



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

DIVISION OF  
MARKET REGULATION

July 20, 2006

David C. Whitcomb, Jr.  
Senior Vice President and Chief Regulatory Officer  
The Chicago Stock Exchange, Inc.  
One Financial Place  
440 S. LaSalle Street  
Chicago, IL 60605-1070

Re: Rule 10a-1 Exemption for Transactions in Securities Listed on the Nasdaq  
Stock Exchange  
TP File No. 06-86

Dear Mr. Whitcomb:

In your letter dated July 20, 2006 as supplemented by telephone conversations with the staff of the Division of Market Regulation ("Division"), you requested on behalf of The Chicago Stock Exchange, Inc. (the "CHX"), a registered national securities exchange, that the Securities and Exchange Commission ("Commission") grant an exemption from Rule 10a-1 of the Securities and Exchange Act of 1934 ("Exchange Act") for transactions in securities listed on the Nasdaq Stock Exchange.

A copy of your letter is attached to this response. By including a copy of your correspondence, we avoid having to repeat or summarize the facts you presented. The defined terms in this letter have the same meaning as in your letter, unless otherwise noted.

## 1. Background

Short sales are defined by Rule 200(a) of Regulation SHO, which provides that a short sale is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Paragraph (a) of Rule 10a-1 governs short sales of any security registered on, or admitted to unlisted trading privileges on, a national securities exchange if such transactions are made pursuant to an effective transaction reporting plan as defined in Rule 600 of Regulation NMS. Unless a specific exemption applies, short sales are prohibited at a price that is either (1) below the last reported price of a transaction reported pursuant to an effective transaction reporting plan (a "minus tick"); or (2) at the last reported price if that price is lower than the last reported different price (a "zero-minus tick"). The

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general purpose of the short sale rule is to prevent manipulative sales of a security for the purpose of accelerating a decline in the price of such security.<sup>1</sup>

Because Nasdaq was not an exchange, Rule 10a-1 did not previously apply to Nasdaq securities. In 1994, the Commission granted temporary approval to the Nasdaq to apply its own short sale rule to Nasdaq National Market securities traded on Nasdaq.<sup>2</sup> NASD Rule 3350 prohibits short sales in Nasdaq National Market securities at or below the current best (inside) bid when the current best (inside) bid is below the previous best (inside) bid in a security. NASD Rule 3350 is inapplicable to National Capital Market securities. Since that time, the NASD has proposed and the Commission has granted extensions of Rule 3350. However, short sales in Nasdaq securities effected on any national securities exchange that traded Nasdaq securities on an unlisted trading privileges basis were not subject to either Rule 10a-1 or NASD Rule 3350.

On January 13, 2006, the Commission approved the Nasdaq Stock Market LLC's ("Nasdaq") application to become an exchange.<sup>3</sup> Once Nasdaq's exchange application becomes effective, Rule 10a-1 would apply to Nasdaq securities wherever traded because they would be exchange-registered securities reported pursuant to an effective transaction reporting plan. Short sales in Nasdaq securities effected on any national securities exchange that trades Nasdaq securities on an unlisted trading privileges basis would become subject to Rule 10a-1 unless exempted.

In Nasdaq's exchange application, Nasdaq requested an exemption from Rule 10a-1 to continue regulating short sales of Nasdaq National Market securities under the bid test of Nasdaq Exchange Rule 3350.<sup>4</sup> Nasdaq also requested an exemption from Rule 10a-1 for Nasdaq Capital Market securities, as Rule 3350 is inapplicable to such securities. The exemption was requested to allow Nasdaq Capital Market securities to continue to trade without being subject to a price test.

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<sup>1</sup> *In the Matter of Tudor Investment Corporation*, Exchange Act Release No. 37669, AP File No. 3-9077, September 12, 1996 at n.3, citing Exchange Act Release No. 34-20715 (March 6, 1984), 49 Fed. Reg. 9414.

<sup>2</sup> Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

<sup>3</sup> SEC Order in the Matter of the Application of The Nasdaq Stock Market LLC for registration as a National Securities Exchange, Securities Exchange Act Release No. 53128 (Jan. 13, 2006).

<sup>4</sup> Nasdaq Exchange Rule 3350 would be substantially identical to NASD Rule 3350. For instance, Nasdaq will continue all current exemptions to NASD Rule 3350 in its Rule 3350, including the exemption for qualified market makers in connection with bona fide market making.

In granting the exemption, the Commission noted that it believed that it is important to maintain the status quo of short sale regulation during the Regulation SHO Pilot Program (“Pilot Program”) in order to avoid unnecessarily burdening the markets.<sup>5</sup> Under the Pilot Program, the Commission by order temporarily suspended short sale price tests in a group of securities to evaluate the overall effectiveness and necessity of such restrictions. We expect that the Commission will consider any further action on the adoption of a price test after the completion of the Pilot Program. In order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary, the Commission stated that it was necessary and appropriate in the public interest and consistent with the protection of investors to maintain the status quo for the price test after Nasdaq becomes an exchange.

As a result, Nasdaq will be able to trade its securities under its bid test.<sup>6</sup> However, Nasdaq securities traded on the facilities of a national securities exchange such as the CHX would default to Rule 10a-1’s tick test unless exempted.

The CHX currently has no specific provisions in its rules regarding the execution of short sales in Nasdaq-listed securities on the facilities of the CHX. The CHX requests that it be permitted to continue trading Nasdaq securities on its facilities under its current regulatory structure until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

## **2. Response**

We believe that maintaining the status quo is sensible in light of the Pilot. Market participants may be required to make significant systems changes to comply with the price test. If the Commission thereafter, as a result of its analysis of the Pilot results, determines to either eliminate the price test or to adopt new short sale price test rules, market participants will be required to incur additional costs to make further systems changes to comply. Thus, we believe it would be reasonable to maintain the status quo for the short

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<sup>5</sup> The Pilot Program commenced on May 2, 2005 and is scheduled to end on August 6, 2007. *See* Securities Exchange Act Release 53684 (April 20, 2006).

<sup>6</sup> In addition, to maintain the status quo for Nasdaq securities traded over-the-counter and reported to an NASD facility, we also granted an exemption to NASD, Inc. to permit Nasdaq National Market Securities traded over-the-counter and reported to an NASD facility to continue to be subject to a bid test rather than Rule 10a-1’s tick test, and Nasdaq Capital Market Securities traded over-the-counter and reported to a NASD facility to continue to not be subject to either Rule 10a-1 or a bid test. *See* Letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, to Marc Menchel, Executive Vice President and General Counsel, NASD, Inc., dated June 26, 2006.

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sale price test until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

Accordingly, we find that it is appropriate in the public interest and consistent with the protection of investors, to grant an exemption from Rule 10a-1, pursuant to Rule 10a-1(f), on the basis of your representations, but without necessarily concurring in your analysis, to permit Nasdaq securities traded on facilities of a national securities exchange such as CHX to remain uncovered by any price test. Alternatively, an exchange may, if it chooses, adopt a rule setting forth a bid test. This exemption would apply until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

The foregoing exemption from Rule 10a-1 is based solely on your letter dated July 20, 2006 and the representations and the facts you have presented to the staff, and is strictly limited to the application of this rule to transactions under the circumstances described above. Such transactions should be discontinued, pending presentation of the facts for our consideration, in the event that any material change occurs with respect to any of those facts or representations. The exemption granted herein is subject to modification or revocation if at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act.

In addition, your attention is directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and other applicable provisions of the federal or state securities laws must rest with participants to the transactions. The Division expresses no view with respect to other questions that the proposed transactions may raise, including, but not limited to, the applicability of other federal and state laws to the proposed transactions.

For the Commission,  
by the Division of Market Regulation,  
pursuant to delegated authority,



James Brigagliano  
Acting Associate Director

Attachment

# The Chicago Stock Exchange

David C. Whitcomb, Jr.  
Senior Vice President  
Chief Regulatory Officer

July 20, 2006

James A. Brigagliano  
Acting Associate Director  
Division of Market Regulation  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: *Request for Rule 10a-1 Exemption for Transactions in Securities Listed on the Nasdaq Stock Exchange*

Dear Mr. Brigagliano,

The Chicago Stock Exchange, Inc. ("CHX" or the "Exchange"), a registered national securities exchange, hereby requests that the U.S. Securities and Exchange Commission (the "Commission") grant, pursuant to the Commission's authority under Rule 10a-1(f) under the Securities Exchange Act of 1934 ("Exchange Act"), an exemption from the "tick test" provisions of Rule 10a-1 of the Exchange Act for transactions executed on the Exchange in securities listed on the Nasdaq Stock Exchange. The requested relief would apply to all transactions in Nasdaq National Market and Nasdaq Capital Market securities executed on the Exchange. The Exchange believes that its proposal is reasonable to maintain the status quo in light of the Regulation SHO Pilot Program ("Pilot Program")<sup>1</sup> and the possibility that the Commission may modify existing short sale price tests after analyzing the results of data gathered during the Pilot Program.

## *I. Background*

The CHX currently has no specific provisions in its rules regarding the execution of short sales in Nasdaq-listed securities on the facilities of the Exchange. The approval by the Commission of the Nasdaq exchange application would normally trigger the "tick test" restrictions of Rule 10a-1 for securities listed on that marketplace. The Commission's approval order notes that Nasdaq has requested exemptive relief from the tick test provisions of Rule 10a-1 so that Nasdaq (and its members) continue its current bid test approach.<sup>2</sup> Absent any exemptive relief, the Exchange would have to apply the tick test

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<sup>1</sup> Under the Pilot Program, the Commission by order temporarily suspended short sale price tests in a group of securities to evaluate the overall effectiveness and necessity of such restrictions. The Commission is expected to consider any further action on the adoption of a price test after the completion of the Pilot Program.

<sup>2</sup> *SEC Order in the Matter of the Application of The Nasdaq Stock Market LLC for registration as a National Securities Exchange*, (Release No. 34-53128; File No. 10-131) footnote 167 and accompanying text, pp. 46-47 (Jan. 13, 2006).

of Rule 10a-1 to Nasdaq-listed securities once the Nasdaq Stock Exchange becomes operational. The Exchange proposes that it be permitted to continue trading Nasdaq securities on its facilities under its current regulatory structure until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

## *II. Short Sale Regulation*

Short sales are defined by Rule 200(a) of Regulation SHO, which provides that a short sale is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Paragraph (a) of Rule 10a-1 governs short sales of any security registered on, or admitted to unlisted trading privileges on, a national securities exchange if such transactions are made pursuant to an effective transaction reporting plan as defined in Rule 600 of Regulation NMS. Unless a specific exemption applies, short sales are prohibited at a price that is either (1) below the last reported price of a transaction reported pursuant to an effective transaction reporting plan (a "minus tick"); or (2) at the last reported price if that price is lower than the last reported different price (a "zero-minus tick"). The general purpose of the short sale rule is to prevent manipulative sales of a security for the purpose of accelerating a decline in the price of such security. *In the Matter of Tudor Investment Corporation*, Exchange Act Release No. 37669, AP File No. 3-9077, September 12, 1996 at n.3, citing Exchange Act Release No. 34-20715 (March 6, 1984), 49 Fed. Reg. 9414.

Short sale regulation in the over-the-counter market is governed by the provisions of NASD Conduct Rule 3350. Rule 3350 precludes an NASD member from effecting a short sale in a Nasdaq National Market security "at or below the current best (inside) bid displayed in the Nasdaq Market Center when the current best (inside) bid is below the preceding best (inside) bid in the security." The restrictions do not apply to Nasdaq Capital Market (formerly known as Nasdaq SmallCap) securities. There is an exemption for qualified market makers engaging in a *bona fide* market making activity. The Exchange does not have any similar set of restrictions on the trading of Nasdaq securities on its facilities.

## *III. Analysis*

In Nasdaq's exchange application, Nasdaq requested an exemption from Rule 10a-1 to continue regulating short sales of Nasdaq National Market Securities under the bid test of Nasdaq Exchange Rule 3350. Nasdaq also requested an exemption from Rule 10a-1 for Nasdaq Capital Market Securities, as Rule 3350 is inapplicable to such securities. The exemption was requested to allow Nasdaq Capital Market Securities to continue to trade without being subject to a price test.

In granting the exemption, the Commission noted that it believed that it is important to maintain the status quo of short sale regulation during the Pilot Program in order to avoid unnecessarily burdening the markets. Under the Pilot Program, the Commission by order temporarily suspended short sale price tests in a group of securities to evaluate

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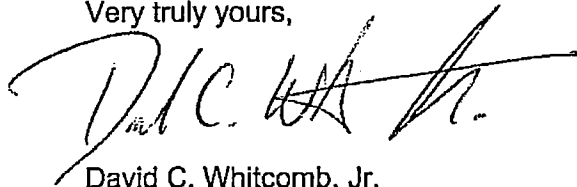
the overall effectiveness and necessity of such restrictions. In order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary, the Commission stated that it was necessary and appropriate in the public interest and consistent with the protection of investors to maintain the status quo for the price test after Nasdaq becomes an exchange. The exemption expires upon completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.<sup>3</sup>

We believe that maintaining the status quo is sensible in light of the Pilot. Market participants may be required to make significant systems changes to comply with the price test. If the Commission thereafter, as a result of its analysis of the Pilot results, determines to either eliminate the price test or to adopt new short sale price test rules, market participants will be required to incur additional costs to make further systems changes to comply. Thus, we believe it would be reasonable to maintain the status quo for the short sale price test until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

#### *IV. Conclusion*

Based upon the foregoing, we respectfully request that the Commission maintain the status quo and grant the requested relief from the requirements of Rule 10a-1 with respect to transactions in Nasdaq National Market and Nasdaq Capital Market securities effected on the Exchange. If you have any questions or require additional information, please do not hesitate to contact me at (312) 663-2628.

Very truly yours,

A handwritten signature in black ink, appearing to read "D.C. Whitcomb, Jr.", with a stylized flourish extending to the right.

David C. Whitcomb, Jr.

<sup>3</sup>

The Pilot Program is currently scheduled to end on August 6, 2007. See Securities Exchange Act Release No. 53684 (April 20, 2006). However, the Commission may from time to time approve further orders affecting the Pilot Program, including extension of the duration of the Pilot Program.