The Return of a Short Sale Price Test: SEC Adopts "Alternative Uptick Rule" in Split Vote

2010-02-25

The Securities and Exchange Commission ("SEC" or "Commission") voted this week – with two Commissioners dissenting – to amend Rule 201 under Regulation SHO and impose a new price restriction on short sales in securities experiencing sudden and significant price declines.[1] Specifically, the Commission voted to adopt a circuit breaker version of the so-called "alternative uptick rule." The rule, which would take effect for a covered security in the event of a 10% intraday price decline, would permit short selling only at a price above the current national best bid.[2]

In April 2009, almost ten months after eliminating all price test restrictions on short sales,[3] the SEC proposed reinstituting some form of price test.[4] The SEC offered five alternative proposals, two of which would have imposed a market-wide, permanent price test on short sales, and three of which would have used a circuit breaker approach to trigger a security-specific, temporary restriction on short sales.[5] After holding a roundtable on short sale price tests and circuit breakers and receiving thousands of comment letters in response to the proposals, the SEC reopened the comment period in August 2009. The August 2009 Release specifically sought comment on the alternative uptick rule, either as a market-wide, permanent restriction or in conjunction with a circuit breaker.[6] In voting to amend Rule 201 to incorporate the alternative uptick rule with a circuit breaker, the SEC staff and the Commissioners in favor of the rule repeatedly cited the aim of bolstering investor confidence in the fairness and integrity of the markets. The Commissioners and staff also noted the potential for legitimate short selling to provide liquidity and price efficiency, describing the circuit breaker approach as "narrowly tailored" to preserve these market benefits.

As adopted, revised Rule 201 will include the following components:

> 1) Scope. The rule will apply to "covered securities," which are defined as NMS stocks. As such, it generally will apply to any security, except an option, that is listed on a national securities exchange, whether traded on an exchange or over-the-counter.
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> 2) The Circuit Breaker. The price restriction will be imposed for a covered security that experiences a 10% intraday price decline, measured by reference to the prior day's closing

price on the listing market. A staff member from the SEC's Division of Trading and Markets explained that the listing market will be responsible for identifying a 10% intraday decline and immediately notifying the single NMS plan processor that consolidates information about the security. The single plan processor will then be responsible for disseminating this information to the markets.

3) The Price Restriction. When triggered, the alternative uptick rule will permit short sales only at a price above the current national best bid. In contrast to former NASD Rule 3350 and the "modified uptick rule" described in the April 2009 Proposal, the alternative uptick rule will restrict short sales without regard to how the current national best bid compares to the previous national best bid. Once triggered, the price restriction will be in effect for the remainder of the trading day, as well as the following trading day.

4) Exceptions. Revised Rule 201 will contain certain limited exceptions to permit the display and execution of certain short sales at or below the national best bid when the price restriction is in effect. There are exceptions for: (a) orders identified by a broker-dealer as being above the national best bid at the time of submission; (b) sales where a seller owns the security, but there is a delay in delivery; (c) certain odd-lot transactions; (d) certain domestic and international arbitrage transactions; (e) over-allotments and lay-off sales; (f) riskless principal transactions; and (g) transactions on a "value-weighted average price" basis. There will not be an exception for market making activity.

5) Policies and Procedures. Trading centers[7] will be required to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale. Trading centers also must have policies and procedures to permit the execution of an order marked "short exempt" by a broker-dealer in accordance with an exception under the rule. In addition, trading centers must monitor their policies and procedures regularly for effectiveness and take prompt action to remedy any deficiencies. A broker-dealer relying on the exception for orders identified as above the national best bid at the time of submission will be required to have policies and procedures to ensure that such reliance is reasonable, and to monitor these policies and procedures and remedy any deficiencies.

6) Marking Requirement. The SEC also voted to amend Rule 200(g) of Regulation SHO to require that a broker-dealer relying on an exception from the short sale restriction mark a sell order "short exempt."

7) Implementation. There will be a 6-month implementation period. Robert Cook, Director of the SEC's Division of Trading and Markets, stated that market participants likely would be able to build on existing policies and procedures, such as those aimed at compliance with Regulation NMS, to achieve compliance with the revised rules. The discussion at the Open Meeting did not delve into the specifics of implementation, however. The Commissioners and staff indicated that they will continue to monitor closely the operation and effects of rules

relating to short selling, including the effect of revised Rule 201 on the options markets.

Commissioners Kathleen L. Casey and Troy A. Paredes dissented from the decision to adopt a new price test. In particular, they argued that the empirical evidence was insufficient to justify SEC action and that the reliance on investor confidence as a rationale was based on "conjecture." Commissioner Paredes, who suggested that a pilot program would have been a more reasonable approach, further argued that – particularly in light of the mixed empirical evidence – the rule could in fact *damage* investor confidence, if it fails to prevent price declines. In addition, both Commissioners criticized the staff's cost-benefit analysis as considering the merits of the alternative uptick rule relative to other potential short sale restrictions, rather than assessing the costs and benefits of the rule against the absence of a price restriction.

We will provide further detail regarding the rule amendments following the SEC's publication of the adopting release.

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[1] A link to the Webcast of the Open Meeting on February 24, 2010 is *available here*. At the time of this writing, some, but not all, of the Commissioners' statements at the Open Meeting were *available here*.

[2] This summary is based on the discussion at the Open Meeting. It is informational only and is not meant to be legal advice. Details of the newly adopted rules will appear in an adopting release to be issued by the Commission.

[3] See Exchange Act Release No. 55,970 (June 28, 2007), 72 Fed. Reg. 36,348 (July 3, 2007) (repealing Exchange Act Rule 10a-1 and adding Rule 201 to Regulation SHO). This change was due in large part to questions about the necessity and efficacy of short sale price restrictions in the modern trading environment.

[4] Exchange Act Release No. 59,748 (Apr. 10, 2009), 74 Fed. Reg. 18,042 (Apr. 20, 2009) ("April 2009 Proposal").

[5] Id. The proposed alternatives are discussed in A Regulatory Policy Dilemma: Short Sale Restrictions and Investor Confidence (Apr. 21, 2009), *available here*.

[6] Exchange Act Release No. 60,509 (Aug. 17, 2009), 74 Fed. Reg. 42,033 (Aug. 20, 2009) ("August 2009 Release"). The April 2009 release had requested comment on the alternative uptick rule, but it was not one of the proposed approaches. See 74 Fed. Reg. at 18,072, 18,081–82.

[7] A "trading center" is defined in Regulation NMS as a national securities exchange or national securities association that operates a self-regulatory organization's 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. Exchange Act Rule 600(b)(78).

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