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17 CFR Part 241

Commission Guidance on Rule 3b–3 and Married Put Transactions; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 241

[Release No. 34–48795]

Commission Guidance on Rule 3b–3 and Married Put Transactions

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission is publishing interpretive guidance on calculating a ''net long'' position under the Securities Exchange Act of 1934 when using married put transactions as a part of certain trading strategies. A seller of securities is required to aggregate all of its positions in that security to determine the seller's ''net long'' position. Determining security ownership is an essential component to aggregating security positions under the Securities Exchange Act of 1934. The guidance we are publishing today clarifies the determination of security ownership when married puts transactions are used.

EFFECTIVE DATE: November 21, 2003.

FOR FURTHER INFORMATION CONTACT: Any of the following attorneys in the Office of Trading Practices, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549–1001, at (202) 942–0772: James Brigagliano, Assistant Director, or Gregory Dumark, Kevin Campion, and Elizabeth Sandoe, Special Counsels.

SUPPLEMENTARY INFORMATION:

I. Background

A seller of securities must determine whether a sale is ''long'' or ''short'' because of special provisions applying to short sales.[1] This determination depends in significant measure on whether the seller owns the security to be sold and the seller's net position in the security. Rule 3b-3 under the Exchange Act provides, in part, that a person owns a security if he or his agent has title to a security or he has purchased or has entered into an unconditional contract to purchase it but has not yet received it.[2]

The seller's net position must be determined with reference to Rule 3b–3. Rule 3b–3 requires a seller of an equity security to aggregate all of its positions in that security.[3] If the seller has a ''net long'' position in the security after this aggregation process, then the sale may be effected as a ''long'' sale to the extent of the ''net long'' position. If the aggregation process results in a ''flat'' or ''net short'' position, the sale must be effected as a ''short'' sale. All sell orders in any security registered on or admitted to unlisted trading privileges on a national securities exchange must be marked either ''long'' or ''short.''[4] A short sale of an exchange-listed security must comply with Rule 10a-1 under the Exchange Act.[5] A sale of a ''long'' position is not subject to the price test of Rule 10a–1.

Calculation of a seller's net position is also necessary for compliance with Rule 105 of Regulation M.[6] Rule 105 prohibits covering a short sale with offering securities obtained from an underwriter or dealer if the short sale occurred during the period 5 days prior to pricing until pricing or the period from filing the registration until pricing, whichever is shorter.[7] Thus, a seller needs to know if any sales during the 5-day period prior to certain repeat or secondary offerings are short sales for which offering shares may not be used to cover such sales.

This release discusses the operation of Rule 3b–3 with respect to sellers who may claim to have a position in a security by virtue of having entered into a ''married put'' transaction.[8]

II. Discussion

A married put is the purchase of an option to sell (*i.e.*, a put option) a certain number of securities at a particular price by a specified time, bought contemporaneously with the same number of underlying securities.[9] When used as a hedging vehicle, the married put is designed to provide protection to the holder of the stock against losses, *i.e.*, if the price of the stock goes up, the put will not be exercised and will expire worthless, and if the price of the stock goes down, the put may be exercised by the holder to sell the underlying stock at the strike price.

The Securities and Exchange Commission (the ''Commission'') is concerned about the abusive use of married puts as a part of trading strategies designed to evade the application of Rule 10a–1 and Rule 105.[10] Some of these strategies appear to

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[1] This interpretation discusses the operation of Rule 10a–1 under the Securities Exchange Act of 1934 (''Exchange Act''), 17 CFR 240.10a–1, and Rule 105 of Regulation M, 17 CFR 242.105. It does not address the operation of all provisions that apply to short sales, such as general anti-fraud and anti-manipulation provisions, *e.g.*, Sections 17(a)(1) and 10b–5 of the Exchange Act, and self-regulatory organization rules, *e.g.*, National Association of Securities Dealers, Inc. (''NASD'') Rule 3370, New York Stock Exchange (''NYSE'') Rule 440C.

[2] 17 CFR 240.3b-3(a)—(b). In addition, Rule 3b–3 provides that a person has a ''long'' position in a security if he holds convertible securities, options, rights, or warrants, and has tendered for conversion or exchange the convertible securities or exercised the options, rights, or warrants. 17 CFR 240.3b–3(c)–(e). Rule 3b–3 defines the term ''short sale'' as any sale of a security that 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.

[3] *See* Exchange Act Release No. 20230 (September 27, 1983), 48 FR 45119, 45120 (October 3, 1983) (to determine whether a person has a ''net long'' position in a security, all accounts must be aggregated).

[4] 17 CFR 240.10a–1(c).

[5] 17 CFR 240.10a–1. Rule 10a–1 (commonly referred as the ''short sale rule'' or ''tick test'') prohibits, subject to certain narrow exceptions, short sales of any security registered on or admitted to unlisted trading privileges on a national securities exchange on minus or zero-minus ticks. Generally, the short sale rule is designed to prevent short selling from accelerating a declining market. Aggregation under Rule 3b–3 is also necessary to ensure compliance with the short sale ''bid test'' of NASD Rule 3350. *See* Rule 3350(k)(1) and NASD Notice to Members 94–68, Question 15.

[6] 17 CFR 242.105. Rule 105 prevents persons from covering short sales with offering securities purchased from an underwriter, broker, or dealer participating in the offering if the short sale was effected during the Rule's restricted period, which is typically five days prior to pricing and ending with pricing (''105 restricted period''.) Rule 105 is designed to ensure that ''secondary'' and ''repeat'' offering prices are based on open market prices determined by supply and demand rather than influenced by artificial forces, and to prevent artificial depression of trading markets that may reduce an issuer's offering proceeds. *See Short Sales in Connection with a Public Offering,* Exchange Act Release No. 26028 (August 25, 1988), 53 FR 33455 (August 31, 1988) (release adopting the predecessor to Rule 105, Rule 10b–21, which prohibited substantially the same conduct as Rule 105).

[7] 17 CFR 242.105(a)(1) and (a)(2). Rule 105 does not apply to offerings filed under Rule 415 of the Securities Act of 1933 (*i.e.*, ''shelf offerings'') or to offerings that are not conducted on a firm commitment basis. 17 CFR 242.105(b).

[8] The Commission has proposed new Regulation SHO that, among other things, would apply a new uniform bid test to all exchange-listed securities and Nasdaq National Market System (''NMS Security'') securities, wherever traded, allowing short sales to be effected at a price one cent above the consolidated best bid. The interpretive guidance we are issuing today on calculating a ''net long'' position applies regardless of whether the Commission adopts Regulation SHO.

[9] The term ''married put'' is used to describe the underlying transaction, *i.e.*, the linked purchase of securities and the put option to sell an equivalent number of securities. Several different terms have been used in the industry to describe various strategies involving married put transactions including, but not limited to, ''bullets,'' ''ghost bullets,'' ''bullet trades,'' and ''slam dunks.'' All of these strategies involve the use of married put transactions.

[10] Traders may also be using married put transactions as part of a scheme to avoid the short sale ''bid test'' adopted by the NASD, Rule 3350. Although an NASD rule, a trader must calculate his ''net long'' position pursuant to Commission Rule 3b–3 in order to comply with Rule 3350. *See, supra* n. 5. Rule 3350 provides that with respect to trades executed on or reported to Nasdaq no member shall effect a short sale, for the account of a customer or for its own account, in a Nasdaq NMS security at

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

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

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

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

We are issuing this guidance to address married puts that are used as part of an attempt to create a ''long'' position for the purpose of circumventing Rules 10a–1 and 105.[15] Such transactions usually have some or all of the following characteristics (or a variation of them):

- the purchase of an at- or in-the-money non-standardized put option with a brief (1 to 5 day) expiration period,
- the contemporaneous purchase of an equivalent number of shares of the same security,
- the contemporaneous sale of the stock acquired with a married put, in essence divorcing the stock position from the put option,[16]
- the repeated use of a ''facilitator''[17] that sells both the puts and the ''long'' position (often by selling the stock short to the counterparty),
- the ''netting out'' of the transaction between the facilitator and the counterparty, often at the end of the day the married put was purchased, and
- the payment of a standardized fee, not calculated in accordance with a standard options pricing model, to the facilitator for the transaction.[18]

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

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

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

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

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

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

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

[16] Identifying a contemporaneous divorce of the stock position from the put option as an indication of a possible abusive use of married put transactions should not discourage legitimate hedging because such activity is inconsistent with hedging. Separating the securities underlying a married put transaction from the put option eliminates one of the legitimate economic reasons why an investor may enter into a married put transaction, *i.e.*, its use to protect from any losses resulting from the stock price falling below the strike price of the option. Once the stock is divorced from the put option, a married put transaction is converted into a speculative ''bearish'' position, with the put option used as a substitute for a short position in the stock. This is not consistent with legitimate hedging but rather aligned with a short strategy. Moreover, it is unlikely that a trader anticipating obtaining a ''long'' position by virtue of an expected allocation of ''repeat'' or ''secondary'' offering shares would use a married put transaction as a legitimate hedging instrument. In such an instance, a trader most likely would simply purchase put options in the offering stock rather than purchasing both the stock and the put options.

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

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

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

stock and options are priced at market levels.[20]

These married transactions have been used in connection with various trading strategies, including, but not limited to, the following:

- contemporaneously with or shortly after the purchase of a married put, stock sales are made without regard to the ''tick test'' as part of a day trading strategy dependent on trading without short sale price test execution delays in order to profit from rapid intra-day trades to take advantage of small price movements in stocks,
- contemporaneously with or shortly after the purchase of a married put, aggressive, rapid stock sales on successive minus or zero-minus ticks as part of a short-term momentum play in which a trader's strategy is aligned with a downward movement of the stock's price, or
- contemporaneously with or shortly after the purchase of a married put, aggressive stock sales are made during the 5-day period prior to the pricing of a secondary or repeat offering where the trader's strategy is aligned with a downward movement of the stock's price in an effort to profit from the difference between the sales prices and the offering price.

We believe it is important to disabuse traders of any notion that the use of married puts, as described above, complies with Commission rules. As such, we are issuing this interpretative release as a means of providing all market participants with guidance regarding the use of married put transactions when determining their net positions under Rule 3b-3. Married puts with the characteristics described above are sham transactions that do not give rise to security ownership under Rule 3b–3.[21] Therefore, sellers who use these types of married puts may violate Rule 10a–1 and Rule 105.[22] Moreover, if sham married puts are used as part of a fraudulent or manipulative scheme, the conduct may also violate the Commission's anti-fraud and anti-manipulation provisions, including, but not limited to, Sections 9(a) and 10(b) of the Exchange Act.[23]

In publishing this interpretative guidance, we recognize that married put transactions may be used as part of a legitimate hedging strategy, and we do not want to discourage their use for that purpose. Rather, we are calling attention to abusive married put transactions that have characteristics described above and are used in a scheme to create sham long positions in order to evade Commission rules.

III. Conclusion

For the foregoing reasons, we find that this interpretation is consistent with Rule 3b–3 of the Exchange Act.[24]

List of Subjects in 17 CFR Part 241

Securities.

Amendments to the Code of Federal Regulations.

■ For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ Part 241 is amended by adding Release No. 34–48795 and the release date of November 17, 2003 to the list of interpretative releases.

Dated: November 17, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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[20] Even viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a ''long'' position in order to effect sales of stock in a manner that would otherwise be prohibited. However, borrowed stock does not confer an ownership position under Rule 3b–3. Therefore, the sale of borrowed securities must be effected in compliance with short sale rules.

[21] A variation on the married put transaction used to facilitate day trading strategies that also may be problematic is a ''conversion'' arrangement. In this arrangement, the trader that purchases the married put is long the stock, long a put option, and short a call option. The facilitator has the opposite side of the transaction, *i.e.*, short the stock, short a put option, and long a call option. Often, the put and call options have the same strike prices. This arrangement provides the facilitator with the right to call the stock to cover its short position at a prearranged price in the event the counter party to the transaction does not exercise the put option. As with married put transactions, where these arrangements, or other similar arrangements, have the characteristics described above, they do not give rise to security ownership under Rule 3b–3.

[22] Scienter is not required to establish a violation of Rule 10a–1. *See U.S.* v. *Mandel,* 296 F. Supp. 1038, 1039 (S.D.N.Y. 1969). Rule 105, as the successor to Rule 10b–21, does not require a showing of scienter. In adopting Rule 10b–21, the Commission made it clear that there was not a requirement to show a specific manipulative intent. *See* Exchange Act Release No. 26028, fn. 6, *supra. See, e.g., Paul Giles et al.,* Exchange Act Release No. 36118 (August 18, 1995), 1995 WL 509484.

[23] 15 U.S.C. 78e (a) and 78j (b). *See also* Securities Act Section 17(a), 15 U.S.C. 77q(a), and Exchange Act Section 15(c) and Rule 15c1–2 thereunder, 17 CFR 240.15c1–2.

[24] 17 CFR 240.3b–3.