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# SEC PROPOSES AND SEEKS COMMENTS ON NEW SHORT SELLING REGULATIONS

On April 10, 2009, the US Securities and Exchange Commission (the SEC) proposed five alternative amendments to Regulation SHO under the Securities Exchange Act of 1934 (the Exchange Act) aimed at promoting market stability and restoring investor confidence (the Proposing Release).[1] These amendments take the form of two approaches; the first approach would establish a permanent market-wide "price test," while the second approach would establish a "circuit breaker" on short sales in a particular covered security. The SEC also proposed additional amendments to Regulation SHO that would require broker-dealers to mark sell orders "short exempt" if the seller is relying on an exception to the short sale rules.

The SEC's Proposing Release is the product of deep pressure from members of Congress and industry representatives and is the SEC's first initiative regarding the regulation of short sale activity in the new administration. The stated purpose of the amendments is to address "investor confidence" (a phrase used 57 times in the release), which has been affected by recent sharp declines in equity markets. The SEC describes, at length, the positive effects that short selling can bring to the markets, notes that there is no evidence that short selling caused the market's decline, and states that there is no evidence that an uptick rule would have had any positive impact on equity prices or market volatility. The SEC release ignores the elephant in the room—that the earnings of the FORTUNE 500 declined by 87% in 2008 compared to 2006—as a possible cause of declines in both investor confidence and market prices.

## 1. BACKGROUND

In July 2007, the SEC eliminated all short sale price test restrictions. At that time, short sale price test restrictions included Rule 10a-1 under the Exchange Act, also referred to as the "uptick rule" or "tick test" that applied to exchange listed securities, and the National Association of Securities Dealers, Inc.'s (NASD)[2] bid test that applied to certain NASDAQ securities. Recently, however, as market conditions have become more volatile and investor confidence has eroded, questions have been raised regarding the role that abusive short selling may have played in connection with price fluctuations and market disruptions and whether short sale price test restrictions could have prevented such occurrences.

The SEC has already taken a number of steps in order to address public concerns that the lack of short sale regulation may have caused the market's volatility, including a

1 Securities Exchange Act Release No. 59,748 (April 10, 2009), *available at* http://www.sec.gov/rules/proposed/2009/34-59748.pdf.

2 NASD is now known as the Financial Industry Regulatory Authority, Inc. (FINRA).

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**Market Volatility and the Changing Regulatory Landscape**

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series of temporary emergency orders issued from July 2008 to September 2008 designed to limit or stop short selling of the equity securities of financial institutions. The SEC also adopted, in October 2008, "interim final temporary rules" to address potential short sale abuses, which generally required "institutional investment managers"[3] that filed or were required to file a Form 13F for a calendar quarter to report certain short sale data and holdings to the SEC staff on an ongoing basis if certain transaction or position thresholds were crossed. These SEC temporary rules are set to expire in mid- to late 2009.

The SEC is now reexamining whether a short sale price test should be reinstated or a circuit breaker should be imposed to help combat the deterioration of market conditions and investor confidence while remaining mindful of the benefits that short selling brings to the markets.

## 2. PROPOSED PRICE TEST RULES

The SEC has proposed two alternative short sale price tests—the proposed modified uptick rule, which would impose a market-wide short sale price test based on the national best bid, and the proposed uptick rule, which would impose a market-wide short sale price test based on the last sale price. The SEC preliminarily believes that the modified uptick rule has certain advantages over the uptick rule. This is partly because bids are generally a more accurate reflection of the current price of a security than the last sale price due to delays that can occur in the reporting of last sale price information and the manner in which last sale price information is published to the markets. The SEC also acknowledges that a final price test rule could be a variation or combination of the alternatives proposed.

Both the modified uptick rule and the uptick rule would generally cover all securities, except options, listed on a national securities exchange whether traded on an exchange or in the over-the-counter (OTC) market.[4]

3 The term "institutional investment manager" is defined in Section 13(f)(5)(a) to include "any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person."

4 All securities that would have been subject to Former Rule 10a-1 would be subject to the proposed rules. In addition, certain securities, such as securities traded on NASDAQ prior to its regulation as an exchange that were not subject to former Rule 10a-1, would be subject to the proposed rules as well.

### a. Proposed Modified Uptick Rule

The proposed modified uptick rule would require that trading centers[5] establish and enforce policies and procedures that are reasonably designed to prevent the execution or display of a short sale order, absent an exception, at 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 (a down-bid).[6] Therefore, a trading center's policies and procedures should require that upon receipt of a short sale order, the trading center must be able to determine whether or not the short sale order can be executed or displayed in accordance with the modified uptick rule.

The proposed modified uptick rule provides trading centers with the flexibility of repricing and displaying previously impermissible priced short sales, which allows for more efficient functioning of the markets than the proposed uptick rule discussed below. In addition, the proposed modified uptick rule would reinstate many of the exceptions contained in former Rule 10a-1. These exceptions include, among other things, situations when a broker-dealer has a reasonable basis to believe that the seller owns the securities being sold and the seller intends to deliver the securities as soon as all restrictions on delivery have been removed; certain odd-lot transactions; and certain domestic and international arbitrage transactions. However, unlike former Rule 10a-1, the proposed modified uptick test would only apply during market hours, at times that the national best bids are calculated and disseminated.

5 A "trading center" is defined as a national securities exchange or national securities association that operates a self-regulatory organization (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. This definition encompasses all entities that may execute short sale orders.

6 The proposed modified uptick rule is similar to a proposal recently submitted to the SEC by the CEOs of the NASDAQ OMX Group, NYSE Euronext, BATS Exchange, Inc., and the National Stock Exchange. *See* Letter from Robert Greifeld, President and CEO, NASDAQ OMX Group; Duncan Niederauer, CEO, NYSE Euronext; Joe Ratterman, CEO, BATS Exchange, Inc.; and Joseph Rizzello, CEO, National Stock Exchange, to Mary Schapiro, Chairman, Securities and Exchange Commission (March 24, 2009), *available at* http://www.nyse.com/pdfs/Uptick_Letter_SEC.pdf.

#### b. Proposed Uptick Rule

As an alternative, the SEC has proposed a modified version of former Rule 10a-1, which would use the last sale price as the reference point for short sale orders. Under the proposed uptick rule, no short sale order may be effected below the last sale price. Short sale orders may be effected at the last sale price only if the last sale price is above the last different price.

The proposed uptick rule does not use a policies and procedures approach to regulation similar to the proposed modified uptick rule; however, it is likely that market participants would use a policies and procedures approach as part of their efforts to comply with the proposed prohibition. The SEC noted that the proposed uptick rule may be more burdensome to apply than the proposed modified uptick rule because the prohibition approach of the proposed uptick rule, as opposed to the policies and procedures approach used in the modified uptick rule, would not allow any short sale at an impermissible price, even if in error or inadvertent, unless an exception applies.

Like the proposed modified uptick rule, the proposed uptick rule would reinstate many of the exceptions contained in former Rule 10a-1, including certain of the same exceptions provided under the proposed modified uptick rule and also many exceptions unique to the proposed uptick rule. One of the unique exceptions to the proposed uptick rule, that is not applicable to the proposed modified uptick rule, exists when a broker-dealer effects a short sale order marked "long" by another broker-dealer, mismarked such that it should have been marked as a "short" sale order. Similarly to the proposed modified uptick rule, however, the SEC does not believe that the proposed uptick rule should apply to covered securities in the after-hours market when the last sale price information has not been collected, processed and disseminated.

### 3. PROPOSED CIRCUIT BREAKER RULES

The SEC has also proposed circuit breaker rules as either an addition or an alternative to the proposed price test restrictions. Unlike market-wide circuit breakers that halt all trading, a short sale circuit breaker would only apply to severe declines of more than 10% in the share price of a covered security from the prior day's closing price (unless within 30 minutes of the end of regular trading hours). As with the price test rules, the SEC has provided alternative approaches for how a short sale circuit breaker could be applied.

#### a. Proposed Circuit Breaker Halt Rule

The proposed circuit breaker halt rule would prohibit, when triggered, any person from selling short that security, wherever it is traded, while the circuit breaker is in effect. Like the proposed modified uptick rule and the proposed uptick rule, the circuit breaker halt rule would generally cover all securities, except options, listed on a national securities exchange whether traded on an exchange or in the OTC market. The SEC has proposed including several exceptions to the circuit breaker halt rule that were included under the temporary bans imposed on the short sales of equity securities of certain financial companies in 2008. These exceptions include, among other things, short sales by registered market makers engaging in bona fide market making activity in a given security, which is not excepted from the proposed price test rules discussed above.

In proposing the circuit breaker halt rule, the SEC acknowledged that certain unintended consequences could occur as a result of such rule. The SEC noted that, for example, short sellers could further decrease the price of an equity security in a rush to execute short sales before the circuit breaker halt was triggered.

#### b. Proposed Circuit Breaker Price Test Rules

The SEC has also proposed a short selling circuit breaker that, when triggered by a severe decline in the price of a particular security, would impose short sale price restrictions for that security wherever it is traded for the remainder of the trading day. The idea is that this type of circuit breaker would be imposed instead of a permanent, market-wide short sale price test restriction. Such a circuit breaker, when triggered, could impose a short sale price test restriction in the form of the proposed modified uptick rule or in the form of the proposed uptick rule as described above.

The SEC stated in the Proposing Release that this type of rule might be a more narrowly tailored means to help restore investor confidence and stabilize the market for individual securities. However, as the SEC acknowledged, a short selling circuit breaker price test could result in substantial compliance and operational difficulties and costs, making support for this approach unlikely.

## 4. CONCLUSION

Although the SEC has laid the framework for price test and circuit breaker rules in the Proposing Release, it has provided a broad spectrum of different alternatives within each approach, and does not seem set on adopting any one alternative. Therefore, it appears that public comment will be instrumental in determining the scope of the final short selling rule that is adopted. The SEC seeks comment on, among other things, whether a short sale price test restriction or circuit breaker is necessary; how effective such measures would be to reduce abusive short selling; and whether such measures would help to improve investor confidence in today's market environment. Public comments on the Proposing Release must be received by the SEC by June 19, 2009. The SEC encourages commenters to provide empirical data to support their views and arguments related to these proposals. The SEC also plans to hold a roundtable on May 5, 2009 for interested persons to publicly present comments on these proposals. If one of the SEC's proposals is adopted, the SEC has proposed a three-month implementation period from the effective date of the amendment in which to comply with the new rule.

*Arnold & Porter LLP will be closely monitoring any developments in this area, including public comments, and will prepare additional client advisories as new information is provided. We hope that you have found this client advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:*

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