



April 15, 2005

James A. Brigagliano  
Assistant Director  
Division of Market Regulation  
U.S. Securities & Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C., 20549

**Via Fax and Hand Delivery**

Re: Request for Relief from Regulation SHO Marking Requirement for Pilot Securities

Dear Mr. Brigagliano:

The Securities Industry Association (the “SIA”)<sup>1</sup> hereby requests that the staff of the Division of Market Regulation (the “Division”) confirm that it will not recommend enforcement action to the Securities and Exchange Commission (the “Commission”) against a broker-dealer that marks “short,”<sup>2</sup> rather than “short exempt,” a short sale effected in any security included in the Regulation SHO Pilot program (the “Pilot”), suspending the operation of the “tick” test of Rule 10a-1 under the Securities Exchange Act of 1934, as amended (“Exchange Act”),<sup>3</sup> or the price test of any national securities exchange or national securities association (collectively, a “Price Test”).<sup>4</sup> This relief shall be conditioned upon the broker-dealer routing the order to a

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<sup>1</sup> The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available on its home page: <http://www.sia.com>.)

<sup>2</sup> Instead of marking sell orders “short,” some broker-dealers currently mark such orders “SS,” or use some other method to identify a short sale. The Division has confirmed in the Q&A on Regulation SHO that this practice is acceptable, provided that the broker-dealers follow a clear and consistent methodology for marking orders, and maintain clear and accurate records to demonstrate compliance. See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO at Question 2.2.

<sup>3</sup> The “tick” test provides that, subject to certain exceptions, a short sale in an exchange-listed security may only be effected (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 is higher than the last different price (zero-plus tick).

<sup>4</sup> For example, the NASD “bid” test embodied in NASD Rule 3350 provides that, subject to certain

“market center”<sup>5</sup> that has made programming changes to remove the Price Test restrictions for all such securities that will be included in the Pilot (*i.e.*, such that all orders marked “short” will be executed without regard to any Price Test). Any broker-dealer will still be required to mark sales in such “Pilot Securities” (as defined herein) “short,” and in no circumstance should such sales be marked “long.”<sup>6</sup> The requested relief would be consistent with the relief that the Division has previously granted from the “short exempt” marking requirement for short sales effected in certain classes of securities, or during certain periods of time, that have been granted an exemption from the Price Test.<sup>7</sup>

## I. Background

In July 2004, the Commission adopted Regulation SHO,<sup>8</sup> which provides a new regulatory framework governing short sales of securities.<sup>9</sup> Simultaneous with the issuance of the Regulation SHO Adopting Release, the Commission issued an order<sup>10</sup> establishing the Pilot, which will suspend the operation of the Price Test for short sales in three different categories of securities: (1) securities identified as Pilot securities in Appendix A of the Pilot order (hereafter referred to as “Category A Pilot securities”);<sup>11</sup> (2) securities identified as Pilot securities for the after-hours portion of the Pilot, and provided such short sale is effected between 4:15 p.m. Eastern Time and the open of the Consolidated Tape on the following day (hereafter referred to

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exceptions, a short sale in a Nasdaq National Market System security may only be effected at a price above the current best (inside) bid, when such best bid is lower than the immediately preceding bid for such security.

<sup>5</sup> For purposes of this no-action request, the term “market center” shall have the same meaning as in Exchange Act Rule 11Ac1-5(a)(14), *i.e.*, “any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.”

<sup>6</sup> Although, pursuant to this no-action request, broker-dealers would not be required to mark such sales “short exempt,” broker-dealers could still mark such sales “short exempt.”

<sup>7</sup> Letter from James A. Brigagliano, Division, to Ira Hammerman, SIA (January 3, 2005) (granting relief from the requirement to mark “short exempt” short sales that are effected in exchange traded funds and during after-hours crossing sessions) ; *see also* Letter from James A. Brigagliano, Division, to ITG, Inc. (January 3, 2005) (granting relief from the requirement to mark “short exempt” short sales effected in certain “POSIT Matches” that are executed at the mid-point of the National Best Bid and Offer).

<sup>8</sup> Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (the “Adopting Release”).

<sup>9</sup> A “short sale” is generally defined in Rule 200(a) of Regulation SHO to mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of borrowed securities.

<sup>10</sup> Securities Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004).

<sup>11</sup> The list of such securities, which comprise one-third of the Russell 3000 index, can be found on the Commission’s web site at <http://www.sec.gov/rules/other/34-50104.htm>. It is our understanding, however, that the Commission intends on publishing on its web site an updated list of such Category A Pilot securities, which will reflect any corporate actions related to such securities since June 25, 2004, the date such securities were identified. After the publication of such updated lists by the Commission, the web sites of the SROs that maintain the primary listing for such securities will publish any subsequent changes to reflect corporate actions.

as “Category B Pilot securities”);<sup>12</sup> and (3) all securities effected outside the hours of the Consolidated Tape (hereafter referred to as “Category C Pilot securities”)<sup>13</sup> (each a “Pilot Security” and, collectively, the “Pilot Securities”). The Commission had noted in the Adopting Release that, pursuant to Rule 200(g) of Regulation SHO, short sales in any Pilot Securities should be marked “short exempt.”<sup>14</sup>

The Commission subsequently issued another order delaying until May 2, 2005 the commencement of the Pilot.<sup>15</sup> It was noted in such order that the decision to delay the Pilot was primarily based on concerns expressed by broker-dealers in complying with the requirement to mark short sales in Pilot Securities “short exempt.” In particular, it was noted that such requirement would impose significant system changes on broker-dealers to ensure that such marking occurs and is maintained throughout the processing of the order. The Commission noted that a number of market centers offered to assist broker-dealers seeking to execute short sales in Pilot Securities, namely by allowing all such short sale orders to be executed without regard to a Price Test, regardless of whether the order had been marked “short” or “short exempt.” The Commission stated that it would consider requests for exemptive relief on behalf of these broker-dealers, to the extent the market centers have implemented the necessary systems changes to remove the Price Test.<sup>16</sup>

The relief requested herein is only intended to apply to short sale orders in Pilot Securities that are routed to market centers that have made programming changes to “mask” (i.e., remove) the Price Test restrictions.<sup>17</sup> If the relief requested herein is granted, it will be

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<sup>12</sup> The Category B Pilot consists of securities that, as of the date of the Commission’s July 2004 order, were included in the Russell 1000 index. In this regard, the Commission had noted in footnote 18 of such order that “[s]ecurities selected for inclusion in this portion of the after-hours Pilot will remain in the Pilot even if during the term of the Pilot they cease being included in the Russell 1000 index.” See, supra n. 10. It is our understanding that the Commission intends on publishing on its web site an updated list of such Category B Pilot securities, which will reflect any corporate actions related to such securities since June 25, 2004, the date such securities were identified. After the publication of such updated lists by the Commission, the web sites of the SROs that maintain the primary listing for such securities will publish any subsequent changes to reflect corporate actions.

<sup>13</sup> Although, at the time of the Commission’s original order the tape had operated from 8:00 a.m. to 8:00 p.m. Eastern Time, the Commission has since approved a rule amendment of the Pacific Exchange to change the opening time and the commencement of the Opening Auction of its facility, the Archipelago Exchange, to 4:00 a.m. Eastern Time. See Securities Exchange Act Release No. 51014 (January 10, 2005). As such, the tape currently operates from 4:00 a.m. to 8:00 p.m. Eastern Time.

<sup>14</sup> 69 FR at 48012.

<sup>15</sup> Securities Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004).

<sup>16</sup> Id.

<sup>17</sup> The market centers generally accomplish the masking process in a number of different ways. For example, the market centers may assign a special coding symbol in the master files to each exempt security, and such information from the master file may be loaded into the market centers’ equity trading system each night when the trading system goes through its nightly processing. System software may use the product type field to determine whether the price test should be applied to any given security, and, for each Pilot Security, the system will be programmed to ignore the fact that an order is marked “short,” and in turn will not administer the Price Test. The market centers’ systems generally do not convert “short” orders into

incumbent upon each broker-dealer seeking to rely on such relief to submit orders in Pilot Securities only to those market centers that have implemented the proper masking procedures.<sup>18</sup> Upon commencement of the Pilot and throughout its duration, such market centers also will be required to monitor on a regular basis to confirm that securities are properly included in the Pilot, and make programming changes to re-institute the Price Test, as applicable, for any security to the extent it ceases to be included in the Pilot.<sup>19</sup> This could occur if, for example, the Commission were to issue a subsequent order terminating or modifying the Pilot, which could include altering the composition of the Category A or Category B Pilot Securities.<sup>20</sup> After the close of the Consolidated Tape, however, such security would still be a Category C Pilot Security and, as such, would be exempt from the Price Test during that time.

Where the market centers have automatic programming procedures in place to “mask” the application of the price test for the Pilot Securities, it is not necessary for market participants submitting orders in such securities to those market centers to distinguish between “short” and “short exempt” orders, as such market centers will generally allow orders marked “short” in these Pilot Securities to be executed without regard to a Price Test.

## II. Discussion

Absent relief, upon commencement of the Pilot on May 2, 2005, broker-dealers would be required to mark short sales in all Pilot Securities “short exempt.” This would in turn have broad impacts across many systems in the firms that process orders, including front-end systems to institute order marking changes for customers, trade processing systems, and customer and

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“short exempt” orders - rather there is no change to the order itself, and the information with respect to that order shown on the order ticket is maintained intact throughout the market centers’ order flow system. In addition, the order as represented in the trading system will also generally reflect the order as “short” and not “short exempt.” Finally, the market centers generally report the trade execution back to the entering firm in the same manner (i.e., “short” or “short exempt”) the order was marked by the firm upon original entry. For example, an order in a Pilot Security originally entered as “Sell Short” would indicate “Sold Short” on the execution report even though the price test was not applied. Finally, the market centers maintain an audit trail of all such trade executions, which is capable of being produced and subject to review upon request by the appropriate regulatory authority, to the extent necessary.

<sup>18</sup> In this regard, NYSE IM 04-64 had noted the following: “Customer SuperDot entered Short Sale orders in Pilot securities transmitted to the post will not be subject to the tick test. The original order details and associated report details will continue to be marked as Short Sale orders (this applies to round-lots & odd-lots, regular trading sessions). Customer entered Short Sale orders in Pilot securities transmitted to the Broker to Booth Support System (“BBSS”) will be presented to users on the trading floor as Short Sale Exempt orders. The original order details and associated report details will continue to be marked as Short Sale orders. Broker-dealers that use a proprietary or vendor order management system (e.g., Tradeware or NYFIX) must ensure that the appropriate system changes are completed prior to May 2, 2005 in order to facilitate the proper marking and representation of short sales in Pilot securities.” (emphasis added)

<sup>19</sup> For any such securities that cease to be included in the Pilot, the market centers would generally assign a different coding symbol to such securities, and the price test would be applied to all orders marked “short” in such securities.

<sup>20</sup> It was noted in the order of July 28, 2004 that, “The Commission, however, may, by further order, terminate, extend the period of, or modify the Pilot as it determines necessary or appropriate in the public interest or for the protection of investors.” 69 FR at 48033.

regulatory reporting systems. Implementing such systems changes would impose upon broker-dealers extreme technological and financial burdens.

Moreover, it is highly questionable whether the potential benefits associated with such requirements would outweigh the associated costs. As noted above, as part of the requested relief, broker-dealers will route short sale orders in Pilot Securities only to those market centers that have instituted the necessary systems changes to remove the Price Test, where appropriate. In this regard, this is very different from the situation where a seller is relying on an exception or exemption from the Price Test based on discrete facts and circumstances.<sup>21</sup> A “short exempt” marking requirement for such “transaction-based exemptions” may be necessary to inform the market center that an individual trade may properly be executed without regard to a Price Test. These same objectives do not exist where a Pilot Security is subject to a wholesale exemption from a Price Test.

To the contrary, requiring short sales in Pilot Securities to be marked “short exempt” could actually act to the detriment of investors by needlessly slowing down executions. For example, absent the requested relief, an order in a Category B Pilot Security (which was not otherwise a Category A Pilot Security) that was marked “short” during the regular trading session would need to be withdrawn and re-marked “short exempt” in order to participate as a Category B Pilot Security after 4:15 p.m. Eastern Time, which could in turn cause these orders to lose priority, and risk their receiving only a partial execution, or no execution at all.

### **III. Request for No-Action Relief**

Based on the foregoing, we respectfully request that the Division confirm that it will not recommend enforcement action to the Commission against a broker-dealer that marks “short,” rather than “short exempt,” a short sale that is effected in any Pilot Security.<sup>22</sup> The requested no-action relief shall be subject to the following conditions:

(i) A broker-dealer relying on this no-action relief must route orders in Pilot Securities to market centers that:

(a) have instituted procedures to “mask” the short sale character of the transaction so that they are executed without regard to the applicable Price Test;

(b) monitor on a regular basis and re-institute the Price Test for any security that ceases to be included in the Pilot; and

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<sup>21</sup> For example, a seller may be entitled to rely on the exception provided in Rule 10a-1(e)(1) or NASD Rule 3350(c)(2) for situations where a seller owns the security sold and, while not being able to deliver the security by settlement date (and thus rendering the sale a short sale), the seller intends to deliver the security sold as soon as possible without undue inconvenience or expense. A seller relying on the exception in 10a-1(e)(1) or NASD Rule 3350(c)(2) in such situation would properly mark the sale “short exempt.”

<sup>22</sup> Although, pursuant to this no-action request, broker-dealers would not be required to mark such sales “short exempt,” broker-dealers could still choose to do so.

(c) make, keep, and produce the books and records of such activities as required under applicable rules and regulations;

(ii) A broker-dealer executing short sales in Pilot Securities will in no event mark such sales as “long.”<sup>23</sup>

If you have any questions or require further information, please do not hesitate to contact Amal Aly, Vice President and Associate General Counsel, at 212-608-1500 or Ann Vlcek, Vice President and Associate General Counsel, at 202-216-2000. Thank you for your attention to this request.

Very truly yours,

Ira Hammerman  
Senior Vice President and General Counsel

cc: Larry E. Bergmann  
Barbara J. Endres, Sidley Austin Brown & Wood LLP  
Kevin J. Campion, Sidley Austin Brown & Wood LLP

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<sup>23</sup> A broker-dealer is required, pursuant to Rule 17a-3 under the Exchange Act, to make and keep current books and records relating to its business, which includes information relating to short sales.