Regulation of Short Sales: SEC Adopts Alternative Uptick Rule Triggered By 10 Percent Circuit Breaker

By Scott C. Budlong, Selina W. Tay and Gianna C.T. Quach[1]

The SEC has returned to the short selling regulatory arena after a hiatus of several months. On February 24, 2010, the Commission adopted an "alternative uptick rule" to restrict short selling when the price of a stock has dropped more than 10 percent in one day. The new rule is notable because, among other reasons, the SEC had abandoned price-based regulation of short selling less than three years ago. The change in approach was not uniformly endorsed, however, with the commissioners' adopting vote split 3-2 along party lines.[2]

Background

For nearly 70 years, short sellers of U.S.-listed stocks were subject to the "uptick rule" set forth in former Rule 10a-1. That rule effectively allowed shorting of an exchange-traded security only at a price above the security's last reported sale price. The SEC eliminated the uptick rule in July 2007, after concluding from various studies that there was no observable link between short sale price restrictions and market stability.

Then came the vertiginous drop in equity markets during 2008, to which the SEC responded with the emergency imposition of heightened borrowing and delivery requirements for short sales of certain financial sector stocks, followed by a temporary ban on shorting a much larger group of stocks.[3] The SEC also adopted interim final temporary Rule 204T, designed to reduce the market impact of fails-to-deliver by imposing stricter close-out requirements on brokers executing short trades,[4] and Rule 10b-21, an anti-fraud measure relating to "naked" short selling.[5]

In April 2009, the SEC released for public comment a menu of four potential new restrictions on short sales.[6] Two of the proposed restrictions were price tests applying permanently to essentially all publicly traded stocks: a "proposed uptick rule" based on the last sale price, and a "proposed modified uptick rule" based on the national best bid. The other two suggested restrictions were variants of a "circuit breaker" approach, in which a severe decline in a particular security's price would trigger either a temporary suspension of, or the imposition of a price test for, further short sales of that security. The April 2009 release also requested comments on, but did not actually propose, an "alternative uptick rule" that would permit short sales only at a price above the current national best bid.

Following receipt of over 4,300 comment letters and a public roundtable in May 2009, the SEC requested additional comments on the alternative uptick rule in August 2009.[7]

Amended Rule 201 of Regulation SHO

The new short sale restrictions adopted by the SEC are embodied in amended Rule 201 of Regulation SHO under the Exchange Act. Amended Rule 201 introduces the alternative

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2 Release No. 34-61595 (Feb. 26, 2010) (the "Adopting Release"), available at www.sec.gov/rules/final/2010/34-61595.pdf.

3 Release No. 34-58166 (Jul. 15, 2008) and Release No. 34-58592 (Sept. 18, 2008).

4 Release No. 34-58773 (Oct. 14, 2008). Rule 204T was replaced by final Rule 204 in mid-2009 (Release No. 34-60388 (Jul. 27, 2009)).

5 Release No. 34-58774 (Oct. 14, 2008).

6 Release No. 34-59748 (Apr. 10, 2009). *See* our April 27, 2009 memorandum, "*SEC Proposes New Price-Based Restrictions on Short Sales*," available at www.rkollp.com/2009/04/sec_proposes_new_pricebased_re.php.

7 Release No. 34-60509 (Aug. 17, 2009).

uptick rule, coupled with a circuit breaker limiting the price-based short sale restriction to securities that experience a 10 percent intra-day price decline.

Covered Securities. Amended Rule 201 applies to any "covered security," which means any "NMS stock" as defined in Rule 600(b)(47) of Regulation NMS. In effect, Rule 201 applies to any equity security (other than options) listed on a U.S. national securities exchange, whether traded on-exchange or over-the-counter.

Circuit Breaker and Price Restriction. Amended Rule 201 combines a circuit breaker and a price test. The circuit is broken for a particular covered security when the security's price decreases by 10 percent or more from its closing price—as determined by the listing market for the covered security—as of the end of regular trading hours on the prior day. Once that price decline has occurred, a short sale order for the covered security may be displayed or executed only at a price above the current national best bid. This price restriction remains in effect for the remainder of the day and throughout the following trading day.[8]

Trading Centers Must Maintain Policies and Procedures. The burden of implementing amended Rule 201 falls primarily on "trading centers," including the national securities exchanges and broker-dealers that execute short trades.[9] Trading centers are required to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a prohibited short sale. Amended Rule 201 differs in this regard from former Rule 10a-1, the prohibitions of which applied directly to short sellers themselves.

Exemptions. Amended Rule 201 contains limited exemptions that allow the display and execution of short sale orders in a covered security at a price at or below the national best bid, notwithstanding the tripping of the circuit breaker. These exemptions relate to: (i) orders identified by a broker-dealer as having been above the national best bid at the time of submission; (ii) sales that are "short" only because of a delay in the seller's ability to deliver an owned security; (iii) certain odd-lot transactions; (iv) certain domestic and international arbitrage transactions; (v) over-allotments; (vi) riskless principal trades; and (vii) transactions effected on a VWAP basis.[10] There is no exemption for market-making activity. A broker-dealer relying on an exception to execute a short trade while the Rule 201 price test restriction is in effect must mark the sell order "short exempt."

Timing of Implementation. Amended Rule 201 takes effect 60 days after the Adopting Release is published in the Federal Register. Market participants will then have six months to comply with the new rule.

Points to Note

The SEC takes pains in the Adopting Release to portray amended Rule 201 as a targeted measure that will not impede the normal functioning of the equity markets:

> Rule 201 is structured so that the circuit breaker generally will not be triggered for the majority of covered securities at any given time and, thereby, will not interfere with the smooth functioning of the markets for those securities, including when prices in such securities are undergoing minimal downward price pressure or are stable or rising. If the short sale price test restrictions of Rule 201 apply to a covered security it will be because and when that security is

8 If the price of a covered security declines 10 percent or more on a day on which the security is already subject to Rule 201's price restriction, the restriction will be re-triggered and thus continue in effect for the remainder of that day and the following day. *See* Adopting Release, note 290.

9 Regulation NMS defines a "trading center" as 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.

10 The domestic arbitrage exemption relates to bona fide short sales of common stock underlying a convertible security in order to profit from a price differential between the two. The international arbitrage exemption applies to bona fide short sales effected to profit from a price differential between a stock on a U.S. market and a stock on a foreign market, provided that the short seller has an offer to buy on a foreign market that enables the seller to cover the short sale immediately (for purposes of this exemption, an ADR is deemed to be the underlying stock it represents).

undergoing significant downward price pressure.[11]

Whether or not Rule 201 turns out to be as non-invasive as the SEC anticipates, there are several points to note about the rule. These include the following:

Execution of Long Sales Privileged. The alternative uptick rule will allow short selling only at a price higher than the current national best bid, absent an exemption. In contrast, both the proposed modified uptick rule and the proposed uptick rule described in the SEC's April 2009 release would have permitted short selling at—not only above—the current national best bid or the last sale price, respectively. Because the alternative uptick rule will allow short selling only at an increment above the national best bid, short sales will not get immediate execution, even in an advancing market, following implementation of the circuit breaker. Long sellers, who may sell at the bid, are effectively placed ahead of short sellers in the execution queue.

Low-Priced Securities More Likely Affected. The SEC's decision to use a 10 percent price decline circuit breaker for all securities—rather than, for example, a graduated series of percentages based on a stock's trading price, volume or volatility—suggests that low-priced securities are more likely to become subject to Rule 201's short sale price restriction, whether or not the 10 percent decline truly indicates abnormal downward selling pressure.

Potential "Magnet Effect". It seems possible that Rule 201's circuit breaker-plus-price test structure could have a self-fulfilling "magnet effect," whereby short sellers drive down a security's price in a rush to execute short trades when the circuit breaker appears close to being triggered. Similarly, one can imagine pent-up short selling demand resulting in a flurry of short trades once the price restriction is lifted.

No Market-Maker Exemption. Many commenters on the SEC's April and August 2009 releases had urged that any new short sale restrictions contain an exemption for bona fide market-making activity. As noted above, however, Rule 201 includes no such exemption. This contrasts with Regulation SHO's "locate" and "close-out" requirements, as well as the SEC's 2008 emergency actions. It remains to be seen whether the absence of a market-maker exemption under Rule 201 will decrease liquidity.

Overseas Execution. The SEC takes the position that Rule 201 applies to any short sale involving U.S. jurisdictional means, regardless of the jurisdiction in which the short sale is actually executed.[12] As an example, the Adopting Release states that Rule 201 would cover a U.S. money manager who decides to sell a block of shares in a covered security and negotiates a price with a U.S. broker-dealer that then sends the order ticket to its foreign trading desk for execution.

Synthetic Shorts Not Covered. Rule 201 does not apply to derivatives and thus does not affect investors' ability to obtain the economic equivalent of a short position through the use of options, swaps and similar instruments.

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11 The Adopting Release cites SEC Staff research concluding that during the period April 2001 through September 2009, the Rule 201 price test restriction would have been triggered on an average day for only 4 percent of covered securities; and that only 1.3 percent of covered securities would have been affected on an average day during the "low volatility period" from January 2004 through December 2006.

12 See Adopting Release, note 593 and accompanying text.

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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