

# ClientAlert

## Financial Markets Developments

Capital Markets  
April 2009

### SEC Proposes Amendments to Regulation SHO to Restrict Short Selling

On April 10, 2009, the US Securities and Exchange Commission (the "SEC") published its much anticipated proposal to restrict short selling.<sup>1</sup> The SEC has been under pressure for some time from investors, industry participants and members of Congress to reinstate the "uptick rule"—which was eliminated in July 2007—or adopt an alternative to it, in order to prevent the type of "bear raids" that some believe contributed to the rapid, massive declines in stock prices of US financial institutions and, in some cases, ultimately led to their demise. The uptick rule, formerly contained in Rule 10a-1 under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), prohibited any short sale unless that price was higher than the prior sale price. The net effect of this was to permit short selling only if there had been an increase, or "uptick," in a stock's price.

Rather than simply reinstate the uptick rule, the SEC has proposed, and is seeking comment on, five alternate approaches to restrict short selling:

- The first alternative is simply to reinstate the uptick rule (the "**Uptick Rule**").
- The second alternative is to base the prohibition on short selling on the current best national bid rather than on the last sale price (the "**Modified Uptick Rule**"). The Modified Uptick Rule would require a trading center to establish, maintain and enforce written policies and procedures designed to prevent it from executing or displaying any short sale order, absent an exception, at a price less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, at a price that is less than or equal to the current national best bid.
- The third alternative (the "**Circuit Breaker Halt Rule**") is an outright prohibition on short sales of an individual security, absent an exception, for the remainder of the trading day if the price of such security has declined by at least ten percent from the prior day's closing price for such security (a "**Circuit Breaker Event**").<sup>2</sup>
- The fourth and fifth alternatives (the "**Circuit Breaker Price Test Rules**") are the same as the first and second alternatives; however, the restrictions under each alternative would only be triggered upon a Circuit Breaker Event and would then remain in effect for the remainder of the trading day. We refer to these alternatives, together with the Circuit Breaker Halt Rule, as the "**Circuit Breaker Rules**."



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<sup>1</sup> "The term *short sale* shall mean 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." 17 CFR 242.200(a).

<sup>2</sup> "The prior day's closing price would be the last price reported during regular trading hours the prior day." Exchange Act Rel. No. 59,748 (Apr. 10, 2009) available at <http://www.sec.gov/rules/proposed/2009/34-59748.pdf>.

Please refer to Appendix A for a diagram of the five alternate approaches to restrict short sales and to Appendix B for a chart summarizing the exceptions applicable to each alternative.

The SEC staff believes that the Modified Uptick Rule would be more suited to today's markets than the Uptick Rule, whether adopted as a full-time rule or as part of a Circuit Breaker Rule. That said, the SEC is encouraging comments on the proposals and has requested that such comments be supported by empirical support wherever possible. The SEC does not itself have empirical evidence supporting the need for restrictions on short selling and its proposals result in large part from political pressure and a perception that short selling restrictions will promote investor confidence among those who believe that recent volatility and depressed prices are due to the removal of Rule 10a-1.

The proposed implementation period for the Uptick Rule, the Modified Uptick Rule or the Circuit Breaker Rules is three months after effectiveness should the SEC adopt a marking requirement (as discussed in Section IV below) in conjunction with any of these rules. Otherwise, the SEC proposes a three-month implementation period after effectiveness if it adopts either of the Uptick Rule or the Modified Uptick Rule and specifically seeks comment on the appropriate length of an implementation period should it adopt a Circuit Breaker Rule. Comments on the release may be submitted to the SEC on or before June 19, 2009.

## I. Overview of Short Selling Restrictions in the United States

The SEC adopted former Rule 10a-1, also known as the "uptick rule," in 1938 to restrict short selling in a declining market, pursuant to its authority to regulate short sales of securities registered on a national securities exchange under Section 10(a) of the Exchange Act. Following comments received in response to its proposal to eliminate all short sale price restrictions, the results of studies on the effects of short selling and the market developments since 1938, the SEC (1) eliminated former Rule 10a-1 and (2) added Rule 201 of Regulation SHO prohibiting any self-regulatory organization (each, a "**SRO**"), such as the national stock exchanges, from having a short sale price test effective July 3, 2007.

In 2008, the SEC took several steps to prevent abuses in markets resulting from short selling, particularly focusing on limiting "naked" short selling.<sup>3</sup> Following concerns that false rumors spread by short sellers regarding significant financial institutions contributed to market volatility in the securities of such institutions, the SEC issued an emergency order on July 15, 2008 imposing borrowing restrictions and delivery requirements on short sales of the securities of certain financial institutions.<sup>4</sup> Further concerns about the impact of short selling on the prices of financial institution securities led to an emergency order on September 18, 2008, prohibiting the short selling of certain financial institution securities.<sup>5</sup> Both such orders with respect to financial institutions have expired. As a result of general concern about the effect of short sales on the broader equity markets, the SEC issued a series of temporary emergency orders in September 2008 imposing various restrictions on short sales. In October 2008, the SEC adopted additional rules aimed at curtailing abusive short selling and persistent fails to deliver.<sup>6</sup>

## II. Alternatives One and Two—Short Sale Prohibitions if Price Tests are Not Met

### Uptick Rule

The first alternative proposed by the SEC is the reinstatement of the Uptick Rule. Under the Uptick Rule, a person would be prohibited from effecting a short sale of any "covered security" below the last sale price unless that price is above the last different price (e.g., only if there has been an "uptick").

The prohibition under the Uptick Rule would apply to a person executing a trade for its own account or the account of a third party. The prohibition is outright and is not based on a requirement to implement policies and procedures to prevent prohibited trades (in contrast to the approach adopted under the Modified Uptick Rule). As a result, the Uptick Rule would be more burdensome to apply than the Modified Uptick Rule because the prohibition approach of the Uptick Rule would not allow any short sale at an impermissible price, even if in error or inadvertent, unless an exception applies. The SEC could decide to provide an exception for inadvertent errors.

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3 A "naked" short sale is the practice of selling shares that a trader does not own and has neither borrowed nor arranged to borrow at the time of sale.

4 For more information regarding the July 15, 2008 emergency order, see White & Case LLP Client Alert, "SEC Issues Emergency Order Restricting Short Selling of Financial Stocks," (July 21, 2008), available at [http://www.whitecase.com/alert\\_securities\\_072108/](http://www.whitecase.com/alert_securities_072108/).

5 LSTA is the Loan Syndications and Trading Association based in New York.

6 For more information regarding the October 2008 rules, see White & Case LLP Client Alert, "SEC Takes Further Action to Curtain Naked Short Selling," (Oct. 2008), available at [http://www.whitecase.com/alert\\_cmsecurities\\_fmd\\_naked\\_short\\_selling\\_102308/](http://www.whitecase.com/alert_cmsecurities_fmd_naked_short_selling_102308/).

The SEC noted that it could adopt a policies and procedures approach for the Uptick Rule, which would require market participants to surveil constantly for compliance and take prompt remedial steps to limit the execution or display of short sales at impermissible prices. This type of approach was not considered for the Uptick Rule because the SEC wanted to seek comment on a price test similar to former Rule 10a-1, eliminated in mid-2007 (the “**Former Uptick Rule**”), and a policies and procedures approach would have been a substantial change from that former rule.

### **Modified Uptick Rule**

The second alternative proposed by the SEC is the Modified Uptick Rule. The Modified Uptick Rule would require that “[a] trading center<sup>7</sup> shall establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order in a covered security at a down-bid price.”<sup>8</sup> A “down-bid price” would be a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid.<sup>9</sup>

This differs from the Uptick Rule in a number of ways:

- a. First, it would use the current best national bid as a reference point for short sale orders rather than the last sale price. As a result, short selling could occur below the last sale price. The SEC recognizes that bids reflect proposed transactions, while last sale prices reflect actual trades. Nevertheless, bids are required to be firm under Rule 602 of Regulation NMS, thereby providing comfort that market participants are making informed decisions based on reliable information. Additionally, the SEC believes that bids are a more accurate reflection of current prices for a security because changes in the national best bid are sequenced across trading centers, while sales may be reported during a 90-second window, leading to inaccurate up-ticks and down-ticks and reporting out of sequence.
- b. Second, the Modified Uptick Rule is not an outright prohibition. Rather, a trading center would be required to have policies and procedures reasonably designed to prevent it from executing or displaying any short sale order, absent an exception, at a price that is below the national best bid. If the current national best bid is below the last differently priced national best bid, a trading center would be required to have policies and procedures reasonably designed to prevent it from executing or displaying the order unless the order is priced above the current national best bid. The SEC believes that trading centers are familiar with establishing, maintaining and enforcing trading-related policies and procedures as a result of existing policy and procedure requirements contained in Regulation NMS.

The Modified Uptick Rule would provide more flexibility to a trading center in handling orders that are not immediately executable or displayable by the trading center. If a short-sale order is impermissibly priced (i.e., the current bid price is below the previous bid), the trading center could, but would not be required to, reprice such order at the lowest permissible price and hold it for later execution at its new price or better. The SEC believes that this aspect of the Modified Uptick Rule allows for more efficiently functioning markets because trading centers would not have to reject or cancel impermissibly priced orders.

A broker-dealer would be permitted to mark a short order “short exempt” if it identifies the short sale order as not being on a down-bid price at the time the order is submitted to the trading center.<sup>10</sup> A broker-dealer would have the burden of establishing, maintaining and enforcing written policies to allow it to correctly identify the pricing of orders and to mark them as “short exempt.” As part of this undertaking, broker-dealers would be required to put in place ongoing surveillance activities to ensure that its policies and procedures remain effective.

The SEC stated that it preliminarily believes that the proposed Modified Uptick Rule would be more suited to today’s markets than the proposed Uptick Rule, whether adopted as a full-time rule or as part of a Circuit Breaker Rule.

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<sup>7</sup> “A ‘trading center’ means a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.” See *supra* n.2 at 33-34.

<sup>8</sup> See Proposed Rule 201(b)(1).

<sup>9</sup> See Proposed Rule 201(a)(2).

<sup>10</sup> See Proposed Rule 201(c)(1).

**Definition of Covered Security**

The Uptick Rule and Modified Uptick Rule would apply to all securities, except options, listed on a national securities exchange whether traded on an exchange or in the over-the-counter (“**OTC**”) market, but does not include stocks otherwise quoted on the OTC Bulletin Board or elsewhere in the OTC market.<sup>11</sup> While this coverage is similar to the coverage under the Former Uptick Rule, the SEC is soliciting comment on whether the Uptick Rule or Modified Uptick Rule should apply to the currently excluded securities.

**Timing of Restrictions**

In contrast to the Former Uptick Rule, the Uptick Rule and Modified Uptick Rule would only apply to trades executed during regular trading hours (from 9:30 a.m. until 4:00 p.m. Eastern Time). This results in part from the difficulty of applying the Modified Uptick Rule outside of regular trading hours when the national best bid is not collected, calculated and disseminated.

**Exceptions and Exemptions to the Uptick Rule and the Modified Uptick Rule**

The Uptick Rule and the Modified Uptick Rule are intended to permit unrestricted short selling in an upward market. In general, the proposed exemptions and exceptions to the Uptick Rule and the Modified Uptick Rule are limited in scope and intended to promote the workability of each rule.

The exemptions from the Uptick Rule and the Modified Uptick Rule generally parallel the exemptions contained in the Former Uptick Rule or granted pursuant to SEC no-action relief.

**Exemptions from the Modified Uptick Rule and the Uptick Rule****1. Seller’s Delay in Delivery<sup>12</sup>**

Rule 200(g)(1) of Regulation SHO provides that a sale can be marked “long” only if the seller is deemed to own the security being sold and either (1) the security is in the broker-dealer’s physical possession or control, or (2) it is reasonably expected that the security will be in the

broker-dealer’s physical possession or control by settlement of the transaction. In order to address situations where a seller is unable to deliver a security prior to settlement solely on logistical grounds (e.g., with respect to formerly restricted securities that are being delegended or where a convertible security has been tendered for conversion but is not expected to be received by the settlement date), the SEC has proposed an exemption if a broker-dealer has a reasonable basis to believe a short sale order is made by a person “deemed to own” the security under Regulation SHO’s Rule 200 and that person intends to deliver the security as soon as all restrictions associated with its delivery have been removed. This type of transaction does not pose a threat akin to naked short sales because, while short-term impediments may prevent transfer of the security by the seller, there is little risk of a fail to deliver because the security is deemed to be owned by the seller. This parallels an exemption that existed under the Former Uptick Rule.

**2. Odd Lot Transactions<sup>13</sup>**

This proposed exemption, which parallels one that existed under the Former Uptick Rule, would allow broker-dealers to act as market makers in odd lots. An “odd lot” is generally considered a transaction for less than 100 shares of a stock. The SEC believes that transactions of this size are not large enough to exert downward pressure on security prices.

**3. Domestic Arbitrage<sup>14</sup>**

This proposed exemption, which parallels one that existed under the Former Uptick Rule, would apply if a broker-dealer has a reasonable basis to believe the short sale is for a bona fide arbitrage transaction. The term “bona fide arbitrage” applies to an activity undertaken by market professionals in which they execute contemporaneous purchase and sale orders in order to lock in a spread between the two prices, usually in the context of a convertible or exchangeable security and its underlying stock.<sup>15</sup> The short sale order must be “for a good faith account by a person who owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold, so long as such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from

<sup>11</sup> The definition of “covered security” is an “NMS stock” under Rule 600(b)(47) of Regulation NMS. Rule 600(b)(47) of Regulation NMS defines an “NMS stock” as “any NMS security other than an option and Rule 600(b)(46) of Regulation NMS defines an “NMS security” as “any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” The SEC notes that a national best bid and offer currently is not required to be collected, consolidated and disseminated for non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. See *supra* n.2 at 32. Thus, even though it may be desirable to extend the rules to OTC Bulletin Board securities, which are of companies that report under the Exchange Act, it would require a further rule change and implementation efforts.

<sup>12</sup> See Proposed Rule 201(c)(1), (Uptick Rule).

<sup>13</sup> See Proposed Rule 201(c)(3) (Uptick Rule) or 201(d)(2) (Modified Uptick Rule). An “odd lot” as defined in Rule 600(b)(49) is “an order for the purchase or sale of an NMS stock in an amount less than a round lot.” 17 CFR 242.600(b)(49).

<sup>14</sup> See Proposed Rule 201(c)(4) (Uptick Rule) or 201(d)(3) (Modified Uptick Rule).

<sup>15</sup> See *supra* n.2, at 52-53 (citing 1999 Concept Release, 64 FR 57996 October 28, 1999 at n.54 and accompanying text).

the difference between the price of the security sold and the security owned.”<sup>16</sup> The rights to acquire the security sold short must have been originally attached to or been represented by another security or have been issued to all the holders of any such securities in connection with the arbitrage.<sup>17</sup> Short sales in connection with bona fide arbitrage transactions do not pose the type of risk which the Uptick Rule and the Modified Uptick Rule were designed to protect given that the short seller already has the ability to make an immediate purchase of like securities to be delivered because it holds such rights to acquire the security. The SEC recognizes that such transactions can reduce pricing disparities between related securities and promote market efficiencies. Nevertheless, the scope of the exemption for bona fide arbitrage may not be large enough to permit the full range of hedging transactions that are common with respect to convertible securities and the ability to hedge outside of trading hours is likely to be insufficient.

#### 4. International Arbitrage<sup>18</sup>

Like domestic arbitrage transactions, international arbitrage transactions would lead to equalization in prices at an instant in time, albeit a convergence of prices in different foreign markets, thereby promoting market efficiency. This exemption, which also parallels one that existed under the Former Uptick Rule, would apply if the broker-dealer has a reasonable basis to believe the short sale order is for a good faith account submitted to profit from a current price difference between a security in a foreign market and a security in the US market so long as the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it was made. As with the domestic arbitrage scenario, the seller would be able to cover the sold securities immediately, so there is little risk of the occurrence of a fail to deliver.

#### 5. Over-Allotments and Lay-Off Sales<sup>19</sup>

This proposed exemption, which parallels one that existed under the Former Uptick Rule, would allow short sale orders by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any short sale orders with respect to lay-off sales by such persons in connection with a distribution of securities through a rights

or standby underwriting commitment. The SEC’s view is that such short sales are regulated by the anti-manipulation rules under Regulation M under the Exchange Act. As a result, for example, short sales in connection with permitted stabilization activities under Regulation M and in connection with a “shields plan” for a rights offering would be permitted.

#### 6. Riskless Principal Transactions<sup>20</sup>

A “riskless principal” transaction is one “in which a broker or dealer, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell.”<sup>21</sup> In these transactions, the broker-dealer does not own the securities that the customer seeks to sell and, instead, the broker-dealer will buy or sell for his own account and then fulfill the customer’s order using those securities. The broker-dealer could be unable to fulfill the order if it has a net short position in the stock and it seeks to effect the transaction when there is no uptick. This proposed exemption would allow short sale orders by a broker-dealer that has a reasonable basis to believe that the purpose of the short sale order is to execute a customer purchase or to execute a customer “long” sale on a riskless principal basis and provided the sell order is given the same per-share price at which the broker-dealer bought shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee. In addition, broker-dealers would be required to have in place policies and procedures to assure that the customer order was received prior to the offsetting transaction, the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution and that it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to this provision. This exemption tracks prior SEC no-action relief based on the notion that the transaction is not really a short sale because of the back-to-back nature of the sale by the broker-dealer and customer.

<sup>16</sup> See supra n.15. The SEC seeks comments on whether the use of a “good faith account” is appropriate.

<sup>17</sup> See id.

<sup>18</sup> See Proposed Rule 201(c)(5) (Uptick Rule) or 201(d)(4) (Modified Uptick Rule). The SEC seeks comments on whether the use of a “good faith account” is appropriate.

<sup>19</sup> See Proposed Rule 201(c)(6) (Uptick Rule) or 201(d)(5) (Modified Uptick Rule).

<sup>20</sup> See Proposed Rule 201(c)(9) (Uptick Rule) or 201(d)(6) (Modified Uptick Rule).

<sup>21</sup> See Proposed Rule 201(a)(6).

## 7. Transactions on a Volume-Weighted Average Price Basis<sup>22</sup>

This exemption, which is broadly consistent with relief that the SEC granted under the Former Uptick Rule, would apply to short sale orders carried out at the volume-weighted average price ("VWAP").<sup>23</sup> This exemption is based on the recognition that VWAP short sale transactions do not impact the VWAP for a particular security and are therefore not prone to the same level of risk as other short selling activities. In order to satisfy this exemption, the short sale order must: (i) be with respect to an "actively-traded security"<sup>24</sup> and, if a security is not "actively-traded," the short sale will be permitted only if it is conducted as part of a basket transaction consisting of twenty or more securities in which the subject security does not comprise more than five percent of the value of the basket traded, (ii) be reported using a special VWAP trade modifier, (iii) not be effected for the purpose of creating active trading in or otherwise affecting the price of any security and (iv) have a broker or dealer act as principal on the contra side to fill customer short sale orders only if the broker-dealer's position in the subject security does not exceed ten percent of the covered security's relevant average daily trading volume, as defined in Regulation M. The SEC's proposed exemption would expand the relief granted under former Rule 10a-1 to include VWAP transactions carried out after the market opens at 9:30 a.m. While prices are not assigned until after the close of trading, the SEC does not believe that VWAP short sale transactions pose the risk of market volatility or rapid declines in security prices.

### Exceptions to the Uptick Rule Only

#### 1. Error in Marking a Short Sale<sup>25</sup>

The Uptick Rule would not apply when a broker-dealer effects a sale order mistakenly marked "long" by another broker-dealer. This rule would not implicate the broker-dealer effecting the sale if it did not knowingly or recklessly violate the proposed Uptick Rule. This exception is required for the Uptick Rule since it is currently proposed as an outright prohibition rather than a requirement to implement policies and procedures.

## 2. Electronic Trading Systems<sup>26</sup>

The Uptick Rule would not apply to any sales of actively-traded securities<sup>27</sup> in electronic trading systems that match and execute trades at various times and at independently-derived prices. Since these types of transactions involve "passive" pricing and a lack of price discovery, the SEC believes that they do not involve the type of abuse sought to be prevented. To be eligible for the exception, the transaction on an applicable electronic trading system must meet the following requirements: (i) matches occur at an externally derived price that is above the current national best bid, (ii) sellers and purchaser may not be assured of receiving a matching order, (iii) sellers and purchasers do not know when a match will occur, (iv) the persons relying on the exception are not represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction, (v) transactions are not made for the purpose of creating active trading in, or depressing or otherwise manipulating the price of, any security and (vi) during the period of time in which the electronic trading system may match buying and selling interest there is no solicitation of customer orders, or any communication with customers that the match has not yet occurred.

## 3. Trade-Throughs<sup>28</sup>

The Uptick Rule would not apply to sales by registered specialists or registered exchange market makers for their own accounts or by third market makers for their own accounts at a price equal to the most recent offer communicated for the security by such registered specialist, registered exchange market maker or third market maker if the offer, when communicated, was equal to or above the last sale price. This exception can be waived by an SRO that determines that it should not apply to certain specialists or market makers. Additionally, the proposed Uptick Rule would not apply to any sales by any broker or dealer, for its own account or that of another person, effected at a price equal to the most recent offer communicated by such broker or dealer to an exchange or

<sup>22</sup> See Proposed Rule 201(c)(7) (Uptick Rule) and 201(d)(7) (Modified Uptick Rule).

<sup>23</sup> VWAP is computed by calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values and dividing the aggregate sum by the total number of reported shares for that day in the security. See Proposed Rule 201(c)(7)(i) (Uptick Rule) and 201(d)(7)(i) (Modified Uptick Rule).

<sup>24</sup> The term "actively-traded security" is defined in Regulation M as a security that has an average daily trading volume (ADTV) of at least US\$1 million and is issued by an issuer whose common equity securities have a public float value of at least US\$150 million. Rule 101(c)(1) of Regulation M. See supra n.2 at 63.

<sup>25</sup> See Proposed Rule 201(c)(2) (Uptick Rule).

<sup>26</sup> See Proposed Rule 201(c)(8) (Uptick Rule).

<sup>27</sup> If a security is not "actively-traded," the same rule will apply to this exception as would apply to a security that is not "actively-traded" under the exemption for Transactions on a Volume-Weighted Average Price Basis. See supra n.23.

<sup>28</sup> See Proposed Rule 201(c)(10) and Proposed Rule 201(c)(11) (Uptick Rule).

association in an amount less than or equal to the quotation size associated with such offer, if such offer, when communicated, was (i) above the last sale price or (ii) at the last sale price, if such last sale price is above the next preceding different price.

#### 4. Facilitation of Customer Buy Orders<sup>29</sup>

The proposed Uptick Rule would not apply to short sales by registered market makers or specialists publishing two-sided quotes to sell short at the offer price to facilitate certain buy limit orders. This exception would apply only in response to customer buy limit orders and only if short sales were made at (but not below) the national best offer. As a result, the SEC believes it would not lead to an abusive use of short selling.

### **III. Alternatives Three, Four and Five— Proposed Circuit Breaker Rules**

#### **Circuit Breaker Rules**

The third, fourth and fifth alternatives proposed by the SEC—the Circuit Breaker Rules—would each be triggered only upon the occurrence of a Circuit Breaker Event. The relevant prohibition would then remain in effect for the remainder of the trading day. The prohibitions will apply to the same classes of securities as the Uptick Rule and the Modified Uptick Rule.

To avoid market disruption that could occur if the prohibitions were triggered late in the trading day, the Circuit Breaker Rules would not be triggered if the Circuit Breaker Event occurs within 30 minutes of the end of the regular trading day (e.g. 4:00 p.m. Eastern Time).

The SEC notes that investors are familiar with circuit breakers in general because all stock exchanges, the Financial Industry Regulatory Authority, Inc. and options markets currently have some form of circuit breaker in place to halt trading generally in the case of significant market declines. The SEC seeks comment on the costs and benefits of a Circuit Breaker Rule.

#### **Alternative Three—Circuit Breaker Halt Rule**

The third alternative proposed by the SEC, the Circuit Breaker Halt Rule, would be a complete prohibition on short sales of a specific security with respect to which a Circuit Breaker Event has occurred.

The SEC has proposed exceptions to the Circuit Breaker Halt Rule to enable the proper functioning of markets and permit already-existing obligations with respect to a security that arose prior to the triggering of the Circuit Breaker Rules.<sup>30</sup> These exceptions are largely based on those adopted by the SEC in its September 18, 2008 emergency order, as amended, prohibiting short sales of securities of certain financial institutions.<sup>31</sup> Excepted are short sales (i) by market makers obligated to quote in the OTC market and engaged in bona fide market making activities, (ii) occurring as a result of automatic exercise or assignment of an equity option or expiration of a futures contract held before the halt was put in place, (iii) by a person that is the writer of a call option if the sale is a result of assignment following exercise by the hold of the call and (iv) by a bona fide market maker in connection with derivative securities based on that covered security or exchange traded funds and notes of which the covered security is a component.

Additionally, the Circuit Breaker Halt Rule, as proposed, would have an exception for sellers' delay in delivery of an owned security, as under the Uptick Rule or the Modified Uptick Rule, effectively rendering such a transaction not to be a naked short sale.

The SEC believes that adoption of the Circuit Breaker Halt Rule could be beneficial by targeting "bear raids" in which attempts are made to drive down the price of a security by flooding the market with increased supply of the security. Nevertheless, the SEC expresses a concern that there may be an unintended side effect of a Circuit Breaker Halt Rule whereby investors might seek to execute short sales before the triggering threshold is reached (a so-called "magnet effect").

#### **Alternatives Four and Five—Circuit Breaker Price Test Rules**

The fourth and fifth alternatives proposed by the SEC, the Circuit Breaker Price Test Rules, are the same as the first and second alternatives, except that they would only be triggered upon the occurrence of a Circuit Breaker Event. Under this circumstance, the applicable Circuit Breaker Price Test Rule would impose either the Modified Uptick Rule or the Uptick Rule for the remainder of the trading day.<sup>32</sup> The exemptions and exceptions that would apply would be the same as are applicable to either the Modified Uptick Rule or the Uptick Rule, respectively.

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<sup>29</sup> See Proposed Rule 201(c)(12) (Uptick Rule).

<sup>30</sup> See Proposed Rule 201(d) (Circuit Breaker Rules).

<sup>31</sup> See *supra* n.5.

<sup>32</sup> The period for the applicability of the Modified Uptick Rule would be during times when the national best bid is calculated and disseminated in the consolidated system. The period for the applicability of the Uptick Rule would be during times when the last sale price is calculated and disseminated in the consolidated system. See *supra* n.2 at 101.

The SEC believes that a Circuit Breaker Price Test Rule may provide more benefits than a Circuit Breaker Halt Rule. A Circuit Breaker Halt Rule may prevent legitimate short selling activity since it would completely shut down short selling for the remainder of a trading day. A Circuit Breaker Price Test Rule would merely implement price test restrictions in increments of one cent. The SEC also believes that another consequence of moving away from a complete prohibition on short selling is the potential for a reduction in the “magnet effect” since investors would not rush to sell before a halt is put in place.

#### IV. Marking

In addition to the proposed amendments to Rule 201 of Regulation SHO discussed in Sections II and III above to add an Uptick Rule, a Modified Uptick Rule or a Circuit Breaker Rule, the SEC is proposing to amend Rule 200(g) of Regulation SHO to reinstate the “short exempt” marking requirement that was removed in conjunction with the elimination of former Rule 10a-1. Proposed Rule 200(g)(2) of the Uptick Rule, the Modified Uptick Rule and Circuit Breaker Rules would provide that a sale order shall be marked “short exempt” only if the applicable exception provisions are met.

As applied to the Modified Uptick Rule, the “short exempt” marking requirement would provide a record that a broker-dealer is availing itself of an exception provision. As applied to the Uptick Rule or a Circuit Breaker Rule, the marking requirement would provide that a seller is relying on an exception provision. The records provided pursuant to the “short exempt” marking requirements of proposed Rule 200(g) would aid surveillance by SROs and the SEC for compliance with the provisions of the short sale restriction ultimately adopted. Further, if the SEC adopts a policies and procedures approach, such as that proposed under the Modified Uptick Rule, the proposed “short exempt” marking requirement would provide an indication to a trading center as to whether it must execute or display a short sale order.

#### V. Looking Forward

One of the SEC’s proposals, the Modified Uptick Rule triggered upon the occurrence of a Circuit Breaker Event, is similar to a proposal made by several major exchanges in March 2009. NYSE Euronext, NASDAQ OMX, BATS Exchange and the National Stock Exchange submitted a joint letter to the SEC

on March 24, 2009, in which they proposed implementing a modified version of the former uptick rule.<sup>33</sup> Key points of the exchanges’ proposal include:

- permitting short sales only at a price above the highest prevailing national bid, which should mean that a short sale would never hit a current bid
- a circuit breaker triggering the proposed restriction on passive short sales upon a decline in a stock price “by a certain percentage, perhaps ten percent”
- a policies and procedures approach placing responsibility for compliance with the rules with broker-dealers
- an explicit exemption for bona fide market makers.

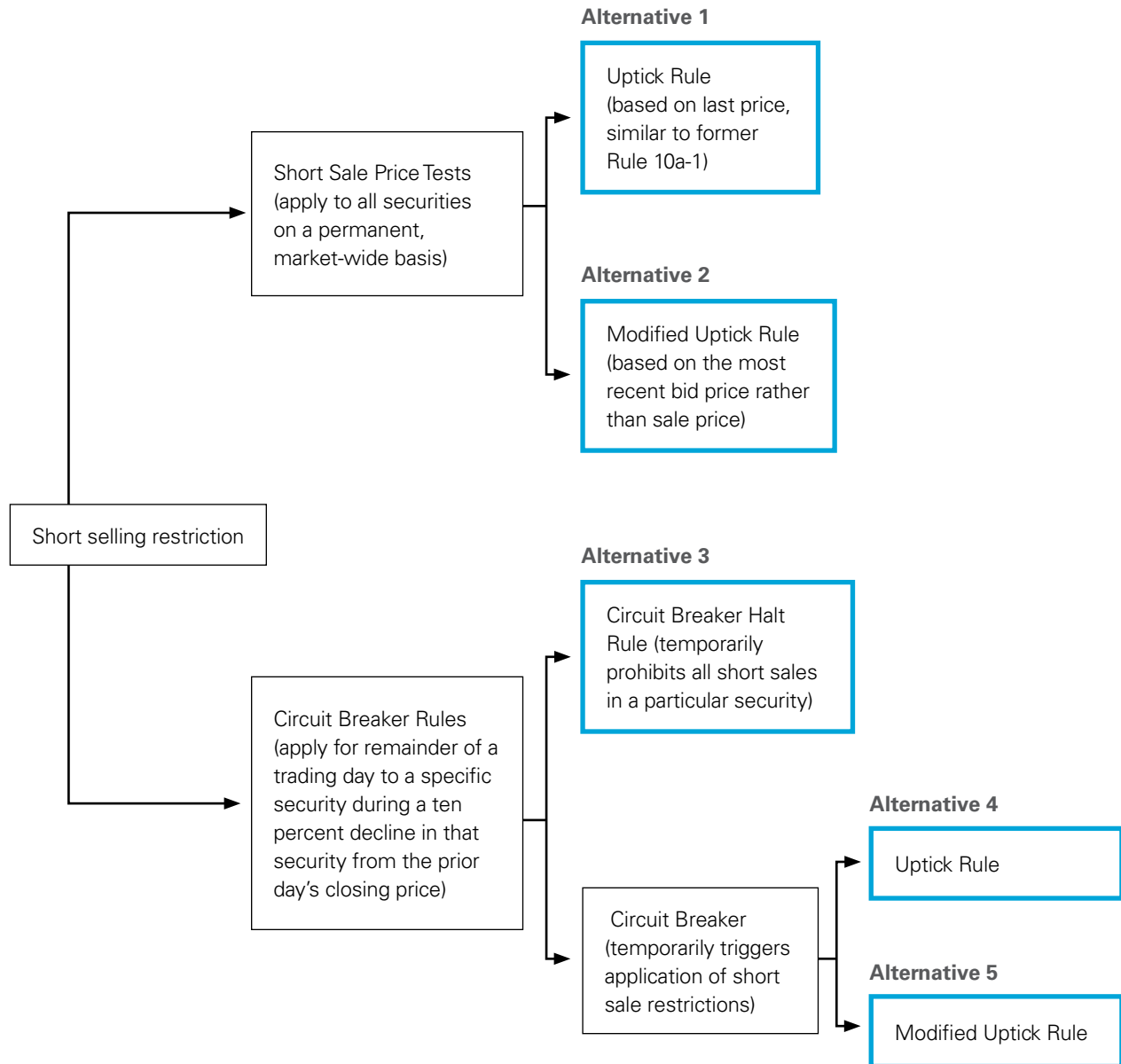
The exchanges’ initial reaction to the SEC proposals was mixed. As a general matter, the exchanges appeared to oppose the proposed Circuit Breaker Halt Rule and emphasized the need for a market-maker exemption. NYSE Euronext and NASDAQ OMX, both of which have received pressure from their listed companies to support efforts to curtail potential abusive short selling, had generally positive reactions to the proposals. Joe Ratterman, Chairman and Chief Executive Officer of BATS Exchange, was more critical. Ratterman noted that the exchanges’ proposal was their preference only if the SEC is compelled to adopt a new rule, but with respect to the proposed rules, he suggested that they were too broad and could result in a restriction that is not carefully critiqued.<sup>34</sup>

At this time, it seems likely that the SEC may be more willing to adopt a Modified Uptick Rule—whether or not triggered upon the occurrence of a Circuit Breaker Event—than any of the other proposals. The Modified Uptick Rule has the initial support of the SEC staff and is more in line with the proposal of the exchanges. In adopting a final rule, the SEC could take several different approaches or a combination of these approaches. The SEC noted that although it has received numerous requests to reinstate short sale price test restrictions, such requests have not included empirical data, but rather focused on what commenters believe to be the impact on the markets of reinstating an uptick rule. Thus, the SEC requests that commenters provide empirical data to support their views related to these proposals. The SEC will hold a roundtable on May 5, 2009 to discuss the issues involved.

<sup>33</sup> See Letter from Duncan Niederauer, CEO, NYSE Euronext, Robert Greifeld, President and CEO, The NASDAQ OMX Group, Inc., Joe Ratterman, CEO, BATS Exchange, Inc. and Joseph Rizzello, CEO, National Stock Exchange to Mary Schapiro, Chairman, SEC, dated Mar. 24, 2009, available at [http://www.nyse.com/pdfs/Uptick\\_Letter\\_SEC.pdf](http://www.nyse.com/pdfs/Uptick_Letter_SEC.pdf).

<sup>34</sup> See Sarah Lynch, BATS CEO: Prefers The SEC Impose No New Short-Sale Rules (Apr. 9, 2009), available at [http://online.wsj.com/article\\_email/BT-CO-20090409-713978-klyVDAiMEM5TzEtNzlxMDcwWj.html](http://online.wsj.com/article_email/BT-CO-20090409-713978-klyVDAiMEM5TzEtNzlxMDcwWj.html).

### Diagram of the Proposed Short Sale Restrictions



## Summary of Exemptions and Exceptions to the Proposed Short Sale Rules

			Proposed Rule		
	Exemption/Exception	Exemption/Relief Under Former Rule 10a-1	Modified Uptick Rule	Uptick Rule	Circuit Breaker Halt Rule
1	<p>Transactions in which the seller is delayed in delivery of securities but the seller is "deemed to own" the securities under Regulation SHO Rule 200</p> <p><i>[Proposed Rule 201(c)(1) (Uptick Rule) or 201(d)(1) (Modified Uptick Rule)]</i></p>	(e)(1)	✓	✓	✓
2	<p>Odd lot transactions</p> <p><i>[See Proposed Rule 201(c)(3) (Uptick Rule) or 201(d)(2) (Modified Uptick Rule)]</i></p>	(e)(3) and (4)	✓	✓	
3	<p>Bona fide domestic arbitrage transactions in which the rights to acquire the security sold short originally attached to or were represented by another security or were issued to all the holders of any such securities of the issuer</p> <p><i>[Proposed Rule 201(c)(4) (Uptick Rule) or 201(d)(3) (Modified Uptick Rule)]</i></p>	(e)(7)	✓	✓	
4	<p>International arbitrage transactions in which the short seller has an offer to buy on a foreign market</p> <p><i>[See Proposed Rule 201(c)(5) (Uptick Rule) or 201(d)(4) (Modified Uptick Rule)]</i></p>	(e)(8)	✓	✓	

			Proposed Rule		
	Exemption/Exception	Exemption/Relief Under Former Rule 10a-1	Modified Uptick Rule	Uptick Rule	Circuit Breaker Halt Rule
5	<p>Transactions in which underwriters or syndicate members participate in a distribution in connection with an over-allotment or lay-off sales in connection with a distribution of securities through a rights or standby underwriting commitment</p> <p><i>[Proposed Rule 201(c)(6) (Uptick Rule) or 201(d)(5) (Modified Uptick Rule)]</i></p>	(e)(10)	✓	✓	
6	<p>Transactions in which the short sale order is to effect the execution of a customer purchase or the execution of a customer "long" sale on a riskless principal basis</p> <p><i>[Proposed Rule 201(c)(9) (Uptick Rule) or 201(d)(6) (Modified Uptick Rule)]</i></p>	Securities Industry Association No-Action Letter, dated July 18, 2005	✓	✓	
7	<p>Transactions in which the short sale order is at a volume-weighted average price transaction</p> <p><i>[Proposed Rule 201(c)(7)]</i></p>	Series of No-Action Letters. See, e.g., Philadelphia Stock Exchange, Inc. No-Action Letter, dated March 24, 1999	✓	✓	
8	<p>Transactions in which a broker-dealer submits a short sale order identified as not on a down-bid price and the broker-dealer has appropriate policies and procedures in place</p> <p><i>[Proposed Rule 201(c)(7) (Uptick Rule) and 201(d)(7) (Modified Uptick Rule)]</i></p>	None	✓		

			Proposed Rule		
	Exemption/Exception	Exemption/Relief Under Former Rule 10a-1	Modified Uptick Rule	Uptick Rule	Circuit Breaker Halt Rule
9	Transactions in which a broker-dealer carries out a sale order mistakenly marked "long" by another broker-dealer  <i>[Proposed Rule 201(c)(2) (Uptick Rule)]</i>	(e)(2)		✓	
10	Transactions on electronic trading systems that match and execute trades at various times and at independently-derived prices  <i>[Proposed Rule 201(c)(8) (Uptick Rule)]</i>	ITG Inc. No-Action Letter, dated April 23, 2003		✓	
11	Sales by registered specialists or registered exchange market makers for their own accounts or by third market makers for their own accounts at a price equal to the most recent offer communicated for the security by such registered specialist, registered exchange market maker or third market maker if the offer, when communicated, was equal to or above the last sale price (e.g., "trade throughs")  <i>[Proposed Rule 201(c)(10) (Uptick Rule)]</i>	(e)(5)(ii)		✓	
12	Transactions effected at a price equal to the most recent offer communicated if such offer, when communicated, was equal to or above the last sale price  <i>[Proposed Rule 201(c)(11) (Uptick Rule)]</i>	(e)(11)		✓	

			Proposed Rule		
	Exemption/Exception	Exemption/Relief Under Former Rule 10a-1	Modified Uptick Rule	Uptick Rule	Circuit Breaker Halt Rule
13	Transactions by registered market makers or specialists publishing two-sided quotes to sell short at the offer to facilitate customer market and marketable buy limit orders  <i>[Proposed Rule 201(c)(12) (Uptick Rule)]</i>	Bernard L. Madoff Investment Securities LLC No-Action Letter, dated February 9, 2001		✓	
14	Short sales as part of bona fide market making activities  <i>[Proposed Rule 201(d)(1) (Circuit Breaker Rule)]</i>	None			✓
15	Short sales occurring as a result of automatic exercise or assignment of an equity option, or future contract, already held  <i>[Proposed Rule 201(d)(2) (Circuit Breaker Rule)]</i>	None			✓
16	Short sales occurring as a result of assignment to call writers upon exercise  <i>[Proposed Rule 201(d)(3) (Circuit Breaker Rule)]</i>	None			✓
17	Short sales by a bona fide market maker in connection with derivative securities based on that covered security or exchange traded funds and notes of which the covered security is a component  <i>[Proposed Rule 201(d)(2) (Circuit Breaker Rule)]</i>	None			✓

**Capital Markets**

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