
Securities Law Developments

SHORT SALES: SEC PONDERES A REGULATORY OVERHAUL

As a first step toward potential regulatory reform, the Securities and Exchange Commission (“SEC” or “Commission”) is soliciting comments on the regulation of short sales.^{1/} The Release represents the Commission’s latest attempt, since the adoption of Rule 10a-1 under Section 10(a) of the Securities Exchange Act of 1934 (“Exchange Act”) more than sixty years ago, to modernize the regulation of short sales in response to current market developments.^{2/} The SEC poses 53 questions, each relating to one of eight broad regulatory reform concepts. *Comments are due on or before December 27, 1999.*

I. Regulatory Background

A “short sale” is defined in Rule 3b-3 under the Exchange Act to be “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.”^{3/} Investors use short selling as a hedge against long positions in a security or as a means of profiting from an anticipated drop in a security’s price. Short sales contribute to market liquidity by, in effect, adding to the supply of a particular security. Short sales also serve to inform the market of expectations that a security is

^{1/} Exchange Act Release No. 42037 (Oct. 20, 1999), 64 Fed. Reg. 57996 (Oct. 28, 1999) (“Release”).

^{2/} 17 C.F.R. § 240.10a-1. Indeed, the debate whether short selling should be allowed, regulated, or prohibited predates the Exchange Act itself. More than 20 years ago, the Commission proposed changes in short sale regulations, which were ultimately abandoned because of public comments opposing the elimination of the short sale rule. *See* Exchange Act Release No. 13091 (Dec. 21, 1976), 41 Fed. Reg. 56530 (Dec. 28, 1976) (proposing temporary partial or full suspension of the short sale rule to assess the true impact of unfettered short sales).

^{3/} 17 C.F.R. § 240.3b-3.

overvalued or may be employed as a tool for arbitrage. Despite these positive functions of short selling, unregulated short selling has raised potential concerns in the past, including, for example, the perception that such activities may aggravate a downward price spiral.

Currently, Rule 10a-1 restricts short sales in exchange-listed securities for which trade information is reported pursuant to a transaction reporting plan and disseminated on a real time basis. In general, short sales in a listed security may be effected only: (1) above the price at which the last transaction in the relevant security took place (“plus tick”); or (2) at the price of the last transaction if that price was above the last reported trading price for the security (“zero-plus tick”).^{4/} For the purposes of applying this “tick test,” the last price may be either the last reported price on the consolidated transaction reporting system or the price of the last transaction on the relevant stock exchange.^{5/} The “tick test” was designed to prevent short sellers, regardless of motive, from causing or accelerating the decline of the market without placing unnecessary limitations on short sales in rising markets. Rule 10a-1 includes a number of exceptions,^{6/} and the staff has relaxed the rule’s requirements further in response to specific requests for relief.^{7/}

Regulators and market participants are increasingly questioning whether the existing regulatory regime is superfluous. The questioning comes in response to the ever-growing transparency in transactions on national securities exchanges and the increasingly effective technologies employed by self-regulatory organizations to detect problematic trading activities. The SEC recognizes, particularly in light of the expanding number of requests for exemptive relief from the rule, that the existing short selling rules may restrict unnecessarily the use of short selling as a risk-management component of investment strategies. Moreover, once the markets move to decimal pricing next July, it is at best unclear how useful the tick test would be where the minimum tick is only a penny.

^{4/} NASD Rule 3350 imposes restrictions on short sales of the Nasdaq National Market securities (“NNM securities”). In general, Rule 3350 precludes short sales of the NNM securities at or below the current best inside bid when the current best inside bid is lower than the preceding best inside bid. This restriction is often referred to as a “bid test” in contradiction to the “tick test” in Rule 10a-1.

^{5/} Currently, two stock exchanges use the price of the last transaction on their own markets, rather than the last price reported to the consolidated transaction reporting system, for the purposes of applying the “tick test.” See NYSE Rule 440B and Amex Rule 7.

^{6/} Excepted transactions, which are set forth in paragraph (e) of Rule 10a-1, include, for example, certain odd-lot transactions; certain international arbitrage transactions; and certain sales in connection with block positioning activities.

^{7/} See, e.g., Letter Regarding Rule 10a-1-Aggregation Units, SEC No-Action Letter (Nov. 23, 1998) (“Aggregation Letter”) (permitting broker-dealers to calculate their positions based on certain “aggregation units,” rather than netting the entire firm’s positions); Letter regarding Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter (Dec. 17, 1986), published with modifications in Exchange Act Release No. 27938 (Apr. 23, 1990), 55 Fed. Reg. 17949 (Apr. 30, 1990) (“Merrill Lynch Letter”) (permitting broker-dealers to effect certain sales in connection with unwinding their index arbitrage positions).

II. Themes for Potential Regulatory Reform

The Release presents eight broad themes regarding short sale regulation:

- ***Advancing Market Above a Threshold Price.*** The SEC seeks comment on suspending the “tick test” when the price of the relevant security is above a predetermined threshold, such as a fixed percentage above the security’s last closing price. In a favorable market environment with generally advancing prices, there would be reduced concerns that short selling might lead to the type of abuse that gave rise to the adoption of Rule 10a-1 in the first place. The Release poses questions aimed at determining whether such a modification is necessary, the feasibility of establishing a threshold price, the appropriate basis for such a threshold, and the potential deleterious effects unique to a regulatory regime utilizing thresholds. The threshold could be market-based on market indications rather than tied to the price of a particular security.
- ***Actively Traded Securities.*** The Commission is considering exempting highly liquid securities from Rule 10a-1 on the assumption that they are less apt to be manipulated. The Release asks whether this is an accurate assumption, what standards for assessing liquidity should be employed, how sufficiently liquid stocks should be identified, and whether it is appropriate to limit the application of the rule based on low susceptibility to manipulation (which is not a prerequisite to the application of the short sale rule).
- ***Certain Corporate Events and Market Conditions.*** It is generally recognized that problematic short selling may increase with certain corporate events, such as pending tender offers. Similarly, such activities may be more likely at certain times in the trading day, such as near the market close. The Release invites comments about the validity of this belief, the kinds of events that pose increased risks for abusive short selling, and the existence of trading abuses that might be caused by short sales during unusual market events that currently are beyond the reach of Rule 10a-1. In particular, the SEC asks whether it would be appropriate to place an absolute prohibition on short sales during specific market conditions and whether existing restrictions on short selling during unusual events should be maintained even if the rule is eliminated entirely in other contexts.
- ***Hedging Transactions.*** Acknowledging the important role of short sales as risk-minimizers, the Release seeks comments on: (1) whether hedged short positions should be excluded in the calculation of a person’s net position; and (2) whether Rule 10a-1 should exempt short sales that are designed to establish a “*bona fide* hedge.”^{8/} In connection with the first question, the SEC asks whether any short position, to the extent that it is the

^{8/} For the purposes of Rule 10a-1, the SEC has taken the position that a hedge “must involve long and short positions in related securities where one security is exercisable, convertible, or otherwise related by its terms to the other security, and substantially offsets the risk of that security.” See the Release n.52 (citing Exchange Act Release Nos. 30772 (June 3, 1992), 57 Fed. Reg. 24415 (June 9, 1992) and 15533 (Jan. 29, 1979), 44 Fed. Reg. 6084 (Jan. 31, 1979)). Moreover, to be considered *bona fide*, the hedge “must offset most or all of the risk of the security being hedged.” *Id.* The Release asks whether this definition should be revised.

subject of one or more offsetting positions created in the course of arbitrage or hedging activities, should be excluded in determining whether a person is net short under Rule 3b-3.^{9/} In connection with the second, the SEC asks whether it would be appropriate to except, from the application of the “tick test,” short sales that are part of trading strategies conducted to establish *bona fide* hedges. For example, should the purchaser of a convertible security be allowed to sell short the underlying security without any restriction, to the extent that such a sale is used to hedge against a potential decline in the price of the underlying security? In this context, the Release seeks comments on how to structure such an exception; *e.g.*, how to determine securities are equivalent and therefore whether they can be hedged against one another. The SEC also seeks comment on whether economic neutrality is the proper basis for the exception. Finally, the SEC asks whether the exception should reach only those short sales conducted as part of a complete hedge and how it should monitor short selling carried out in furtherance of economically neutral transactions.

- ***After-Hours Trading and Decimalization.*** The SEC believes that regulatory changes may be necessitated by changes in the operation of the national securities exchanges and alternative trading systems. Of particular relevance are the extension of trading hours and the decimalization of stock price quotes. With respect to the former, the SEC asks how the reference price should be determined in markets with extended hours and how multiple permissible reference prices would affect regulation. With respect to decimalization, the SEC asks for comments on likely effects of the decrease in the minimum trading increment -- the smallest amount by which a security’s price can change -- on the operation of Rule 10a-1.
- ***Netting and Temporary Long Positions under Rule 3b-3.*** Because the operation of Rule 10a-1 turns on the definition of “short sale” in Rule 3b-3, the Release solicits comments on the adequacy of that definition. Absent specific relief, sellers are currently required to net all of their positions in order to determine whether they are short for the purposes of Rule 3b-3.^{10/} The SEC asks to what extent it is appropriate to aggregate positions within a single entity in determining whether the entity is short. Similarly, expressing concerns that married puts and similar arrangements for creating temporary “long” positions may be particularly susceptible to manipulation, the Commission also asks whether it should adopt new regulatory strategies to address such schemes.^{11/}

^{9/} Currently, certain hedged short positions created in the course of block positioning activities may be excluded for the purposes of Rule 3b-3. See Rule 10a-1(e)(13). Under a similar rationale, the SEC staff took a no-action position to facilitate a broker-dealer to unwind its index arbitrage positions by allowing the broker-dealer to disregard its hedged short positions. See the Merrill Lynch Letter.

^{10/} Recently, the staff has granted certain relief from the so-called “netting” requirement to various multi-service broker-dealers. See the Aggregation Letter.

^{11/} See the Release n. 67 and accompanying text (expressing concern that married puts and similar arrangements, in addition to their legitimate purposes, could be used for manipulations).

- ***Non-Exchange Listed Securities.*** The Release asks whether the existing framework for regulating short sales (including NASD Rule 3350) is sufficiently expansive. Short selling regulation also may be appropriate for other securities traded in the over-the-counter markets, such as the Nasdaq SmallCap Market securities. Because Section 10(a) of the Exchange Act does not provide the Commission with specific authority to regulate this market sector, any such regulation would have to be based on other statutory authority.
- ***Elimination of the Short Sale Rule.*** The Release raises the more fundamental issue of whether short sale regulation is superfluous with respect to all securities. Some market participants may believe that the availability of other statutes and rules, such as the antifraud and anti-manipulation regulations, vitiates the need for having the “tick test” as a prophylactic measure. In particular, the SEC asks whether the rule has deleterious effects, such as interfering with efficient pricing, and what kinds of harmful effects deregulation would have on market speculation, price volatility, and investor confidence. The Release asks whether there are now or could be alternatives to Rule 10a-1 and whether elimination of Rule 10a-1 would necessitate the elimination of regulation of short selling by self-regulatory organizations. The SEC is concerned that the elimination of the rule may generate an unfair advantage for market professionals who will be able to take advantage of the limit orders placed by the slower-to-respond public. In the event the rule is retained, the Release asks whether a “bid test,” such as the one used in NASD Rule 3350, should replace the existing “tick test.”

III. Conclusion

With this Release, the Commission seeks to initiate a public dialogue about various ways to modernize the existing regulatory framework for short sales. As evidenced by the adoption of Regulation M, the SEC appears willing to rely on market forces and vigorous oversight, in lieu of mechanical prohibitions, “where either the risk of manipulation is small or the costs of the restrictions are disproportionate to the purposes they serve.”^{12/} While it is too early to predict what the final outcome of this process will provide, the Release represents a critical opportunity for the public to participate in an important area of policy making.

If you have questions or would like to comment on the Release, please contact Brandon Becker (202.663.6979; bbecker@wilmer.com), Soo Yim (202.663.6958; syim@wilmer.com), or Hester Peirce (202.663.6839; hpeirce@wilmer.com).

^{12/} See Exchange Act Release No. 38067 (Dec. 20, 1996), 62 Fed. Reg. 520, 520 (Jan. 3, 1997) (promulgating Regulation M).

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