternative uptick rule might be easier and/or less costly for trading centers, this would not hold true for broker-dealers.<sup>713</sup> One of these commenters stated that “in order to avoid rejection of short sale orders under an alternative uptick rule, programming would need to be implemented to anticipate changes in the national best bid between the time a short sale order is entered and the time it reaches the relevant market center.”<sup>714</sup> However, the broker-dealer provision of Rule 201(c) is designed specifically to help avoid this result. Under the broker-dealer provision, a broker-dealer may, in accordance with the policies and procedures required by the provision, identify the order as being at a price that is above the current national best bid at the time the order is submitted to the trading center and mark the order “short exempt.” Trading centers are required to have written policies and procedures in place to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.<sup>715</sup>

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<sup>711</sup> See supra notes 660 to 669 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>712</sup> Letter from Credit Suisse (June 2009).

<sup>713</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from EWT (Sept. 2009); letter from Lime Brokerage (Sept. 2009).

<sup>714</sup> Letter from Citadel et al. (Sept. 2009).

<sup>715</sup> See Rule 201(b)(1)(iii).

In addition, as noted in the Proposal, while we have based our burden estimates on the burden estimates provided in connection with the adoption of Regulation NMS with respect to non-SRO trading centers (which includes broker-dealers),<sup>716</sup> we note that these estimates may be on the high end for those broker-dealers that have already had to establish policies and procedures in connection with that Regulation's Order Protection Rule, which could help form the basis for the policies and procedures for the broker-dealer provision of Rule 201(c), or the riskless principal provision under Rule 201(d)(6). Several commenters agreed, indicating that broker-dealers' previous experience with the policies and procedures required under Regulation NMS might reduce the implementation and on-going monitoring and compliance burdens on broker-dealers.<sup>717</sup> Some commenters stated that the Commission overstated the benefit of such previous experience<sup>718</sup> because, for example, "systems re-written and architected for Reg NMS ... did not include any short sale restrictions,"<sup>719</sup> or because such systems will require modifications in order to be used in the context of a short sale price test restriction.<sup>720</sup> However, we considered these issues when considering the impact of previous experience with the policies and procedures requirement of Regulation NMS's Order Protection Rule. We continue to believe that because broker-dealers may already have in place systems and written policies and procedures in connection with Regulation NMS's Order Protection Rule, those broker-dealers will already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, which will mitigate the burden of implementation of the policies and procedures

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<sup>716</sup> See supra note 670.

<sup>717</sup> See, e.g., letter from EWT (Sept. 2009); letter from MFA (Oct. 2009).

<sup>718</sup> See, e.g., letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009).

<sup>719</sup> Letter from FIF (June 2009); see also letter from RBC (June 2009).

<sup>720</sup> See letter from NSCP; letter from RBC (June 2009).

requirement under the broker-dealer provision of Rule 201(c), or the riskless principal provision under Rule 201(d)(6). We realize, however, that the exact nature and extent of the policies and procedures that a broker-dealer must establish likely will vary depending upon the type, size, and nature of the broker-dealer. Thus, our estimates take into account different types of broker-dealers and we realize that these estimates may be on the low-end for some broker-dealers while they may be on the high-end for other broker-dealers.

We considered whether our estimates of the burdens associated with the collection of information requirements for broker-dealers with respect to the proposed modified uptick rule included in the Proposal<sup>721</sup> would change under the circuit breaker approach of Rule 201, but concluded, as discussed below, that these estimates continue to represent reasonable estimates under the circuit breaker approach.

As discussed previously,<sup>722</sup> despite some commenters' concerns regarding the implementation costs of a circuit breaker rule,<sup>723</sup> we believe that the circuit breaker approach will result in largely the same implementation costs as we estimated would be incurred if we adopted a permanent, market-wide short sale price test restriction.<sup>724</sup> We believe that that there will be only minimal, if any, implementation costs for a circuit breaker approach in addition to the costs we estimated previously for the implementation of a permanent, market-wide short sale price test rule because broker-dealers relying on Rule 201(c) or Rule 201(d)(6) must establish written policies and procedures required to comply with those provisions regardless of whether the short sale

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<sup>721</sup> See Proposal, 74 FR at 18088-18089.

<sup>722</sup> See *supra* Section IX.E.1. (discussing estimated burdens of the collection of information requirements applicable to trading centers under Rule 201).

<sup>723</sup> See *supra* note 676.

<sup>724</sup> See Proposal, 74 FR at 18088.

price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker. Several other commenters agreed, stating that the costs of the circuit breaker approach would be similar to, or only incrementally higher than, the costs of a permanent, market-wide approach.<sup>725</sup>

In addition, with respect to on-going monitoring and surveillance costs of the circuit breaker approach, we recognize, as noted by one commenter,<sup>726</sup> that broker-dealers relying on Rule 201(c) or Rule 201(d)(6) must continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the circuit breaker approach, the alternative uptick rule is time limited and will only apply on a stock by stock basis, which will reduce our previously estimated costs for on-going monitoring and surveillance. This is because broker-dealers relying on Rule 201(c) will only need to monitor and surveil for compliance with the alternative uptick rule, and broker-dealers relying on Rule 201(d)(6) will only need to monitor for compliance with the requirements of that provision, during the limited period of time that the circuit breaker is in effect with respect to a specific security. As such, the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure.<sup>727</sup>

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<sup>725</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from Credit Suisse (Sept. 2009); letter from STA (June 2009).

<sup>726</sup> See letter from Glen Shipway (June 2009).

<sup>727</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

On balance, we believe that the estimates of the burdens associated with the collection of information requirements for broker-dealers included in the Proposal<sup>728</sup> are appropriate with respect to Rule 201. Thus, our estimates have not changed from the Proposal, except to the extent that total burden estimates have changed because we have updated the estimated number of broker-dealers.<sup>729</sup>

Although the exact nature and extent of the required policies and procedures that a broker-dealer must establish under the broker-dealer or the riskless principal provisions likely will vary depending upon the nature of the broker-dealer (e.g., full service broker-dealer vs. market maker), we estimate that it initially will, on average, take a broker-dealer approximately 160 hours<sup>730</sup> of legal, compliance, information technology and business operations personnel time,<sup>731</sup> to develop the required policies and procedures. In addition to this estimate of 160 hours, we expect that broker-dealers will incur one-time external costs for outsourced legal services. While we recognize that the amount of legal outsourcing utilized to help establish written policies and procedures will vary widely from entity to entity, we estimate that on

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<sup>728</sup> See Proposal, 74 FR at 18088-18089.

<sup>729</sup> The Proposal indicated that there were approximately 5,561 broker-dealers. This number was based on a review of 2007 FOCUS Report filings reflecting registered broker-dealers, including introducing broker-dealers. This number did not include broker-dealers that were delinquent on FOCUS Report filings. See Proposal, 74 FR at 18086. We now estimate that there are approximately 5,178 broker-dealers. See supra note 652 and accompanying text.

<sup>730</sup> We base this estimate of 160 hours on the estimated burden hours we believe it will take a non-SRO trading center (which includes broker-dealers) to develop similarly required policies and procedures, since the policies and procedures required under the broker-dealer provision or the riskless principal exception will be similar to those required for non-SRO trading centers in complying with paragraph (b) of Rule 201. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087.

<sup>731</sup> Based on experience and the estimates provided in connection with Regulation NMS, we anticipate that of the 160 hours we estimate will be spent to establish policies and procedures, 37 hours will be spent by legal personnel, 77 hours will be spent by compliance personnel, 23 hours will be spent by information technology personnel and 23 hours will be spent by business operations personnel of the broker-dealer.

average, each broker-dealer will outsource 50 hours<sup>732</sup> of legal time in order to establish policies and procedures in accordance with the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6).

We estimate that, on average, there will be an initial one-time burden of 160 burden hours per broker-dealer or 828,480 hours<sup>733</sup> to establish policies and procedures required under the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6). We estimate an average cost of approximately \$103,560,000 for broker-dealers resulting from outsourced legal work.<sup>734</sup>

Once a broker-dealer has established written policies and procedures that are required under Rule 201(c) or Rule 201(d)(6), we estimate that it will take, on average, a broker-dealer approximately two hours per month of internal legal time and three hours of internal compliance time to ensure that its written policies and procedures are up-to-date and remain in compliance with Rule 201(c) or 201(d)(6), or a total of 60 hours annually per respondent.<sup>735</sup> In addition, we estimate that, on average, it will take a broker-dealer approximately 16 hours per month of on-going compliance time, 8 hours per month of on-going information technology time, and 4 hours per month of on-going legal time associated with on-going monitoring and surveillance for and

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<sup>732</sup> As discussed above, we base our burden estimate of 50 hours of outsourced legal time on the burden estimate used for Regulation NMS because the policies and procedures developed in connection with that Regulation's Order Protection Rule are in many ways similar to what a broker-dealer will need to do to comply with the policies and procedures required under the broker-dealer provision and the riskless principal exception of Rule 201. See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087.

<sup>733</sup> The estimated 828,480 burden hours necessary for a broker-dealer to establish policies and procedures are calculated by multiplying 5,178 times 160 hours (5,178 x 160 hours = 828,480 hours). See supra note 730.

<sup>734</sup> This figure was calculated as follows: (50 legal hours x \$400 x 5,178 broker-dealers) = \$103,560,000. Based on industry sources, we estimate that the average hourly rate for outsourced legal services in the securities industry is \$400.

<sup>735</sup> This figure was calculated as follows: (2 legal hours x 12 months) + (3 compliance hours x 12 months). As discussed above, this burden estimate of 60 hours is based on experience and what was estimated for a Regulation NMS respondent to ensure that its written policies and procedures were up-to-date and remained in compliance.

enforcement of trading in compliance with Rule 201, or a total of 336 hours annually per respondent.<sup>736</sup>

### 3. Marking Requirements

The amendments to Rule 200(g) add a new marking requirement of “short exempt.”<sup>737</sup> In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>738</sup>

In the Proposal, we provided estimates of the reporting and recordkeeping burdens for the “short exempt” marking requirement. We also requested comment, in the Proposal and Re-Opening Release, on the accuracy of such estimates.<sup>739</sup>

Several commenters noted that the “short exempt” marking requirement would impose significant implementation costs, but did not provide a specific estimate of such costs.<sup>740</sup> One commenter stated that costs of the “short exempt” marking requirement would be worth the benefits gained.<sup>741</sup> We considered these comments in reviewing the burden estimates of the “short exempt” marking requirement of Rule 200(g).

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<sup>736</sup> This figure was calculated as follows: (16 compliance hours x 12 months) + (8 information technology hours x 12 months) + (4 legal hours x 12 months) = 336 hours annually per respondent. As discussed above, this burden estimate of 336 hours is based on experience and what was estimated for Regulation NMS for similarly required on-going monitoring and surveillance for and enforcement of trading in compliance with that regulation’s policies and procedures requirement.

<sup>737</sup> See Rule 200(g); see also *supra* Section IV. (discussing the amendments to Rule 200(g)).

<sup>738</sup> See Rule 200(g)(2).

<sup>739</sup> See Proposal, 74 FR at 18089; Re-Opening Release, 74 FR at 42036.

<sup>740</sup> See, e.g., letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009).

<sup>741</sup> See letter from STA (June 2009).

We also considered whether our estimates of the burdens associated with the collection of information requirements for broker-dealers with respect to the amendments to Rule 200(g) in conjunction with the proposed modified uptick rule included in the Proposal<sup>742</sup> would change under the circuit breaker approach of Rule 201, but concluded, as discussed below, that these estimates continue to represent reasonable estimates under the circuit breaker approach.

We believe that the “short exempt” marking requirements of Rule 200(g), in conjunction with a circuit breaker approach, will result in largely the same implementation costs as would be incurred if the “short exempt” marking requirements were combined with a market-wide short sale price test restriction. This is because broker-dealers relying on the provisions of Rule 201(c) or Rule 201(d) would need to make systems changes to implement the “short exempt” marking requirements regardless of whether the short sale price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker.

In addition, with respect to on-going monitoring and surveillance costs of the “short exempt” marking requirements in conjunction with a circuit breaker approach, we recognize, as noted by one commenter,<sup>743</sup> that market participants will need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the circuit breaker approach, use of the “short exempt” provisions of Rule 201(c) and Rule 201(d) and the related marking requirements are time limited and will only apply on a stock by stock basis, which will reduce our previously estimated costs for on-going monitoring and surveillance. This is because broker-dealers who choose to rely on Rule 201(c) or Rule 201(d) will only need to

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<sup>742</sup> See Proposal, 74 FR at 18089.

<sup>743</sup> See letter from Glen Shipway (June 2009).

monitor and surveil for compliance with the requirements of those provisions and will only need to mark qualifying orders “short exempt” during the limited period of time that the circuit breaker is in effect with respect to a specific security. As such, the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure.<sup>744</sup>

On balance, we believe our proposed estimates of the burdens associated with the collection of information requirements of the “short exempt” marking requirement<sup>745</sup> are appropriate with respect to Rule 200(g) as adopted. Thus, our estimates have not changed from the Proposal, except to the extent that total burden estimates have changed because we have updated the estimated number of broker-dealers.<sup>746</sup>

We believe that the implementation cost of the “short exempt” marking requirement will likely be similar to the implementation cost of the order marking requirements of Rule 200(g) of Regulation SHO, which had originally included the category of “short exempt.” Industry sources at that time estimated initial implementation costs for the former “short exempt” marking requirement to be approximately \$100,000 to \$125,000.<sup>747</sup> Based on these estimates, as adjusted for inflation, we estimate that the initial implementation cost of the “short exempt” marking

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<sup>744</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>745</sup> See Proposal, 74 FR at 18089.

<sup>746</sup> See supra note 729.

<sup>747</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48023.

requirement will be approximately \$115,000 to \$145,000 per broker-dealer<sup>748</sup> for a total initial implementation cost of approximately \$595,470,000 to \$750,810,000 for all broker-dealers.<sup>749</sup>

While not all broker-dealers likely will enter sell orders in securities covered by the amendments to Rules 200(g) and 201 in a manner that will subject them to this collection of information, we estimate, for purposes of the PRA, that all of the approximately 5,178 registered broker-dealers will do so. For purposes of the PRA, the Staff has estimated that a total of approximately 12.9 billion “short exempt” orders are entered annually.<sup>750</sup>

This is an average of approximately 2,491,309 annual responses by each respondent.<sup>751</sup> As we discussed in the Proposal, each response of marking sell orders “short exempt” will take approximately .000139 hours (.5 seconds) to complete. This estimate is based on the same time estimate for marking sell orders “long” or “short” used upon adoption of Rule 200(g) under Regulation SHO.<sup>752</sup> We believe this estimate is appropriate because, in accordance with the current marking requirements of Rule 200(g) of Regulation SHO, broker-dealers are already

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<sup>748</sup> The adjustment for inflation was calculated using information in the Consumer Price Index, U.S. Department of Labor, Bureau of Labor Statistics.

<sup>749</sup> These figures were calculated as follows:  $(\$115,000 \times 5,178) = \$595,470,000$  and  $(\$145,000 \times 5,178) = \$750,810,000$ .

<sup>750</sup> As we stated in the Proposal, our estimate of 12.9 billion “short exempt” orders was calculated based on a review of short sale trades and short sale orders during August 2008. We believe that August 2008 data is representative of a normal month of trading. Specifically, we calculated that there were about 263 million short sale trades during August 2008 for Amex, FINRA, Nasdaq, NYSE Arca, and NYSE market centers. Based on a review of Rule 605 reports from the three largest market centers during August 2008, we estimate a ratio of 14.4 orders to trades. We gross up 263 million short sale trades by 14.4, which yields 3.8 billion short sale orders during August 2008 or an annualized figure of 45.4 billion. We estimate that approximately 28.5% of short sale orders are short exempt using Nasdaq short sale data from January to April 2005. We multiply 45.4 billion times 0.285 to obtain our estimate of 12.9 billion short exempt orders. See Proposal, 74 FR at 18089. We also note that, because the circuit breaker rule will not be in place at all times or for all securities, the frequency and, therefore, the estimated burden of marking “short exempt” is expected to be lower. We did not receive any comments on the estimated number of annual “short exempt” orders.

<sup>751</sup> This figure was calculated as follows: 12.9 billion “short exempt” orders divided by 5,178 broker-dealers.

<sup>752</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48023, n.140; see also 2003 Regulation SHO Proposing Release, 68 FR at 63000, n.232.

required to mark a sell order either “long” or “short.” Thus, most broker-dealers already have the necessary mechanisms and procedures in place and are already familiar with processes and procedures to comply with the marking requirements of Rule 200(g) of Regulation SHO and broker-dealers will be able to continue to use the same mechanisms, processes and procedures to comply with the amendments to Rules 200(g) and 200(g)(2). We note, however, that this estimate may be too high given technological advances, such as automation of sell order marking, since the adoption of Rule 200(g) in 2004.

Thus, the total approximate estimated annual hour burden per year is 1,793,100 burden hours (12,900,000,000 orders marked “short exempt” multiplied by 0.000139 hours/order marked “short exempt”). Our estimate for the paperwork compliance for the marking requirement of Rule 200(g) for each broker-dealer is approximately 346 burden hours (2,491,309 responses multiplied by 0.000139 hours/responses) or (a total of 1,793,100 burden hours divided by 5,178 respondents).

## **F. Collection of Information Is Mandatory**

### **1. Policies and Procedures Requirements**

The collection of information required under Rule 201’s policies and procedures requirement is mandatory for trading centers executing and displaying short sale orders in covered securities. The collection of information required under Rule 201’s policies and procedures requirements in connection with the broker-dealer provision in Rule 201(c) and the riskless principal exception in Rule 201(d)(6) is mandatory for broker-dealers relying on these provisions.

## **2. Marking Requirements**

The collection of information is mandatory for all broker-dealers submitting sale orders marked “short exempt” in reliance on one of the provisions contained in paragraph (c) or (d) of Rule 201.

### **G. Confidentiality**

#### **1. Policies and Procedures Requirements**

We expect that the information collected pursuant to Rule 201’s required policies and procedures for trading centers will be communicated to the members, subscribers, and employees (as applicable) of all trading centers. In addition, the information collected pursuant to Rule 201’s required policies and procedures for trading centers will be retained by the trading centers and will be available to the Commission and SRO examiners upon request, but not subject to public availability. The information collected pursuant to Rule 201’s broker-dealer provision and the riskless principal exception will be retained by the broker-dealers and will be available to the Commission and SRO examiners upon request, but not subject to public availability.

#### **2. Marking Requirements**

The information collected pursuant to the “short exempt” marking requirements in Rule 200(g) and Rule 200(g)(2) will be submitted to trading centers and will be available to the Commission and SRO examiners upon request. The information collected pursuant to the “short exempt” marking requirement may be publicly available because it may be published, in a form that would not identify individual broker-dealers, by SROs that publish on their Internet Web sites aggregate short selling volume data in each individual equity security for that day and, on a one-month delayed basis, information regarding individual short sale transactions in all exchange-listed equity securities.

## **H. Record Retention Period**

### **1. Policies and Procedures Requirements**

Any records generated in connection with Rule 201's requirements that trading centers and broker-dealers (with respect to the broker-dealer and riskless principal provisions) establish written policies and procedures must be preserved in accordance with, and for the periods specified in, Exchange Act Rules 17a-1<sup>753</sup> for SRO trading centers and 17a-4(e)(7)<sup>754</sup> for non-SRO trading centers and registered broker-dealers.

### **2. Marking Requirements**

The amendments to Rule 200(g) and Rule 200(g)(2) do not contain any new record retention requirements. All registered broker-dealers that are subject to the amendments are currently required to retain records in accordance with Rule 17a-4(e)(7) under the Exchange Act.<sup>755</sup>

## **X. Cost-Benefit Analysis**

We are sensitive to the costs and benefits of our rules. To assist us in evaluating the costs and benefits of the amendments to Regulation SHO, in the Proposal and the Re-Opening Release, we encouraged commenters to discuss any costs or benefits that the proposed rules might impose.<sup>756</sup> In particular, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposed amendments for registrants, issuers, investors, broker-dealers, other securities industry

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<sup>753</sup> 17 CFR 240.17a-1.

<sup>754</sup> 17 CFR 240.17a-4(e)(7).

<sup>755</sup> Id.

<sup>756</sup> See Proposal, 74 FR at 18090; Re-Opening Release, 74 FR at 42037.

professionals, regulators, and others.<sup>757</sup> We also requested comment as to the extent to which placing price restrictions on short selling could impact or lessen some of the benefits of legitimate short selling or could lead to a decrease in market efficiency, price discovery, or liquidity.<sup>758</sup> Commenters were requested to provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Rule 201 and Rule 200(g).<sup>759</sup> We discuss below the benefits and costs, including cost mitigation features, of Rule 201.

#### **A. Benefits**

We believe it is appropriate at this time to adopt in Rule 201 a circuit breaker approach combined with the alternative uptick rule. Specifically, Rule 201(b) requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>760</sup> In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>761</sup>

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<sup>757</sup> See Proposal, 74 FR at 18090.

<sup>758</sup> See *id.*

<sup>759</sup> See *id.*; Re-Opening Release, 74 FR at 42037.

<sup>760</sup> Rule 201(b).

<sup>761</sup> Rule 201(b).

In conjunction with the amendments to Rule 201, we are amending Rule 200(g) of Regulation SHO to provide that a broker-dealer may mark certain qualifying sell orders “short exempt.” In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>762</sup>

We discuss below the benefits of Rule 201 with respect to two inter-related aspects of the Rule: the short sale price test restriction, specifically the alternative uptick rule, and the circuit breaker approach that triggers application of that restriction. We have separated the discussion into two parts in order to more clearly address the comments that we received with respect to the various aspects of Rule 201. However, the circuit breaker approach and the alternative uptick rule under Rule 201 operate in conjunction with one another and should not be considered isolated provisions.

### **1. Alternative Uptick Rule**

The alternative uptick rule is designed to prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid. By not allowing short sellers to sell at or below the current national best bid, the alternative uptick rule will allow long sellers, by selling at the bid, to sell first in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long sellers to sell first in a declining market.<sup>763</sup> A short seller that is seeking to profit quickly from accelerated, downward market moves may find it advantageous to

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<sup>762</sup> See Rules 200(g) and 200(g)(2).

<sup>763</sup> See supra note 17.

be able to short sell at the current national best bid. By placing long sellers ahead of short sellers in the execution queue under certain circumstances, Rule 201 will help promote capital formation, since investors may be more willing to hold long positions if they know they may have a preferred position over short sellers when they wish to sell.<sup>764</sup>

In addition, because the alternative uptick rule, when triggered, will generally permit short selling only at a price above the current national best bid, the alternative uptick rule will not allow short sales to get immediate execution at the bid.<sup>765</sup> In other words, short sellers will not be permitted to act as liquidity takers when the alternative uptick rule applies, but will participate, if at all, as liquidity providers (unless an exception applies), adding depth to the market. Put another way, unless an exception applies, short sales will execute only when purchasers arrive willing to buy at prices above the national best bid. In discussing the alternative uptick rule, one commenter stated that “[n]ot only does it faithfully replicate the old uptick rule it improves upon it by making each and every short sale a liquidity providing transaction.”<sup>766</sup>

Further, the alternative uptick rule is designed to help restore investor confidence in the securities markets.<sup>767</sup> It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security’s continued price

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<sup>764</sup> But see infra notes 821 to 827 and accompanying text (discussing the potential negative impact of Rule 201 on various trading strategies that include short selling).

<sup>765</sup> As noted by some commenters, there may be situations in which a short seller could get immediate execution, such as where an order is executed in a facility that provides executions at the mid-point of the national best bid and offer. See, e.g., letter from ISE (Sept. 2009); see also letter from BATS (Sept. 2009).

<sup>766</sup> Letter from Glen Shipway (Sept. 2009).

<sup>767</sup> See, e.g., supra note 94 (citing comment letters suggesting that reinstatement of short price test restrictions in some form will help restore investor confidence in the markets).

decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors. Bolstering investor confidence in the markets should help to encourage investors to be more willing to invest in the markets, thus adding depth and liquidity to the markets. In addition, we note that a number of commenters stated that they believe that a short sale price test restriction will aid small investors.<sup>768</sup>

As we stated in the Proposal, short sale price test restrictions, whether a permanent market-wide restriction or in combination with a circuit breaker, might help prevent short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.<sup>769</sup> Because the alternative uptick rule only permits short selling at a price above the current national best bid, unless an exception applies, we believe it will be more effective than the proposed uptick rule or the proposed modified uptick rule at achieving our goals in helping to prevent short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security. Several commenters stated that the alternative uptick rule would dramatically decrease price pressure on a security<sup>770</sup> and, thereby, the ability of market participants to use short selling as a market manipulation tool.<sup>771</sup> Another commenter, in supporting the alternative uptick rule,

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<sup>768</sup> See supra note 97 (citing commenters who stated that a short sale price test restriction would aid small investors).

<sup>769</sup> See Proposal, 74 FR at 18050, 18053, 18059, 18061, 18065, 18069; see also Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1<sup>st</sup> Sess., at 251 (1963).

<sup>770</sup> See, e.g., letter from BATS (Sept. 2009); letter from Wells Fargo (Sept. 2009); see also letter from SIFMA (Sept. 2009) (stating that a circuit breaker coupled with the alternative uptick rule “would limit instances where a security is the subject of severe downward pressure”).

<sup>771</sup> See letter from BATS (Sept. 2009); letter from Wells Fargo (Sept. 2009); letter from STA (Sept. 2009); letter from Glen Shipway (Sept. 2009).

stated that it would “likely be more restrictive on short selling than the original Rule 10a-1 ‘uptick rule’.”<sup>772</sup>

In addition, we believe that the alternative uptick rule is preferable to the proposed modified uptick rule or the proposed uptick rule, in part, because it will be easier and less costly to implement and monitor. Unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, the alternative uptick rule references only the current national best bid. Several commenters expressed support for the alternative uptick rule, stating that the alternative uptick rule was preferable to the proposed modified uptick rule or the proposed uptick rule because it would eliminate sequencing issues<sup>773</sup> and would be easier and less costly to implement.<sup>774</sup> One commenter noted that the alternative uptick rule would simplify on-going surveillance and enforcement, as compared to the other proposed short sale price test restrictions.<sup>775</sup> In addition, we believe that the implementation and on-going monitoring and compliance costs of the alternative uptick rule are justified by the benefits provided in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

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<sup>772</sup> Letter from Virtu Financial.

<sup>773</sup> See, e.g., letter from Direct Edge (June 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from STA (Sept. 2009); letter from Wells Fargo (Sept. 2009); see also letter from Hudson River Trading (expressing a preference for the alternative uptick rule, as opposed to the proposed modified uptick rule or the proposed uptick rule, if in conjunction with a circuit breaker); see also supra notes 661 to 664 and accompanying text.

<sup>774</sup> See, e.g., letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from European Investors (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from STA (Sept. 2009); letter from Glen Shipway (Sept. 2009); letter from T. Rowe Price (Sept. 2009); letter from Wells Fargo (Sept. 2009); see also letter from Hudson River Trading; see also supra notes 661 to 664 and accompanying text.

<sup>775</sup> See letter from SIFMA (Sept. 2009).

## 2. Circuit Breaker Approach

Under the circuit breaker approach, the alternative uptick rule will apply only if the price of a covered security has declined by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>776</sup> In addition, the short sale price test restriction will only remain in place for the remainder of the day and for the following day.<sup>777</sup> The listing market for each covered security must determine whether that covered security is subject to Rule 201<sup>778</sup> and must immediately notify the single plan processor responsible for consolidation of information for the covered security in accordance with Rule 603(b) of Regulation NMS<sup>779</sup> of the fact that a covered security has become subject to the short sale price test restriction of Rule 201. The plan processor must then disseminate this information.<sup>780</sup>

We believe that a circuit breaker approach strikes the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets.<sup>781</sup> The circuit breaker approach of Rule 201 will help benefit the market for a particular security by allowing participants, when a security is undergoing a significant intra-day price decline, an opportunity to re-evaluate circumstances and respond to

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<sup>776</sup> See Rule 201(b).

<sup>777</sup> See *id.*

<sup>778</sup> See Rule 201(b)(3).

<sup>779</sup> 17 CFR 242.603(b); see *supra* note 368.

<sup>780</sup> See Rule 201(b)(3); 17 CFR 242.603(b).

<sup>781</sup> See *supra* Section III.A.4.

volatility in that security. We also believe that a circuit breaker will better target short selling that may be related to potential bear raids<sup>782</sup> and other forms of manipulation that may be used to exacerbate a price decline in a covered security.

In response to our requests for comment, some commenters expressed support for a circuit breaker approach because it would be more narrowly-tailored to address our concerns about the effects of short selling in a market subject to a significant downturn than a permanent, market-wide short sale price test restriction.<sup>783</sup> For example, one commenter noted that “by implementing the alternative uptick rule only after a circuit breaker threshold has been reached, [the commenter] believes the Commission would strike the appropriate balance between the desirable goals of maximizing efficiency when the market is operating within normal trading ranges and prohibiting potentially abusive short selling when it is not, while refraining from imposing excessive implementation costs on the industry.”<sup>784</sup> Another commenter stated that a circuit breaker is preferable because it “will restrict short selling when prices begin to decline substantially and short selling becomes more likely to be abusive and potentially harmful.”<sup>785</sup>

As discussed above, short selling is an important tool in price discovery and the provision of liquidity to the market, and we recognize that imposition of a short selling circuit breaker that when triggered imposes the alternative uptick rule could restrict otherwise legitimate short selling activity

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<sup>782</sup> See supra note 36 and accompanying text.

<sup>783</sup> See, e.g., letter from Direct Edge (June 2009); letter from Citadel et al. (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from BATS (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from Hudson River Trading (Sept. 2009); letter from Qtrade; letter from SIFMA (Sept. 2009); letter from Virtu Financial; see also letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009); letter from Nasdaq OMX Group (Oct. 2009).

<sup>784</sup> Letter from BATS (Sept. 2009).

<sup>785</sup> Letter from Nasdaq OMX Group (Oct. 2009); see also letter from Goldman Sachs (June 2009); letter from BATS (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Virtu Financial.

during periods of significant volatility. Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day. As discussed previously,<sup>786</sup> commenters' estimates and the Staff's analysis show that a 10% circuit breaker threshold generally should affect only a limited percentage of covered securities. In addition, when triggered, the short sale price test restriction will apply for a limited period of time, i.e., the remainder of the day and the following day, rather than all the time. Thus, Rule 201 is structured so that it will not be triggered for the majority of covered securities most of the time and, thereby, will not interfere with the smooth functioning of the markets for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. To the extent that Rule 201 results in a disruption to the smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

Several commenters stated their belief that implementing short sale price test restrictions on a permanent, market-wide basis, rather than in combination with a circuit breaker, would substantially diminish the benefits that short sellers bring to the markets.<sup>787</sup> Another commenter stated that a circuit breaker is preferable to a permanent, market-wide short sale price test restriction because it “permits normal market activity while a stock is trading in a natural range

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<sup>786</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level).

<sup>787</sup> See, e.g., letter from Direct Edge (Sept. 2009); letter from Credit Suisse (Sept. 2009).

and short selling is more likely to benefit the market (by, for example, increasing price discovery and liquidity).”<sup>788</sup>

The Commission has long held the view that circuit breakers may help restore investor confidence during times of substantial uncertainty.<sup>789</sup> We believe that the requirements of Rule 201 will produce such benefits. By imposing the alternative uptick rule once a security’s price is experiencing a significant intra-day price decline, the short selling circuit breaker rule in Rule 201(b) is designed to target only those securities that experience such declines and, therefore, will help to prevent short selling from being used as a tool to exacerbate the decline in the price of those securities. This approach establishes a narrowly-tailored Rule that targets only those securities experiencing such a decline and which only applies a short sale price test restriction for a limited period of time. We believe that addressing short selling in connection with such declines will help restore investor confidence in the markets generally. One commenter noted that “preventing rapid declines in stock prices strengthens investor confidence.”<sup>790</sup> Another commenter stated that a circuit breaker triggering a short sale price test restriction would provide “investors with confidence that short sellers will be restricted from conducting any perceived market manipulation strategies such as ‘bear raids.’”<sup>791</sup>

A circuit breaker approach will also allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure. As noted by one commenter, a circuit breaker “is

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<sup>788</sup> Letter from Nasdaq OMX Group (Oct. 2009); see also letter from Goldman Sachs (June 2009); letter from BATS (Sept. 2009); letter from SIFMA (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Virtu Financial.

<sup>789</sup> See, e.g., 1998 Release, 63 FR 18477; see also Proposal, 74 FR at 18067.

<sup>790</sup> Letter from BIO.

<sup>791</sup> Letter from Brian M. Collie, Esq., Associate, Taurus Compliance Consulting, LLC, dated June 19, 2009 (“Taurus Compliance”).

particularly efficient in stable and rising markets because it avoids imposing continuous monitoring and compliance costs where there is little or no corresponding risk of abusive short selling.”<sup>792</sup>

Requiring the listing market for a covered security to determine whether the security has become subject to the short sale price test restrictions of Rule 201 will help ensure consistency for each covered security with respect to such determinations as only the listing market for that covered security will be making the determination. In addition, we believe that listing markets will be in the best position to respond to anomalous or unforeseeable events that may impact a covered security’s price, such as an erroneous trade, because the listing markets generally have in place specific procedures designed to address such events.<sup>793</sup> Further, because the single plan processors currently receive information from listing markets regarding trading restrictions (i.e. Regulatory Halts as defined in those plans) on individual securities and disseminate such information, the requirements of Rule 201(b)(3) are similar to existing obligations on plan processors pursuant to the requirements of Regulation NMS, the CTA and CQ Plans and the Nasdaq UTP Plan.

### **3. Marking Requirements**

The “short exempt” marking requirements under Rule 200(g) will provide a record that a broker-dealer is availing itself of the provisions of paragraph (c) or (d) of Rule 201. Thus, the records created pursuant to the “short exempt” marking requirements of Rule 200(g) will aid surveillance by SROs and the Commission for compliance with the provisions of Rule 201. In addition, the “short exempt” marking requirement will provide an indication to a trading center

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<sup>792</sup> Letter from Nasdaq OMX Group (Oct. 2009); see also letter from SIFMA (Sept. 2009).

<sup>793</sup> See supra note 327 (discussing NYSE’s procedures to ensure the accuracy and reliability of its closing price).

regarding when it must execute or display a short sale order without regard to whether the order is at a price that is less than or equal to the current national best bid and will aid broker-dealers in complying with their legal requirements.

In response to our requests for comment, several commenters indicated that requiring broker-dealers to mark all sell orders “long,” “short,” or “short exempt” would provide valuable information to the Commission<sup>794</sup> and that such information would be worth the costs of requiring such marking.<sup>795</sup> One commenter stated that the information provided by a “short exempt” marking requirement would provide the Commission with data on the extent to which exceptions are being used to circumvent the requirements of Rule 201.<sup>796</sup>

## **B. Costs**

In the Proposal, we discussed the anticipated costs of the proposed short sale price test restrictions, both on a permanent, market-wide basis and in conjunction with a circuit breaker.<sup>797</sup> We requested comment, in the Proposal and Re-Opening Release, on the costs associated with the proposed amendments.<sup>798</sup> In particular, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures.<sup>799</sup> We also requested comment as to the extent to which placing price restrictions on short selling could impact or lessen some of the benefits of legitimate short selling or could lead to a decrease in market

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<sup>794</sup> See, e.g., letter from STA (June 2009); letter from CFA.

<sup>795</sup> See, e.g., letter from STA (June 2009).

<sup>796</sup> See letter from STA (June 2009).

<sup>797</sup> See Proposal, 74 FR at 18092-18100.

<sup>798</sup> See Proposal, 74 FR at 18100; Re-Opening Release, 74 FR at 42037.

<sup>799</sup> See Proposal, 74 FR at 18090.

efficiency, price discovery, or liquidity.<sup>800</sup> We discuss the comments that we received with respect to the costs of Rule 201 in detail in Sections X.B.1., X.B.2., X.B.3 and X.B.4., below.

We recognize that Rule 201 will impose costs on market participants to implement and assure compliance with the requirements of the Rule. After considering empirical evidence regarding former Rule 10a-1 and the comments that we received in response to the Proposal and the Re-Opening Release, as discussed below, we believe that Rule 201 will have a minimal, if any, negative effect on market liquidity, price efficiency, and quote depths.<sup>801</sup> In addition, we recognize that there will be market costs associated with Rule 201 in terms of the potential impact of such a short sale-related circuit breaker on execution speed and probability. By requiring for a limited time-period that short sales may only be executed or displayed above the current national best bid once a covered security has experienced an intra-day price decline of 10% or more, Rule 201 may slow the speed of executions and impose additional costs on market participants, including buyers.<sup>802</sup> Such costs may increase the costs of legitimate short selling.

To the extent that Rule 201 results in increased costs for short selling in covered securities that trigger the alternative uptick rule, it may increase the trading costs of legitimate short selling for these securities and may result in a reduction in short selling generally. Restricting short selling may also reduce “long” activity where the short selling is part of a larger trading strategy.

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<sup>800</sup> See id.

<sup>801</sup> See infra note 878 (citing empirical evidence showing that former Rule 10a-1 did not have an effect on market liquidity and price efficiency and that price test restrictions resulted in an increase in quote depths). We note that, although the alternative uptick rule is by definition more restrictive than the proposed modified uptick rule, differences between the operation of the proposed uptick rule and the alternative uptick rule mean that one approach or the other would be more restrictive in particular circumstances. See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

<sup>802</sup> As discussed above, on the day the Pilot went into effect, listed Pilot securities underperformed listed control group securities by approximately 24 basis points. The Pilot and control group securities, however, had similar returns over the first six months of the Pilot. See supra note 52 (referencing Staff’s Summary Pilot Report at 8).

We believe, however, that such costs will be mitigated by the circuit breaker approach of Rule 201. Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day. As discussed previously,<sup>803</sup> commenters' estimates and the Staff's analysis show that a 10% circuit breaker threshold generally should affect only a limited percentage of covered securities. In addition, when triggered, the short sale price test restriction will apply for a limited period of time, i.e., the remainder of the day and the following day, rather than all the time. Thus, Rule 201 is structured so that it will not be triggered for the majority of covered securities most of the time and, thereby, will not interfere with the smooth functioning of the markets for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. To the extent that Rule 201 results in increased costs for short selling in covered securities that trigger the alternative uptick rule, a reduction in short selling generally, and a reduction in "long" activity where the short selling is part of a larger trading strategy, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

In addition, we recognize that Rule 201, when triggered, will impose a short sale price test restriction, when, currently, there is an absence of any short sale price test restrictions. This will result in costs in terms of modifications to systems and surveillance mechanisms, as well as changes to processes and procedures. We anticipate that these changes will likely result in immediate implementation costs for trading centers and SROs and other market participants

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<sup>803</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level).

associated with reprogramming trading and surveillance systems to account for short sale price test restrictions based on best bid information, as discussed in more detail below. We also believe Rule 201 will impose costs on trading centers and SROs and other market participants related to systems changes to computer software, reprogramming costs, and surveillance and compliance costs, as well as staff time and technology resources, associated with monitoring compliance with Rule 201, as discussed below.

Moreover, imposing a short sale-related circuit breaker that, if triggered, will impose a short sale price test restriction, when there are currently no short sale price test restrictions in place also may mean that staff (compliance personnel, associated persons, etc.) may need to be trained or re-trained regarding rules related to short sale price test restrictions. As such, we believe Rule 201 may impose training and compliance costs for trading centers, SROs, and other market participants.

However, as discussed below, because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, we believe that the alternative uptick rule will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>804</sup>

Further, we note that the policies and procedures that are required to be implemented under Rule 201 are similar to those that are required under the Order Protection Rule of Regulation NMS.<sup>805</sup> Thus, we believe trading centers and broker-dealers may already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures,

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<sup>804</sup> See infra Section X.B.1.b.i. and Section X.B.1.b.ii. (discussing the implementation and on-going monitoring and surveillance costs of the alternative uptick rule on trading centers and broker-dealers).

<sup>805</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087; 17 CFR 242.611.

including programming their trading systems in accordance with such policies and procedures. We believe this familiarity may reduce the implementation costs of Rule 201 and may make Rule 201 less burdensome to implement.

In addition, we believe that the implementation, and on-going monitoring and compliance costs of Rule 201 are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

We discuss below the costs of Rule 201 with respect to two inter-related aspects of the Rule: the short sale price test restriction, specifically the alternative uptick rule, and the circuit breaker approach that triggers application of that restriction. We have separated the discussion into two parts in order to more clearly address the comments that we received with respect to the various aspects of Rule 201. However, the circuit breaker approach and the alternative uptick rule under Rule 201 operate in conjunction with one another and should not be considered isolated provisions.

### **1. Alternative Uptick Rule**

Rule 201 requires a trading center to have written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>806</sup>

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<sup>806</sup> See Rule 201(b)(1).

**a. Impact on Market Quality**

As stated above, in the Proposal and Re-Opening Release, we requested comment on the costs of a short sale price test restriction,<sup>807</sup> and specifically as to the extent to which placing price restrictions on short selling could impact or lessen some of the benefits of legitimate short selling or could lead to a decrease in market efficiency, price discovery, or liquidity.<sup>808</sup>

The Commission received comments stating that the alternative uptick rule, or any short sale price restriction for that matter, would reduce the benefits that short selling provides to the markets.<sup>809</sup> For example, commenters stated that a short sale price test restriction would negatively impact liquidity,<sup>810</sup> market volume,<sup>811</sup> bid-ask spreads and price discovery.<sup>812</sup> Several

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<sup>807</sup> See Proposal, 74 FR at 18090, 18100; Re-Opening Release, 74 FR at 42037.

<sup>808</sup> See Proposal, 74 FR at 18090.

<sup>809</sup> See, e.g., letter from Prof. Lipkin; letter from Citadel *et al.* (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); letter from ICI (June 2009); letter from ISDA; letter from Lime Brokerage (June 2009); letter from RBC (June 2009); letter from Vanguard (June 2009); letter from Allston Trading (Sept. 2009); letter from TD Asset Management; letter from EWT (Sept. 2009); letter from BATS (Sept. 2009); letter from Citadel *et al.* (Sept. 2009); letter from CPIC (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from EWT (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from GETCO (Sept. 2009); letter from Hudson River Trading; letter from Lime Brokerage (Sept. 2009); letter from RBC (Sept. 2009); letter from STA (Sept. 2009); letter from STANY (Sept. 2009); letter from Vanguard (Sept. 2009); letter from Bingham McCutchen; letter from MFA (Oct. 2009); letter from Nasdaq OMX Group (Oct. 2009); see also letter from Credit Suisse (Mar. 2009).

<sup>810</sup> See, e.g., letter from Chad Stogel, Trillium Trading, LLC, dated May 26, 2009 (“Chad Stogel”); letter from Citadel *et al.* (June 2009); letter from Credit Suisse (June 2009); letter from Lime Brokerage (June 2009); letter from MFA (June 2009); letter from STA (June 2009); letter from EWT (Sept. 2009); letter from BATS (Sept. 2009); letter from Citadel *et al.* (Sept. 2009); letter from Lime Brokerage (Sept. 2009); letter from RBC (Sept. 2009); letter from STA (Sept. 2009); letter from Bingham McCutchen; see also letter from Credit Suisse (Mar. 2009).

<sup>811</sup> See, e.g., letter from Chad Stogel; letter from Citadel *et al.* (June 2009); letter from Credit Suisse (June 2009); letter from MFA (June 2009); letter from STA (June 2009); letter from EWT (Sept. 2009); letter from BATS (Sept. 2009); letter from Citadel *et al.* (Sept. 2009); letter from RBC (Sept. 2009); letter from Bingham McCutchen; see also letter from Credit Suisse (Mar. 2009).

<sup>812</sup> See, e.g., letter from Credit Suisse (June 2009); letter from MFA (June 2009); letter from Lime Brokerage (June 2009); letter from STA (June 2009); letter from RBC (Sept. 2009); see also letter from Credit Suisse (Mar. 2009).

commenters also stated that a short sale price test restriction might increase volatility.<sup>813</sup>

We believe, however, that the short sale price test restriction of Rule 201 will have a limited negative effect on liquidity, market volume, bid-ask spreads, price discovery and volatility. The Pilot Results found that the former tick test of Rule 10a-1 and former bid test of NASD, which were permanent, market-wide short sale price tests, did not have a significant impact on daily volatility, and also found some evidence that the short sale price tests dampened intra-day volatility for smaller stocks.<sup>814</sup> In addition, the Pilot Results found that the Pilot data provided limited evidence that then-current short sale price test restrictions distort a security's price. The Pilot Results also found that the short sale price test restrictions resulted in an increase in quote depths.<sup>815</sup> Realized liquidity levels, however, were unaffected by the removal of such short sale price test restrictions.<sup>816</sup> In addition, one study concluded that former Rule 10a-1 had little or no effect on price efficiency.<sup>817</sup> Another study found no evidence that former Rule 10a-1 negatively impacted price discovery.<sup>818</sup> Due to differences in the operation of former Rule 10a-1 and Rule 201, when it applies, the alternative uptick rule under Rule 201 will be more restrictive than former Rule 10a-1 in some circumstances and less restrictive in others.<sup>819</sup> As discussed above, however, due to the circuit breaker approach in Rule 201, the alternative

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<sup>813</sup> See, e.g., letter from Prof. Lipkin; letter from AIMA; letter from Citadel *et al.* (June 2009); letter from Credit Suisse (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from Citadel *et al.* (Sept. 2009); letter from TD Asset Management; letter from Barclays (Sept. 2009); see also letter from NSCP.

<sup>814</sup> See Staff's Summary Pilot Report at 55-56.

<sup>815</sup> See Staff's Summary Pilot Report at 55; see also Karl B. Diether, Kuan Hui Lee and Ingrid M. Werner, 2009, It's SHO Time! Short-Sale Price-Tests and Market Quality, *Journal of Finance* 64:37.

<sup>816</sup> See supra note 54.

<sup>817</sup> See J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006.

<sup>818</sup> See Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? *Rutgers Business Law Journal* 5:1-63.

<sup>819</sup> See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

uptick rule of Rule 201 generally will apply to a limited number of covered securities<sup>820</sup> and will apply only when the circuit breaker has been triggered for a covered security. As such, it will not be triggered for the majority of covered securities at any given time and, when triggered, will remain in effect for a short duration – that day and the following day. Considering the empirical studies and the comments, and because of the limited scope and duration of Rule 201, we believe that the impact of Rule 201, if any, on liquidity, market volume, bid-ask spreads, price discovery and volatility will be limited. To the extent that Rule 201 negatively impacts liquidity, market volume, bid-ask spreads, price discovery and volatility, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

The Commission received a number of comments addressing the extent to which a short sale price test restriction might cause a reduction in short selling.<sup>821</sup> For example, commenters stated that a reduction in short selling might result from: the implementation costs and on-going compliance costs of a short sale price test restriction;<sup>822</sup> uncertainty about whether a short sale order can be executed;<sup>823</sup> and reduced use of trading strategies that are market neutral or that rely

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<sup>820</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

<sup>821</sup> See, e.g., letter from Peter J. Driscoll, Chairman, John C. Giese, President and CEO, Security Traders Association, dated May 4, 2009 (“STA (May 2009)”); letter from Citadel et al. (June 2009); letter from CPIC (June 2009); letter from MFA (June 2009); letter from Allston Trading (Sept. 2009); letter from Barclays (Sept. 2009); letter from CBOE (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from CPIC (Sept. 2009); letter from EWT (Sept. 2009); letter from GETCO (Sept. 2009); letter from ICI (Sept. 2009); letter from ISE (Sept. 2009); letter from RBC (Sept. 2009); letter from MFA (Oct. 2009).

<sup>822</sup> See, e.g., letter from CPIC (June 2009); letter from Barclays (Sept. 2009).

<sup>823</sup> See, e.g., letter from STA (May 2009); letter from Citadel et al. (June 2009); letter from STA (June 2009); letter from Barclays (Sept. 2009); letter from STA (Sept. 2009); see also letter from Lime Brokerage (June 2009) (explaining specifically the increased risk that would be associated with virtual market making strategies).

on the ability to hedge through short sales.<sup>824</sup> Several commenters stated that the alternative uptick rule would restrict short sales more than the other proposed short sale price test restrictions, specifically because it would not allow immediate execution, and fewer short sales might be executed as a result.<sup>825</sup> A number of commenters stated that a reduction in short selling would result in decreased liquidity, wider price spreads, and more costly trading for investors overall.<sup>826</sup> Some commenters stated that such an increase in costs to investors would have a negative effect on investor confidence.<sup>827</sup>

The short sale price test restriction of Rule 201 may cause a limited reduction in short selling as a result of the implementation costs and on-going compliance costs of a short sale price test restriction; uncertainty about whether a short sale order can be executed; and reduced use of trading strategies that are market neutral or that rely on the ability to hedge through short sales. However, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day. Due to the limited scope and applicability of Rule 201, we

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<sup>824</sup> See, e.g., letter from STA (May 2009); letter from Credit Suisse (June 2009); letter from STA (June 2009); letter from Barclays (Sept. 2009); letter from STA (Sept. 2009); letter from MFA (Oct. 2009); see also letter from Lime Brokerage (June 2009) (explaining specifically the increased risk that would be associated with virtual market making strategies).

<sup>825</sup> See, e.g., letter from Allston Trading (Sept. 2009); letter from Barclays (Sept. 2009); letter from CBOE (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from CPIC (Sept. 2009); letter from EWT (Sept. 2009); letter from GETCO (Sept. 2009); letter from ICI (Sept. 2009); letter from ISE (Sept. 2009); letter from RBC (Sept. 2009); letter from MFA (Oct. 2009).

<sup>826</sup> See, e.g., letter from STA (May 2009); letter from Chad Stogel; letter from Allston Trading (June 2009); letter from Credit Suisse (June 2009); letter from STA (June 2009); letter from STA (Sept. 2009); letter from MFA (June 2009).

<sup>827</sup> See, e.g., letter from Citadel et al. (June 2009); letter from Vanguard (June 2009); letter from Allston Trading (Sept. 2009); letter from EWT (Sept. 2009); letter from GETCO (Sept. 2009); see also letter from NSCP (stating that, without empirical evidence of inefficiency or failure in the equity markets that both caused deterioration of investor confidence and that would be remedied by a short sale price test restriction, a loss in confidence in the Commission as a fair and impartial regulator could do more harm in the long-run to damage the confidence of investors); letter from STA (June 2009) (stating that “[p]romulgating a rule that would not have any impact on the execution of abusive short sales may, in fact, foster further deterioration of investor confidence”).

believe that any reduction in short selling will be limited.<sup>828</sup> In addition, we believe that any such reduction in short selling will have a minimal, if any, resulting negative impact on liquidity and price efficiency. As noted above, the Pilot Results found that the Pilot data provided limited evidence that then-current short sale price test restrictions, which were permanent and market-wide, distort a security's price. The Pilot Results also found that the short sale price test restrictions resulted in an increase in quote depths.<sup>829</sup> Realized liquidity levels, however, were unaffected by the removal of such short sale price test restrictions.<sup>830</sup> In addition, one study concluded that former Rule 10a-1 had little or no negative effect on price efficiency.<sup>831</sup> Another study found no evidence that former Rule 10a-1 negatively impacted price discovery.<sup>832</sup> Due to differences in the operation of former Rule 10a-1 and Rule 201, when it applies, the alternative uptick rule under Rule 201 will be more restrictive than former Rule 10a-1 in some circumstances and less restrictive in others.<sup>833</sup> As discussed above, however, due to the circuit breaker approach in Rule 201, the alternative uptick rule of Rule 201 generally will apply to a limited number of covered securities<sup>834</sup> and will apply only when the circuit breaker has been triggered for a covered security. As such, it will not be triggered for the majority of covered securities at any given time and, when triggered, will remain in effect for a short duration – that day and the following day. Considering the empirical studies and the comments, and due to the

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<sup>828</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

<sup>829</sup> See Staff's Summary Pilot Report at 55 and supporting text; see also Karl B. Diether, Kuan Hui Lee and Ingrid M. Werner, 2009, It's SHO Time! Short-Sale Price-Tests and Market Quality, Journal of Finance 64:37.

<sup>830</sup> See supra note 54.

<sup>831</sup> See J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006.

<sup>832</sup> See Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? Rutgers Business Law Journal 5:1-63.

<sup>833</sup> See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

<sup>834</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

limited scope and duration of Rule 201, we believe that any reduction in short selling as a result of Rule 201 will have a minimal, if any, negative impact on liquidity and price efficiency. To the extent that Rule 201 has a negative impact on liquidity and price efficiency, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

In addition, commenters stated that a short sale price test restriction in general, or the alternative uptick rule specifically, might negatively impact various trading strategies that include short selling,<sup>835</sup> such as high frequency trading,<sup>836</sup> options valuation models that are used to value and hedge equity derivatives transactions,<sup>837</sup> market neutral trading strategies or those that rely on hedging,<sup>838</sup> convertible arbitrage,<sup>839</sup> statistical arbitrage,<sup>840</sup> program or portfolio trading baskets,<sup>841</sup> and hedging strategies that significantly contribute to market liquidity, such as computerized liquidity providers or “virtual market makers.”<sup>842</sup> Commenters noted what they believe would be the negative consequences of such an impact, including increasing bid-ask

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<sup>835</sup> See, e.g., letter from Citadel et al. (June 2009); letter from Credit Suisse (June 2009); letter from ISDA; letter from RBC (June 2009); letter from STA (June 2009); letter from Vanguard (June 2009); letter from EWT (Sept. 2009); letter from TD Asset Management; letter from Lime Brokerage (Sept. 2009); letter from Bingham McCutchen; letter from MFA (Oct. 2009); see also letter from Credit Suisse (Mar. 2009).

<sup>836</sup> See, e.g., letter from Bingham McCutchen.

<sup>837</sup> See, e.g., letter from ISDA.

<sup>838</sup> See, e.g., letter from Citadel et al. (June 2009); letter from Credit Suisse (June 2009); letter from EWT (Sept. 2009); letter from TD Asset Management; letter from MFA (Oct. 2009). This category includes such trading methods as long short equity strategies, convertible securities investors, and hedged strategies such as 130/30 portfolios. See id.

<sup>839</sup> See, e.g., letter from Citadel et al. (June 2009); letter from Credit Suisse (June 2009); letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009).

<sup>840</sup> See, e.g., letter from Citadel et al. (June 2009).

<sup>841</sup> See letter from TD Asset Management.

<sup>842</sup> See, e.g., letter from Lime Brokerage (June 2009); letter from Lime Brokerage (Sept. 2009).

spreads, reducing market volume,<sup>843</sup> reducing market liquidity,<sup>844</sup> reducing market efficiency,<sup>845</sup> complicating the raising of capital by corporate issuers,<sup>846</sup> and causing investors to exit the market.<sup>847</sup> Other commenters expressed the belief that restrictions on short selling might encourage the use of other trading strategies that largely mirror the benefits of short selling (such as sales of calls, purchase of puts, synthetic short sales of OTC derivatives, and sales of security futures), but that impose additional costs, such as reduced efficiency or inaccessibility to small investors.<sup>848</sup>

To the extent that Rule 201 may have a negative effect on various trading strategies that include short selling, we believe any such negative effect will be limited. Under Rule 201, although short selling will be restricted for a limited time by the alternative uptick rule if the price of a covered security decreases by 10% or more, unlike with securities subject to the Short Sale Ban Emergency Order, Rule 201 will permit short selling at a price above the current national best bid in the covered security even when the restriction is in place. Thus, short sellers engaged in various trading strategies that include short selling will generally continue to be able

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<sup>843</sup> See, e.g., letter from Citadel *et al.* (June 2009); letter from Lime Brokerage (Sept. 2009); letter from Bingham McCutchen; letter from Credit Suisse (June 2009).

<sup>844</sup> See, e.g., letter from Chad Stogel; letter from Citadel *et al.* (June 2009); letter from Lime Brokerage (June 2009); letter from STA (June 2009); letter from EWT (Sept. 2009); letter from BATS (Sept. 2009); letter from Citadel *et al.* (Sept. 2009); letter from Lime Brokerage (Sept. 2009); letter from STA (Sept. 2009); letter from Bingham McCutchen.

<sup>845</sup> See e.g., letter from Citadel *et al.* (June 2009); letter from Citadel *et al.* (Sept. 2009).

<sup>846</sup> See, e.g., letter from Citadel *et al.* (June 2009); letter from Credit Suisse (June 2009); letter from Goldman Sachs (June 2009); letter from SIFMA (June 2009).

<sup>847</sup> See, e.g., letter from Credit Suisse (June 2009).

<sup>848</sup> See, e.g., letter from Prof. Rosenthal; letter from Barclays (June 2009) (warning that a mere transfer of short selling activity to other types of markets would impair the price discovery, efficiency, safety, and soundness of the public equity markets); letter from STA (June 2009) (discussing a possible shift to the derivative markets); letter from RBC (June 2009) (discussing sales of calls, purchases of puts, and short selling of security futures as methods to bypass the price restrictions); letter from Vanguard (June 2009) (discussing the use of synthetic short sales through OTC derivatives); see also *supra* Section III.A.1. (discussing the creation of “synthetic” short positions that are the economic equivalent of a short sale through the use of derivative securities).

to sell short for the limited period of time when the short sale price test restriction is in effect. In addition, we note that many of the above comments on potential market-wide impacts of a short sale price test restriction on various trading strategies that include short selling were not specific to a short sale price test applied in conjunction with a circuit breaker.<sup>849</sup> Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day.<sup>850</sup> We believe that the negative impact of Rule 201, if any, on various trading strategies that include short selling will be limited because of the limited scope and duration of Rule 201. To the extent that Rule 201 has a negative impact on various trading strategies that include short selling, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

We recognize that imposing a short sale price test restriction with respect to NMS stocks, without a similar restriction on derivative securities, could increase the use of derivative securities to create a short position and that such “synthetic” short positions could increase as a result of Rule 201. As discussed in Section III.A.1., above, however, short sales in the equity markets to hedge derivatives transactions are subject to Rule 201. In addition, we remain concerned that the ability to create a short position through the use of derivative securities may undermine the goals of short sale price test restrictions. At a later time, we may reconsider whether additional regulation of derivative securities and the use of “synthetic” short positions may be appropriate.

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<sup>849</sup> See, e.g., letter from Bingham McCutchen; letter from ISDA; letter from TD Asset Management; letter from EWT (Sept. 2009); letter from Lime Brokerage (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from STA (Sept. 2009); letter from BATS (Sept. 2009); letter from MFA (Oct. 2009).

<sup>850</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

Several commenters discussed how constraints on short selling might harm price discovery and pricing efficiency.<sup>851</sup> Commenters stated that, under the alternative uptick rule, only long sellers could hit bids displayed as part of the national market system, which would result in long sellers exclusively dictating the market price of purchases, which would harm price discovery.<sup>852</sup> Additionally, commenters stated that the alternative uptick rule would restrict the informational content that short sale orders contain to only passive orders, meaning that the information would not be fully communicated in the price discovery process and pricing inefficiency would arise.<sup>853</sup> Other commenters stated that the alternative uptick rule might result in an inflated transaction price<sup>854</sup> or upward stock price manipulation.<sup>855</sup>

We believe that Rule 201 will have a limited negative effect on price discovery and price efficiency. As discussed above, the Pilot Results<sup>856</sup> found that the Pilot data provided limited

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<sup>851</sup> See, e.g., letter from Matlock Capital (May 2009); letter from Prof. Rosenthal; letter from Goldman Sachs (June 2009); Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009); letter from GETCO (June 2009); letter from STA (June 2009); letter from Allston Trading (Sept. 2009); letter from Bingham McCutchen; letter from Citadel et al. (Sept. 2009); letter from CPIC (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from EWT (Sept. 2009); letter from Hudson River Trading; letter from STA (Sept. 2009); letter from TD Asset Management.

<sup>852</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from Bingham McCutchen; see also letter from GETCO (June 2009); letter from Charles A. Trzcinka, Professor of Finance and Chairman of the Finance Department, Kelly School of Business, Indiana University, dated May 10, 2009; letter from Prof. Rosenthal; Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009).

<sup>853</sup> See, e.g., letter from TD Asset Management; letter from CPIC (Sept. 2009); see also letter from GETCO (June 2009); letter from Goldman Sachs (June 2009).

<sup>854</sup> See, e.g., letter from Allston Trading (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from CPIC (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from EWT (Sept. 2009); letter from Hudson River Trading; letter from STA (Sept. 2009).

<sup>855</sup> See, e.g., letter from Allston Trading (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from RBC (Sept. 2009); see also letter from AIMA; letter from Citadel et al. (June 2009); letter from Goldman Sachs (June 2009); letter from RBC (June 2009).

<sup>856</sup> See Staff's Summary Pilot Report at 55; Karl B. Diether, Kuan Hui Lee and Ingrid M. Werner, 2009, It's SHO Time! Short-Sale Price-Tests and Market Quality, Journal of Finance 64:37-73; Gordon J. Alexander and Mark A. Peterson, 2008, The Effect of Price Tests on Trader Behavior and Market Quality: An Analysis of Reg. SHO, Journal of Financial Markets 11:84-111; J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug.

evidence that the former tick test of Rule 10a-1(a) and former bid test of NASD, which were permanent, market-wide short sale price tests, distorted a security's price. In addition, one study concluded that former Rule 10a-1 had little or no effect on price efficiency.<sup>857</sup> Another study found no evidence that former Rule 10a-1 negatively impacted price discovery.<sup>858</sup> Due to differences in the operation of former Rule 10a-1 and Rule 201, when it applies, the alternative uptick rule under Rule 201 will be more restrictive than former Rule 10a-1 in some circumstances and less restrictive in others.<sup>859</sup> As discussed above, however, due to the circuit breaker approach in Rule 201, the alternative uptick rule of Rule 201 generally will apply to a limited number of covered securities<sup>860</sup> and will apply only when the circuit breaker has been triggered for a covered security. As such, it will not be triggered for the majority of covered securities at any given time and, when triggered, will remain in effect for a short duration – that day and the following day. Considering the empirical studies and the comments and because of the limited scope and duration of Rule 201, we believe that Rule 201 will have little, if any, negative effect on price discovery and price efficiency. To the extent that Rule 201 negatively affects price discovery and price efficiency, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

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14, 2006; Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? Rutgers Business Law Journal 5:1-63.

<sup>857</sup> See J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006.

<sup>858</sup> See Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? Rutgers Business Law Journal 5:1-63.

<sup>859</sup> See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

<sup>860</sup> See supra notes 305 to 311 and accompanying text (discussing data reflecting that, on average, a limited number of covered securities would hit a 10% trigger level each day).

A number of commenters discussed the impact that the alternative uptick rule might have on execution.<sup>861</sup> Several commenters stated that, under the alternative uptick rule, short sales would be ineligible for immediate execution, causing increased trading costs and opportunity costs, decreased liquidity, and widened spreads.<sup>862</sup> Commenters also stated that the alternative uptick rule would increase the risk of non-execution of a short sale, which would reduce the speed of price discovery and increase execution prices.<sup>863</sup> Commenters also noted that the alternative uptick rule could cause missed execution opportunities, thereby causing retail investors to pay artificially high prices to obtain execution.<sup>864</sup>

As we stated in the Re-Opening Release, because the alternative uptick rule will only permit short selling at a price above the current national best bid, the alternative uptick rule will generally not allow short sales to get immediate execution, even in an advancing market,<sup>865</sup> which may slow the speed of executions and impose additional costs on market participants, including buyers.<sup>866</sup> We note, however, that the above comments on the potential impacts of the alternative uptick rule on execution were not specific to a short sale price test in conjunction with

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<sup>861</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from Group One Trading (Sept. 2009); letter from TD Asset Management; letter from CPIC (Sept. 2009); letter from Lime Brokerage (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from STA (Sept. 2009); letter from Barclays (Sept. 2009).

<sup>862</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from TD Asset Management; letter from CPIC (Sept. 2009); letter from STA (Sept. 2009). As noted by some commenters, however, there may be situations in which a short seller could get immediate execution, such as where an order is executed in a facility that provides executions at the mid-point of the national best bid and offer. See, e.g., letter from ISE (Sept. 2009); see also letter from BATS (Sept. 2009).

<sup>863</sup> See, e.g., letter from Barclays (Sept. 2009); letter from STA (Sept. 2009).

<sup>864</sup> See, e.g., letter from Allston Trading (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from Dialectic Capital (Sept. 2009); see also letter from Chad Stogel.

<sup>865</sup> See Re-Opening Release, 74 FR at 42034; see also supra note 227 (noting that under some circumstances a short seller may be able to get immediate execution).

<sup>866</sup> See supra note 52 (discussing returns for listed Pilot securities and listed control group securities during the first six months of the Pilot and referencing Staff's Summary Pilot Report at 8).

a circuit breaker.<sup>867</sup> Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day.<sup>868</sup> We believe that the negative impact of Rule 201, if any, on execution speed and probability will be limited because of the limited scope and duration of Rule 201. To the extent that Rule 201 negatively impacts execution speed and probability, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

Several commenters suggested that short sellers who remain in the markets, as well as other market participants, might change their trading behavior in response to a short sale price test restriction.<sup>869</sup> For example, commenters expressed the belief that other traders might use computer algorithms to identify the presence of short sellers who have sell orders exactly one increment above the bid and quickly adjust their bid price downward in anticipation of the stock price dropping, which would result in the price of the security declining even further overall.<sup>870</sup> Similarly, several commenters stated that short sale limit orders might be perceived by other market participants as a negative view on a covered security, which might have negative implications on market efficiency, market liquidity, and bid-ask spreads and might cause buyers

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<sup>867</sup> See, e.g., letter from Allston Trading (Sept. 2009); letter from Barclays (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from Dialectic Capital (Sept. 2009); letter from TD Asset Management; letter from CPIC (Sept. 2009); letter from STA (Sept. 2009).

<sup>868</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

<sup>869</sup> See, e.g., letter from STA (May 2009); letter from Group One Trading (Sept. 2009); letter from Lime Brokerage (Sept. 2009).

<sup>870</sup> See letter from Group One Trading (Sept. 2009); letter from STANY (Sept. 2009).

to withdraw their bids.<sup>871</sup> One commenter noted that displayed short sale limit orders could be “subject to the risk that long sellers would use the information in the orders to their advantage and front-run or pick off the orders.”<sup>872</sup> Additionally, commenters stated that short sellers who seek to execute above the best bid without displaying the offer would be driven to transact in market centers that do not display their better-priced bids as part of the national market system, such as dark pools, or through broker-dealers that offer internalization.<sup>873</sup> Commenters noted that such an increase in volume directed to non-public markets would decrease overall market transparency, liquidity, and pricing efficiency.<sup>874</sup>

Although we recognize that short sellers who remain in the markets, as well as other market participants, might change their trading behavior in response to a short sale price test restriction, we believe any such effect will be limited by the circuit breaker approach of Rule 201. Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day.<sup>875</sup> To the extent that Rule 201 results in changes in trading behavior, we believe that such an impact is justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

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<sup>871</sup> See, e.g., letter from Barclays (Sept. 2009); letter from MFA (Oct. 2009); see also letter from STA (Sept. 2009) (stating that because short sale orders would have to be priced one increment above the national best bid, and would drop in price as bids were exhausted, the alternative uptick rule “would also prolong and deepen downward moves by forcing there to be overhanging, passive supply”).

<sup>872</sup> Letter from Citadel et al. (Sept. 2009).

<sup>873</sup> See, e.g., letter from EWT (Sept. 2009); letter from Group One Trading (Sept. 2009); letter from STANY (Sept. 2009).

<sup>874</sup> See id.; see also letter from STA (May 2009).

<sup>875</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level and duration).

In addition, we note that, as discussed in Section II.D., above, we reviewed the empirical analyses that commenters submitted to us or discussed in their comments. Consistent with the Pilot Results, a study of the effect that rescission of former Rule 10a-1 had on market quality found that the elimination had no measurable effect on market volatility,<sup>876</sup> while the results of other studies on the effect of the lack of a short sale price test restriction on volatility were mixed.<sup>877</sup> However, we note that the study showing no measurable effect on market volatility only analyzed daily volatility during a six-week period following the elimination of former Rule 10a-1 and, thus, may have limited statistical significance. In addition, the studies evidencing an increase in volatility do not address the extent to which other factors may have contributed to or caused the increased volatility.

Studies of other aspects of market quality suggest little measurable impact of a short sale price test restriction on price discovery, market efficiency, liquidity or market quality in general.<sup>878</sup> Several commenters cited empirical evidence showing that restrictions on short selling, particularly bans on short selling, may impede liquidity, price discovery, and market efficiency,<sup>879</sup> but the cited studies do not address the effects of a short sale price test restriction in general or Rule 201 in particular. The empirical analyses that commenters submitted on whether

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<sup>876</sup> See Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, Unshackling Short Sellers: The Repeal of the Uptick Rule (Nov. 2008).

<sup>877</sup> See, e.g., letter from NAREIT; letter from High Street Advisors; letter from European Investors (Sept. 2009).

<sup>878</sup> See, e.g., the Pilot Results; see also supra note 856 and accompanying text. Numerous commenters also sent analyses on short selling restrictions in general or on the short selling ban. See, e.g., letter from AIMA; letter from Allston Trading (June 2009); Autore, Billingsley, and Kovacs, Short Sale Constraints, Dispersion of Opinion, and Market Quality: Evidence from the Short Sale Ban on U.S. Financial Stocks (June 19, 2009); letter from BATS (May 2009); letter from CBOE (June 2009); letter from Citadel et al. (June 2009); letter from Credit Suisse (June 2009), letter from CPIC (June 2009); letter from GETCO (June 2009); letter from Goldman Sachs (Sept. 2009); letter from Hudson River Trading; letter from ICI (June 2009); letter from NSCP; letter from NYSE Euronext (June 2009); letter from TD Asset Management; letter from STANY (June 2009); letter from Wolverine.

<sup>879</sup> See supra note 128.

a short sale price test restriction dampens price pressure from short sellers are mixed, but generally focus on long time horizons, such as weeks or months, as opposed to short time horizons, such as seconds or minutes, which are more relevant to the impact of a short sale price test restriction on price pressure.<sup>880</sup>

In summary, after considering the empirical evidence and the comments that we received in response to the Proposal and the Re-Opening Release, we believe that Rule 201 will have a minimal, if any, negative effect on market liquidity, price efficiency, and quote depths.<sup>881</sup> In addition, we recognize that there will be market costs associated with Rule 201 in terms of the potential impact of such a short sale-related circuit breaker on execution speed and probability. Such costs may increase the costs of legitimate short selling. To the extent that Rule 201 results in increased costs for short selling in covered securities, it may increase the trading costs of legitimate short selling for these securities and may result in a reduction in short selling generally. Restricting short selling may also reduce “long” activity where the short selling is part of a larger trading strategy. As discussed above, we believe that these costs will be limited because of the circuit breaker approach of Rule 201.

We believe that the potential costs of Rule 201 are justified by its design, such that, when Rule 201 is triggered, it will allow long sellers, by selling at the bid, to sell first, ahead of short sellers, in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long

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<sup>880</sup> See, e.g., J. Julie Wu, Uptick Rule, short selling and price efficiency, Aug. 14, 2006.

<sup>881</sup> See supra note 878 (citing empirical evidence showing that former Rule 10a-1 did not have an effect on market liquidity and price efficiency and that price test restrictions resulted in an increase in quote depths). We note that, although the alternative uptick rule is by definition more restrictive than the proposed modified uptick rule, differences between the operation of the proposed uptick rule and the alternative uptick rule mean that one approach or the other would be more restrictive in particular circumstances. See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

sellers to sell first in a declining market.<sup>882</sup> A short seller that is seeking to profit quickly from accelerated, downward market moves may find it advantageous to be able to short sell at the current national best bid. In addition, by making bids accessible only by long sellers when a security's price is undergoing significant downward price pressure, Rule 201 will help to facilitate and maintain stability in the markets and help ensure that they function efficiently. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors. In addition, combining the alternative uptick rule with a circuit breaker strikes the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets.

In addition, we believe several of the provisions contained in paragraph (d) of Rule 201 will help to mitigate any potential price distortions or costs associated with Rule 201. These provisions are designed to help promote the workability of Rule 201, while at the same time furthering our goals for adopting short sale price test regulation.

As discussed above,<sup>883</sup> we are adopting the seller's delay in delivery exception under Rule 201(d)(1) to allow sale orders of owned but restricted securities to be displayed or executed at a price that is less than or equal to the current national best bid, thereby mitigating the negative

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<sup>882</sup> See supra note 17.

<sup>883</sup> See supra Section III.B.2. (discussing the "short exempt" provision for seller's delay in delivery).

impact of Rule 201, if any, on execution speed and probability and helping to promote the workability of Rule 201.

Rule 201(d)(2) allows a broker-dealer to mark a short sale order as “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is by a market maker to off-set a customer odd-lot order or liquidate an odd-lot position which changes such broker-dealer’s position by no more than a unit of trading.<sup>884</sup> We believe that the odd-lot exception will promote the workability of Rule 201 and help mitigate potential price distortions or costs associated with the Rule, if any, because it will allow those acting in the capacity of a “market maker” to off-set customer odd-lot orders without regard to whether the sale order is at a price that is less than or equal to the current national best bid, thereby facilitating the liquidity providing function of market makers.

Rule 201(d)(3) permits a broker-dealer to mark as “short exempt” short sale orders associated with certain bona fide domestic arbitrage transactions.<sup>885</sup> Moreover, to facilitate arbitrage transactions in which a short position is taken in a security in the U.S. markets, and which is to be immediately covered on a foreign market, Rule 201(d)(4) permits a broker-dealer to mark as “short exempt” short sale orders associated with certain international arbitrage transactions.<sup>886</sup> Because domestic arbitrage and international arbitrage transactions promote market efficiency by equalizing prices at an instant in time in different markets or between relatively equivalent securities,<sup>887</sup> we believe these provisions will help mitigate the negative

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<sup>884</sup> See supra Section III.B.3. (discussing the “short exempt” provision for odd lot transactions).

<sup>885</sup> See supra Section III.B.4. (discussing the “short exempt” provision for domestic arbitrage transactions).

<sup>886</sup> See supra Section III.B.5. (discussing the “short exempt” provision for international arbitrage transactions).

<sup>887</sup> See supra Sections III.B.4. and III.B.5. (discussing the benefits of bona fide arbitrage activities to market efficiency because they tend to reduce pricing disparities between related securities).

effect of Rule 201, if any, on market and pricing efficiency and help to promote the workability of Rule 201.

Rule 201(d)(5) permits a broker-dealer to mark as “short exempt” short sale orders by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any short sale orders for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment.<sup>888</sup> We are including a “short exempt” marking provision for syndicate and lay-off sales because, as discussed above, we have historically excepted such activity from short sale rules.<sup>889</sup> In addition, we note that the public offering process is key to capital formation. By facilitating price support during the offering process, Rule 201(d)(5) will mitigate the negative effects of Rule 201, if any, on capital formation.

Rule 201(d)(6) allows a broker-dealer to mark as “short exempt” short sale orders where broker-dealers are facilitating customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal.<sup>890</sup> We believe that the riskless principal exception of Rule 201(d)(6) will facilitate broker-dealers’ ability to provide best execution to certain customer orders, thus mitigating the negative impact of Rule 201, if any, on execution speed and probability and helping to promote the workability of Rule 201.

Rule 201(d)(7) permits a broker-dealer to mark as “short exempt” certain short sale orders executed on a VWAP basis.<sup>891</sup> We believe that the exception for VWAP short sale transactions

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<sup>888</sup> See supra Section III.B.6. (discussing the “short exempt” provision for over-allotments and lay-off sales).

<sup>889</sup> See id.

<sup>890</sup> See supra Section III.B.7. (discussing the “short exempt” provision for riskless principal transactions).

<sup>891</sup> See supra Section III.B.8. (discussing the “short exempt” provision for transactions on a volume weighted average price basis).

will provide an additional source of liquidity for investors' VWAP orders and will help enable investors to achieve their objective of obtaining an execution at the VWAP, thus mitigating the negative impact of Rule 201, if any, on liquidity and execution speed and probability and helping to promote the workability of Rule 201.

**b. Implementation and On-going Monitoring and Surveillance Costs**

**i. Policies and Procedures Requirement under Rule 201**

Rule 201 requires a trading center to have written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>892</sup> In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>893</sup> In addition, trading centers are required to regularly surveil to ascertain the effectiveness of the policies and procedures required under the Rule and to take prompt action to remedy deficiencies in such policies and procedures.<sup>894</sup>

As stated previously, we discussed in the Proposal the anticipated costs of the proposed short sale price test restrictions and, in the Proposal and Re-Opening Release, we requested

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<sup>892</sup> See Rule 201(b)(1)(i).

<sup>893</sup> See Rule 201(b)(1)(ii).

<sup>894</sup> See Rule 201(b)(2).

comment on the costs associated with the proposed amendments.<sup>895</sup> In particular, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures.<sup>896</sup>

A number of commenters expressed concerns that the costs of implementing a short sale price test restriction would be significant.<sup>897</sup> However, many of these comments were not specific to the alternative uptick rule.<sup>898</sup> While some commenters discussed the potential implementation costs of the alternative uptick rule, they did not provide specific estimates of such costs.<sup>899</sup> Most commenters compared estimated implementation costs of the alternative uptick rule to the other proposed rules.<sup>900</sup>

As discussed in the PRA section above, we believe that the implementation and on-going monitoring and surveillance costs of the alternative uptick rule will be lower than the implementation and on-going monitoring and surveillance costs that would be associated with adoption of the proposed modified uptick rule or the proposed uptick rule.<sup>901</sup> Unlike the

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<sup>895</sup> See Proposal, 74 FR at 18090, 18092-18103; Re-Opening Release, 74 FR at 42037.

<sup>896</sup> See Proposal, 74 FR at 18090.

<sup>897</sup> See, e.g., letter from NSCP; letter from STANY (June 2009); letter from RBC (June 2009); letter from Wolverine; letter from CPIC (Sept. 2009); letter from EWT (Sept. 2009); letter from RBC (Sept. 2009); letter from STA (Sept. 2009).

<sup>898</sup> See, e.g., letter from NSCP; letter from STANY (June 2009); letter from RBC (June 2009); letter from Wolverine.

<sup>899</sup> See, e.g., letter from CPIC (Sept. 2009); letter from EWT (Sept. 2009); letter from RBC (Sept. 2009); letter from STA (Sept. 2009).

<sup>900</sup> See, e.g., letter from EWT (Sept. 2009) (stating that the net savings of the alternative uptick rule to the broader industry compared to the other proposals would at best be minimal); letter from STA (Sept. 2009); letter from BATS (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from Wells Fargo (Sept. 2009); letter from SIFMA (Sept. 2009); letter from ICI (Sept. 2009); letter from Credit Suisse (Sept. 2009).

<sup>901</sup> See *supra* Section IX.E.1. (discussing estimated burdens on trading centers of the collection of information requirements in connection with Rule 201).

proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price (i.e., whether the current national best bid or last sale price is above or below the previous national best bid or last sale price), the alternative uptick rule references only the current national best bid. In addition, we believe that the implementation and on-going monitoring and surveillance costs of the alternative uptick rule are justified by the benefits provided by preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

A number of commenters stated that because the alternative uptick rule would not require monitoring of the sequence of bids or last sale prices, implementing the alternative uptick rule would be less costly<sup>902</sup> or easier than implementing the proposed modified uptick rule or the proposed uptick rule.<sup>903</sup> In addition, several commenters stated that the alternative uptick rule would be easier to program into trading and surveillance systems than the proposed modified uptick rule or the proposed uptick rule.<sup>904</sup> Another commenter stated, with respect to the alternative uptick rule, that “actual implementation costs in terms of time and capital expenditure would be negligible when compared to those involved in implementing either the uptick rule or modified uptick rule.”<sup>905</sup>

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<sup>902</sup> See, e.g., letter from BATS (May 2009); letter from BATS (Sept. 2009); letter from GETCO (Sept. 2009); letter from ICI (Sept. 2009); letter from Glen Shipway (Sept. 2009). In addition, several commenters acknowledged that implementation of the alternative uptick rule will likely be less costly, without referencing the sequencing issue. See, e.g., letter from STANY (Sept. 2009).

<sup>903</sup> See, e.g., letter from Glen Shipway (Sept. 2009); letter from SIFMA (Sept. 2009); letter from STA (Sept. 2009); see also letter from Credit Suisse (June 2009). In addition, one commenter acknowledged that implementation of the alternative uptick rule will likely be easier, without referencing the sequencing issue. See letter from Allston Trading (Sept. 2009).

<sup>904</sup> See, e.g., letter from BATS (May 2009); letter from Glen Shipway (Sept. 2009); letter from ICI (Sept. 2009); see also letter from National Stock Exchange et al.

<sup>905</sup> Letter from BATS (Sept. 2009).

Several commenters indicated that implementation of the alternative uptick rule would not be easier or less costly than implementation of the proposed modified uptick rule or the proposed uptick rule.<sup>906</sup> However, we note that some of these commenters presented concerns that were not directly related to the alternative uptick rule<sup>907</sup> or to implementation costs or difficulties.<sup>908</sup> Additionally, one commenter did not provide the reasoning for its belief that the alternative uptick rule would not be easier or less costly to implement.<sup>909</sup>

Several commenters indicated their belief that other commenters' estimates regarding the difficulty or costs of implementing and monitoring the proposed modified uptick rule and the proposed uptick rule were exaggerated.<sup>910</sup> We recognize that some commenters' estimates of the costs of the proposed modified uptick rule or the proposed uptick rule may have been conservative. We also believe that because the alternative uptick rule does not include a sequencing requirement, the implementation and on-going monitoring and surveillance costs of the alternative uptick rule will be less than such costs would be with respect to the other proposed short sale price test restrictions.

One commenter stated that the Commission "underestimate[s] the time and expense that will be required for market participants to comply with the [alternative uptick] rule (or any other of the proposed alternatives)" and that such costs "will include expenses ... for the initial

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<sup>906</sup> See, e.g., letter from Matlock Capital (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from Knight Capital (Sept. 2009).

<sup>907</sup> See, e.g., letter from NYSE Euronext (Sept. 2009) (stating that implementation of the alternative uptick rule would be more difficult on the basis that the alternative uptick rule would be paired with a circuit breaker and attributing implementation difficulties to the circuit breaker approach, not the alternative uptick rule).

<sup>908</sup> See, e.g., letter from Knight Capital (Sept. 2009) (characterizing a potential increase in friction, confusion, or inefficiency in the market as an implementation difficulty that may arise from the alternative uptick rule).

<sup>909</sup> See letter from Matlock Capital (Sept. 2009).

<sup>910</sup> See, e.g., letter from Matlock Capital (Sept. 2009); letter from ISE (Sept. 2009); letter from Bingham McCutchen.

implementation of any restriction.”<sup>911</sup> However, this commenter did not specify why or how the implementation cost of the alternative uptick rule may be greater than we estimated.<sup>912</sup>

One commenter indicated that implementation costs would be approximately \$500,000 per firm, for a total of \$191,000,000 for all non-SRO trading centers subject to Rule 201,<sup>913</sup> including costs for “the purchase of additional costly data feeds” but not including “costs associated with developing appropriate internal supervisory procedures and compliance programs.”<sup>914</sup> The implementation cost estimates provided by this commenter, which are significantly higher than our estimate of, on average, \$68,381 per non-SRO trading center,<sup>915</sup> were not specific to the alternative uptick rule. Because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, we believe that the alternative uptick rule will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>916</sup> In addition, we note that implementation of Rule 201 will not require modifications to how data feeds are currently

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<sup>911</sup> Letter from RBC (Sept. 2009).

<sup>912</sup> In addition, with respect to the commenter’s concern that we underestimated the time required for implementation, we note that, as discussed in Section VII., above, we believe that a six month implementation period is appropriate. This implementation period, which is longer than the implementation periods proposed in the Proposal and the Re-Opening Release, takes into consideration commenters’ concerns that implementation of a price test could be complex. We do not believe that a longer implementation time is warranted because, for example, Rule 201 does not require monitoring of the sequence of bids or last sale prices, unlike other proposed price tests, and because Rule 201 requires the implementation of policies and procedures similar to those required for trading centers under Regulation NMS.

<sup>913</sup> See letter from Wolverine. In its letter, Wolverine multiplied its implementation cost estimate of \$500,000 by 382 non-SRO trading centers for a total of \$191,000,000. See *id.* As indicated above, however, we now estimate that there are 407 non-SRO trading centers. See *supra* note 686.

<sup>914</sup> *Id.*

<sup>915</sup> See *infra* note 960 and accompanying text (discussing our estimated implementation costs for trading centers).

<sup>916</sup> See *supra* notes 661 to 669 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

received. As discussed above, Rule 201 does not mandate that the receipt of the current national best bid must be from any one particular data feed; thus, trading centers will be able to continue using the data feed they currently use, and for which they currently pay.<sup>917</sup> As a result, we believe this commenter's estimates of the implementation costs are higher than our estimated implementation costs for Rule 201.

Another commenter conducted a survey of firms with respect to implementation cost estimates. Cost estimates in response to the survey indicated that a circuit breaker triggering a short sale price test based on the national best bid would have implementation costs that averaged between \$235,000 and \$2,000,000 per firm.<sup>918</sup> This estimated implementation cost range is significantly higher than our estimated range of, on average, \$68,381 per non-SRO trading center to \$86,880 per SRO trading center for implementation.<sup>919</sup> We note that the commenter's survey results covered fifty firms, categorized as large firms, regional firms, and clearing firms, rather than SRO trading centers, non-SRO trading centers and broker-dealers. Thus, it is difficult to determine the implementation costs to trading centers, including non-SRO trading centers, from these survey results. In addition, these cost estimates were based on a circuit breaker triggering the proposed modified uptick rule and, as such, were not specific to the alternative uptick rule. Because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would

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<sup>917</sup> See supra notes 404 to 411 and accompanying text (discussing the use of various data feeds in determining the current national best bid).

<sup>918</sup> See letter from SIFMA (June 2009). SIFMA did not categorize estimates of the implementation costs of a circuit breaker triggering a short sale price test based on the national best bid by SRO trading centers, non-SRO trading centers, and other broker-dealers, but categorized responses by larger firms, with implementation cost estimates that averaged \$2,000,000 per firm, with the highest estimate at \$9,000,000 per firm, regional firms, with estimates that averaged \$235,000 per firm, with the highest estimate at \$500,000 per firm, and clearing firms, with estimates that averaged \$1,200,000 per firm, with the highest estimate at \$1,900,000 per firm. SIFMA only provided the average and highest cost estimates per category. See id.

<sup>919</sup> See infra note 960 and accompanying text (discussing our estimated implementation costs for trading centers).

have required sequencing of the national best bid or last sale price, we believe that the alternative uptick rule will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>920</sup>

Commenters indicated that implementation costs would include costs for modifications to multiple systems, including blue sheet, OATS, and OTS reporting systems, trading system interfaces, execution management systems, and order management systems; modifications to data feeds;<sup>921</sup> adjustments to data retention capabilities; revisions to written policies and procedures; and personnel training regarding the new requirements.<sup>922</sup> We recognize that implementation of Rule 201 will impose surveillance and reprogramming costs for enforcing, monitoring, and updating trading, order management, execution management, surveillance, and reporting systems under Rule 201, systems changes to computer software, adjustments to data retention capabilities, as well as staff time and technology resources. These costs are included in our estimates of the costs of implementing Rule 201.<sup>923</sup>

In addition, commenters expressed concerns that the costs of on-going monitoring and surveillance of a short sale price test restriction would be significant.<sup>924</sup> Only one commenter specifically discussed concerns about the on-going monitoring and surveillance costs of the

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<sup>920</sup> See supra notes 661 to 669 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>921</sup> As discussed above, implementation of Rule 201 will not require modifications to how data feeds are currently received. See supra notes 404 to 411 and accompanying text (discussing the use of various data feeds in determining the current national best bid).

<sup>922</sup> See, e.g., letter from NSCP; letter from STANY (June 2009); letter from RBC (June 2009); letter from Wolverine; letter from EWT (Sept. 2009).

<sup>923</sup> See infra note 960 and accompanying text (discussing our estimates of the implementation costs of Rule 201 by trading centers).

<sup>924</sup> See, e.g., letter from NSCP; letter from RBC (June 2009); letter from SIFMA (June 2009); letter from Wolverine; letter from RBC (Sept. 2009).

alternative uptick rule, and this commenter did not provide specific cost estimates.<sup>925</sup> One commenter stated that the alternative uptick rule would be easier to surveil and monitor than the proposed modified uptick rule or the proposed uptick rule, and thus would present lower on-going costs to the industry.<sup>926</sup> The alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price. Thus, we believe that the alternative uptick rule will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>927</sup>

Another commenter estimated that on-going system maintenance would cost \$20,000 annually per firm.<sup>928</sup> This estimate is lower than our estimated total cost of, on average, \$121,356 annually per trading center for on-going monitoring and surveillance.<sup>929</sup> This commenter stated that this estimate covers the cost “annually to maintain the system.” It is not clear what specific on-going monitoring and surveillance functions are included in the commenter’s estimate but we believe that our estimate is more inclusive, in that it specifically takes into account costs for the commitment of resources associated with compliance administration and oversight, response to regulatory inquiries and examinations, response to

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<sup>925</sup> See letter from RBC (Sept. 2009).

<sup>926</sup> See letter from STA (Sept. 2009).

<sup>927</sup> See *supra* notes 661 to 669 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>928</sup> See letter from Wolverine. Wolverine does not apply this estimate to exchanges and ATSs, but only to other non-SRO trading centers (such as market makers), noting that on-going costs for exchanges and ATSs “should be minimal because they would be limited to system testing and maintenance, not the regulation of hundreds of members’ systems, procedures and trading activity.” *Id.*

<sup>929</sup> See *infra* notes 961 to 962 and accompanying text (discussing our estimates of the on-going monitoring and surveillance costs of Rule 201 by trading centers).

internal inquiries, market surveillance, data retention, testing, training, and enforcement, with attendant opportunity costs.<sup>930</sup>

One commenter conducted a survey of fifty firms with respect to on-going monitoring cost estimates. Cost estimates in response to the survey indicated that a circuit breaker triggering a short sale price test based on the national best bid would have on-going monitoring costs that averaged between \$45,000 and \$175,000 per firm.<sup>931</sup> Although our estimated cost of, on average, \$121,356 per trading center for on-going monitoring and surveillance,<sup>932</sup> falls within this commenter's estimated range of on-going monitoring cost, we note that the survey results covered fifty firms, categorized as large firms, regional firms, and clearing firms, rather than SRO trading centers, non-SRO trading centers and broker-dealers. Thus, it is difficult to determine the implementation costs to trading centers, including non-SRO trading centers, from these survey results. In addition, these cost estimates were not specific to the alternative uptick rule. Because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, we believe that the alternative uptick rule

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<sup>930</sup> See *infra* notes 934 and 935 and accompanying text (discussing the scope of our on-going monitoring and compliance cost estimates).

<sup>931</sup> See letter from SIFMA (June 2009). SIFMA did not categorize estimates of the on-going monitoring costs of a circuit breaker triggering a short sale price test based on the national best bid by SRO trading centers, non-SRO trading centers, and other broker-dealers, but categorized responses by larger firms, with on-going monitoring cost estimates that averaged \$130,000 per firm, with the highest estimate at \$1,500,000 per firm, regional firms, with estimates that averaged \$45,000 per firm, with the highest estimate at \$350,000 per firm, and clearing firms, with estimates that averaged \$175,000 per firm, with the highest estimate at \$250,000 per firm. SIFMA only provided the average and highest cost estimates per category. See *id.*

<sup>932</sup> See *infra* notes 961 to 962 and accompanying text (discussing our estimated on-going monitoring and surveillance costs for trading centers).

will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>933</sup>

Commenters indicated that the on-going costs to trading centers of a short sale price test restriction would include surveillance, testing, training, administration and supervision, data retention, response to regulatory inquiries and examinations, and response to internal inquiries.<sup>934</sup> We agree with these comments and believe that Rule 201 will require the commitment of resources associated with compliance administration and oversight, response to regulatory inquiries and examinations, response to internal inquiries, market surveillance, data retention, testing, training, and enforcement, with attendant opportunity costs. These costs are included in our estimates of the costs of on-going monitoring and surveillance of Rule 201.<sup>935</sup>

In estimating the costs to trading centers of implementing Rule 201, we considered that the policies and procedures required to be implemented for purposes of Rule 201 are similar to those that are required under Regulation NMS.<sup>936</sup> In accordance with Regulation NMS, trading centers must have in place written policies and procedures in connection with that Regulation's Order Protection Rule, which could help form the basis for implementing the policies and procedures for Rule 201.<sup>937</sup> Thus, we believe trading centers may already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.

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<sup>933</sup> See supra notes 661 to 669 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>934</sup> See, e.g., letter from NSCP; letter from RBC (June 2009); letter from SIFMA (June 2009); letter from Wolverine; letter from RBC (Sept. 2009).

<sup>935</sup> See infra notes 961 to 962 and accompanying text (discussing our estimates of the on-going monitoring and surveillance costs of Rule 201 to trading centers).

<sup>936</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087; 17 CFR 242.611.

<sup>937</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also 17 CFR 242.611.

We believe this familiarity will reduce the implementation costs of Rule 201 on trading centers and will make Rule 201 less burdensome to implement. Moreover, because trading centers have already developed or modified their surveillance mechanisms in order to comply with Regulation NMS's policies and procedures requirement, trading centers may already have retained and trained the necessary personnel to ensure compliance with that Regulation's policies and procedures requirements and, therefore, may already have in place most of the infrastructure and potential policies and procedures necessary to comply with Rule 201.<sup>938</sup> Further, we believe that the implementation and on-going monitoring and surveillance costs of the alternative uptick rule are justified by the benefits provided in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

Several commenters indicated that the Commission overstated the benefit of previous implementation of Regulation NMS in mitigating the costs of implementing a short sale price test restriction,<sup>939</sup> because, for example, "systems re-written and architected for Reg NMS ... did not include any short sale restrictions,"<sup>940</sup> or because such systems will require modifications in order to be used in the context of a short sale price test restriction.<sup>941</sup> However, we took into account that Regulation NMS was implemented after elimination of the prior short sale price tests when considering the impact of previous experience with the policies and procedures requirement of Regulation NMS's Order Protection Rule. And, although we recognize that

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<sup>938</sup> We also believe some trading centers may have retained personnel familiar with the former SRO bid tests, which may make Rule 201 even less burdensome to implement. See, Proposal, 74 FR at 18095, n.393 and 18053, n.125.

<sup>939</sup> See, e.g., letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009).

<sup>940</sup> Letter from FIF (June 2009); see also letter from RBC (June 2009).

<sup>941</sup> See letter from NSCP; letter from RBC (June 2009).

systems and processes will have to be modified for implementation of Rule 201, we continue to believe that because most trading centers already have in place systems and written policies and procedures in order to comply with Regulation NMS's Order Protection Rule, most trading centers will already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, which will mitigate the burden of implementation of the policies and procedures requirement under Rule 201.

Several commenters agreed, stating that previous experience with the policies and procedures required under Regulation NMS might reduce the implementation and on-going monitoring and compliance burdens on trading centers.<sup>942</sup> One commenter stated that implementation of a circuit breaker approach combined with the alternative uptick rule would be easier to implement than the other proposed short sale price tests or proposed circuit breaker rules, "provided that the Commission permits firms to leverage the numerous systems changes made to facilitate compliance with Regulation NMS (including the use of internal market data rather than consolidated data supplied by the industry plans)."<sup>943</sup> And one commenter stated that prior implementation of Regulation NMS could ease implementation of a short sale price test restriction, "provided that broker-dealers' implementations of Regulation NMS was sufficiently modular and extensible."<sup>944</sup> We believe that Rule 201 is structured so that trading centers will be able to leverage their existing systems and experience with implementing the policies and procedures required by Regulation NMS's Order Protection Rule. For example, Rule 201 does not mandate that the receipt of the current national best bid must be from any one particular data

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<sup>942</sup> See, e.g., letter from EWT (Sept. 2009); letter from Goldman Sachs (Sept. 2009); letter from MFA (Oct. 2009).

<sup>943</sup> Letter from Goldman Sachs (Sept. 2009); see also letter from MFA (Oct. 2009).

<sup>944</sup> Letter from EWT (Sept. 2009).

feed; thus, trading centers will be able to use internal market data if they choose.<sup>945</sup> Thus, as stated above, we believe that familiarity with trading-related policies and procedures under Regulation NMS will mitigate the burden of implementation of the policies and procedures requirement under Rule 201.

Moreover, the written policies and procedures requirement of Rule 201 is designed to provide trading centers with significant flexibility in determining how to comply with the requirements of the Rule. For example, Rule 201 is designed to provide trading centers and their customers with flexibility in determining how to handle orders that are not immediately executable or displayable by the trading center because the order is impermissibly priced. Thus, if an order were impermissibly priced, the trading center could, in accordance with policies and procedures reasonably designed to prevent the execution or display of a short sale at a price that is less than or equal to the current national best bid, re-price the order upwards to the lowest permissible price and hold it for later execution at its new price or better.<sup>946</sup> As quoted prices change, Rule 201 allows a trading center to repeatedly re-price and display an order at the lowest permissible price down to the order's original limit order price (or, if a market order, until the order is filled). Because a trading center could re-price and display a previously impermissibly priced short sale order, Rule 201 may allow for the more efficient functioning of the markets because trading centers do not have to reject or cancel impermissibly priced orders unless instructed to do so by the trading center's customer submitting the short sale order. We note that

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<sup>945</sup> See supra notes 404 to 411 and accompanying text (discussing the use of various data feeds in determining the current national best bid).

<sup>946</sup> For example, if a trading center receives a short sale order priced at \$47.00 when the current national best bid in the security is \$47.00, the trading center could re-price the order at the permissible offer price of \$47.01, and display the order for execution at this new limit price.

a number of commenters expressed support for a policies and procedures approach to any short sale price test restriction, in part, because it would add flexibility to the Rule's requirements.<sup>947</sup>

Moreover, while latencies in obtaining data regarding the national best bid from consolidated market data feeds, as discussed in detail above, may impact implementation costs associated with Rule 201, a trading center could have policies and procedures that would provide for a snapshot of the applicable national best bid of the security. We note that some commenters expressed concerns regarding latencies in obtaining data regarding the national best bid disseminated by proprietary data feeds and/or by SIPs.<sup>948</sup> We believe that a policies and procedures approach that provides for a snapshot of the applicable current national best bid will aid trading centers in dealing with time lags in receiving data regarding the national best bid from different data sources, as well as lead to reduced initial and on-going costs associated with Rule 201 for trading centers by facilitating verification of whether a short sale order was executed or displayed at a permissible price.

We considered whether our estimates of the costs to trading centers for implementation and on-going monitoring and surveillance of the proposed modified uptick rule included in the Proposal<sup>949</sup> would change under the circuit breaker approach of Rule 201, but concluded, as discussed below, that these estimates continue to represent reasonable estimates under the circuit breaker approach.

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<sup>947</sup> See, e.g., letter from T. Rowe Price (June 2009); letter from AIMA; letter from RBC (June 2009); letter from Citadel et al. (Sept. 2009).

<sup>948</sup> See, e.g., letter from Glen Shipway (Sept. 2009); see also letter from Credit Suisse (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from RBC (June 2009); letter from SIFMA (June 2009); letter from Direct Edge (June 2009); letter from BATS (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Lime Brokerage (Sept. 2009).

<sup>949</sup> See Proposal, 74 FR at 18093.

Despite some commenters' concerns regarding the implementation costs of a circuit breaker rule,<sup>950</sup> we believe that the circuit breaker approach will result in largely the same implementation costs as we estimated would be incurred if we adopted a permanent, market-wide short sale price test restriction.<sup>951</sup> As one commenter stated, "[o]nce the price test is in place, there is minimal incremental effort required to add a Circuit Breaker that controls the application of the price test."<sup>952</sup> Similarly, another commenter stated that "[t]he additional coding required to implement a circuit breaker is minimal..."<sup>953</sup> We believe that that there will be only minimal, if any, implementation costs for a circuit breaker approach in addition to the costs that we estimated previously for the implementation of a permanent, market-wide short sale price test rule because trading centers will need to establish written policies and procedures to implement the short sale price test restriction regardless of whether the short sale price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker. Several other commenters agreed, stating that the costs of the circuit breaker approach would be similar to, or only incrementally higher than, the costs of a permanent, market-wide approach.<sup>954</sup>

In addition, with respect to on-going monitoring and surveillance costs of the circuit breaker approach, we recognize, as noted by one commenter,<sup>955</sup> that trading centers will need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be

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<sup>950</sup> See supra note 676.

<sup>951</sup> See Proposal, 74 FR at 18093.

<sup>952</sup> Letter from Nasdaq OMX Group (Oct. 2009).

<sup>953</sup> Letter from Credit Suisse (Sept. 2009).

<sup>954</sup> See, e.g., letter from STA (June 2009).

<sup>955</sup> See letter from Glen Shipway (June 2009).

offset because, under the circuit breaker approach, the alternative uptick rule will be time limited and will only apply on a stock by stock basis, which will reduce our previously estimated costs for on-going monitoring and surveillance. This is because trading centers will only need to monitor and surveil for compliance with the alternative uptick rule during the limited period of time that the circuit breaker is in effect with respect to a specific security. As such, the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure.<sup>956</sup> Further, although, under the circuit breaker approach, market participants will need to monitor whether a stock is subject to Rule 201 or not, we believe that familiarity with a circuit breaker approach may help mitigate such compliance costs.<sup>957</sup>

On balance, we believe that the estimates of the costs to trading centers for implementation and on-going monitoring and surveillance of the proposed modified uptick rule included in the Proposal<sup>958</sup> are appropriate with respect to Rule 201. Thus, our estimates have not changed from the Proposal, except to the extent that total burden estimates have changed because we have updated the estimated number of trading centers.<sup>959</sup> As detailed in PRA Section IX.E.1., above, we realize that the exact nature and extent of the policies and procedures that a trading center is required to establish likely will vary depending upon the type, size, and nature of the trading center (e.g., SRO vs. non-SRO, full service broker-dealer vs. market maker). Thus, our estimates take into account different types of trading centers and we realize that these

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<sup>956</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>957</sup> See supra notes 292 and 684 and accompanying text (discussing stock exchanges' and FINRA's rules or policies to implement coordinated circuit breaker halts and SRO rules or policies to coordinate individual security trading halts corresponding to significant news events).

<sup>958</sup> See Proposal, 74 FR at 18093.

<sup>959</sup> See supra note 686 (discussing the change in the estimated number of trading centers).

estimates may be on the low-end for some trading centers while they may be on the high-end for other trading centers.

As detailed in PRA Section IX.E.1., above, we estimate a total one-time initial cost of \$28,699,867<sup>960</sup> for all trading centers subject to Rule 201 to establish the written policies and procedures reasonably designed to prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid.

Once a trading center has established written policies and procedures reasonably designed to prevent the execution or display of a short sale order at a price that is less than or equal to the current national best bid, we estimate a total annual on-going cost of \$7,751,196<sup>961</sup> for all trading centers subject to Rule 201 to ensure that their written policies and procedures are up-to-date and remain in compliance with Rule 201. In addition, with regard to on-going monitoring for and enforcement of trading in compliance with Rule 201, as detailed in PRA Section IX.E.1., above, we believe that, once the tools necessary to carry out on-going monitoring have been put in place, a trading center will be able to incorporate on-going

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<sup>960</sup> This figure was calculated by adding \$20,359,867 and \$8,340,000 (for outsourced legal work). The \$20,359,867 figure was calculated as follows: (70 legal hours x \$305) + (105 compliance hours x \$313) + (20 information technology hours x \$292) + (25 business operation hours x \$273) = \$66,880 per SRO x 10 SROs = \$668,800 total cost for SROs; (37 legal hours x \$305) + (77 compliance hours x \$313) + (23 information technology hours x \$292) + (23 business operation hours x \$273) = \$48,381 per broker-dealer x 407 broker-dealers = \$19,691,067 total cost for broker-dealers; \$668,800 + \$19,691,067 = \$20,359,867. The \$8,340,000 figure for outsourced legal work was calculated as follows: (50 legal hours x \$400 x 10 SROs) + (50 legal hours x \$400 x 407 broker-dealers) = \$8,340,000.

Based on industry sources, we estimate that the average hourly rate for outsourced legal services in the securities industry is \$400. For in-house legal services, we estimate that the average hourly rate for an attorney in the securities industry is approximately \$305 per hour. The \$305/hour figure for an attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. In addition, we estimate that the average hourly rate for an assistant compliance director, a senior computer programmer, and a senior operations manager in the securities industry is approximately \$313, \$292, and \$273 per hour, respectively. These figures are from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>961</sup> This figure was calculated as follows: (2 legal hours x 12 months x \$305) x (10 + 407) + (3 compliance hours x 12 months x \$313) x (10 + 407) = \$7,751,196.

monitoring and enforcement within the scope of its existing surveillance and enforcement policies and procedures without a substantial additional burden. We recognize, however, that this on-going compliance will not be cost-free, and that trading centers will incur some additional annual costs associated with on-going compliance, including compliance costs of reviewing transactions. We estimate that each trading center will incur an average annual on-going compliance cost of \$102,768, for a total annual cost of \$42,854,256 for all trading centers.<sup>962</sup>

To summarize, we estimate an average one-time initial cost of \$86,880 per SRO trading center and \$68,381 per non-SRO trading center for a total one-time initial cost of \$28,699,867<sup>963</sup> for all trading centers subject to Rule 201 to establish the written policies and procedures reasonably designed to prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid. We estimate an average annual on-going cost of \$18,588 per trading center for a total annual on-going cost of \$7,751,196<sup>964</sup> for all trading centers subject to Rule 201 to ensure that their written policies and procedures are up-to-date and remain

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<sup>962</sup> We estimate that each trading center will incur an average annual on-going compliance cost of \$102,768 for a total annual cost of \$42,854,256 for all trading centers. This figure was calculated as follows: (16 compliance hours x \$313) + (8 information technology hours x \$292) + (4 legal hours x \$305) x 12 months = \$102,768 per trading center x 417 trading centers = \$42,854,256. As discussed above, we base our burden hour estimates on the estimates used for Regulation NMS because it requires similar on-going monitoring and surveillance for and enforcement of trading in compliance with that regulation's policies and procedures requirement.

For in-house legal services, we estimate that the average hourly rate for an attorney in the securities industry is approximately \$305 per hour. The \$305/hour figure for an attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. In addition, we estimate that the average hourly rate for an assistant compliance director, a senior computer programmer, and a senior operations manager in the securities industry is approximately \$313, \$292, and \$273 per hour, respectively. These figures are from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>963</sup> See supra note 960.

<sup>964</sup> See supra note 961.

in compliance with Rule 201. In addition, we estimate an average annual cost of \$102,768 per trading center for a total annual cost of \$42,854,256 for all trading centers for on-going monitoring for and enforcement of trading in compliance with Rule 201.<sup>965</sup>

**ii. Policies and Procedures Requirement under the  
Broker-Dealer and Riskless Principal Provisions**

A broker-dealer marking an order “short exempt” under Rule 201(c) must identify the order as being at a price above the current national best bid at the time of submission to the trading center<sup>966</sup> and must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being priced in accordance with the requirements of Rule 201(c).<sup>967</sup>

Rule 201(d)(6) allows a broker-dealer to mark short sale orders of a covered security “short exempt” where a broker-dealer is facilitating customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal, provided certain conditions are satisfied.<sup>968</sup> A broker-dealer marking an order “short exempt” under this provision is required to have written policies and procedures in place to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60

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<sup>965</sup> See supra note 962.

<sup>966</sup> See Rule 201(c). As a result, a trading center’s policies and procedures will need to be reasonably designed to permit the execution or display of such orders without regard to whether the order is at a price that is less than or equal to the current national best bid. See Rule 201(b)(1)(iii).

<sup>967</sup> See Rule 201(c)(1). As part of its written policies and procedures, a broker-dealer also is required to regularly surveil to ascertain the effectiveness of its policies and procedures and take prompt remedial steps. See Rule 201(c)(2). This provision is intended to reinforce the on-going maintenance and enforcement requirements of the provision contained in Rule 201(c)(1) by explicitly assigning an affirmative responsibility to broker-dealers to surveil to ascertain the effectiveness of their policies and procedures. See id.

<sup>968</sup> See Rule 201(d)(6). As a result, a trading center’s policies and procedures must be reasonably designed to permit the execution or display of such orders without regard to whether the order is at a price that is less than or equal to the current national best bid. See Rule 201(b)(1)(iii).

seconds of execution; and (iii) that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision.<sup>969</sup>

As stated previously, we discussed in the Proposal the anticipated costs of the proposed short sale price test restrictions and we requested comment, in the Proposal and Re-Opening Release, on the costs associated with the proposed amendments.<sup>970</sup> In particular, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures.<sup>971</sup> In response to our request for comment, commenters that specifically addressed the riskless principal provision of Rule 201(d)(6) supported its inclusion.<sup>972</sup>

Several commenters expressed concerns with respect to the costs of the broker-dealer provision of Rule 201(c), but did not provide a specific estimate of such costs.<sup>973</sup> Several commenters stated that the broker-dealer provision would place responsibility for ensuring order compliance with Rule 201 on broker-dealers, rather than exchanges, and noted that this is a significant difference from former Rule 10a-1 and NASD's former bid test.<sup>974</sup> Similarly, one commenter stated that the broker-dealer provision would significantly expand the implementation cost of Rule 201, without providing a specific estimate of such cost.<sup>975</sup> Although

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<sup>969</sup> See Rule 201(d)(6).

<sup>970</sup> See Proposal, 74 FR at 18090, 18092-18103; Re-Opening Release, 74 FR at 42037.

<sup>971</sup> See Proposal, 74 FR at 18090.

<sup>972</sup> See, e.g., letter from BATS (May 2009); letter from SIFMA (June 2009); letter from Credit Suisse (June 2009); letter from NYSE Euronext (Sept. 2009).

<sup>973</sup> See, e.g., letter from Credit Suisse (June 2009); letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from NSCP; letter from Direct Edge (June 2009).

<sup>974</sup> See, e.g., letter from Credit Suisse (June 2009); letter from STANY (June 2009).

<sup>975</sup> See letter from Lime Brokerage (June 2009).

we agree that implementation of the broker-dealer provision of Rule 201(c) will impose costs on broker-dealers who choose to rely on this provision, we note that Rule 201(c) is not a requirement of the Rule, but rather provides that a broker-dealer may mark a sell order for a security that has triggered the circuit breaker as “short exempt,” provided that the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission to the trading center and otherwise complies with the requirements of the provision.

In addition, as discussed throughout this adopting release, the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price. In order to rely on the broker-dealer provision, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being at a price above the current national best bid at the time of submission of the order to the trading center. Because the alternative uptick rule does not require sequencing of the national best bid, we believe that the policies and procedures required in order to rely on the broker-dealer provision under the alternative uptick rule will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick rule.<sup>976</sup> We note that one of the commenters that expressed concerns about the implementation cost of the broker-dealer provision also acknowledged that a rule “that would not require data centralization and sequencing would be significantly less complex and faster to implement.”<sup>977</sup>

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<sup>976</sup> See supra notes 709 to 715 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>977</sup> Letter from Credit Suisse (June 2009).

We disagree with several commenters who stated that, although implementation and on-going monitoring and surveillance of the alternative uptick rule might be easier and/or less costly for trading centers, this would not hold true for broker-dealers.<sup>978</sup> One of these commenters stated that “in order to avoid rejection of short sale orders under an alternative uptick rule, programming would need to be implemented to anticipate changes in the national best bid between the time a short sale order is entered and the time it reaches the relevant market center.”<sup>979</sup> However, the broker-dealer provision of Rule 201(c) is designed specifically to help avoid this result. Under the broker-dealer provision, a broker-dealer may, in accordance with the policies and procedures required by the provision, identify the order as not being at a price that is less than or equal to the current national best bid at the time the order is submitted to the trading center and mark the order “short exempt.” Trading centers are required to have written policies and procedures in place to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.<sup>980</sup>

Commenters also expressed concerns about the competitive pressure of the broker-dealer provision, stating either that broker-dealers would feel compelled to undertake implementation of the provision, despite the high cost,<sup>981</sup> which would be particularly burdensome for smaller firms,<sup>982</sup> or that smaller firms would find the costs prohibitive, placing them at a competitive

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<sup>978</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from EWT (Sept. 2009); letter Lime Brokerage (Sept. 2009).

<sup>979</sup> Letter from Citadel et al. (Sept. 2009).

<sup>980</sup> See Rule 201(b)(1)(iii).

<sup>981</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009).

<sup>982</sup> See, e.g., letter from T.D. Pro Ex; letter from Taurus Compliance; letter from Credit Suisse (June 2009).

disadvantage.<sup>983</sup> We recognize that broker-dealers are faced with competitive concerns and that such concerns may influence their decision whether or not to rely on the broker-dealer provision of Rule 201(c). With respect to the cost, as stated above, although we recognize that the broker-dealer provision will impose implementation costs on broker-dealers who choose to rely on this provision, we believe that this cost will not be as great as stated by some commenters because the alternative uptick rule does not require sequencing of the national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price.<sup>984</sup> We believe that, without a sequencing requirement, the policies and procedures required in order to rely on the broker-dealer provision under the alternative uptick rule will be easier and less costly to implement and monitor, for all broker-dealers including smaller broker-dealers, than would be the case under the proposed modified uptick rule or the proposed uptick rule.<sup>985</sup>

Further, we believe that the implementation and on-going monitoring and compliance costs for broker-dealers who choose to rely on the broker-dealer provision are justified by the benefits of providing broker-dealers with the option to manage their order flow, rather than having to always rely on their trading centers to manage their order flow on their behalf.

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<sup>983</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP.

<sup>984</sup> We also note that it is possible that some smaller broker-dealers that determine to rely on the broker-dealer provision may determine that it is cost-effective for them to outsource certain functions necessary to comply with Rule 201(c) to larger broker-dealers, rather than performing such functions in house, to remain competitive in the market. This may help mitigate costs associated with implementing and complying with Rule 201(c). Additionally, they may decide to purchase order management software from technology firms. Order management software providers may integrate changes imposed by Rules 200(g) and 201 into their products, thereby providing another cost-effective way for smaller broker-dealers to comply with the requirement of Rule 201(c).

<sup>985</sup> See *supra* notes 709 to 715 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs to broker-dealers).

One commenter stated that the broker-dealer provision would impose significant on-going costs in the form of data storage, surveillance, and review, but did not provide a specific estimate of such cost.<sup>986</sup> We agree that broker-dealers who choose to rely on the broker-dealer provision of Rule 201(c) will face on-going costs for data storage, surveillance and review. However, we believe that broker-dealers' on-going monitoring and surveillance costs under Rule 201(c) will be mitigated by the alternative uptick rule, as compared to the proposed modified uptick rule or the proposed uptick rule, because the alternative uptick rule will reference only the current national best bid in determining permissible short sales.<sup>987</sup> In order to rely on the broker-dealer provision, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being at a price above the current national best bid at the time of submission of the order to the trading center. Under the alternative uptick rule, broker-dealers who choose to rely on Rule 201(c) will need to monitor the current national best bid, but will not be required to monitor the sequence of bids or last sale prices, as would have been required under the proposed modified uptick rule or the proposed uptick rule, respectively. Several commenters noted that the lack of a sequencing requirement would make the alternative uptick rule, in comparison to the other proposed short sale price tests, less costly<sup>988</sup> or easier to monitor on an on-going basis.<sup>989</sup> One commenter stated

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<sup>986</sup> See letter from NSCP; see also letter from Credit Suisse (June 2009).

<sup>987</sup> See supra notes 709 to 715 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs to broker-dealers).

<sup>988</sup> See supra note 661.

<sup>989</sup> See, e.g., letter from Glen Shipway (Sept. 2009); letter from SIFMA (Sept. 2009); letter from STA (Sept. 2009); see also letter from Credit Suisse (June 2009). In addition, one commenter acknowledged that monitoring of the alternative uptick rule will likely be easier, without referencing the sequencing issue. See letter from Allston Trading (Sept. 2009).

that the alternative uptick rule would reduce the data retention requirements of a new short sale price test restriction.<sup>990</sup>

Another commenter stated that the “Commission’s cost estimates seem to underestimate the cost to large, full service broker-dealers, since the volume of orders handled by these firms are likely to lead to significantly greater technology and storage costs alone as well as more frequent reviews” but did not provide a specific cost estimate.<sup>991</sup> As we stated in the Proposal,<sup>992</sup> we recognize that the exact nature and extent of the required policies and procedures, and thus the costs associated with such policies and procedures, that a broker-dealer is required to establish under the broker-dealer provision in Rule 201(c) likely will vary depending upon the nature of the broker-dealer, and we have taken this into account in our cost estimates.<sup>993</sup>

The following discussion of comments on the costs to broker-dealers includes comments that were discussed above with respect to the costs to trading centers<sup>994</sup> because, in some cases, commenters provided comments and estimates on the costs of establishing and monitoring policies and procedures under the proposed short sale price tests without distinguishing between costs that would be applicable to trading centers as opposed to broker-dealers. One commenter provided a dollar estimate of broker-dealer implementation costs at approximately \$500,000 per broker-dealer, for a total of \$2,780,500,000 for all broker-dealers subject to Rule 201,<sup>995</sup>

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<sup>990</sup> See letter from STA (Sept. 2009).

<sup>991</sup> Letter from NSCP.

<sup>992</sup> See Proposal, 74 FR at 18093.

<sup>993</sup> See *infra* notes 1022 to 1024 and accompanying text (discussing our estimates of implementation and on-going monitoring and surveillance costs to broker-dealers).

<sup>994</sup> See *supra* Section X.B.1.b.i. (discussing costs to trading centers).

<sup>995</sup> See letter from Wolverine. Wolverine provided an estimate of \$500,000 per firm for implementation costs, which it applied to both non-SRO trading centers and other registered broker-dealers. In its letter, Wolverine multiplied its implementation cost estimate of \$500,000 by 5,561 for a total of \$2,780,500,000. See *id.* As indicated above, the Commission now estimates the number of broker-dealers at 5,178 based on a review of

including costs for “the purchase of additional costly data feeds” but not including “costs associated with developing appropriate internal supervisory procedures and compliance programs.”<sup>996</sup> However, we note that this implementation cost estimate for the broker-dealer provision, which is significantly higher than our estimate of, on average, \$68,381 per broker-dealer,<sup>997</sup> was not specific to the alternative uptick rule. As discussed above, we believe that the alternative uptick rule will be easier and less costly to monitor than the proposed modified uptick rule or the proposed uptick rule because under the alternative uptick rule, broker-dealers who choose to rely on Rule 201(c) will need to monitor the current national best bid, but will not be required to monitor the sequence of bids or last sale prices, as would have been required under the proposed modified uptick rule or the proposed uptick rule, respectively.<sup>998</sup> In addition, we note that implementation of Rule 201 will not require modifications to how data feeds are currently received. As discussed above, Rule 201 does not mandate that the receipt of the current national best bid must be from any one particular data feed; thus, broker-dealers will be able to continue using the data feed they currently use and for which they currently pay.<sup>999</sup>

Another commenter conducted a survey of fifty firms with respect to implementation and on-going monitoring cost estimates. Cost estimates in response to the survey indicated that a circuit breaker triggering a short sale price test based on the national best bid would have

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2008 FOCUS Report filings reflecting registered broker-dealers, including introducing broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings. See supra note 652.

<sup>996</sup> Letter from Wolverine.

<sup>997</sup> See infra note 1022 and accompanying text (discussing our estimated implementation costs for broker-dealers).

<sup>998</sup> See supra notes 709 to 715 and accompanying text and notes 978 to 980 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>999</sup> See supra notes 404 to 411 and accompanying text (discussing the use of various data feeds in determining the current national best bid).

implementation costs that averaged between \$235,000 and \$2,000,000 per firm.<sup>1000</sup> This estimated implementation cost range is significantly higher than our cost estimate of, on average, \$68,381 per broker-dealer for implementation.<sup>1001</sup> In addition, cost estimates in response to the survey indicated that a circuit breaker triggering a short sale price test based on the national best bid would have on-going monitoring costs that averaged between \$45,000 and \$175,000 per firm.<sup>1002</sup> Our estimated cost of \$121,356 per broker-dealer for on-going monitoring and surveillance<sup>1003</sup> falls within this commenter's estimated range of on-going monitoring cost. We note that the estimated costs were categorized by large firms, regional firms, and clearing firms, rather than by SRO trading centers, non-SRO trading centers and broker-dealers. As a result, it is difficult to determine the applicability of these cost estimates to the expected implementation and on-going monitoring and compliance costs of Rule 201 to broker-dealers. In addition, this commenter's cost estimates were not specific to the alternative uptick rule. As discussed above, because the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, we believe that the alternative uptick rule will be easier and less costly to implement and monitor than the proposed modified uptick rule or the proposed uptick rule.<sup>1004</sup>

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<sup>1000</sup> See supra note 918 (discussing the results of SIFMA's cost estimate survey with respect to the costs of implementing a circuit breaker triggering a short sale price test based on the national best bid); see also letter from Wolverine.

<sup>1001</sup> See infra note 1022 and accompanying text (discussing our estimated implementation costs for broker-dealers).

<sup>1002</sup> See supra note 931 (discussing the results of SIFMA's cost estimate survey with respect to the on-going monitoring costs of a circuit breaker triggering a short sale price test based on the national best bid).

<sup>1003</sup> See infra note 1022 and accompanying text (discussing our estimated implementation costs for broker-dealers).

<sup>1004</sup> See supra notes 709 to 715 and accompanying text and notes 978 to 980 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

We considered these comments in evaluating the costs of implementation and on-going monitoring and surveillance of the broker-dealer provision of Rule 201(c) and the riskless principal provision of Rule 201(d)(6). We note that the policies and procedures that must be implemented under the broker-dealer provision are similar to those that are required under the Order Protection Rule of Regulation NMS.<sup>1005</sup> Thus, we believe broker-dealers will already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.

Although, as discussed above with respect to trading centers, several commenters stated that previous implementation of Regulation NMS would not mitigate the costs to broker-dealers of implementing a short sale price test restriction,<sup>1006</sup> we considered these comments, as well as comments stating that previous implementation of Regulation NMS could ease implementation provided that broker-dealers could leverage existing systems in implementing Rule 201,<sup>1007</sup> and continue to believe that familiarity with Regulation NMS policies and procedures will reduce the implementation costs of the broker-dealer provision under Rule 201(c) on broker-dealers. Moreover, because broker-dealers may have already developed or modified their surveillance mechanisms in order to comply with the policies and procedures requirement of the Order Protection Rule under Regulation NMS, broker-dealers may already have retained and trained the necessary personnel to ensure compliance with that Regulation's policies and procedures requirements and, therefore, may already have in place most of the infrastructure and potential policies and procedures necessary to comply with the broker-dealer provision of Rule 201(c). In

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<sup>1005</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also 17 CFR 242.611.

<sup>1006</sup> See, e.g., letter from FIF (June 2009); letter from RBC (June 2009).

<sup>1007</sup> See, e.g., letter from MFA (Oct. 2009).

addition, one commenter supported using a policies and procedures approach to any short sale price test restriction because it would ease implementation for broker-dealers.<sup>1008</sup>

Moreover, while latencies in obtaining data regarding the national best bid from consolidated market data feeds, as discussed in detail above, may impact implementation costs associated with Rule 201, a broker-dealer could have policies and procedures that would provide for a snapshot of the applicable national best bid of the security. Several commenters expressed concerns that implementing “snapshot” capability to preserve an auditable record of the current national best bid would be difficult and costly for broker-dealers,<sup>1009</sup> particularly because this is not a capability currently supported by many broker-dealers.<sup>1010</sup> Commenters also noted that “snapshot” capability would require increased data storage.<sup>1011</sup>

Although we recognize commenters’ concerns that implementing “snapshot” capability could be costly for some broker-dealers, we note that most broker-dealers may already have developed “snapshot” capability in connection with Regulation NMS’s Order Protection Rule. We also agree that “snapshot” capability will require data storage by broker-dealers; however, as noted by one commenter,<sup>1012</sup> because the alternative uptick rule does not require sequencing of the national best bid, the data storage requirements under the alternative uptick rule are lower than they would be under the proposed modified uptick rule or the proposed uptick rule. In addition, we believe that the costs of a policies and procedures approach that provides for a

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<sup>1008</sup> See, e.g., letter from GE.

<sup>1009</sup> See, e.g., letter from Credit Suisse (June 2009); letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from NSCP.

<sup>1010</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009).

<sup>1011</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009); letter from NSCP; letter from Direct Edge (June 2009).

<sup>1012</sup> See letter from STA (Sept. 2009).

snapshot of the applicable current national best bid of the security are justified because snapshot capability will aid broker-dealers in dealing with time lags in receiving data regarding the national best bid from different data sources and facilitate verification of whether a short sale order was executed or displayed at a permissible price.

We considered whether our estimates of the costs to broker-dealers for implementation and on-going monitoring and surveillance of the proposed modified uptick rule included in the Proposal<sup>1013</sup> would change under the circuit breaker approach of Rule 201, but, as discussed below, concluded that these estimates continue to represent reasonable estimates under the circuit breaker approach combined with the alternative uptick rule.

As discussed previously,<sup>1014</sup> despite some commenters' concerns regarding the implementation costs of a circuit breaker rule,<sup>1015</sup> we believe that the circuit breaker approach will result in largely the same implementation costs as we estimated would be incurred if we adopted a permanent, market-wide short sale price test restriction.<sup>1016</sup> We believe that that there will be only minimal, if any, implementation costs for a circuit breaker approach in addition to the costs we estimated previously for the implementation of a permanent, market-wide short sale price test rule because broker-dealers relying on Rule 201(c) or Rule 201(d)(6) are required to establish written policies and procedures required to comply with those provisions regardless of whether the short sale price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker. Several other commenters agreed, stating that

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<sup>1013</sup> See Proposal, 74 FR at 18093-18094.

<sup>1014</sup> See supra Section IX.E.1. (discussing estimated burdens of the collection of information requirements applicable to trading centers under Rule 201).

<sup>1015</sup> See supra note 676.

<sup>1016</sup> See Proposal, 74 FR at 18093-18094.

the costs of the circuit breaker approach would be similar to, or only incrementally higher than, the costs of a permanent, market-wide approach.<sup>1017</sup>

In addition, with respect to on-going monitoring and surveillance costs of the circuit breaker approach, we recognize, as noted by one commenter,<sup>1018</sup> that broker-dealers relying on Rule 201(c) or Rule 201(d)(6) will need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the circuit breaker approach, the alternative uptick rule will be time limited and will only apply on a stock by stock basis, which will reduce our previously estimated costs for on-going monitoring and surveillance. This is because broker-dealers relying on Rule 201(c) will only need to monitor and surveil for compliance with the alternative uptick rule, and broker-dealers relying on Rule 201(d)(6) will only need to monitor for compliance with the requirements of that provision, during the limited period of time that the circuit breaker is in effect with respect to a specific security. As such, the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure.<sup>1019</sup>

On balance, we believe that the estimates of the costs to broker-dealers for implementation and on-going monitoring and surveillance of the proposed modified uptick rule included in the Proposal<sup>1020</sup> are appropriate with respect to the broker-dealer provision of Rule

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<sup>1017</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from Credit Suisse (Sept. 2009); letter from STA (June 2009).

<sup>1018</sup> See letter from Glen Shipway (June 2009).

<sup>1019</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>1020</sup> See Proposal, 74 FR at 18093-18094.

201(c) and the riskless principal provision of Rule 201(d)(6). Thus, our estimates have not changed from the Proposal, except to the extent that total cost estimates have changed because we have updated the estimated number of broker-dealers.<sup>1021</sup> Our estimates of the implementation costs to broker-dealers include the costs of surveillance and reprogramming costs for enforcing, monitoring, and updating trading, execution management, and surveillance systems under Rule 201, systems changes to computer software, as well as staff time and technology resources. Our estimates of the on-going monitoring and surveillance costs include the commitment of resources associated with compliance oversight, market surveillance, data storage and enforcement, with attendant opportunity costs.

As detailed in PRA Section IX.E.2., above, we realize that the exact nature and extent of the required policies and procedures that a broker-dealer is required to establish under the broker-dealer provision in Rule 201(c), as well as under the riskless principal provision in Rule 201(d)(6), likely will vary depending upon the type, size and nature of the broker-dealer (e.g., full service broker-dealer vs. market maker). Thus, our estimates take into account different types of broker-dealers and we realize that these estimates may be on the low-end for some broker-dealers while they may be on the high-end for other broker-dealers.

As detailed in PRA Section IX.E.2., above, we estimate a total one-time initial cost of \$354,076,818 for all broker-dealers relying on the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6) to establish written policies and procedures reasonably designed to prevent the incorrect identification of orders as being priced in accordance with the broker-dealer provision or, in the case of the riskless principal provision, to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction;

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<sup>1021</sup> See supra note 729 (discussing the change in the estimated number of broker-dealers).

(ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision.<sup>1022</sup>

Once a broker-dealer has established written policies and procedures so that it may rely on the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6), we estimate a total annual on-going cost of \$96,248,664 for all broker-dealers relying on either of these provisions to ensure that their written policies and procedures are up-to-date and remain in compliance with Rule 201.<sup>1023</sup> In addition, with regard to on-going monitoring for and enforcement of trading in compliance with the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6), as detailed in PRA Section IX.E.2., above, we believe that, once the tools necessary to carry out on-going monitoring have been put in place, a broker-dealer will be able to incorporate on-going monitoring and enforcement within the scope of its existing surveillance and enforcement policies and procedures without a substantial additional burden. We recognize, however, that this on-going compliance will not be cost-free,

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<sup>1022</sup> This figure was calculated by adding \$250,516,818 and \$103,560,000 (for outsourced legal work). The \$250,516,818 figure was calculated as follows: (37 legal hours x \$305) + (77 compliance hours x \$313) + (23 information technology hours x \$292) + (23 business operation hours x \$273) = \$48,381 per broker-dealer x 5,178 broker-dealers = \$250,516,818 total cost for broker-dealers. The \$103,560,000 figure was calculated as follows: (50 legal hours x \$400 x 5,178) = \$103,560,000.

Based on industry sources, we estimate that the average hourly rate for outsourced legal services in the securities industry is \$400. For in-house legal services, we estimate that the average hourly rate for an attorney in the securities industry is approximately \$305 per hour. In addition, we estimate that the average hourly rate for an assistant compliance director, a senior computer programmer, and a senior operations manager in the securities industry is approximately \$313, \$292, and \$273 per hour, respectively. The estimates for in-house legal services, assistant compliance director, senior computer programmer, and senior operations manager are from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>1023</sup> This figure was calculated as follows: (2 legal hours x 12 months x \$305) x 5,178 + (3 compliance hours x 12 months x \$313) x 5,178 = \$96,248,664.

and that broker-dealers will incur some additional annual costs associated with on-going compliance, including compliance costs of reviewing transactions. We estimate that each broker-dealer will incur an average annual on-going compliance cost of \$102,768, for a total annual cost of \$532,132,704 for all broker-dealers.<sup>1024</sup>

To summarize, we estimate an average one-time initial cost of \$68,381 per broker-dealer for a total one-time initial cost of \$354,076,818 for all broker-dealers relying on the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6) to establish the written policies and procedures required to rely on the broker-dealer provision or the riskless principal provision.<sup>1025</sup> We estimate an average annual on-going cost of \$18,588 per broker-dealer for a total annual on-going cost of \$96,248,664 for all broker-dealers relying on either of these provisions to ensure that their written policies and procedures are up-to-date and remain in compliance with Rule 201.<sup>1026</sup> In addition, we estimate an average annual cost of \$102,768 per broker-dealer for a total annual cost of \$532,132,704 for all broker-dealers for on-going monitoring for and enforcement of trading in compliance with the broker-dealer provision in Rule 201(c) and the riskless principal provision in Rule 201(d)(6).<sup>1027</sup>

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<sup>1024</sup> This figure was calculated as follows: (16 compliance hours x \$313) + (8 information technology hours x \$292) + (4 legal hours x \$305) x 12 months = \$102,768 per broker-dealer x 5,178 broker-dealers = \$532,132,704. As discussed above, we base our estimate of burden hours on the estimates used for Regulation NMS because it requires similar on-going monitoring and surveillance for and enforcement of trading in compliance with that regulation's policies and procedures requirement.

For in-house legal services, we estimate that the average hourly rate for an attorney in the securities industry is approximately \$305 per hour. In addition, we estimate that the average hourly rate for an assistant compliance director and a senior computer programmer in the securities industry is approximately \$313 and \$292 per hour, respectively. These figures are from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>1025</sup> See supra note 1022.

<sup>1026</sup> See supra note 1023.

<sup>1027</sup> See supra note 1024.

## **2. Circuit Breaker Approach**

Under the circuit breaker approach, the alternative uptick rule will apply only if the price of a covered security has declined by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day.<sup>1028</sup> In addition, this short sale price test restriction will apply for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>1029</sup>

### **a. Impact on Market Quality**

As stated above, in the Proposal and Re-Opening Release, we requested comment on the costs of a circuit breaker rule,<sup>1030</sup> and specifically on the extent to which the proposed amendments to Regulation SHO, including the proposed circuit breaker rules, could impact or lessen some of the benefits of legitimate short selling or could lead to a decrease in market efficiency, price discovery, or liquidity.<sup>1031</sup>

As we stated in the Proposal, we understand that there are concerns about a potential “magnet effect” that could arise as an unintended consequence of a circuit breaker that imposes a short selling price test restriction.<sup>1032</sup> This “magnet effect” could result in short sellers driving down the price of an equity security in a rush to execute short sales before the circuit breaker is

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<sup>1028</sup> See Rule 201(b)(i).

<sup>1029</sup> See Rule 201(b)(ii).

<sup>1030</sup> See Proposal, 74 FR at 18090, 18100; Re-Opening Release, 74 FR at 42037.

<sup>1031</sup> See Proposal, 74 FR at 18090.

<sup>1032</sup> See Proposal, 74 FR at 18067.

triggered. We are also concerned about short selling demand building until the circuit breaker is lifted.

In response to our requests for comments, several commenters stated that a short sale circuit breaker could exacerbate downward pressure on stocks as their value reached the threshold level.<sup>1033</sup> Commenters also discussed the possibility that short selling demand could be built up until the short selling restriction is lifted.<sup>1034</sup> Other commenters, however, discounted the possibility or impact of a “magnet effect,”<sup>1035</sup> including some commenters who cited empirical studies that question whether a circuit breaker would result in artificial pressure on the price of individual securities.<sup>1036</sup>

After considering the comments, including studies cited by commenters, we do not believe that the evidence is clear regarding a “magnet effect.”<sup>1037</sup> In fact, many academic studies that have analyzed circuit breakers in other contexts found no evidence of such trading patterns.<sup>1038</sup> We recognize, however, that some of these studies were conducted in markets dissimilar from the highly automated markets currently existing in the United States and, therefore, that limits their utility in this context. Overall, however, the most relevant studies fail

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<sup>1033</sup> See, e.g., letter from Matlock Capital (May 2009); letter from Schwab; letter from Lime Brokerage (June 2009); letter from STA (June 2009); letter from Glen Shipway (June 2009); letter NYSE Euronext (June 2009); letter from Wolverine; letter from Direct Edge (June 2009); letter from Amer. Bankers Assoc.; letter from NYSE Euronext (Sept. 2009); see also letter from SIFMA (June 2009) (indicating that an “on/off” circuit breaker trigger could dampen any magnet effect); letter from Direct Edge (Mar. 2009).

<sup>1034</sup> See letter from STA (June 2009); letter from Wolverine.

<sup>1035</sup> See letter from BATS (May 2009); letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); letter from Hudson River Trading; letter from Virtu Financial; see also letter from Credit Suisse (Mar. 2009).

<sup>1036</sup> See letter from Credit Suisse (June 2009); letter from Credit Suisse (Sept. 2009); see also letter from Credit Suisse (Mar. 2009); letter from Nasdaq OMX Group (Oct. 2009).

<sup>1037</sup> See supra notes 280 to 285 and accompanying text (discussing comments on the “magnet effect” and our response).

<sup>1038</sup> See supra note 285.

to demonstrate a magnet effect and we believe that adopting the circuit breaker approach best serves our goals.

Commenters also stated that a circuit breaker could have a stigmatizing effect on affected securities by creating the impression that a stock is “down so significantly that the trading rules must change.”<sup>1039</sup> Other commenters expressed concerns that the circuit breaker could have a negative effect on affected securities because “if a security has suffered a significant decline, additional constraints that affect the ability of market makers to provide high-quality markets may actually hasten the decline, as decreased size and wider spreads will further undermine the already battered investor confidence in the security.”<sup>1040</sup> Another commenter noted that a circuit breaker “may exacerbate market dislocations by suddenly and unexpectedly altering the regulatory regime and liquidity characteristics of a particular security, precisely when it is under duress.”<sup>1041</sup>

We recognize that the circuit breaker approach of Rule 201 could result in some perception of stigmatization of stocks that trigger the short sale price test restriction of Rule 201. As discussed above in Section X.B.1.a., we also recognize that imposing a short sale price test restriction may negatively impact market quality with respect to a covered security that has triggered the circuit breaker. In addition, although we agree that a circuit breaker combined with a halt on short selling could cause or exacerbate market dislocations, we do not believe that the circuit breaker approach of Rule 201 will have the same impact because it will continue to allow short selling at a price above the national best bid, even when the short sale price test restriction is in effect. Further, to the extent that the circuit breaker approach results in stigmatization, market dislocations, or other negative

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<sup>1039</sup> Letter from Schwab; see also letter from Amer. Bankers Assoc.

<sup>1040</sup> Letter from EWT (June 2009).

<sup>1041</sup> Letter from EWT (June 2009); see also letter from Matlock Capital (May 2009).

impacts on market quality, we believe any such costs are justified by the benefits provided by the Rule.

As discussed in detail in Section III.A.5., above, commenters' estimates and the Staff's analysis show that a 10% circuit breaker threshold generally should affect only a limited percentage of covered securities, thus will not interfere with the smooth functioning of the markets for the majority of covered securities most of the time. And, although a permanent market-wide approach that would apply to all covered securities all the time may, as one commenter stated, provide an element of predictability,<sup>1042</sup> we believe that the circuit breaker approach of Rule 201 is appropriate because it provides a balance between achieving our goals for adopting a short sale price test restriction and limiting impediments to the normal operations of the market. As discussed above, due to the changes in market conditions and erosion of investor confidence that occurred recently, investors have become increasingly concerned about sudden and excessive declines in prices that appear to be unrelated to issuer fundamentals.<sup>1043</sup> We believe that a time-limited circuit breaker that is triggered by a significant intra-day decline in price of an individual security is a targeted response to address these concerns.

Commenters also expressed concerns that, during periods of volatility, "circuit breakers could potentially impact far too many stocks on any given day and damage the benefits of short selling."<sup>1044</sup> Similarly, a number of commenters expressed concerns that, if the trigger level for a circuit breaker were set too low, the circuit breaker would impose a short sale price test restriction that would impair trading in a stock not only due to a price decline that might indicate abusive or

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<sup>1042</sup> See letter from NYSE Euronext (Sept. 2009).

<sup>1043</sup> See supra Section II.C. (discussing investor confidence); see also Proposal, 74 FR at 18046-18049.

<sup>1044</sup> Letter from Atherton Lane; see also letter from Citadel et al. (June 2009); letter from Goldman Sachs (June 2009); letter from ISE (June 2009); letter from MFA (June 2009); letter from SIFMA (June 2009); letter from Wells Fargo (June 2009); letter from SIFMA (Sept. 2009).

abnormal trading activity, but also during normal market conditions, thus impairing normal trading activity, further limiting the provision of market benefits such as liquidity and price efficiency, and causing disruptions to investors and markets.<sup>1045</sup>

When the markets experience periods of extreme volatility, we expect that the circuit breaker will be triggered for more securities than during periods of low volatility. We believe this is an appropriate result of Rule 201 because it is designed to impose restrictions on short selling when individual securities are undergoing significant intra-day price declines. In addition, we recognize that a 10% trigger level may capture some “normal” trading activity. However, as discussed in detail in Section III.A.5., above, commenters’ estimates and the Staff’s analysis show that a 10% circuit breaker threshold generally should affect only a limited percentage of covered securities. This supports the conclusion that Rule 201 provides a tailored approach that reaches a limited subset of covered securities that are experiencing a significant intra-day price decline, while generally not restricting short selling in the majority of covered securities. To the extent that Rule 201 impairs normal trading activity, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

Several commenters expressed concerns that a circuit breaker approach “does not adequately address the negative implications of unregulated short selling” because it would permit relatively unrestricted, and potentially manipulative, short selling up to the trigger point.<sup>1046</sup> One commenter stated that a circuit breaker would not be effective to address manipulative short selling

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<sup>1045</sup> See, e.g., letter from Citadel et al. (June 2009); letter from Goldman Sachs (June 2009); letter from MFA (June 2009); letter from SIFMA (June 2009); letter from SIFMA (Sept. 2009).

<sup>1046</sup> Letter from T. Rowe Price (June 2009); see also letter from Atherton Lane; letter from Chlebina (Apr. 2009); letter from Equity Insight; letter from Wells Fargo (June 2009); letter from Glen Shipway (Sept. 2009).

because “predatory short selling is not a one-day event, but the culmination of a series of events.”<sup>1047</sup>

While it is true that, under a circuit breaker approach, the short sale price test restriction of Rule 201 will not apply to short selling in a security before the 10% intra-day decline trigger is reached, or after the duration of the restriction has passed, we believe that the circuit breaker approach is designed to strike the appropriate balance between our goal of preventing potential short sale abuse and the need to limit impediments to the normal operations of the market. As we stated in the Proposal, in discussing a short selling circuit breaker, one commenter noted that such a measure could address the issue of “bear raids” while limiting the market impact that may arise from other forms of short sale price test restrictions.<sup>1048</sup> As discussed above, short selling is an important tool in price discovery and the provision of liquidity to the market, and we recognize that imposition of a short selling circuit breaker that when triggered imposes the alternative uptick rule could restrict otherwise legitimate short selling activity during periods of significant volatility. To the extent that Rule 201 permits relatively unrestricted, and potentially manipulative, short selling during times when the circuit breaker has not been triggered for a particular security, we believe that such costs are justified by the benefits provided by the circuit breaker approach in not interfering with the provision of market benefits such as liquidity and price efficiency for the majority of covered securities most of the time.

After considering the comments, as discussed above, that we received with respect to the potential market impacts of a circuit breaker approach, we believe that such potential market impacts do not undermine our goals of preventing potential short sale abuse and addressing

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<sup>1047</sup> Letter from Equity Insight.

<sup>1048</sup> See Proposal, 74 FR at 18067, n.252 (noting a letter from Peter Brown, dated Dec. 12, 2008).

investor confidence, while balancing these goals with the need to limit impediments to the normal operations of the market. The Commission has long held the view that circuit breakers may help restore investor confidence during times of substantial uncertainty.<sup>1049</sup> We believe that the requirements of Rule 201 will produce such benefits. By imposing the alternative uptick rule once a security's price is experiencing a significant price decline, the short selling circuit breaker rule in Rule 201(b) is designed to target only those securities that experience significant intra-day price declines and, therefore, will help to prevent short selling from being used as a tool to exacerbate the decline in the price of those securities. This approach establishes a narrowly-tailored Rule that will target only those securities experiencing such a decline. We believe that addressing short selling in connection with such declines in individual securities will help restore investor confidence in the markets generally.

Further, as discussed above, short selling is an important tool in price discovery and the provision of liquidity to the market, and we recognize that imposition of a short selling circuit breaker that when triggered imposes the alternative uptick rule could restrict otherwise legitimate short selling activity during periods of significant volatility. Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day. We believe that the negative impact of Rule 201, if any, on the market will be limited because of the limited scope and duration of Rule 201. Further, to the extent that Rule 201 negatively impacts market quality, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

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<sup>1049</sup> See, e.g., 1998 Release, 63 FR 18477; see also Proposal, 74 FR at 18067.

**b. Implementation and On-going Monitoring and Surveillance Costs**

We discussed in the Proposal and the Re-Opening Release the anticipated costs of the proposed circuit breaker rules<sup>1050</sup> and we requested comment on the costs associated with the proposed circuit breaker rules.<sup>1051</sup> In particular, we requested comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures.<sup>1052</sup>

Several commenters expressed concerns regarding the implementation costs of a circuit breaker approach in comparison to the costs of implementing a permanent, market-wide test, but did not provide specific cost estimates.<sup>1053</sup> One commenter stated that “the circuit breaker proposal would be the least cost effective” but did not provide a specific cost estimate with respect to a circuit breaker rule.<sup>1054</sup>

One commenter conducted a survey of fifty firms with respect to implementation cost and on-going monitoring costs estimates of a new short sale price test restriction.<sup>1055</sup> Cost estimates in response to the survey indicated that a permanent, market-wide short sale price test based on the national best bid would have implementation costs that averaged between \$200,000 and \$1,100,000 per firm,<sup>1056</sup> while a circuit breaker triggering a short sale price test based on the

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<sup>1050</sup> See Proposal, 74 FR at 18097-18100; Re-Opening Release, 74 FR at 42035.

<sup>1051</sup> See Proposal, 74 FR at 18101-18103; Re-Opening Release, 74 FR at 42037.

<sup>1052</sup> See Proposal, 74 FR at 18090.

<sup>1053</sup> See *supra* note 676.

<sup>1054</sup> Letter from T. Rowe Price (June 2009).

<sup>1055</sup> See letter from SIFMA (June 2009).

<sup>1056</sup> See letter from SIFMA (June 2009). SIFMA did not categorize estimates of the implementation costs of a permanent, market-wide short sale price test based on the national best bid by SRO trading centers, non-SRO trading centers, and other broker-dealers, but categorized responses by larger firms, with implementation cost estimates that averaged \$1,000,000 per firm, with the highest estimate at \$7,000,000 per firm, regional firms

national best bid would have implementation costs that averaged between \$235,000 and \$2,000,000 per firm.<sup>1057</sup> This represents an estimated increase in implementation costs for a circuit breaker approach, as compared to a permanent, market-wide approach, of \$35,000 to \$900,000 per firm. However, we note that these cost estimates were based on a circuit breaker triggering the proposed modified uptick rule and, as such, were not specific to the alternative uptick rule.<sup>1058</sup> As discussed throughout this adopting release, because the alternative uptick rule does not require sequencing of the national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price, we believe that the policies and procedures required under the alternative uptick rule will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick rule.

We recognize that imposing a short sale-related circuit breaker rule when, currently, there is an absence of a short sale-related circuit breaker may result in costs in terms of modifications to systems and surveillance mechanisms, as well as changes to processes and procedures.<sup>1059</sup>

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with estimates that averaged \$200,000 per firm, with the highest estimate at \$500,000 per firm, and clearing firms, with estimates that averaged \$1,100,000 per firm, with the highest estimate at \$1,900,000 per firm. SIFMA provided cost estimates in terms of the average estimated cost and the highest estimated cost. See id.

<sup>1057</sup> See supra note 918 (discussing SIFMA's survey of cost estimates with respect to the implementation costs of a circuit breaker triggering a short sale price test based on the national best bid).

<sup>1058</sup> We also that the commenter's survey results covered fifty firms, categorized as large firms, regional firms, and clearing firms, rather than SRO trading centers, non-SRO trading centers and broker-dealers. Thus it is difficult to determine costs of a circuit breaker approach to trading centers as opposed to broker-dealers from the survey results.

<sup>1059</sup> Although under the circuit breaker approach, a price test will not be in place all the time or for all securities, trading centers, and broker-dealers relying on Rule 201(c) or Rule 201(d)(6), will need to establish reasonable policies and procedures in advance to ensure compliance whenever the circuit breaker is triggered. We note that it would not be reasonable for a trading center, or a broker-dealer relying on Rule 201(c) or Rule 201(d)(6) to wait until the circuit breaker is triggered to begin establishing reasonable policies and procedures to prevent the execution or display of the particular covered security at a price that is less than or equal to the current national best bid. Thus, we recognize that the circuit breaker approach will result in immediate upfront costs to trading centers and to broker-dealers intending to rely on Rule 201(c) or Rule 201(d)(6). See supra Section X.B.1. (discussing costs of the alternative uptick rule).

Such costs will include implementation costs for market participants associated with reprogramming trading and surveillance systems to account for the requirements of the short sale related circuit breaker. We also recognize that the circuit breaker approach may impose costs on market participants related to systems changes to computer software, reprogramming costs, and surveillance and compliance costs, as well as staff time and technology resources, associated with monitoring compliance with the short sale related circuit breaker. Moreover, imposing a short sale related circuit breaker rule when there are currently no short sale related circuit breakers in place also may mean that staff (compliance personnel, associated persons, etc.) may need to be trained or re-trained regarding rules related to the circuit breaker requirements.

As discussed previously,<sup>1060</sup> despite some commenters' concerns regarding the implementation costs of a circuit breaker rule, we believe that the circuit breaker approach will result in largely the same implementation costs as we estimated would be incurred if we adopted a permanent, market-wide short sale price test restriction.<sup>1061</sup> We believe that there will be only minimal, if any, implementation costs for a circuit breaker approach in addition to the costs we estimated previously for the implementation of a permanent, market-wide short sale price test rule.<sup>1062</sup>

In addition, with respect to on-going monitoring and surveillance costs of the circuit breaker approach, we recognize, as noted by one commenter,<sup>1063</sup> that market participants will

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<sup>1060</sup> See supra notes 676 to 684 and 723 to 727 and accompanying text (discussing the impact of the circuit breaker approach on implementation and on-going monitoring and surveillance costs to trading centers and broker-dealers).

<sup>1061</sup> See Proposal, 74 FR 18093-18094.

<sup>1062</sup> Several commenters agreed, stating that the costs of the circuit breaker approach would be similar to, or only incrementally higher than, the costs of a permanent, market-wide approach. See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from Credit Suisse (Sept. 2009); letter from STA (June 2009).

<sup>1063</sup> See letter from Glen Shipway (June 2009).

need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the limited scope and duration of the circuit breaker approach, market participants will only need to monitor and surveil for compliance with the alternative uptick rule during the limited period of time that the circuit breaker is in effect with respect to a specific security. This will reduce our previously estimated costs for on-going monitoring and surveillance.<sup>1064</sup>

In addition, although, under the circuit breaker approach, market participants will need to monitor whether a stock is subject to Rule 201 or not, we believe that familiarity with a circuit breaker approach may help mitigate such compliance costs. As discussed in the Proposal, currently, all stock exchanges and FINRA have rules or policies to implement coordinated circuit breaker halts.<sup>1065</sup> Moreover, SROs have rules or policies in place to coordinate individual security trading halts corresponding to significant news events.<sup>1066</sup>

We also note that one commenter conducted a survey of firms with respect to on-going monitoring costs estimates of a new short sale price test restriction.<sup>1067</sup> Cost estimates in response to the survey indicated that a permanent, market-wide short sale price test based on the national best bid would have on-going monitoring costs that averaged between \$50,000 and

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<sup>1064</sup> Commenters noted that the circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure. See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>1065</sup> See supra note 292.

<sup>1066</sup> See, e.g., FINRA Rule 6120; see also Proposal, 74 FR at 18065-18066 (discussing the background on circuit breakers).

<sup>1067</sup> See letter from SIFMA (June 2009).

\$175,000 per firm,<sup>1068</sup> while a circuit breaker triggering a short sale price test based on the national best bid would have on-going monitoring costs that averaged between \$45,000 and \$175,000 per firm.<sup>1069</sup> This seems to support our view that the on-going monitoring costs of a circuit breaker approach, as compared to a permanent, market-wide approach, would be largely the same.

After considering the comments, we believe that the implementation, on-going monitoring and surveillance costs of a circuit breaker triggering a short sale price test restriction will be similar to the implementation, on-going monitoring and surveillance costs of the same short sale price test restriction on a permanent, market-wide basis. Thus, we believe that our estimates of the implementation and on-going monitoring and surveillance costs of Rule 201 for trading centers and broker-dealers, as reflected in Sections X.B.1.b.i and X.B.1.b.ii., discussing the implementation and on-going monitoring and compliance costs of the alternative uptick rule, are appropriate after taking into consideration the circuit breaker approach of Rule 201. Further, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

Under the circuit breaker approach of Rule 201, the listing market for each covered security must determine whether that covered security is subject to Rule 201.<sup>1070</sup> Once the listing

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<sup>1068</sup> See letter from SIFMA (June 2009). SIFMA did not categorize estimates of the on-going costs of a permanent, market-wide short sale price test based on the national best bid by SRO trading centers, non-SRO trading centers, and other broker-dealers, but categorized responses by larger firms, with on-going monitoring cost estimates that averaged \$100,000 per firm, with the highest estimate at \$1,500,000 per firm, regional firms with estimates that averaged \$50,000 per firm, with the highest estimate at \$450,000 per firm, and clearing firms, with estimates that averaged \$175,000 per firm, with the highest estimate at \$250,000 per firm. SIFMA only provided the average and highest cost estimates per category. See *id.*

<sup>1069</sup> See *supra* note 931 (discussing SIFMA's survey of cost estimates with respect to the on-going monitoring costs of a circuit breaker triggering a short sale price test based on the national best bid).

<sup>1070</sup> See Rule 201(b)(3).

market has determined that a security has become subject to the requirements of Rule 201, the listing market shall immediately notify the single plan processor responsible for consolidation of information for the covered security in accordance with Rule 603(b) of Regulation NMS<sup>1071</sup> of this fact. The plan processor must then disseminate this information.<sup>1072</sup> We recognize that these requirements will require changes by the listing markets and single plan processors to systems currently supported by each.<sup>1073</sup> We note that, because listing markets and single plan processors will require time in which to reprogram and test their systems and procedures to comply with Rule 201, the systems and programming costs associated with Rule 201 might be higher without a sufficient implementation period.<sup>1074</sup> We believe that the six month implementation period will provide listing markets and single plan processors with time to make required changes in a measured fashion, which will help alleviate some of the potential disruptions that may be associated with implementing Rule 201.<sup>1075</sup>

While we recognize that listing markets will incur initial up-front costs associated with having to update their systems, including systems changes to computer software, as well as staff time and technology resources to update their systems and surveillance mechanisms to ensure

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<sup>1071</sup> See supra note 368 (discussing the single plan processors for NMS stocks).

<sup>1072</sup> See Rule 201(b)(3); 17 CFR 242.603(b).

<sup>1073</sup> See letter from FIF (June 2009); see also supra Section III.A.6. (discussing the determination regarding securities subject to Rule 201 and dissemination of such information).

<sup>1074</sup> For example, commenters indicated that a circuit breaker rule triggering the alternative uptick rule would require an implementation period of between three and twelve months. See letter from NSCP; letter from NYSE Euronext (June 2009); letter from RBC (June 2009); letter from STA (June 2009); letter from FIF (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from EWT (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from MFA (Oct. 2009); see also letter from Amer. Bankers Assoc.; letter from NYSE Euronext (Sept. 2009); letter from Goldman Sachs (Sept. 2009).

<sup>1075</sup> See supra Section VII. (discussing the implementation period for Rule 201); see also supra Section III.A.6.

compliance with the Rule's requirements,<sup>1076</sup> familiarity with a circuit breaker approach may help mitigate the implementation and compliance costs. In addition, we believe that listing markets may be able to leverage some of their existing procedures to ease the implementation of Rule 201's requirements. For example, as discussed in the Proposal, currently, all stock exchanges and FINRA have rules or policies to implement coordinated circuit breaker halts<sup>1077</sup> and listing markets also already send information to single plan processors regarding Regulatory Halts as defined in those plans. Moreover, SROs have rules or policies in place to coordinate individual security trading halts corresponding to significant news events.<sup>1078</sup> In addition, we note that listing markets are familiar with making determinations regarding, and imposing trading restrictions on, individual NMS stocks.<sup>1079</sup> Similarly, in connection with such activities, listing markets currently monitor price changes in covered securities relative to the closing price as of the end of regular trading hours on the prior day.

Further, we note that listing markets are also trading centers, as defined by Rule 201,<sup>1080</sup> and as such, will have costs in connection with systems changes to implement the policies and procedures requirements of Rule 201 applicable to trading centers.<sup>1081</sup> We believe that the costs to listing markets associated with having to update their systems to ensure compliance with the Rule's requirements applicable to listing markets will be an incremental addition to the costs

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<sup>1076</sup> See supra Section X.B.1. (discussing costs of the alternative uptick rule).

<sup>1077</sup> See supra note 292.

<sup>1078</sup> See supra note 684.

<sup>1079</sup> For example, listing markets already have rules or policies in place to coordinate trading suspensions or halts in individual NMS stocks. See, e.g., Nasdaq Rule 4120 (relating to trading halts in Nasdaq-listed securities); NYSE Rule 123D (relating to delayed openings and trading halts in NYSE-listed securities).

<sup>1080</sup> See Rule 201(a)(9).

<sup>1081</sup> See supra Section IX.E.1. (discussing implementation costs to trading centers).

associated with the implementation of the policies and procedures requirements applicable to trading centers.<sup>1082</sup> We believe that the implementation and compliance costs for listing markets are justified by the benefits provided by requiring the listing market for a covered security to determine whether the security has become subject to the short sale price test restrictions of Rule 201 because this will help to ensure consistency for each covered security with respect to such determinations.

We recognize that single plan processors will also incur initial up-front costs associated with having to update their systems, including systems changes to computer software, as well as staff time and technology resources to update their systems and surveillance mechanisms in order to ensure compliance with the circuit breaker requirements.<sup>1083</sup> We believe, however, that the single plan processors' current familiarity with receiving and disseminating information regarding individual NMS stocks will help mitigate these implementation and compliance costs. For example, the single plan processors currently receive information from listing markets regarding trading restrictions, such as Regulatory Halts as defined in those plans, on individual securities and disseminate such information. As a result, the requirements of Rule 201(b)(3) are similar to existing obligations on plan processors pursuant to the requirements of Regulation NMS, the CTA and CQ Plans and the Nasdaq UTP Plan. Two commenters agreed that dissemination of information regarding the triggering of Rule 201 would be a function similar to other functions currently performed by the plan processors.<sup>1084</sup> Further, we believe that the implementation and compliance costs for single plan processors are justified by the benefits provided by requiring the single plan processors to disseminate information on whether a

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<sup>1082</sup> See id.

<sup>1083</sup> See supra Section X.B.1. (discussing costs of the alternative uptick rule).

<sup>1084</sup> See letter from NYSE Euronext (Sept. 2009); letter from Virtu Financial.

security has become subject to the short sale price test restrictions of Rule 201 because the similarity of this function to current functions performed by the single plan processors will help to ensure the workability and smooth functioning of the Rule.

### **3. Implementation Period**

We believe that a six month implementation period will provide trading centers, broker-dealers, listing markets, the single plan processors and other market participants with a sufficient amount of time in which to modify their systems and procedures in order to comply with the requirements of Rule 201.<sup>1085</sup> The six month implementation period will provide market participants with time to make required changes in a measured fashion, which will help alleviate some of the potential disruptions that may be associated with implementing Rule 201. Because trading centers, listing markets, the single plan processors and other market participants will require time in which to reprogram and test their systems and procedures to comply with Rule 201, the systems and programming costs associated with Rule 201 might be higher without a sufficient implementation period. For example, commenters indicated that a circuit breaker rule triggering the alternative uptick rule would require an implementation period of between three and twelve months.<sup>1086</sup>

The six month implementation period, which is longer than the implementation periods proposed in the Proposal and the Re-Opening Release, takes into consideration commenters'

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<sup>1085</sup> See supra Section VII. (discussing the implementation period).

<sup>1086</sup> See letter from NSCP; letter from NYSE Euronext (June 2009); letter from RBC (June 2009); letter from STA (June 2009); letter from FIF (Sept. 2009); letter from Citadel et al. (Sept. 2009); letter from Credit Suisse (Sept. 2009); letter from Direct Edge (Sept. 2009); letter from EWT (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009); letter from MFA (Oct. 2009); see also letter from Amer. Bankers Assoc.; letter from NYSE Euronext (Sept. 2009); letter from Goldman Sachs (Sept. 2009).

concerns that implementation of a short sale price test could be complex.<sup>1087</sup> We do not believe that an implementation period longer than 6 months is warranted because Rule 201 does not require monitoring of the sequence of bids or last sale prices, unlike other proposed short sale price tests,<sup>1088</sup> and because Rule 201 requires the implementation of policies and procedures similar to those required for trading centers under Regulation NMS.<sup>1089</sup> In addition, as discussed above, market participants will be able to leverage the numerous systems changes made and current architecture developed to facilitate compliance with Regulation NMS. These factors should reduce implementation time.

#### 4. Marking Requirements

While the current marking requirements in Rule 200(g) of Regulation SHO, which require broker-dealers to mark all sell orders of any equity security as either “long” or “short,”<sup>1090</sup> will remain in effect, the amendments to Rule 200(g) will add a new marking

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<sup>1087</sup> See, e.g., letter from NSCP; letter from RBC (June 2009); letter from SIFMA (June 2009); letter from RBC (Sept. 2009); see also letter from Direct Edge (Sept. 2009) (stating that adoption of a circuit breaker approach will add approximately four to six weeks to the implementation time of the alternative uptick rule); letter from NYSE Euronext (Sept. 2009) (stating that “a circuit breaker approach raises significant implementation complexities”). But cf. letter from Credit Suisse (Sept. 2009) (stating that a circuit breaker approach will not significantly increase implementation time); letter from Nasdaq OMX Group (Oct. 2009) (stating that “[o]nce the price test is in place, there is minimal incremental effort required to add a Circuit Breaker that controls the application of the price test”).

<sup>1088</sup> Several commenters noted that because the alternative uptick rule, unlike the other proposed price tests, does not require sequencing of bids or last sale prices, the alternative uptick rule could be implemented more quickly than the other proposed price tests, in three to six months. See, e.g., letter from Credit Suisse (June 2009); letter from STA (June 2009); letter from Credit Suisse (Sept. 2009); letter from FIF (Sept. 2009). But cf. letter from Citadel et al. (Sept. 2009); letter from NYSE Euronext (Sept. 2009); letter from RBC (Sept. 2009); letter from SIFMA (Sept. 2009).

<sup>1089</sup> One commenter stated that implementation concerns with respect to a short sale price test restriction could be mitigated, provided that trading centers “could leverage existing architecture developed to comply with the order protection rule in Reg NMS (Rule 611).” Letter from MFA (Oct. 2009). Another commenter stated that implementation of a circuit breaker triggering the alternative uptick rule would be easier to implement, “provided that the Commission permits firms to leverage the numerous systems changes made to facilitate compliance with Regulation NMS (including the use of internal market data rather than consolidated data supplied by the industry plans).” Letter from Goldman Sachs (Sept. 2009). But cf. letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009).

<sup>1090</sup> 17 CFR 242.200(g).

requirement of “short exempt.”<sup>1091</sup> In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>1092</sup> We discussed in the Proposal the anticipated costs of the proposed amendments<sup>1093</sup> and, in the Proposal and Re-Opening Release, we requested comment on the costs associated with the proposed amendments.<sup>1094</sup>

Several commenters expressed concerns regarding the implementation costs of the “short exempt” marking requirements.<sup>1095</sup> Several commenters noted that the “short exempt” marking requirements would require modifications to multiple systems, including modifications to blue sheet, OATS and OTS reporting systems.<sup>1096</sup> One commenter noted that such modifications would be in addition to changes to order entry and routing applications.<sup>1097</sup> Another commenter noted that one of its primary implementation concerns was related to “re-implementation of ‘Short Sale Exempt’ order types in interfaces between [the commenter] and [its] Customers as well as the venues that support such exempt order types.”<sup>1098</sup> In contrast, one commenter, in supporting adoption of the “short exempt” marking requirements (in the event that the

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<sup>1091</sup> See Rule 200(g); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>1092</sup> See Rule 200(g)(2).

<sup>1093</sup> See Proposal, 74 FR at 18100.

<sup>1094</sup> See Proposal, 74 FR at 18103; Re-Opening Release, 74 FR at 42037.

<sup>1095</sup> See, e.g., letter from FIF (June 2009); letter from NSCP; letter from RBC (June 2009); letter from Lime Brokerage (Sept. 2009); letter from FIF (Sept. 2009).

<sup>1096</sup> See, e.g., letter from NSCP; letter from RBC (June 2009); letter from FIF (June 2009); letter from FIF (Sept. 2009).

<sup>1097</sup> See letter from FIF (June 2009); letter from FIF (Sept. 2009).

<sup>1098</sup> Letter from Lime Brokerage (Sept. 2009).

Commission decided to adopt a short sale price test restriction), stated that “[t]he costs of marking the orders appropriately will be worth the benefits gained.”<sup>1099</sup>

We recognize commenters’ concerns with respect to the costs of the “short exempt” marking requirement and we considered these comments in evaluating the costs of the “short exempt” marking requirement. Such costs will include one-time costs for broker-dealers for reprogramming and systems changes, including modifications to reporting systems, order entry and routing applications. In addition, the costs of the “short exempt” marking requirement will include on-going monitoring and surveillance costs for broker-dealers. However, we believe that such costs will be limited because broker-dealers already have established systems, processes, and procedures in place to comply with the current marking requirements of Rule 200(g) of Regulation SHO with respect to marking a sell order either “long” or “short” and, therefore, will likely leverage such systems, processes and procedures to comply with the “short exempt” marking requirements in Rules 200(g) and 200(g)(2). Further, we believe that the implementation and compliance costs of the “short exempt” marking requirements are justified by the benefits provided by the requirements in aiding surveillance by SROs and the Commission for compliance with the provisions of Rule 201 and providing an indication to a trading center regarding when it must execute or display a short sale order without regard to whether the order is at a price that is less than or equal to the current national best bid.

We also considered whether our estimates of the implementation and on-going monitoring and compliance costs associated with the “short exempt” marking requirements under the amendments to Rule 200(g), as proposed in conjunction with the proposed modified

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<sup>1099</sup> Letter from STA (June 2009).

uptick rule<sup>1100</sup> would change under the circuit breaker approach of Rule 201, but concluded, as discussed below, that these estimates continue to represent reasonable estimates under the circuit breaker approach.

We believe that the “short exempt” marking requirements of Rule 200(g), in conjunction with a circuit breaker approach, will result in largely the same implementation costs as we estimated would be incurred if the “short exempt” marking requirements were combined with a market-wide short sale price test restriction.<sup>1101</sup> This is because broker-dealers relying on the provisions of Rule 201(c) or Rule 201(d) will need to make systems changes to implement the “short exempt” marking requirements regardless of whether the short sale price test restriction is adopted on a permanent, market-wide basis or, in the case of Rule 201, adopted in conjunction with a circuit breaker.

In addition, with respect to on-going monitoring and surveillance costs of the “short exempt” marking requirements in conjunction with a circuit breaker approach, we recognize, as noted by one commenter,<sup>1102</sup> that market participants will need to continuously monitor whether a security is subject to the provisions of Rule 201 and that there will be costs associated with such monitoring. However, we believe that these costs will be offset because, under the circuit breaker approach, use of the “short exempt” provisions of Rule 201(c) and Rule 201(d) and the related marking requirements will be time limited and will only apply on a stock by stock basis. As a result, broker-dealers who choose to rely on Rule 201(c) or Rule 201(d) will only need to monitor and surveil for compliance with the requirements of those provisions and will only need to mark qualifying orders “short exempt” during the limited period of time that the circuit

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<sup>1100</sup> See Proposal, 74 FR at 18089.

<sup>1101</sup> See Proposal, 74 FR at 18100.

<sup>1102</sup> See letter from Glen Shipway (June 2009).

breaker is in effect with respect to a specific security. The circuit breaker approach will allow regulatory, supervisory and compliance resources to focus on, and to address, those situations where a specific security is experiencing significant downward price pressure.<sup>1103</sup>

On balance, we believe our proposed estimates of the costs associated with the “short exempt” marking requirement<sup>1104</sup> are appropriate with respect to Rule 200(g) as adopted. Thus, our estimates have not changed from the Proposal, except to the extent that total burden estimates have changed because we have updated the estimated number of broker-dealers.<sup>1105</sup>

We believe that the implementation cost of the “short exempt” marking requirement will likely be similar to the implementation cost of the order marking requirements of Rule 200(g) of Regulation SHO, which had originally included the category of “short exempt.” Industry sources at that time estimated initial implementation costs for the former “short exempt” marking requirement to be approximately \$100,000 to \$125,000.<sup>1106</sup> Based on these estimates, as adjusted for inflation, we estimate that the initial implementation cost of the “short exempt” marking requirement will be approximately \$115,000 to \$145,000 per broker-dealer<sup>1107</sup> for a total initial implementation cost of approximately \$595,470,000 to \$750,810,000 for all broker-dealers.<sup>1108</sup>

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<sup>1103</sup> See, e.g., letter from Nasdaq OMX Group (Oct. 2009); letter from SIFMA (Sept. 2009).

<sup>1104</sup> See Proposal, 74 FR at 18089.

<sup>1105</sup> See *supra* note 729.

<sup>1106</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48023.

<sup>1107</sup> The adjustment for inflation was calculated using information in the Consumer Price Index, U.S. Department of Labor, Bureau of Labor Statistics.

<sup>1108</sup> These figures were calculated as follows:  $(\$115,000 \times 5,178) = \$595,470,000$  and  $(\$145,000 \times 5,178) = \$750,810,000$ .

We recognize that there will be an on-going paperwork burden cost associated with adding the “short exempt” marking requirements. For example, as detailed in PRA Section IX.E.3., above, we estimate that the total annual cost for each broker-dealer subject to the “short exempt” marking requirements will be \$93,420<sup>1109</sup> for a total annual on-going cost of \$483,728,760 for all broker-dealers subject to the “short exempt” marking requirements.<sup>1110</sup>

To provide market participants with the time needed to make the changes required to comply with Rule 200(g), we are adopting an implementation period under which market participants will have to comply with these requirements six months following the effective date of the adoption of these amendments. In the Proposal, we proposed a three month implementation period for the “short exempt” marking requirements under Rule 200(g). In response to our request for comment, several commenters stated that the “short exempt” marking requirement would require systems changes.<sup>1111</sup> Another commenter stated that the “short exempt” marking requirement would require coding for new fields in order records, which should be accomplished in approximately three months.<sup>1112</sup>

We are sensitive to commenters’ concerns that implementation of the “short exempt” marking requirement could be complex, and believe that a six month implementation period, which is longer than the 3 month implementation period proposed in the Proposal, will afford

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<sup>1109</sup> This figure was calculated as follows: (346 hours x \$270) = \$93,420 per broker-dealer. The 346 hour estimate was calculated as follows: 12.9 billion “short exempt” orders / 5,178 broker-dealers = 2,491,309 annual responses by each broker-dealer. Each response of marking sell orders “short exempt” will take approximately .000139 hours (.5 seconds) to complete. (2,491,309 responses x 0.000139 hours) = 346 burden hours.

Based on industry sources, we estimate that the average hourly rate for compliance attorneys is \$270. The \$270/hour figure for compliance attorneys is from SIFMA’s Management & Professional Earnings in the Securities Industry 2008, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>1110</sup> This figure was calculated as follows: (\$93,420 x 5,178) = \$483,728,760.

<sup>1111</sup> See, e.g., letter from RBC (June 2009); letter from NSCP; letter from FIF (June 2009).

<sup>1112</sup> See letter from STA (June 2009).

market participants sufficient time to make the necessary modifications to their systems and procedures. In addition, we believe that because it will provide broker-dealers with time to make required changes in a measured fashion, the six month implementation period will help alleviate some of the potential disruptions that may be associated with implementing the “short exempt” marking requirements.

## **XI. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.<sup>1113</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>1114</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

A number of commenters noted concerns about the impact of a short sale price test restriction on efficiency, competition and capital formation.<sup>1115</sup> One commenter stated that “the empirical evidence from the many academic and Commission studies and experiences of [the commenters] ... raise a substantial question about whether the proposed short sale restrictions

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<sup>1113</sup> 15 U.S.C. 78c(f).

<sup>1114</sup> 15 U.S.C. 78w(a)(2).

<sup>1115</sup> See, e.g., letter from Joseph A. Dear, Chief Investment Officer, California Public Employees’ Retirement System, dated June 19, 2009; letter from Citadel *et al.* (June 2009); letter from Pershing Square; letter from Vanguard (June 2009); letter from Amer. Bar Assoc. (July 2009); letter from Amer. Bar Assoc. (Sept. 2009); letter from MFA (Oct. 2009).

can satisfy these standards.”<sup>1116</sup> Another commenter noted the beneficial impact of short selling on efficiency and competition, quoting the Commission’s statements that short selling provides the market with liquidity and pricing efficiency.<sup>1117</sup> As discussed below, we considered these concerns, and took them into account in formulating Rules 200(g) and 201, as adopted, to address, to the extent possible, these concerns.

## **A. Competition**

We begin our consideration of potential competitive impacts with observations of the current structure of the markets with respect to trading centers and broker-dealers, mindful of the statutory requirements regarding competition. Based on our experience in regulating the securities markets, including reviewing information provided by trading centers and broker-dealers in their registrations and filings with us, and approving such registration applications, we discuss below the basic framework of the markets they comprise.

### **1. Market Structure for Trading Centers and Broker-Dealers**

Trading centers include national securities exchanges or national securities associations that operate an SRO trading facility, ATSS,<sup>1118</sup> exchange market makers and OTC market makers, and any other broker-dealer that executes orders internally, whether as agent or principal.<sup>1119</sup> All of these entities will be required to alter their trading mechanisms to comply with Rule 200(g) and Rule 201.

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<sup>1116</sup> Letter from Citadel et al. (June 2009).

<sup>1117</sup> See letter from Pershing Square (citing 2006 Price Test Elimination Proposing Release, 71 FR at 75069-75070).

<sup>1118</sup> Under Regulation ATS, any entity that falls within the definition of a securities exchange must apply to be a securities exchange or must register as an ATS, subject to certain exceptions. See 17 CFR 242.300, 301; see also 15 U.S.C. 78c(a)(1); 17 CFR 240.3b-16.

<sup>1119</sup> See 17 CFR 242.600(b)(78). Currently, no national securities association is a trading center, as that term is defined in Rule 600(b)(78) of Regulation NMS.

The equity trading industry is a competitive one, with reasonably low barriers to entry. The intensity of competition across trading platforms in this industry has increased in the past decade as a result of a number of factors, including market reforms and technological advances. This increase in competition has resulted in decreases in market concentration, more competition among trading centers, a proliferation of trading platforms competing for order flow, and decreases in trading fees.

The reasonably low barriers to entry for trading centers are evidenced, in part, by the fact that new entities, primarily ATSS, continue to enter the market.<sup>1120</sup> For example, currently there are approximately 50 registered ATSS that trade covered securities. In addition, the Commission within the past few years has approved applications by two entities – BATS and Nasdaq – to become registered as national securities exchanges for trading equities, and approved proposed rule changes by two existing exchanges – ISE and CBOE – to add equity trading facilities to their existing options business. We believe that competition among trading centers has been facilitated by Rule 611 of Regulation NMS,<sup>1121</sup> which encourages quote-based competition between trading centers; Rule 605 of Regulation NMS,<sup>1122</sup> which empowers investors and broker-dealers to compare execution quality statistics across trading centers; and Rule 606 of Regulation NMS,<sup>1123</sup> which enables customers to monitor order routing practices.

Broker-dealers are required to register with the Commission and at least one SRO. The broker-dealer industry, including market makers, is a competitive industry, with most trading

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<sup>1120</sup> See Exchange Act Release No. 60997 (Nov. 13, 2009), 74 FR 61208, 61234 (Nov. 23, 2009) (discussing the reasonably low barriers to entry for ATSS and that these reasonably low barriers to entry have generally helped to promote competition and efficiency).

<sup>1121</sup> 17 CFR 242.611.

<sup>1122</sup> 17 CFR 242.605.

<sup>1123</sup> 17 CFR 242.606.

activity concentrated among several dozen larger participants and with thousands of smaller participants competing for niche or regional segments of the market.

There are 5,178 registered broker-dealers, of which 890 are small broker-dealers.<sup>1124</sup> Larger broker-dealers often enjoy economies of scale over smaller broker-dealers and compete with each other to service the smaller broker-dealers, who are both their competitors and customers. The reasonably low barriers to entry for broker-dealers are evidenced, for example, by the fact that the average number of new broker-dealers entering the market each year between 2001 and 2008 was 389.<sup>1125</sup>

## **2. Discussion of Impacts of Rules 200(g) and 201 on Competition**

We believe that the estimated costs associated with implementing and complying with Rules 200(g) and 201 are not so large as to raise significant barriers to entry, or otherwise significantly alter the competitive landscape of the industries involved. In industries characterized by reasonably low barriers to entry and intense competition, the viability of some of the less successful competitors may be sensitive to regulatory costs. Nonetheless, given the reasonably low barriers to entry into the market for execution services, we believe that the trading center and broker-dealer industries will remain competitive, despite the costs associated with implementing and complying with Rules 200(g) and 201, even if those costs influence to some degree the entry or exit decisions of individual trading centers or broker-dealers at the margin.

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<sup>1124</sup> These numbers are based on a review of 2007 and 2008 FOCUS Report filings reflecting registered broker-dealers, and discussions with SRO staff. The number does not include broker-dealers that are delinquent on FOCUS Report filings. We discuss the impact of Rule 201 on small broker-dealers in Section XII.B., below.

<sup>1125</sup> This number is based on a review of FOCUS Report filings reflecting registered broker-dealers from 2001 through 2008. The number does not include broker-dealers that are delinquent on FOCUS Report filings. New registered broker-dealers for each year during the period from 2001 through 2008 were identified by comparing the unique registration number of each broker-dealer filed for the relevant year to the registration numbers filed for each year between 1995 and the relevant year.

Several commenters expressed concerns about the impact of a short sale price test restriction on competition among broker-dealers.<sup>1126</sup> For example, one commenter noted concerns with respect to decreased competition and increased broker-dealer “internalization.”<sup>1127</sup> Specifically, this commenter stated that, as a result of short sale price test restrictions, “a widening of bid/offer spreads and decrease in liquidity provided by professional market makers could reverse the consolidation of liquidity in the public markets, permitting some brokers once again to take advantage of decreased competition in price discovery and offer substantially inferior (but still technically legal) internalization prices to their customers.”<sup>1128</sup> Although we considered this commenter’s concerns, we note that, as discussed above, due to the circuit breaker approach of Rule 201, as well as findings by the Pilot Results regarding the market impact of former Rule 10a-1, we believe that the short sale price test restrictions of Rule 201 will have a limited, if any, negative market impact, such as widening of bid/offer spreads or decreased liquidity.<sup>1129</sup> Thus, we do not believe that Rule 201 will result in decreased competition in price discovery or increased internalization.

Another commenter stated that “while it will not be mandated that firms avail themselves of the [broker-dealer provision], competitive pressure is likely to mean that broker dealers will need to invest resources and time in building this functionality.”<sup>1130</sup> We recognize that broker-

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<sup>1126</sup> See, e.g., letter from Credit Suisse (June 2009); letter from EWT (June 2009); letter from FIF (June 2009); letter from NSCP.

<sup>1127</sup> Letter from EWT (June 2009).

<sup>1128</sup> Id.

<sup>1129</sup> See supra Section X.B.1.a. (discussing the impact of Rule 201 on liquidity, market volume, bid-ask spreads, price discovery and volatility).

<sup>1130</sup> Letter from FIF (June 2009). In addition, some commenters raised concerns with respect to competitive pressure on smaller broker-dealers, in particular, in connection with a short sale price test restriction. As noted above, we discuss the impact of Rule 201 on small broker-dealers in Section XII.B., below.

dealers are faced with competitive concerns and that such concerns may influence their decision whether or not to rely on the broker-dealer provision of Rule 201(c). We also recognize that if a broker-dealer chooses to rely on the broker-dealer provision it will impose costs on such broker-dealers, and we considered these costs in determining to adopt in Rule 201 the alternative uptick rule rather than a rule that requires sequencing of the national best bid.<sup>1131</sup> Although commenters expressed concerns with respect to the costs of the broker-dealer provision of Rule 201(c) and the resulting impact on competition, many of these comments were not specific to the alternative uptick rule.<sup>1132</sup> Without a sequencing requirement under the alternative uptick rule, we believe that the policies and procedures required to rely on the broker-dealer provision under Rule 201(c) will be easier and less costly to implement and monitor than the cost concerns and estimates provided by some commenters.

Other commenters noted concerns regarding reduced competition among market makers in the absence of a bona fide market making exception.<sup>1133</sup> We believe, however, that due to the approach of Rule 201, that is, the combination of a circuit breaker with the alternative uptick rule, the lack of such a bona fide market maker exception will have minimal, if any, impact on competition among market makers. This is because, as noted by some commenters, equity market makers for the most part sell at their offer quote.<sup>1134</sup> Thus, the short sale price test

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<sup>1131</sup> See supra Section IX.E.2. (discussing the implementation and on-going monitoring and compliance costs of the broker-dealer provision).

<sup>1132</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009); letter from T.D. Pro Ex; letter from Taurus Compliance; letter from Credit Suisse (June 2009); letter from NSCP.

<sup>1133</sup> See, e.g., letter from EWT (June 2009); letter from EWT (Sept. 2009); letter from GETCO (June 2009); letter from Goldman Sachs (June 2009); but cf. letter from Dr. Jim DeCosta (noting that there are currently few barriers to entry for market makers and abuse can arise from small market makers, who are in need of business, being willing to misuse a bona fide market making exemption in exchange for order flow). See also supra Section III.B.9. (discussing the decision not to include an exemption for bona fide market making).

<sup>1134</sup> See, e.g., letter from CBOE (June 2009).

restriction of Rule 201, which requires short selling at a price above the national best bid and only if the circuit breaker has been triggered, is consistent with equity market making strategies because these market makers generally sell at prices above the national best bid.<sup>1135</sup> This is particularly true where a security's price is declining, as market makers often provide liquidity on the opposite side of price moves to help reduce volatility. Thus, even during times when a covered security is undergoing significant downward price pressure, market makers are generally required to provide liquidity in that security.<sup>1136</sup>

Weighing against the competitive concerns for the trading center and broker-dealer industries, Rule 201 will advance the purposes of the Exchange Act in a number of significant ways. It will help benefit the market for a particular security by allowing market participants, when a security is undergoing a significant intra-day price decline, an opportunity to re-evaluate circumstances and respond to volatility in that security. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors. We also believe that a circuit

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<sup>1135</sup> See letter from Direct Edge (Sept. 2009); see also *supra* note 532 (discussing a 1997 study indicating that during a sample month in 1997, market maker short sales at or below the inside bid accounted for only 2.41% of their total share volume).

<sup>1136</sup> See, e.g., NYSE Rule 104(f) (stating that "it is commonly desirable that a member acting as [a designated market maker] engage to a reasonable degree under existing circumstances in dealings for the [designated market maker's] own account when lack of price continuity, lack of depth, or disparity between supply and demand exists or is reasonably to be anticipated"); CBOE Rule 53.23(a)(1) (stating that "[w]ith respect to each security for which it holds an Appointment, a CBSX Remote Market Maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for its own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, or a temporary disparity between the supply of and demand for a particular security").

breaker will better target short selling that may be related to potential bear raids<sup>1137</sup> and other forms of manipulation that may be used to exacerbate a price decline in a covered security.

At the same time, however, we recognize the benefits to the market of legitimate short selling, such as the provision of liquidity and price efficiency, and considered these benefits in adopting the circuit breaker approach of Rule 201. Under the circuit breaker approach, the alternative uptick rule will only be imposed when a covered security has experienced an intra-day price decline of 10% or more and will only apply for the remainder of the day and the following day. We believe that because of the limited scope and duration of Rule 201, it will not interfere with the smooth functioning of the markets for the majority of securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. To the extent that Rule 201 impacts the benefits of legitimate short selling, such as the provision of liquidity and price efficiency, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

After due consideration of all these factors and the comments we have received, we have determined that any burden on competition that Rules 200(g) and 201 may impose is necessary or appropriate in the furtherance of the purposes of the Exchange Act noted above.

## **B. Capital Formation**

A purpose of Rule 201 is to strengthen investor confidence in the markets we regulate which should help make investors more willing to invest, resulting in the promotion of capital formation. Fair and robust secondary markets, in which legitimate short selling can play a positive role, supports the public offerings by which issuers raise capital and, as a result,

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<sup>1137</sup> See supra note 36 and accompanying text.

investors who provided private capital realize profits and obtain liquidity. In addition, long holdings are integral to capital formation. By placing long holders ahead of short sellers in the execution queue under certain limited circumstances, Rule 201 promotes capital formation, since investors should be more willing to hold long positions if they know they may have a preferred position over short sellers when they wish to sell in the market for that security during a significant price decline in that security.

In addition, paragraphs (c) and (d) of Rule 201 include provisions that are designed to limit any adverse effects on the public offering process, which is necessary to capital formation, while at the same time not undermining the goals of Rule 201.<sup>1138</sup> In particular, Rule 201(d)(5) is designed to facilitate price support during the offering process by allowing broker-dealers to mark short sale orders “short exempt” if the short sale is by an underwriter or syndicate member participating in a distribution in connection with an over-allotment or if the short sale order is by an underwriter or syndicate member for purposes of a lay-off sale in connection with a distribution of securities through a rights or standby underwriting commitment.<sup>1139</sup>

We note that short sales can facilitate convertible securities offerings, and, as stated by some commenters,<sup>1140</sup> we recognize that hedges for this subset of offerings may become more expensive under Rule 201 due to the absence of an exception from Rule 201 for short selling in connection with convertible instruments. In this regard, however, we note that as adopted, as

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<sup>1138</sup> See supra Section III.B. (discussing “short exempt” provisions to Rule 201). Under these provisions, if a broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”

<sup>1139</sup> See Rule 201(d)(5).

<sup>1140</sup> See supra notes 425 to 426 and accompanying text (noting requests by commenters for exceptions for short sales in connection with the facilitation of capital raising transactions through convertible instruments by issuers and selling shareholders, and to allow investors purchasing a convertible instrument to hedge their long exposure).

opposed to some of our alternative proposals, Rule 201 will not prohibit short selling to hedge a position, although it could marginally increase the cost of adjusting a hedge after a significant market decline. Even if these indirect costs could, at the margin, reduce the attractiveness and, therefore, the volume of certain types of offerings, we do not believe that any such reduction will be significant because short sellers will be able to sell at a price above the national best bid even during the limited time the circuit breaker is in effect. Moreover, as described above, Rule 201 includes an exception for short selling in connection with certain types of capital-raising structures. Thus, while there may be a change in the total mix of offering types, we have no reason to believe that, in light of the anticipated positive effect of Rule 201 on investor confidence, particularly confidence in long holdings, that there will be any overall negative effect on capital formation as a result of our adoption of this Rule.

We believe, and commenters agreed, that by helping to prevent short selling, including manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline, Rule 201 will help restore and maintain investor confidence in the securities markets.<sup>1141</sup> Bolstering investor confidence in the markets will help to encourage investors to be more willing to invest in the markets, including during times of substantial uncertainty, thereby adding depth and liquidity to the markets and promoting capital formation.

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<sup>1141</sup> See supra Section II.C. (discussing restoring investor confidence); see also letter from Edward C. Springer, dated May 3, 2009; letter from Richard Anderson, dated May 5, 2009; letter from Mike Pascale, dated May 11, 2009; letter from Sigmon Wealth Management (June 2009); form letter type C, a petition drafted by Jim Cramer, William Furber, Eric Oberg, and Scott Rothbort and signed by 5,605 investors. Another commenter stated that adoption of the alternative uptick rule would have a beneficial impact on capital formation, stating that “[t]he most important function of the capital markets is to raise capital for American corporations,” and that “by adopting the alternative uptick rule, the Commission will have chosen the best approach to deal with the loss of confidence by Congress and most importantly the investing public.” Letter from Glen Shipway (Sept. 2009). We note, however, that this commenter did not support adoption of the alternative uptick rule in conjunction with a circuit breaker.

### C. Efficiency

Rule 201 is designed to achieve the appropriate balance between our goal of preventing short selling, including manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets. By not allowing short sellers to sell at or below the current national best bid while the circuit breaker is in effect, the short sale price test restriction in Rule 201 will allow long sellers in certain limited circumstances, by selling at the bid, to sell first in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long sellers to sell first in a declining market.<sup>1142</sup>

The term “price efficiency” has a technical meaning in financial economics, which is not the only way the term can be interpreted in the Exchange Act.<sup>1143</sup> We have, nonetheless, considered the effect of Rule 201 on price efficiency in terms of financial economic theory.<sup>1144</sup>

We have structured Rule 201 to mitigate its impact on price efficiency. In response to the Proposal and Re-Opening Release, several commenters cited empirical evidence showing that short selling contributes to price efficiency and that restrictions on short selling, particularly bans on short selling, may negatively impact price efficiency.<sup>1145</sup> We note, however, that empirical

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<sup>1142</sup> See supra note 17.

<sup>1143</sup> See supra note 18 (defining the term “price efficiency”).

<sup>1144</sup> See, e.g., Edward M. Miller, 1977, Risk, uncertainty, and divergence of opinion, Journal of Finance 32, 1151-1168; Douglas W. Diamond and Robert E. Verrecchia, 1987, Constraints on short-selling and asset price adjustment to private information, Journal of Financial Economics 18, 277-311.

<sup>1145</sup> See, e.g., letter from Pershing Square (citing 2006 Price Test Elimination Proposing Release, 71 FR at 75069-75070); letter from CPIC (June 2009) (citing Pedro A. C. Saffi and Kari Sigurdson, Price Efficiency and Short Selling, IESE Business School Working Paper No. 748 (Apr. 2008); letter from Citadel et al. (June 2009).

evidence on former Rule 10a-1 suggests that the former rule, which applied to all short selling all the time unless an exception or exemption applied, had minimal effect on price efficiency.<sup>1146</sup> Due to differences in the operation of former Rule 10a-1 and Rule 201, when it applies, the alternative uptick rule under Rule 201 will be more restrictive than former Rule 10a-1 in some circumstances and less restrictive in others.<sup>1147</sup> As discussed above, however, due to the circuit breaker approach in Rule 201, the alternative uptick rule of Rule 201 generally will apply to a limited number of covered securities<sup>1148</sup> and will apply only to a particular security for a limited period of time when the circuit breaker has been triggered for a covered security. As such, it will not be triggered for the majority of covered securities at any given time and, when triggered, will remain in effect for a short duration – that day and the following day. Thus, consistent with the empirical evidence on former Rule 10a-1, we expect that the alternative uptick rule will have a minimal impact on price efficiency.

Moreover, paragraphs (c) and (d) of Rule 201 include provisions designed to limit any adverse effects on price efficiency and liquidity, while at the same time not undermining the goals of Rule 201.<sup>1149</sup> In particular, paragraphs (d)(3) and (d)(4) of Rule 201 are designed to facilitate pricing efficiency through certain domestic and international arbitrage transactions. As stated above, allowing arbitrage at a price that is less than or equal to the current national best bid will potentially promote market efficiency. In addition, paragraph (d)(6) of Rule 201, which relates to riskless principal transactions, is designed to facilitate liquidity.

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<sup>1146</sup> See, e.g., supra Section II.B. (discussing the Pilot Results).

<sup>1147</sup> See, e.g., supra note 242 and accompanying text (discussing automated trade matching systems).

<sup>1148</sup> See supra notes 305 to 311 and accompanying text (discussing data reflecting that, on average, a limited number of covered securities would hit a 10% trigger level each day).

<sup>1149</sup> See supra Section III.B. (discussing “short exempt” provisions to Rule 201); see also supra note 1138.

## **XII. Final Regulatory Flexibility Analysis**

The Commission has prepared a Final Regulatory Flexibility Analysis (“FRFA”), in accordance with the provisions of the Regulatory Flexibility Act.<sup>1150</sup> This FRFA relates to the amendments to Rules 200(g) and 201 of Regulation SHO under the Exchange Act. Rule 201 of Regulation SHO implements a short sale-related circuit breaker that, if triggered, will impose a short sale price test restriction. Specifically, Rule 201 requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security’s closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>1151</sup> In addition, Rule 201 provides that the listing market for each covered security must determine whether that covered security is subject to Rule 201.<sup>1152</sup> Once the listing market has determined that a security has become subject to the requirements of Rule 201, the listing market shall immediately notify the single plan processor responsible for consolidation of information for the covered security in accordance with Rule 603(b) of

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<sup>1150</sup> 5 U.S.C. 604.

<sup>1151</sup> See Rule 201(b); see also supra Section III.A.7. (discussing the policies and procedures approach).

<sup>1152</sup> See Rule 201(b)(3).

Regulation NMS<sup>1153</sup> of the fact that a covered security has become subject to the short sale price test restriction of Rule 201. The plan processor must then disseminate this information.<sup>1154</sup> The amendments to Rule 200(g) of Regulation SHO add a new marking requirement of “short exempt.”<sup>1155</sup> In particular, if the broker-dealer chooses to rely on its own determination that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order as “short exempt.”<sup>1156</sup>

#### **A. Need for and Objectives of the Rule**

We believe it is appropriate to adopt a circuit breaker in combination with the alternative uptick rule because, when triggered, it will prevent short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and will facilitate the ability of long sellers to sell first upon such decline. This approach establishes a narrowly-tailored Rule that will target only those securities that are experiencing significant intra-day price declines. We believe that addressing short selling in connection with such declines in individual securities will help address erosion of investor confidence in our markets generally. We are also adopting amendments to Rule 200(g) of Regulation SHO in order to aid surveillance by SROs and the Commission for compliance with the provisions of Rule 201.

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<sup>1153</sup> Rule 603(b) of Regulation NMS provides that “[e]very national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.” 17 CFR 242.603(b).

<sup>1154</sup> See Rule 201(b)(3); 17 CFR 242.603(b).

<sup>1155</sup> See Rule 200(g); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>1156</sup> See Rule 200(g)(2).

As discussed above, following changes in market conditions since the elimination of former Rule 10a-1, including marked increases in market volatility in the U.S. and in every major stock market around the world, we proposed to re-examine and seek comment on whether to impose short sale price test restrictions or circuit breaker restrictions on short selling.<sup>1157</sup> Although in recent months there has been an increase in stability in the securities markets, we remain concerned that excessive downward price pressure on individual securities accompanied by the fear of unconstrained short selling can undermine investor confidence in our markets generally. In addition, we are concerned about potential future market turmoil, including significant increases in market volatility and steep price declines. Thus, as discussed in more detail throughout this adopting release, after considering the comments, we have determined that it is appropriate to adopt in Rule 201 a targeted short sale price test restriction that will apply the alternative uptick rule for the remainder of the day and the following day if the price of an individual security declines intra-day by 10% or more from the prior day's closing price for that security as determined by the covered security's listing market.

By not allowing short sellers to sell at or below the current national best bid while the circuit breaker is in effect, the short sale price test restriction in Rule 201 will allow long sellers, by selling at the bid, to sell first in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of such restrictions is to allow long sellers to sell first in a declining market.<sup>1158</sup> A short seller that is seeking to profit quickly from accelerated, downward market moves may find it advantageous to be able to short sell at the current national best bid. In addition, by making bids accessible

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<sup>1157</sup> See Proposal, 74 FR at 18043, 18046; see also supra Section II.C. (discussing the Proposal).

<sup>1158</sup> See supra note 17.

only by long sellers when a security's price is undergoing significant downward price pressure, Rule 201 will help to facilitate and maintain stability in the markets and help ensure that they function efficiently. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors.

In addition, combining the alternative uptick rule with a circuit breaker strikes the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets. The circuit breaker approach of Rule 201 will help benefit the market for a particular security by allowing participants, when a security is undergoing a significant intra-day price decline, an opportunity to re-evaluate circumstances and respond to volatility in that security. We also believe that a circuit breaker will better target short selling that may be related to potential bear raids<sup>1159</sup> and other forms of manipulation that may be used as a tool to exacerbate a price decline in a covered security.

At the same time, however, we recognize the benefits to the market of legitimate short selling, such as the provision of liquidity and price efficiency. Thus, by imposing a short sale price test restriction only when an individual security is undergoing significant price pressure, rather than on all securities all the time, the short sale price test restrictions of Rule 201 will

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<sup>1159</sup> See supra note 36 and accompanying text.

apply to a limited number of securities and for a limited duration.<sup>1160</sup> Rule 201 is structured so that generally it will not be triggered for the majority of covered securities at any given time and, thereby, will not interfere with the smooth functioning of the markets for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. If the short sale price test restrictions of Rule 201 apply to a covered security it will be because and when that security is undergoing significant downward price pressure. To the extent that Rule 201 negatively affects the benefits of legitimate short selling, such as the provision of liquidity and price efficiency, we believe that such costs are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

In addition, to help ensure the Rule's workability, we are amending Rule 200(g) of Regulation SHO, as proposed, to provide that, once the circuit breaker has been triggered for a covered security, if a broker-dealer chooses to rely on its own determination that it is submitting a short sale order to a trading center at a price that is above the current national best bid at the time of submission or to rely on an exception specified in the Rule, it must mark the order "short exempt." The short sale price test restriction of Rule 201 generally will apply to a small number of securities for a limited duration, and will continue to permit short selling rather than, for example, halting short selling when the restriction is in place. As such, we believe that the circumstances under which a broker-dealer may need to mark a short sale order "short exempt" under Rule 201 are limited.

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<sup>1160</sup> See supra Section III.A.5. (discussing the circuit breaker trigger level).

## **B. Significant Issues Raised by Public Comment**

In the Initial Regulatory Flexibility Analysis included in the Proposal, we requested comment on the number of small entities that would be affected by the proposed amendments and on the impact the proposed amendments would have on small entities and how to quantify the impact.<sup>1161</sup> The Commission did not receive any comment letters addressing the number of small entities that would be affected by the proposed amendments.

Several commenters stated that the costs of implementing and complying with the broker-dealer provision of Rule 201(c) could be particularly burdensome for smaller broker-dealers, but did not provide a cost estimate of such burdens.<sup>1162</sup> One commenter stated that this burden would “adversely affect the ability of smaller broker-dealers to compete or the level of service that they can provide to their customers,”<sup>1163</sup> while another stated that a short sale price test would “disproportionately burden smaller broker-dealers, who would likely be forced to route their flow through a handful of larger brokers, impeding competition and adding to systemic risk as flow is consolidated among fewer players.”<sup>1164</sup>

Although we agree that implementation of the broker-dealer provision of Rule 201(c) will impose costs on broker-dealers who choose to rely on this provision, we note that Rule 201(c) is not a requirement of the Rule, but rather provides that a broker-dealer may mark a sell order for a security that has triggered the circuit breaker as “short exempt,” provided that the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission to the trading center and otherwise complies with the requirements of the provision.

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<sup>1161</sup> See Proposal, 74 FR at 18107.

<sup>1162</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP; letter from T.D. Pro Ex.

<sup>1163</sup> Letter from NSCP.

<sup>1164</sup> Letter from Credit Suisse (June 2009).

In addition, as discussed throughout this adopting release, the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price. Although commenters expressed concerns with respect to the costs of the broker-dealer provision of Rule 201(c), these comments were not specific to the alternative uptick rule.<sup>1165</sup> In order to rely on the broker-dealer provision, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being at a price above the current national best bid at the time of submission of the order to the trading center. Without a sequencing requirement under the alternative uptick rule, we believe that the policies and procedures required to rely on the broker-dealer provision under Rule 201(c) will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick rule,<sup>1166</sup> and, therefore, lower than the cost concerns and estimates provided by commenters. We note that one of the commenters that expressed concerns about the implementation cost of the broker-dealer provision acknowledged that a rule “that would not require data centralization and sequencing would be significantly less complex and faster to implement.”<sup>1167</sup>

We disagree with several commenters who stated that, although implementation and on-going monitoring and surveillance of the alternative uptick rule might be easier and/or less costly for trading centers, this would not hold true for broker-dealers.<sup>1168</sup> One of these commenters

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<sup>1165</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP; letter from T.D. Pro Ex.

<sup>1166</sup> See supra notes 709 to 715 and accompanying text (discussing comments on the impact of the alternative uptick rule on implementation and on-going monitoring and compliance costs).

<sup>1167</sup> Letter from Credit Suisse (June 2009).

<sup>1168</sup> See, e.g., letter from Citadel et al. (Sept. 2009); letter from EWT (Sept. 2009); letter Lime Brokerage (Sept. 2009).

stated that “in order to avoid rejection of short sale orders under an alternative uptick rule, programming would need to be implemented to anticipate changes in the national best bid between the time a short sale order is entered and the time it reaches the relevant market center.”<sup>1169</sup> However, the broker-dealer provision of Rule 201(c) is designed specifically to avoid this result. Under the broker-dealer provision, a broker-dealer may, in accordance with the policies and procedures required by the provision, identify the order as being at a price above the current national best bid at the time the order is submitted to the trading center and mark the order “short exempt.” Trading centers are required to have written policies and procedures in place to permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.<sup>1170</sup>

Commenters also expressed concerns about the competitive pressure of the broker-dealer provision, stating either that broker-dealers would feel compelled to undertake implementation of the provision, despite the high cost,<sup>1171</sup> which would be particularly burdensome for smaller firms,<sup>1172</sup> or that smaller firms would find the costs prohibitive, placing them at a competitive disadvantage.<sup>1173</sup> We recognize that broker-dealers are faced with competitive concerns and that such concerns may influence their decision whether or not to rely on the broker-dealer provision of Rule 201(c).

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<sup>1169</sup> Letter from Citadel et al. (Sept. 2009).

<sup>1170</sup> See Rule 201(b)(1)(iii).

<sup>1171</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009).

<sup>1172</sup> See, e.g., letter from T.D. Pro Ex; letter from Taurus Compliance; letter from Credit Suisse (June 2009).

<sup>1173</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP.

However, with respect to the cost, although we recognize that the broker-dealer provision will impose implementation costs on broker-dealers who choose to rely on this provision, we believe that this cost will not be as great as stated by some commenters because the alternative uptick rule does not require sequencing of the national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price.<sup>1174</sup> We believe that, without a sequencing requirement, the policies and procedures required in order to rely on the broker-dealer provision under the alternative uptick rule will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick rule.

In addition, we note that it is possible that some smaller broker-dealers that determine to rely on the broker-dealer provision may determine that it is cost-effective for them to outsource certain functions necessary to comply with Rule 201(c) to larger broker-dealers, rather than performing such functions in house, to remain competitive in the market. This may help mitigate costs associated with implementing and complying with Rule 201(c). Additionally, they may decide to purchase order management software from technology firms. Order management software providers may integrate changes imposed by Rules 200(g) and 201 into their products, thereby providing another cost-effective way for smaller broker-dealers to comply with the requirements of Rule 201(c).

Although we agree that the broker-dealer provision will impose costs for implementation and on-going monitoring and surveillance, we note that the policies and procedures that are required to be implemented under the broker-dealer provision are similar to those that are

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<sup>1174</sup> See *supra* note 1165 and accompanying text (discussing impact of the alternative uptick rule on commenters' cost concerns with respect to the broker-dealer provision of Rule 201(c)).

required under the Order Protection Rule of Regulation NMS.<sup>1175</sup> In order to rely on the broker-dealer provision, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the incorrect identification of orders as being at a price above the current national best bid at the time of submission of the order to the trading center. Because some broker-dealers, including small broker-dealers, may have already developed or modified their surveillance mechanisms in order to comply with the policies and procedures requirement of the Order Protection Rule under Regulation NMS, broker-dealers may already have retained and trained the necessary personnel to ensure compliance with that Regulation's policies and procedures requirements and, therefore, may already have in place most of the infrastructure and potential policies and procedures necessary to comply with the broker-dealer provision of Rule 201(c). In addition, one commenter supported using a policies and procedures approach to any short sale price test restriction because it would ease implementation for broker-dealers.<sup>1176</sup> Thus, we believe broker-dealers will already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.

Although several commenters stated that previous implementation of Regulation NMS would not mitigate the costs to broker-dealers of implementing a short sale price test restriction,<sup>1177</sup> we considered these comments, as well as comments stating that previous implementation of Regulation NMS could ease implementation provided that broker-dealers could leverage existing systems in implementing Rule 201,<sup>1178</sup> and continue to believe that

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<sup>1175</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also 17 CFR 242.611.

<sup>1176</sup> See, e.g., letter from GE.

<sup>1177</sup> See, e.g., letter from FIF (June 2009); letter from RBC (June 2009).

<sup>1178</sup> See, e.g., letter from MFA (Oct. 2009).

familiarity with Regulation NMS policies and procedures will reduce the implementation costs of the broker-dealer provision under Rule 201(c) on broker-dealers.<sup>1179</sup>

Further, we believe that the implementation and on-going monitoring and compliance costs for broker-dealers who choose to rely on the broker-dealer provision are justified by the benefits of providing broker-dealers with the option to manage their order flow, rather than having to always rely on their trading centers to manage their order flow on their behalf.

### **C. Small Entities Affected by the Rule**

Rule 201 requires that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day. In addition, the Rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.<sup>1180</sup> Rule 201(a)(9) states that the term "trading center" shall have the same meaning as in Rule 600(b)(78) of Regulation NMS, which defines a "trading center" as "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange

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<sup>1179</sup> See supra Section X.B.1.b.ii. (discussing implementation and on-going monitoring and surveillance costs to broker-dealers under Rule 201(c) and Rule 201(d)(6)).

<sup>1180</sup> See Rule 201(b)(1).

market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.”<sup>1181</sup>

Rule 0-10(e) under the Exchange Act provides that the term “small business” or “small organization,” when referring to an exchange, means any exchange that: (i) has been exempted from the reporting requirements of Rule 601 under the Exchange Act;<sup>1182</sup> and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10.<sup>1183</sup> No national securities exchanges are small entities because none meets these criteria. Thus, the current national securities exchanges that are subject to Rule 201 are not “small entities” for purposes of the Regulatory Flexibility Act.

The remaining non-SRO trading centers that are subject to Rule 201 are registered broker-dealers. The Commission has determined that there are approximately 407 broker-dealers registered with the Commission that may meet the definition of a trading center,<sup>1184</sup> which includes broker-dealers operating as equity ATs, broker-dealers registered as market makers or specialists in covered securities, and any broker-dealer that is in the business of executing orders internally in covered securities. Pursuant to Rule 0-10(c) under the Exchange Act, a broker-dealer is defined as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a

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<sup>1181</sup> See Rule 201(a)(9); see also 17 CFR 242.600(b)(78).

<sup>1182</sup> See 17 CFR 242.601.

<sup>1183</sup> See 17 CFR 240.0-10(e); 13 CFR 121.201 (setting size standards to define small business concerns).

<sup>1184</sup> See *supra* note 651.

small entity.<sup>1185</sup> Of these 407 non-SRO trading centers, only five<sup>1186</sup> are “small entities” for purposes of the Regulatory Flexibility Act.

In addition, the broker-dealer provision of Rule 201(c) and the riskless principal provision of Rule 201(d)(6) include policies and procedures requirements to help prevent incorrect identification of orders by broker-dealers for purposes of the provisions. The entities covered by the broker-dealer provision of Rule 201(c), the riskless principal provision of Rule 201(d)(6) and the marking requirements of Rule 200(g) include small broker-dealers. Paragraph (c)(1) of Rule 0-10 under the Exchange Act, as mentioned above, states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and is not affiliated with any person (other than a natural person) that is not a small entity.<sup>1187</sup> We estimate that as of 2008 there were approximately 890 broker-dealers that are “small entities” for purposes of the Regulatory Flexibility Act.<sup>1188</sup>

In addition, Rule 201(b)(3) provides that the listing market for each covered security must determine whether that covered security is subject to Rule 201 and must notify the single plan processor responsible for that covered security that the covered security has become subject to the short sale price test restriction of Rule 201. The plan processor must then disseminate this

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<sup>1185</sup> See 17 CFR 240.0-10(c)(1).

<sup>1186</sup> This number was derived from a review of 2008 FOCUS Report filings and discussion with SRO staff.

<sup>1187</sup> 17 CFR 240.0-10(c)(1).

<sup>1188</sup> These numbers are based on a review of 2008 FOCUS Report filings reflecting registered broker-dealers, including introducing broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

information.<sup>1189</sup> As discussed below, the entities covered by the determination and dissemination requirements of Rule 201(b)(3) do not include small entities.

Rule 201(a)(3) defines the term “listing market” to have the same meaning as defined in the effective transaction reporting plan for the covered security.<sup>1190</sup> Under the definitions of “listing market” of the two effective transaction reporting plans, the CTA Plan and the Nasdaq UTP Plan, “listing markets” are national securities exchanges.<sup>1191</sup> Rule 0-10(e) under the Exchange Act provides that the term “small business” or “small organization,” when referring to an exchange, means any exchange that: (i) has been exempted from the reporting requirements of Rule 601 under the Exchange Act;<sup>1192</sup> and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10.<sup>1193</sup> No national securities exchanges are small entities because none meets these criteria. Thus, the listing markets that are subject to Rule 201 are not “small entities” for purposes of the Regulatory Flexibility Act.

There are two effective transaction reporting plans, the CTA Plan and the Nasdaq UTP Plan. In accordance with Rule 603(b) of Regulation NMS,<sup>1194</sup> these plans, together with the CQ Plan, provide for the dissemination of all consolidated information for individual NMS stocks through a single plan processor. The plan processor for the CTA Plan is SIAC and the plan processor for the Nasdaq UTP Plan is Nasdaq. Rule 201(a)(6) defines the term “plan processor”

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<sup>1189</sup> See Rule 201(b)(3).

<sup>1190</sup> See Rule 201(a)(3). Rule 201(a)(2) provides that “[t]he term effective transaction reporting plan for a covered security shall have the same meaning as in §242.600(b)(22).” Rule 201(a)(2); 17 CFR 600(b)(22).

<sup>1191</sup> See supra note 364 (discussing the definition of “listing market” in the CTA Plan and the Nasdaq UTP Plan).

<sup>1192</sup> See 17 CFR 242.601.

<sup>1193</sup> See 17 CFR 240.0-10(e); 13 CFR 121.201.

<sup>1194</sup> See 17 CFR 242.603(b).

to have the same meaning as in Rule 600(b)(55) of Regulation NMS<sup>1195</sup>. Under Rule 600(b)(55), the term “plan processor” means “any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.”<sup>1196</sup> Paragraph (g) of Rule 0-10 defines the term “small business” or “small organization,” when referring to a securities information processor, to mean a securities information processor that had gross revenues of less than \$10 million during the preceding fiscal year; provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year; and is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>1197</sup> Neither SIAC nor Nasdaq meet these criteria. Thus, the plan processors that are subject to Rule 201 are not “small entities” for purposes of the Regulatory Flexibility Act.

#### **D. Projected Reporting, Recordkeeping and Other Compliance Requirements**

Rule 201 imposes some new or additional reporting, recordkeeping, or compliance costs on trading centers and other broker-dealers that are small entities. Rule 201 focuses on a trading center’s written policies and procedures as the mechanism through which to help prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid, unless an exception applies. In addition, the broker-dealer provision of Rule 201(c) and the riskless principal provision of Rule 201(d)(6) include policies and procedures requirements to help prevent incorrect identification of orders by broker-dealers for purposes of those provisions.

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<sup>1195</sup> See Rule 201(a)(6); 17 CFR 242.600(b)(55).

<sup>1196</sup> 17 CFR 242.600(b)(55).

<sup>1197</sup> See 17 CFR 240.0-10(g).

In regard to implementation and on-going monitoring and surveillance costs of Rule 201 on trading centers that are small entities,<sup>1198</sup> we considered commenters' concerns that the cost and time required for trading centers' implementation and on-going monitoring and surveillance of a short sale price test restriction could be high.<sup>1199</sup> However, we note that the alternative uptick rule references only the current national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price. Thus, we believe that the alternative uptick rule will be easier and less costly to implement and monitor for trading centers that are small entities than the proposed modified uptick rule or the proposed uptick rule.<sup>1200</sup>

In addition, we note that the policies and procedures required to be implemented for purposes of Rule 201 are similar to those that trading centers are required to have in place under the Order Protection Rule of Regulation NMS.<sup>1201</sup> Thus, we believe trading centers that are small entities may already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.

Although, as discussed above, several commenters stated that previous implementation of Regulation NMS would not mitigate the costs of implementing a short sale price test

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<sup>1198</sup> As discussed above, there are no SRO trading centers that are "small entities" for purposes of the Regulatory Flexibility Act. Of the estimated 407 non-SRO trading centers (which include broker-dealers operating as equity ATSS, broker-dealers registered as market makers or specialists in covered securities, and any broker-dealer that is in the business of executing orders internally in covered securities) we estimate that there are only 5 non-SRO trading centers that are "small entities" for purposes of the Regulatory Flexibility Act. See supra Section XII.C.

<sup>1199</sup> See supra Section X.B.1.b.i. (discussing comments on the implementation and on-going monitoring and compliance costs of the policies and procedures requirement of Rule 201).

<sup>1200</sup> See supra notes 661 to 669 and accompanying text (discussing comments on the effect of the alternative uptick rule on implementation and on-going monitoring and surveillance costs).

<sup>1201</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also Proposal, 74 FR at 18087; 17 CFR 242.611.

restriction,<sup>1202</sup> we considered these comments, as well as comments stating that previous implementation of Regulation NMS could ease implementation provided that trading centers could use existing systems in implementing Rule 201,<sup>1203</sup> and continue to believe that familiarity with Regulation NMS policies and procedures will reduce the implementation costs for trading centers of the policies and procedures requirement under Rule 201.

Further, we believe that the implementation and on-going monitoring and compliance costs for trading centers are justified by the benefits provided by the Rule in preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security.

In regard to implementation and on-going monitoring and surveillance costs of the broker-dealer provision of Rule 201(c) or the riskless principal provision of Rule 201(d)(6) on small broker-dealers,<sup>1204</sup> as discussed in Section XII.B., above, several commenters stated that the costs of implementing and complying with the broker-dealer provision of Rule 201(c) could be particularly burdensome for smaller broker-dealers.<sup>1205</sup> Commenters also expressed concerns about the competitive pressure of the broker-dealer provision, stating either that broker-dealers would feel compelled to undertake implementation of the provision, despite the high cost,<sup>1206</sup>

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<sup>1202</sup> See supra notes 939 to 941 and accompanying text (discussing comments that prior implementation of Regulation NMS would not mitigate the costs of implementing a short sale price test restriction).

<sup>1203</sup> See supra notes 942 to 945 and accompanying text (discussing comments that prior implementation of Regulation NMS could mitigate the costs of implementing a short sale price test restriction).

<sup>1204</sup> As discussed above, we estimate that as of 2008 there were approximately 890 broker-dealers that are “small entities” for purposes of the Regulatory Flexibility Act. See supra Section XII.C.

<sup>1205</sup> See supra notes 1162 to 1173 and accompanying text (discussing comments on the costs of the broker-dealer provision of Rule 201(c) for smaller broker-dealers).

<sup>1206</sup> See, e.g., letter from STANY (June 2009); letter from FIF (June 2009); letter from Lime Brokerage (June 2009).

which would be particularly burdensome for smaller firms,<sup>1207</sup> or that smaller firms would find the costs prohibitive, placing them at a competitive disadvantage.<sup>1208</sup>

We considered these comments in evaluating the costs of implementation and on-going monitoring and surveillance of the broker-dealer provision of Rule 201(c) on small broker-dealers. Although we agree that implementation of the broker-dealer provision of Rule 201(c) will impose costs on broker-dealers who choose to rely on this provision, we note that Rule 201(c) is not a requirement of the Rule, but rather provides that a broker-dealer may mark a sell order for a security that has triggered the circuit breaker as “short exempt,” provided that the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission to the trading center and otherwise complies with the requirements of the provision. We recognize, however, that broker-dealers are faced with competitive concerns and that such concerns may influence their decision whether or not to rely on the broker-dealer provision of Rule 201(c).

With respect to the cost, although we recognize that the broker-dealer provision will impose implementation costs on broker-dealers who choose to rely on this provision, we believe that this cost will not be as great as stated by some commenters because the alternative uptick rule does not require sequencing of the national best bid, unlike the proposed modified uptick rule and the proposed uptick rule, which would have required sequencing of the national best bid or last sale price.<sup>1209</sup> We believe that, without a sequencing requirement, the policies and procedures required in order to rely on the broker-dealer provision under the alternative uptick

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<sup>1207</sup> See, e.g., letter from T.D. Pro Ex; letter from Taurus Compliance; letter from Credit Suisse (June 2009).

<sup>1208</sup> See, e.g., letter from Credit Suisse (June 2009); letter from NSCP.

<sup>1209</sup> See *supra* notes 1165 to 1167 and accompanying text (discussing impact of the alternative uptick rule on commenters’ cost concerns with respect to the broker-dealer provision of Rule 201(c)).

rule will be easier and less costly to implement and monitor than would be the case under the proposed modified uptick rule or the proposed uptick rule.<sup>1210</sup>

In addition, we note that it is possible that some smaller broker-dealers that determine to rely on the broker-dealer provision may determine that it is cost-effective for them to outsource certain functions necessary to comply with Rule 201(c) to larger broker-dealers, rather than performing such functions in house, to remain competitive in the market. This may help mitigate costs associated with implementing and complying with Rule 201(c). Additionally, they may decide to purchase order management software from technology firms. Order management software providers may integrate changes imposed by Rules 200(g) and 201 into their products, thereby providing another cost-effective way for smaller broker-dealers to comply with the requirement of Rule 201(c).

In addition, we note that the policies and procedures that are required to be implemented under the broker-dealer provision are similar to those that are required under the Order Protection Rule of Regulation NMS.<sup>1211</sup> Thus, we believe broker-dealers will already be familiar with establishing, maintaining, and enforcing trading-related policies and procedures, including programming their trading systems in accordance with such policies and procedures.

Although several commenters stated that previous implementation of Regulation NMS would not mitigate the costs to broker-dealers of implementing a short sale price test restriction,<sup>1212</sup> we considered these comments, as well as comments stating that previous implementation of Regulation NMS could ease implementation provided that broker-dealers

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<sup>1210</sup> See supra notes 709 to 715 and accompanying text (discussing comments on the effect of the alternative uptick rule on implementation and on-going monitoring and surveillance costs).

<sup>1211</sup> See Regulation NMS Adopting Release, 70 FR 37496; see also 17 CFR 242.611.

<sup>1212</sup> See, e.g., letter from FIF (June 2009); letter from RBC (June 2009).

could leverage existing systems in implementing Rule 201,<sup>1213</sup> and continue to believe that familiarity with Regulation NMS policies and procedures will reduce the implementation costs of the broker-dealer provision under Rule 201(c) on broker-dealers.

Further, we believe that the implementation and on-going monitoring and compliance costs for broker-dealers who choose to rely on the broker-dealer provision are justified by the benefits of providing broker-dealers with the option to manage their order flow, rather than having to always rely on their trading centers to manage their order flow on their behalf.

The amendments to Rule 200(g), to add a new marking requirement of “short exempt”<sup>1214</sup> and to provide that a broker-dealer may mark a sell order “short exempt” only if the provisions in paragraph (c) or (d) of Rule 201 are met,<sup>1215</sup> may impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. We recognize commenters’ concerns with respect to the costs of the “short exempt” marking requirement and we considered these comments in evaluating the costs of the “short exempt” marking requirement.<sup>1216</sup> However, we believe that such costs will be limited because small broker-dealers already have established systems, processes, and procedures in place to comply with the current marking requirements of Rule 200(g) of Regulation SHO with respect to marking a sell order either “long” or “short” and, therefore, will likely leverage such systems, processes and procedures to comply with the “short exempt” marking requirements in Rules 200(g) and 200(g)(2).<sup>1217</sup> Further, we believe that the implementation and compliance costs of the “short

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<sup>1213</sup> See, e.g., letter from MFA (Oct. 2009).

<sup>1214</sup> See Rule 200(g); see also supra Section IV. (discussing the amendments to Rule 200(g)).

<sup>1215</sup> See Rule 200(g)(2).

<sup>1216</sup> See supra notes 582 to 588 (discussing comments on the costs of the “short exempt” marking requirement).

<sup>1217</sup> See supra notes 747 to 752 (discussing estimated costs of the amendment to Rule 200(g)(2)).

exempt” marking requirements are justified by the benefits provided by the requirements in aiding surveillance by SROs and the Commission for compliance with the provisions of Rule 201 and providing an indication to a trading center regarding when it must execute or display a short sale order without regard to whether the order is at a price that is less than or equal to the current national best bid.

In addition, to provide market participants with the time needed to make the changes required to comply with Rule 200(g), we are adopting an implementation period under which market participants will have to comply with these requirements six months following the effective date of the adoption of these amendments. We are sensitive to commenter’s concerns that implementation of the “short exempt” marking requirement could be complex,<sup>1218</sup> and believe that a six month implementation period, which is longer than the 3 month implementation period proposed in the Proposal, will afford market participants sufficient time to make the necessary modifications to their systems and procedures. In addition, we believe the six month implementation period will help alleviate some of the potential disruptions that may be associated with implementing the “short exempt” marking requirements.

#### **E. Agency Action to Minimize Effect on Small Entities**

As required by the Regulatory Flexibility Act, we have considered alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. As noted above, Rule 201 imposes some new or additional reporting, recordkeeping, or compliance costs on trading centers and other broker-dealers that are small entities. However, we expect the impact of the new or additional reporting, recordkeeping, or compliance costs will be limited by the similarity of the policies and procedures requirements of Rule 201 to the

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<sup>1218</sup> See *supra* notes 582 to 588 and accompanying text (discussing comments on the implementation time for the “short exempt” marking requirement).

policies and procedures requirement of the Order Protection Rule under Regulation NMS. Although, as discussed above, several commenters stated that previous implementation of Regulation NMS would not mitigate the costs of implementing a short sale price test restriction,<sup>1219</sup> we considered these comments, as well as comments stating that previous implementation of Regulation NMS could ease implementation provided that firms could use existing systems in implementing Rule 201,<sup>1220</sup> and continue to believe that familiarity with Regulation NMS policies and procedures will reduce the implementation costs of the broker-dealer provision under Rule 201(c) on broker-dealers.

Thus, the five non-SRO trading centers that qualify as small entities and the approximately 890 broker-dealers that qualify as small entities should already have in place most of the infrastructure necessary to comply with Rule 201. The marking requirements of the amendments to Rule 200(g) are not expected to adversely affect small entities because they impose minimal reporting, recordkeeping, or compliance requirements. Rule 200(g) currently requires that broker-dealers mark all sell orders of any equity security as either “long” or “short.”<sup>1221</sup> Broker-dealers that are small entities should already be familiar with the current marking requirements and should already have in place mechanisms that could be used to comply with the new “short exempt” marking requirement of Rule 200(g). Moreover, it is not appropriate to develop separate requirements for small entities under either Rule 201 or Rule 200(g) because we believe that to accomplish the Commission’s goals, as well as to avoid the possibility of regulatory arbitrage that would undermine the Commission’s goals, all trading

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<sup>1219</sup> See supra notes 939 to 941 and accompanying text (discussing comments that prior implementation of Regulation NMS would not mitigate the costs of implementing a short sale price test restriction).

<sup>1220</sup> See supra notes 942 to 944 and accompanying text (discussing comments that prior implementation of Regulation NMS could mitigate the costs of implementing a short sale price test restriction).

<sup>1221</sup> See 17 CFR 242.200(g).

centers and broker-dealers, regardless of size, should be subject to the same circuit breaker short sale price test restrictions and all broker-dealers, regardless of size, should be subject to the same order marking requirements.

## **F. Significant Alternatives**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities.<sup>1222</sup> In connection with Rules 201 and 200(g), we considered the following alternatives:

(i) establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the Rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the Rule, or any part of the Rule. First, we note that Rule 201 as adopted and the amendments to Rule 200(g) use performance standards, which we believe will help to minimize any significant adverse impact on small entities.

A primary goal of the short sale-related circuit breaker under Rule 201 is to help restore investor confidence by not allowing sellers to sell short at or below the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day, unless an exception applies. Rule 201 will allow long sellers, by selling at the bid, to sell first in a declining market for a particular security. As the Commission has noted previously in connection with short sale price test restrictions, a goal of

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<sup>1222</sup> See 5 U.S.C. 603(a)(5).

such restrictions is to allow long sellers to sell first in a declining market.<sup>1223</sup> A short seller that is seeking to profit quickly from accelerated, downward market moves may find it advantageous to be able to short sell at the current national best bid. In addition, by making bids accessible only by long sellers when a security's price is undergoing significant downward price pressure, Rule 201 will help to facilitate and maintain stability in the markets and help ensure that they function efficiently. It will also help restore investor confidence during times of substantial uncertainty because, once the circuit breaker has been triggered for a particular security, long sellers will have preferred access to bids for the security, and the security's continued price decline will more likely be due to long selling and the underlying fundamentals of the issuer, rather than to other factors.

In addition, combining the alternative uptick rule with a circuit breaker strikes the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets. The circuit breaker approach of Rule 201 will help benefit the market for a particular security by allowing participants, when a security is undergoing a significant intra-day price decline, an opportunity to re-evaluate circumstances and respond to volatility in that security. We also believe that a circuit breaker will better target short selling that may be related to potential bear raids<sup>1224</sup> and other forms of manipulation that may be used as a tool to exacerbate a price decline in a covered security.

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<sup>1223</sup> See supra note 17.

<sup>1224</sup> See supra note 36 and accompanying text.

As discussed throughout this adopting release, we have designed Rule 201 to accomplish its objectives with lower costs to trading centers and broker-dealers than some of the alternatives we proposed and considered. We believe the alternative uptick rule will require less time and less costs for implementation because it does not require sequencing of bids or last sale prices.<sup>1225</sup> In addition, we believe that the circuit breaker approach, which limits the short sale price test restriction for an individual security to a two-day period following a significant intra-day decline in share price in that security, will also limit compliance costs for all participants.<sup>1226</sup>

The costs of compliance with Rules 201 and 200(g) are likely to vary among individual trading centers and broker-dealer firms. As detailed in PRA Section IX.E.1., above, we realize that the policies and procedures that a trading center is required to establish will likewise vary depending upon the type, size, and nature of the trading center. In addition, as detailed in PRA Section IX.E.2., above, we note that the nature and extent of policies and procedures that a broker-dealer must establish under Rule 201(c) or 201(d)(6), if it determines to rely on either provision to mark an order “short exempt,” likely will vary based upon the type, size, and nature of the broker-dealer.<sup>1227</sup> Our estimates take into account different types of trading centers and broker-dealers (including large versus small), and we realize that the applicable estimates may be on the low-end for some trading centers and broker-dealers while they may be on the high-end for others.

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<sup>1225</sup> See supra Section X.B.1. (discussing the costs of the alternative uptick rule).

<sup>1226</sup> See supra Section III.A.4. (discussing the circuit breaker approach).

<sup>1227</sup> We note that one commenter stated that the “Commission’s cost estimates seem to underestimate the cost to large, full service broker-dealers, since the volume of orders handled by these firms are likely to lead to significantly greater technology and storage costs alone as well as more frequent reviews” but did not provide a specific cost estimate. See letter from NSCP.

Although we recognize that the costs of the Rules may vary based upon the type, size, and nature of the trading center or broker-dealer, we believe that uniform application of Rules 201 and 200(g) to all trading centers and broker-dealers is necessary to prevent damaging opportunities for regulatory arbitrage and to avoid confusion in the markets. In addition, different application of the Rules' requirements for small entities could undermine the goals of the short sale related circuit breaker by potentially providing an avenue for short sellers to evade the requirements of Rule 201. Further, in relation to the already-mentioned concerns, we believe that our goal of restoring investor confidence could be undermined by actual or perceived regulatory arbitrage, market confusion, and/or evasion of Rule 201's requirements as a result of different requirements for different market participants in Rules 201 and 200(g).

Due to these concerns, we have concluded that in order for Rules 201 and 200(g) to be effective in helping to restore investor confidence by preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security, the Rules' requirements must apply uniformly to all trading centers and broker-dealers. Thus, we have determined not to adopt different compliance requirements or a different timetable for compliance requirements for small entities. In addition, and for the same reasons, we have determined not to clarify, consolidate, simplify, or otherwise modify Rules 201 and 200(g) for small entities. Finally, we believe that it is inconsistent with the purposes of the Exchange Act and the goals of adopting Rules 201 and 200(g) to except small entities from having to comply with Rules 201 and 200(g).

### **XIII. Statutory Authority**

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78(f), 78i(h), 78j, 78k-1, 78o, 78o-3,

78q, 78s, 78w(a), and 78mm, the Commission is amending §§ 242.200 and 242.201 of Regulation SHO.

#### **XIV. Text of the Amendments to Regulation SHO**

##### **List of Subjects**

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, Part 242, of the Code of Federal Regulations is amended as follows.

#### **PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES**

1. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-l(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Section 242.200 is amended by revising paragraph (g) introductory text and adding paragraph (g)(2) to read as follows:

##### **§242.200 Definition of “short sale” and marking requirements.**

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(g) A broker or dealer must mark all sell orders of any equity security as “long,” “short,” or “short exempt.”

(1) \* \* \*

(2) A sale order shall be marked “short exempt” only if the provisions of § 242.201(c) or (d) are met.

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3. Section 242.201 is revised to read as follows:

**§242.201 Circuit breaker.**

(a) Definitions. For the purposes of this section:

(1) The term covered security shall mean any NMS stock as defined in §242.600(b)(47).

(2) The term effective transaction reporting plan for a covered security shall have the same meaning as in §242.600(b)(22).

(3) The term listing market shall have the same meaning as the term “listing market” as defined in the effective transaction reporting plan for the covered security.

(4) The term national best bid shall have the same meaning as in §242.600(b)(42).

(5) The term odd lot shall have the same meaning as in §242.600(b)(49).

(6) The term plan processor shall have the same meaning as in §242.600(b)(55).

(7) The term regular trading hours shall have the same meaning as in §242.600(b)(64).

(8) The term riskless principal shall mean a transaction in which a broker or dealer, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee, or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee.

(9) The term trading center shall have the same meaning as in §242.600(b)(78).

(b) (1) A trading center shall establish, maintain, and enforce written policies and procedures reasonably designed to:

(i) Prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security

decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day; and

(ii) Impose the requirements of paragraph (b)(1)(i) of this section for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.

(iii) Provided, however, that the policies and procedures must be reasonably designed to permit:

(A) The execution of a displayed short sale order of a covered security by a trading center if, at the time of initial display of the short sale order, the order was at a price above the current national best bid; and

(B) The execution or display of a short sale order of a covered security marked "short exempt" without regard to whether the order is at a price that is less than or equal to the current national best bid.

(2) A trading center shall regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (b)(1) of this section and shall take prompt action to remedy deficiencies in such policies and procedures.

(3) The determination regarding whether the price of a covered security has decreased by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day shall be made by the listing market for the covered security and, if such decrease has occurred, the listing market shall immediately notify the single plan processor responsible for consolidation of information for the

covered security pursuant to §242.603(b). The single plan processor must then disseminate this information.

(c) Following any determination and notification pursuant to paragraph (b)(3) of this section with respect to a covered security, a broker or dealer submitting a short sale order of the covered security in question to a trading center may mark the order “short exempt” if the broker or dealer identifies the order as being at a price above the current national best bid at the time of submission; provided, however:

(1) The broker or dealer that identifies a short sale order of a covered security as “short exempt” in accordance with this paragraph (c) must establish, maintain, and enforce written policies and procedures reasonably designed to prevent incorrect identification of orders for purposes of this paragraph; and

(2) The broker or dealer shall regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (c)(1) of this section and shall take prompt action to remedy deficiencies in such policies and procedures.

(d) Following any determination and notification pursuant to paragraph (b)(3) of this section with respect to a covered security, a broker or dealer may mark a short sale order of a covered security “short exempt” if the broker or dealer has a reasonable basis to believe that:

(1) The short sale order of a covered security is by a person that is deemed to own the covered security pursuant to §242.200, provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed.

(2) The short sale order of a covered security is by a market maker to offset customer odd-lot orders or to liquidate an odd-lot position that changes such broker’s or dealer’s position by no more than a unit of trading.

(3) The short sale order of a covered security is for a good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities of the issuer.

(4) The short sale order of a covered security is for a good faith account and submitted to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States, provided that the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it was made. For the purposes of this paragraph (d)(4), a depository receipt of a security shall be deemed to be the same security as the security represented by such receipt.

(5) (i) The short sale order of a covered security is by an underwriter or member of a syndicate or group participating in the distribution of a security in connection with an over-allotment of securities; or

(ii) The short sale order of a covered security is for purposes of a lay-off sale by an underwriter or member of a syndicate or group in connection with a distribution of securities through a rights or standby underwriting commitment.

(6) The short sale order of a covered security is by a broker or dealer effecting the execution of a customer purchase or the execution of a customer “long” sale on a riskless principal basis. In addition, for purposes of this paragraph (d)(6), a broker or dealer must have written policies and procedures in place to assure that, at a minimum:

- (i) The customer order was received prior to the offsetting transaction;
  - (ii) The offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and
  - (iii) The broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which a broker or dealer relies pursuant to this exception.
- (7) The short sale order is for the sale of a covered security at the volume weighted average price (VWAP) that meets the following criteria:
- (i) The VWAP for the covered security is calculated by:
    - (A) Calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price;
    - (B) Compiling an aggregate sum of all values; and
    - (C) Dividing the aggregate sum by the total number of reported shares for that day in the security.
  - (ii) The transactions are reported using a special VWAP trade modifier.
  - (iii) The VWAP matched security:
    - (A) Qualifies as an “actively-traded security” pursuant to §242.101 and §242.102; or
    - (B) The proposed short sale transaction is being conducted as part of a basket transaction of twenty or more securities in which the subject security does not comprise more than 5% of the value of the basket traded.
  - (iv) The transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.

(v) A broker or dealer shall be permitted to act as principal on the contra-side to fill customer short sale orders only if the broker's or dealer's position in the covered security, as committed by the broker or dealer during the pre-opening period of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the covered security's relevant average daily trading volume.

(e) No self-regulatory organization shall have any rule that is not in conformity with, or conflicts with, this section.

(f) Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any person or class of persons, to any transaction or class of transactions, or to any security or class of securities to the extent that such exemption is necessary or appropriate, in the public interest, and is consistent with the protection of investors.

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: February 26, 2010