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Client Alert

Capital Markets

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SEC Adopts Amendments to Regulation SHO to Restrict Short Selling

Introduction

On February 24, 2010, the US Securities and Exchange Commission adopted a new rule restricting short sales of stocks experiencing significant downward price pressure. New Rule 201 under the Securities Exchange Act of 1934, as amended, is a combination of the "circuit breaker" and "alternative uptick" proposals issued by the SEC in April 2009.[1] Compliance with the new rule is required starting on November 10, 2010.

The SEC's adoption of Rule 201 is a response to the elimination in July 2007 of former Rule 10a-1, known as the "uptick rule." In adopting Rule 201, the SEC stated that it hopes to achieve a balance between preventing short sale abuse and limiting interference with the normal operations of the market. It noted that while short selling provides important market benefits, including liquidity and pricing efficiency, it is necessary to prevent severe price declines that are independent of issuer fundamentals. Consistent with the objectives of Rule 10a-1 and Rule 204T,[2] Rule 201 is intended to address the issues of short selling practices that exacerbate rapidly declining prices in a security, often referred to as "bear raids," and illegal manipulation of stock prices. While noting that no empirical evidence definitively links the elimination of Rule 10a-1 and recent market volatility, the SEC acknowledged that many market observers saw the elimination of Rule 10a-1 as one of the primary causes of the market disruption.

Discussion

Generally

Rule 201 contains two major elements; the first, a hybrid of the circuit breaker and alternative uptick rule, as noted above, and exemptions in the form of "short exempt" marking requirements. Rather than simply reinstate the uptick rule, Rule 201 incorporates a number of new elements outlined in the SEC's April 2009 proposal (the "Proposal")

1 Exchange Act Rel. No. 59,748 (Apr. 10, 2009) available at: http://www.sec.gov/rules/proposed/2009/34-59748.pdf. For more information regarding the prior SEC proposals, see our Client Alerts titled "SEC Proposes Alternative Approaches to Restrict Short Selling," available at: http://www.whitecase.com/alert_05062009/, and "SEC Reopens Comment Period for Proposed Rules to Restrict Short Selling," available at: http://www.whitecase.com/alerts_08182009/.

2 For further information regarding Rule 204T, please see our Client Alert titled "SEC Takes Further Action to Curtail Naked Short Selling," available at: http://www.whitecase.com/alert_cmsecurities_fmd_naked_short_selling_102308/.

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as well as the August 2009 proposal,[3] for additional flexibility and efficiency. In lieu of an outright ban on short sales, Rule 201 provides for restrictions on short selling that are triggered by a circuit breaker—a ten percent decline in the price of the security from the prior day's closing price. Once a circuit breaker is triggered, a price test would apply to short sales in that security, with such price test based not on the last sale price, but the current national best bid. After being triggered, the restriction on short selling remains in place for the remaining trading hours of the day and the following day.

Under Rule 201, trading centers are required to establish, maintain and enforce written policies and procedures reasonably designed to prevent them from executing or displaying any short sale order, absent an exception, at a price that is below or equal to the current national best bid. In order to rely on an exemption from Rule 201, broker-dealers are also required to establish written policies and procedures, as discussed below.

Definition of Covered Security

Rule 201 will apply to all securities, except options, listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market, but excluding securities otherwise quoted on the OTC Bulletin Board or elsewhere in the OTC market. All securities that would have been subject to former Rule 10a-1 will also be subject to Rule 201. In addition, securities that traded on Nasdaq prior to its conversion to an exchange and that were exempt from former Rule 10a-1, will be subject to Rule 201.

Operation of Rule 201

1. Circuit Breaker Approach

The SEC adopted the circuit breaker approach in part because it believes market participants are familiar with circuit breakers. All stock exchanges, the Financial Industry Regulatory Authority, Inc. and options markets currently have some form of circuit breaker in place to halt trading in the case of significant market declines. The SEC believes the circuit breaker approach adopted in Rule 201 to be a narrowly tailored and effective response to a sudden and excessive decline in the price of a security. It would permit short selling at a price above the current national best bid, as well as under certain limited exceptions. In addition, long sellers will be able to sell their shares even after the circuit breaker is triggered.

2. Alternative Uptick Rule

The alternative uptick rule component of Rule 201 is similar to the modified uptick rule contained in the Proposal, as it is based on the current national best bid rather than the last sale price as a reference point. Unlike the modified uptick rule, however, the alternative uptick rule permits short selling only at a price above (and not at a price equal to), the current national best bid. The SEC noted, however, that it will not specify in Rule 201 the particular increment above the current national best bid at which a covered security may be sold short.

As noted above, short sellers will be prohibited from selling at the current national best bid, but long sellers will be allowed to sell at the bid. The SEC believes that the flexibility provided by allowing long sellers to sell first and achieve liquidity in a declining market for that security will encourage investors to hold long positions in such security and promote capital formation.

3. Ten Percent Price Decline Trigger

Consistent with the Proposal, the SEC considered a ten percent trigger to be an appropriate threshold level because it prevents any short sale restriction from interfering with trading in the majority of securities, including securities experiencing minimal downward price pressures. Although the ten percent trigger would capture some normal trading activity, the restriction will affect a limited percentage of covered securities. According to the SEC, during the period from April 9, 2001 to September 30, 2009, the ten percent trigger in Rule 201 would have been triggered on an average day for approximately four percent of covered securities. While recognizing that lower priced stocks will be more impacted by the ten percent trigger, the SEC believes such a larger impact will in fact be beneficial, as it will curb price volatility for these stocks.

The SEC reiterated its view that the ten percent decline be measured from the prior day's closing price rather than the last price reported on the consolidated system, as it believes the closing price is less likely to reflect anomalous trades or uncorrected errors and is thus more accurate. Additionally, the closing price provides clear parameters from which any decline can be measured, and listing markets generally have procedures that ensure the accuracy and reliability of their closing prices.

3 The SEC requested comments on the alternative uptick rule in August 2009. See Exchange Act Rel. No. 60,509 (Aug. 17, 2009) available at: http://www.sec.gov/rules/proposed/2009/34-60509.pdf.

4. Current National Best Bid Price Test

Unlike former Rule 10a-1, Rule 201 will apply a uniform price test to trades in the same securities that occur across multiple markets. Under former Rule 10a-1, different price tests could apply to the same security trading in different markets, but Rule 201 attempts to resolve this problem by applying a single price test, the current national best bid. While bids reflect proposed transactions and last sale prices reflect actual trades, Rule 602 of Regulation NMS requires bids to be firm, 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 current national best bid are sequenced across trading centers. Sales, on the other hand, may be reported during a 90-second window, leading to inaccurate up-ticks and down-ticks and reporting out of sequence.

In contrast to former Rule 10a-1, Rule 201 will only apply to trades executed during regular trading hours (from 9:30 a.m. to 4:00 p.m. Eastern Time). This is due in part to the difficulty of applying the rule outside of regular trading hours when the current national best bid is not collected, calculated and disseminated. Notably, the SEC expressly declined to include in Rule 201 a broad exemption for market making activity.

Exceptions and Exemptions to the Adopted Short Sale Rules[4]

The exemptions from Rule 201 generally parallel the exemptions contained in former Rule 10a-1 or granted pursuant to SEC no-action relief. These exemptions allow short sale orders of a covered security that are marked "short exempt" to be executed or displayed without regard to the price test restriction.

1. Broker Dealer Provisions

Rule 201(c) will permit broker-dealers to mark a short sale order as "short exempt" if the broker-dealer identifies the order price as being above the current national best bid at the time the order is submitted to the trading center. To rely on this exemption, however, such broker-dealer must establish and enforce written policies and procedures that are designed to ensure that any such orders are correctly identified, as well as regularly assess the adequacy of such written policies and procedures. The written policies and procedures must enable the broker-dealer to monitor, on a real-time basis, the national best bid for a particular security so as to enable the broker-dealer to determine the price at which a short sale order may be submitted to a trading center.

This exemption was adopted substantially in the form proposed; however, the SEC clarified that a broker-dealer may mark an order as "short exempt" only after a circuit breaker is triggered for a covered security.

2. Seller's Delay in Delivery

Rule 201(d)(1) was adopted without modification and provides an exemption to allow a broker-dealer to mark a short sale order as "short exempt" if the 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.

3. Odd Lot Transactions

The Rule 201(d)(2) exemption allows broker-dealers to act as market makers in odd lots. This exception is similar to the exemption contained in former Rule 10a-1 but has been broadened to include all broker-dealers acting as market makers in odd lots. The SEC believes that such an exemption does not conflict with the objectives of the rule, as odd lot transactions by market makers facilitating customer orders would not cause a downward movement in the price of a particular security.

4. Domestic Arbitrage and International Arbitrage

Rule 201(d)(3) and Rule 201(d)(4) apply if a broker-dealer has a reasonable basis to believe a short sale is for a bona fide arbitrage transaction. Although the SEC received comments suggesting that the domestic arbitrage and international arbitrage exemptions should be broadened to cover more trading scenarios, this exemption was adopted without modification, as the SEC believes broader exemptions would conflict with the underlying goals of Rule 201.

5. Over-Allotments and Lay-Off Sales

Rule 201(d)(5) was also adopted without modification, and would allow short sale orders to be marked "short exempt" when made 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 believes it is not appropriate to broaden the scope of this exemption, although many commenters requested a broader approach.

4 Please refer to Appendix A for a summary of the exemptions.

6. Riskless Principal Transactions

Rule 201(d)(6), adopted without modification, is an exemption that would allow short sale orders by a broker-dealer facilitating buy or sell orders for a customer that is net long and where the broker-dealer is net short and effects the sale on a riskless principal basis. The SEC noted that this exemption would only apply where the customer is selling long and that such a provision would enable the broker-dealer to provide the best execution to customers.

7. Transactions on a Volume-Weighted Average Price Basis

This exemption, contained in Rule 201(d)(7), was also adopted as proposed, and applies to short sale orders carried out at the volume-weighted average price ("VWAP"), subject to certain conditions being met. The Rule 201(d)(7) exemption as adopted is broader than the parallel exemption in former Rule 10a-1, as it is not limited to VWAP transactions arranged before the market opens or that are assigned a price only after the close of trading, when the value of the VWAP is measured.

Going Forward

The adoption of amendments to Regulation SHO reflects the SEC's acknowledgment that the elimination of former Rule 10a-1 may have had detrimental effects on the markets. It also appears to be an effort to restore investor confidence. While the SEC's goals in adopting the rules in their final form was to strike a balance between curbing abusive short sale practices and maintaining operating efficiency in the markets, compliance with the rules will impose costs on market participants, such as trading centers without legacy price test programming, as well as broker-dealers that will be required to establish written policies and procedures. The SEC noted, however, that in recognition of the significant burdens of compliance, it will provide a six-month implementation period for the short exempt marking requirement of the rules. The SEC also stated that it may reconsider at a later time whether application of the new rules to the OTC market, changes to the duration of the circuit breaker or any additional exemptions or exceptions are warranted.

Appendix A—Summary of Exemptions and Exceptions to the Final Short Sale Rules

	Exemption/Exception	Final Rule	Exemption/Relief Under Former Rule 10a-1	Changes from Proposed Rule
1	Transactions in which a broker-dealer submits a short sale order identified above the current national best bid at the time of such submission and the broker-dealer has appropriate policies and procedures in place	Rule 201(c)(1)	None	Modified to clarify that a broker-dealer may only mark an order as "short exempt" after a circuit breaker has been triggered for a security
2	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	Rule 201(d)(1)	(e)(1)	None
3	Certain odd lot transactions	Rule 201(d)(2)	(e)(3) and (4)	None
4	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	Rule 201(d)(3)	(e)(7)	None
5	International arbitrage transactions in which the short seller has an offer to buy on a foreign market	Rule 201(d)(4)	(e)(8)	None
6	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	Rule 201(d)(5)	(e)(10)	None
7	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	Rule 201(d)(6)	Securities Industry Association No-Action Letter, dated July 18, 2005	None
8	Transactions in which the short sale order is at a volume-weighted average price transaction	Rule 201(d)(7)	Series of No-Action Letters. See, e.g., Philadelphia Stock Exchange, Inc. No-Action Letter, dated March 24, 1999	None

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