Regulatory Circular 93-29

DATE: April 27, 1993

TO: The Membership

FROM: Division of Regulatory Services

RE: Short Sale Rule

The purpose of this circular is to respond to recent inquiries from members regarding the applicability of the SEC short sale rules, 3b-3 and 10a-1, to certain transactions in stock baskets. Generally the questions have been related to the trading of stock baskets on narrow-based or sector indexes such as the Biotech Index, and the members have requested clarification on a December 17, 1986 no-action letter issued by the Securities and Exchange Commission (the "Letter"). This circular summarizes the short sale requirements and the relief contained in the Letter. Attached for members to review is a copy of an April 23, 1990 SEC release which provides greater detail on this issue and includes a copy of the Letter.

SEC Rule 10a-1 states that, except for certain limited exemptions, short sales "may be effected only (1) at a price above the price at which the immediately preceding sale was effected ("plus tick"), or (2) at the last sale price if it was higher than the last different price ("zero-plus tick")."[1] According to SEC Rule 3b-3, to determine a broker-dealer's net long or short position in a particular security all long and short positions in that security in all proprietary accounts must be aggregated.

The purpose of the Letter was to provide an exception to the aggregation requirement for a specific situation. The Letter permits a broker-dealer to liquidate existing index arbitrage positions involving long stock baskets, without aggregating short stock positions in the same security in other proprietary accounts where the short position is the subject of a bona fide arbitrage, risk arbitrage or bona fide hedge position. The Letter defined index arbitrage as "the concurrent purchase (sale) of all stocks comprising a securities index, or a "basket" of such stocks consisting of a sufficient number of stocks comprising the index to closely track the day-to-day price movement of the index, and an offsetting transaction in a financial futures contract or a standardized option contract on that index." (Market makers are

[1] See attached SEC Release No. 34-27938 dated April 23, 1990.

reminded that in order to receive market maker ("permitted offset") margin treatment on a stock basket on a narrow-based index the basket must be complete, that is, all of the component stocks must be maintained in the correct proportions.)

It is important to emphasize the following:

- The Letter only provides an exemption from the restrictions on selling stock short pursuant to SEC Rules 3b-3 and 10a-1 when liquidating an index arbitrage position, not establishing an index arbitrage position.

- The liquidation of both sides of the index arbitrage position must occur as concurrently as practicable; legging out is not permissible.

- The short stock positions which are not required to be netted against long stock positions must be part of bona fide arbitrage, risk arbitrage, or bona fide hedge positions.

It should be noted that the SEC staff has proposed certain amendments to the short sale rule which would codify the terms of the Letter, with one significant change. Under the terms of the proposed rule change, the exemption would not be available following a specified decline in the Dow Jones Industrial Average. The membership will be advised if the proposed amendments are approved.

The Exchange wishes to remind members that all sell orders must be marked long, short, or where applicable, short exempt. Members must maintain records of all exempt sales for a period of not less than three years, and such records must be readily available during the initial two-year period.

Questions regarding this circular should be directed to Steven O'Malley in the Department of Financial Compliance at (312)786-7925.