

Regulatory Circular RG91-35

Date: May 1, 1991

To: All Members, Registered Options Principals,
Compliance Directors

From: Regulatory and Legal Divisions

Re: Short Sale Requirements

In conjunction with the commencement of trading in securities, the Exchange wishes to remind members of the short sale requirements of Rule 10a-1 (the "SEC Rule") under Section 10(a) of the Securities Exchange Act of 1934 (the "Act"), which have been codified with respect to sales effected on the CBOE in CBOE Stock Rule 30.20 (the "CBOE Rule"). This Circular discusses those requirements, as well as pertinent exemptions under both the CBOE and the SEC Rules (collectively, the "Rules"). For the most part, the Rules are co-extensive. The CBOE Rule, however, governs trades effected on the CBOE; while, the SEC Rule, as modified by the relevant exchange, governs sales effected on an exchange other than the CBOE.

Briefly, the Rules are designed to prevent sellers from accelerating a decline in market prices by selling securities in a declining market with the intention of covering those sales with securities purchased at a lower price. To that end, the Rules provide that all sale order tickets must be marked either "short" or "long", prescribe the minimum permissible prices for short sales, and dictate when short sales must be covered. Each of these subjects is discussed more fully below. Please note that this Regulatory Bulletin supersedes Educational Circular Number 10 (Revised) dated January 19, 1982.

A. Information Required on Orders

1. **The Rules:** The CBOE Rule provides that no member shall accept, represent, or execute an order to sell a security registered on the CBOE, unless the order ticket is marked long or short. The Exchange also requires that, where applicable, order tickets should be marked short exempt. If a member receives a sell order that is not so marked, he should not fill or execute it; rather, he should return it so that the required information can be inserted. With respect to sales effected on an exchange other than the CBOE, the SEC Rule provides that no broker or dealer shall effect any sell order for a security registered on, or admitted to unlisted trading privileges on, a national securities exchange unless such order is marked either long or short.

2. **Responsible Parties:** Both the person initiating a sale order and the firm processing and transmitting that order are responsible for ensuring that a sale order ticket contains accurate information. Specifically, the initiating party--whether a member or customer--must correctly direct the firm to mark the order ticket either long or short. The firm, in turn, must mark the ticket accurately based on the information supplied. In the event an error is made in identifying the order as long, short, or short exempt, only the party directly responsible for an incorrectly marked ticket will be held liable.

3. Long Sales

(a) Definition: A member should mark an order long only if (i) the security is held in the seller's account, or (ii) the member has been informed that the seller owns the security and will deliver it as soon as is possible without undue inconvenience or expense.

(b) Criteria for Determining Ownership: A person is deemed to own a security if (i) he or his agent has title to it; (ii) he has purchased it, or has entered into an unconditional, binding contract to purchase it, but has not yet received it; (iii) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; (iv) he has an option to purchase or acquire it and has exercised such option; or (v) he has rights or warrants to subscribe to it and has exercised such rights or warrants.

(c) Suggested Method of Compliance: The Exchange recommends, but does not require, that members enter into a written agreement with each of their customers, pursuant to which each customer agrees to designate all sell orders as either short, long, or short exempt, acknowledges his understanding of those terms, and represents that each designation shall constitute the customer's warranty that the designation is accurate.

4. **Short Sales**: Rule 3b-3 under Section 3 of the Act defines a short sale as any sale of a security which the seller does not own, or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Thus, the Commission has ruled that "sales against the box" are short sales, even though the seller owns sufficient securities to cover the sale.

5. Netting Requirement

(a) The Rule: A person and all affiliates of that person must net their positions in a security to determine their aggregate net position in the security. A person owns securities only to the extent that he has a net long position in those securities.

(b) Examples:

(I) If a member maintains two accounts, one long a number of shares and the other short the same or a greater number of shares of the same security, any sale order for that security must be marked short. This rule of aggregation applies to all accounts in which a member has an interest, including joint accounts.

(ii) If a member with an existing short position in an underlying security successively purchases a call option representing a number of shares less than or equal to the existing short position, exercises those options, and enters an order for the sale of the underlying security, the sale order must be marked short.

(iii) If a member has a net long position in a security and wishes to sell a greater number of shares than he is net long, the member may either (a) enter two separate orders: the first order marked long, representing the number of shares he is net long, and a second order marked short, representing the remaining shares he wishes to sell, or (b) enter one order with instructions as to the number of shares to be sold long and the number to be sold short.

(c) Chinese Walls: If any member and its affiliates maintain an Exchange-approved Chinese Wall between the member and its affiliates, which would prohibit netting of positions, that member and its affiliates may be exempt from the netting requirements of the short sale rules. Since this exemption is strictly circumscribed, any member who believes he and his affiliates may fall within its ambit is advised to contact the Legal Division for further information.

6. Exercising Options to Create a Long Position

(a) A member with no prior position in an underlying security, who wishes to create an immediate net long position, may concurrently acquire a call option and irrevocably exercise it. If the option purchase and exercise occurs concurrently with or prior to the sale of the underlying security, as evidenced by the option purchase execution time, the preparation time of the exercise notice, and the sale order entry time, the sale order ticket for the security may be marked long. If, however, the option purchase occurs after the underlying security sale order entry time, or if the option is not irrevocably exercised, the sale order must be marked short. The following constitute irrevocable instructions to exercise:

(i) A Market Maker must either make a notation on his Market-Maker hard card containing the option purchase transaction or complete an exercise instruction form. If he elects to make a notation on his hard card, he must thereafter complete an exercise instruction form. The exercise instruction form and, where applicable, the hard card must then have the time of exercise recorded on it and must be submitted to the Market Maker's clearing firm. A copy of each exercise instruction received must be maintained by the clearing firm. If the time stamp is concurrent with or prior to the entry of the order to sell the underlying security, the sale order ticket may be marked long, in which event the exercise cannot be rescinded.

(ii) A member firm that is exercising for its own account must prepare, time stamp, and maintain a memorandum indicating an intention to exercise. If the time stamp on the memorandum is concurrent with or prior to the entry of the order to sell the underlying security, the sale order ticket may be marked long, in which event the exercise cannot be rescinded.

(iii) A public customer must give the member carrying his account an instruction to exercise. The member must maintain a memorandum of this instruction that is time stamped upon receipt. (See Interpretation .02 to CBOE Rule 11.1.) If the time stamp on the memorandum is concurrent with or prior to the entry of the order to sell the underlying security, the sale order ticket may be marked long, in which event the exercise cannot be rescinded.

(b) If on the Friday immediately prior to expiration Saturday, a member or customer wishes to sell an underlying security long and he either maintains or acquires an in-the-money expiring call option position on that Friday, he must still execute or cause to be executed an irrevocable exercise instruction even though OCC will not accept the instruction. Although OCC does not accept, on Friday, exercise notices for options expiring on Saturday, the exercise notice must be written, time stamped, and preserved, as required on any other business day, so that the member or customer can show that the exercise was concurrent with or prior to the entry of an order to sell the underlying security.

B. Sale Price Restrictions

1. **The General Rule:** Subject to certain limited exemptions discussed below, the CBOE Rule prohibits a short sale of securities on the CBOE unless the sale is effected on a plus tick or zero-plus tick, established by reference to the last sale effected on the Exchange. Sales effected on exchanges other than the CBOE are governed by the applicable exchange's short sale rules.

2. **Securities Affected:** Generally, all securities registered, or admitted to unlisted trading privileges, on a national securities exchange, other than government or municipal securities, are subject to the Rule. In addition, a short sale of any security effected on a national securities exchange is subject to the Rule. The Rule does not apply to NASDAQ securities, however, unless (a) such securities are reported on a real-time, last-sale basis or (b) a short sale of such securities is effected on a national securities exchange.

3. The "Tick Test"

(a) Definition: The "tick test" is used to determine the minimum permissible prices for short sales effected on the floor of the CBOE. Generally, a short sale may be effected only on a plus tick--a price above the last regular way sale on the CBOE--or a zero plus tick--a price equal to the last sale on the CBOE, if that price is higher than the immediately preceding different regular way sale. Thus, at a plus or zero plus tick, a short sale may be effected at or above the price at which the last regular way sale was effected on the CBOE. On a minus or zero minus tick, however, a short sale may be made only at a price that is higher than the price of the last sale. Where securities are priced in increments of less than 1/8, the price is determined by the minimum increment permitted. In sum, before executing any sell short order on the CBOE, a member must determine the last regular way sale price on the CBOE and, if the bid is equal to or less than that last price, he must also determine the previous different regular way price on the CBOE to ensure that the bid price is permissible.

(b) Examples

(i) Where the last sale was at 50, and the preceding different sale was at 50 1/8, a short sale may be effected only at 50 1/8 or above;

(ii) Where the last sale was at 50, and the preceding different sale was at 49 3/4, a short sale may be effected at 50 or above;

(iii) Where the last sale was at 50, and the preceding different sale was at 50 1/4, a short sale may be effected at 50 1/8 or above.

4. **Ex-Distribution Price:** After a security goes ex-dividend, ex-right, or ex-any other distribution, the last sale price and the previous different sale price in effect prior to the "ex" date may be reduced by the value of such distribution in computing the permissible short sale price. For example, if the value of the distribution was \$1, the last sale price prior to the "ex" date was \$50, and the previous different sale price was \$50 1/8, the last sale price may be deemed to be \$49, the previous sale price may be treated as \$49 1/8, and the short sale may be effected only at \$49 1/8 or above.

5. Exempt Persons and Transactions: The SEC Rule enumerates 12 exemptions, all of which have been incorporated by reference in the CBOE Rule. Some of these exemptions are designed to protect persons who may undertake short selling passively pursuant to their market obligations; others govern transactions that the Commission has concluded are not susceptible to the manipulative market practices associated with short selling. The most significant of these exemptions are discussed below.

(a) Market Makers and DPMs

(i) The Exemption: A short sale of a security--other than a sale to a stabilizing bid complying with Rule 10b-7--is exempt if it is made by a registered specialist for his own account in any security for which he has an appointment on any exchange with which that specialist is registered for such security at (i) a price equal to or above the last regular way sale reported in the consolidated system from any market, including the CBOE, or (ii) a price equal to the price associated with the registered specialist's most recent offer communicated pursuant to the Quote Rule, if such offer, when communicated, was equal to or above the last sale, regular way, reported in the consolidated system.¹

Please Note: This exemption applies only to sales effected on the CBOE. With respect to trades effected on any exchange other than the CBOE, CBOE registered specialists are not entitled to an exemption, and must follow the rules of the applicable exchange with respect to the permissible price at which a short sale may be effected.

(ii) Examples:

(aa) The last sale price on the CBOE is 50, down from 50 1/8. Thereafter, the consolidated tape shows a subsequent sale at 49. The Market Maker or DPM may effect a short sale on the CBOE at 49 or above. All other members not subject to exemption may effect a short sale only at 50 1/8 or above.

(bb) The last sale price on both the CBOE and the consolidated tape is 50, down from 50 1/8, and the MarketMaker or DPM makes an offer at 50. If the offer is publicly disseminated pursuant to the Quote Rule, the Market Maker or DPM may supply stock at 50, even though in the interim the consolidated tape shows a subsequent sale at 50 1/8.

¹The latter exemption addresses the potential conflict between the short sale rules and the Quote Rule contained in SEC Rule

11Ac-1, where a registered specialist executes an offer and a subsequent trade through occurs. The Quote Rule provides that a member must honor his displayed quotations. Assume, for purposes of illustration, that a member makes an offer to sell short at 50; the offer is permissible when made, because made on an uptick; and the offer is publicly disseminated. Thereafter, a trade through occurs and the consolidated tape shows a sale at 51. A purchase order then comes in at 50. Technically, under the short sale rules, the member cannot sell at 50. The exemption contained in the Rules permits the sale to be effected.

(b) Broker-Dealers: A broker-dealer who effects a sale for an account in which he has no interest is exempt, if the order to sell was marked long. Also exempt is any short sale by a broker-dealer, for his or another's account--other than sales to a stabilizing bid complying with Rule 10b-7--effected at the price associated with the broker-dealer's most recent offer, in an amount less than or equal to the quotation size associated with that offer, provided that such offer was communicated pursuant to the Quote Rule and, when communicated, was at a plus tick or zero plus tick, with reference to the last regular way sale reported on the consolidated tape.

(c) Odd-Lot Dealers: The Rules exempt any sale by an odd-lot dealer in a security in which he is registered, if the sale is effected to offset odd-lot orders of customers. Also, any sale by an odd-lot dealer to liquidate a long position which is less than a round lot is exempt if such sale does not change his position by more than one round lot.

(e) Arbitrage: Any sale of a security for a special arbitrage account by a person who then owns another security which does, or presently will, entitle him to acquire an equivalent number of securities of the same class as the securities sold, is exempt, if (i) such sale, or the purchase that such sale offsets, is effected in order to profit from the spread between the price of the security sold and the security owned, and (ii) such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any class of securities of the issuer. Please Note: Puts and calls may not be considered exchangeable or convertible securities that would support a sale in a special arbitrage account. Therefore, an option position does not fall within the arbitrage exemption.

(f) International Arbitrage: Any sale of a security registered or UTP'd on the CBOE that is effected for a special international arbitrage account in order to profit from the spread between the price of the security on a foreign securities market and on a domestic market is exempt, if the seller at the time of the sale knows or, has reasonable grounds to believe, that an offer enabling him to cover that sale is then available to him in that foreign securities market and intends to accept that offer immediately.

(g) Block Positioners: A broker-dealer selling a security acquired in his capacity as a block positioner shall be deemed to have a long position in such security to the extent that his short position in the security is the subject of one or more offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

(h) Initial Public Offerings: The Rules exempt any sale by an underwriter, or any member of a syndicate or group participating in an initial public offering, in connection with an over-allotment of securities, or any lay-off sale by such a person in connection with a distribution of securities through rights pursuant to Rule 10b-8 under the Act or a standby underwriting commitment. The Commission has ruled that the initial sale of a security newly listed on an exchange may be a short sale. Subsequent sales on that exchange at the same price may also be short sales, provided that there is no intervening transaction on the exchange at a different price. Once a transaction at a different price occurs, the short sale rules takes effect.

(i) Market-On-Close Orders: Although this exemption is not contained in the Rules, the Commission has granted other exchanges an exemption for market-on-close ("MOC") orders to sell short, where (i) the member firm has also entered an MOC order to buy the same amount of

securities, and (ii) both MOC orders are part of a program trading strategy by the member firm, and the orders are so identified.

(j) Others: The Rules also provide an exemption for sales effected with the CBOE's approval which are necessary to equalize the price of the security on the CBOE with the current price of the security on the principal exchange. In addition, sales effected in accordance with a special offering plan pursuant to Rule 10b-2(d) under the Act are exempt. Finally, the Commission has issued narrow exemptions for certain liquidations of index arbitrage positions and for equity index participations.

Please Note: Because the preceding exemptions are addressed only cursorily, any member who believes a transaction may be exempt from the short sale rules may contact the Legal Division for further information.

6. Exempt Sale Tickets: The Exchange requires that members mark as "short exempt" all short sales orders that fall within the exemptions described above, except for the exemption described at paragraph (b) concerning sales marked long. In addition, members must maintain records of such exempt sales for a period of not less than three years, and such records shall be readily available during the initial two-year period.

C. Delivery of Securities

1. The Covering Requirement

(a) The SEC Rule: SEC Rule 10a-2(a) provides that on the delivery date for a security sold pursuant to an order marked long, a member must cover any open position in that security, unless the member knows, or has been informed by the seller that:

- (i) The security has been forwarded to the seller's account with the member; or
- (ii) The seller owns the security sold, it is impracticable to deliver it, and the customer will deliver the security as soon as is possible without undue inconvenience or expense.

Although the SEC Rule does not state that the position must be covered, it prohibits non-delivery on the due date or delivery with a borrowed security, unless one of the preceding exceptions applies. As a practical matter, therefore, the member must cover. If, however, one of the preceding exceptions is applicable, the member may either fail to deliver or deliver borrowed securities.

(b) **Exceptions**: The prohibitions contained in SEC Rule 10a-2(a) do not apply in the following circumstances:

- (i) A loan between members, unless the lending member knows that the borrowing member intends to violate the short sale regulations, or

(ii) An erroneous short sale on the CBOE, provided that the CBOE first finds that the member made a good-faith mistake; that the member exercised due diligence to ascertain that the sale was long; and either that undue hardship would result from covering the transaction by a cash purchase, or that the mistake was made by the seller's broker on a plus or zero plus tick. Accordingly, a short sale made erroneously need not be covered if (aa) the error was made by the customer or (bb) the error was made by the broker, but the price was permissible for a short sale. Members should submit to the CBOE all requests for exemptions as promptly as possible after the error is discovered. To assist the CBOE in evaluating these requests, please furnish sufficient information to enable the CBOE to determine whether all of the preceding criteria have been met.

2. **Method of Covering:** A member may cover a short sale either by (a) buying in the security for "cash", and seeking reimbursement from the customer, or (b) in the event of a bona fide error, applying to the Exchange for an exemption. If, on the date when delivery upon the original contract is due, the member receives the security bought in, or knows that it is in transit to him, he may deliver the security received, deliver borrowed securities, or fail to deliver.

3. **Prompt Delivery:** The Commission has cautioned broker-dealers who sell securities to their customers in a short sale that failure to promptly purchase and deliver the securities may violate the antifraud provisions of the federal securities laws. A broker-dealer who sells securities to a customer should exercise diligence to deliver the securities promptly, and if such broker-dealer has any reason to believe he will be unable to do so, he should disclose all material facts to the customer before entering into the transaction.

D. Penalties

In addition to the disciplinary sanctions that may be imposed by the CBOE for violations of the CBOE Rule, the SEC Rule authorizes the imposition of the following cumulative penalties:

1. **Criminal:** Any person who violates the short sale rules may be held criminally liable. This includes a broker-dealer who lends a security, knowing that the borrower intends to violate the short sale rules.

2. **Registration Revocation:** A registered broker-dealer who fails to mark a sale order correctly or effects a short sale at an impermissible price may have his registration revoked.

In light of the serious penalties attendant to a violation of the short sale rules, members are advised at all times to determine whether a sale of securities is long or short; to record that information accurately on the sale order ticket; to sell short only at a permissible price; and to cover all short sales, unless the transaction is exempt from the covering requirements set forth in the SEC Rule.

Any questions concerning this circular should be directed to either Barbara Casey [(312) 786-7712] or Jeff Schroer [(312) 786-7716], in the Regulatory Services Division, Deborah Bleich Cogan [(312) 786-7416], in the Legal Division, or a Floor Official.

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