

SEC ADOPTS RESTRICTIONS ON SHORT SALES

On February 24, 2010, the US Securities and Exchange Commission (SEC) adopted a new short sale pricing rule that imposes restrictions on short selling in a particular stock only when that stock's price declines on any day by 10% or more from the prior day's closing price, thereby triggering a circuit breaker. Once the circuit breaker has been triggered, as determined by the listing market for the security, short sale orders in that particular stock are generally only permitted if the sale price is above the current national best bid for that stock (the alternative uptick rule). This restriction remains in effect for the remainder of the day on which the circuit breaker is triggered and the following trading day.

The new short sale pricing rule, Rule 201 of Regulation SHO, generally applies to all securities, except options, that are listed on a national securities exchange, whether traded on an exchange or in the over-the-counter (OTC) market (covered securities).

The new rule will generally give long sellers priority over short sellers in a declining market when the circuit breaker in a covered security is triggered by limiting the execution or display of short sale orders to those at a price above the national best bid, while continuing to allow long sellers to sell at the bid. Therefore, short sale orders will be executed only when purchasers arrive willing to buy at prices above the national best bid. The rule is designed to ensure that in these circumstances short sellers will participate, if at all, as liquidity providers rather than liquidity takers (unless an exception applies).

The rule will also impact trading centers and brokers or dealers that are required to adopt policies and procedures to help implement the rule. The new restrictions will require "trading centers" to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security that is not in compliance with the rule. The term "trading center" includes 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. The SEC has estimated that there are more than 400 brokers or dealers registered with the SEC that may meet the definition of a trading center.

After the circuit breaker is triggered for a covered security, a broker or dealer submitting a short sale order to a trading center may mark the order "short exempt" if the broker or dealer identifies the order as being at a price above

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the current national best bid at the time of submission. A broker or dealer marking an order “short exempt” on this basis must have and enforce written policies and procedures reasonably designed to prevent incorrect identification of these orders. Brokers or dealers may also mark an order “short exempt” after the circuit breaker has been triggered in reliance on one of several other exceptions in the rule.

The rule has been the subject of much controversy and was adopted with a 3-to-2 vote split, with Commissioners Casey and Paredes dissenting. Both Commissioners criticized the decision based on the lack of empirical evidence that repeal of the uptick rule in 2007 contributed to the steep declines in stocks and increased market volatility. Although the adopting release expresses the SEC’s concern that “excessive downward price pressure on individual securities accompanied by the fear of unconstrained short selling can undermine investor confidence in our markets generally,” Commissioner Casey stated that it is “pure conjecture” that the rule will “shore up investor confidence.” Similarly, Commissioner Paredes stated that “investor confidence is at risk of being undermined if the short selling restriction adversely impacts market quality, such as by interfering with price discovery... Investor confidence may erode if the price test fails to ensure that prices do not continue to drop.”¹

The rule will become effective on May 10, 2010; however, trading centers and market participants will have until November 10, 2010 to comply with the rule (Compliance Date).

Following is additional information about the new rule in question and answer format.

What short selling restrictions apply under the new rule?

New Rule 201 of Regulation SHO imposes restrictions on short selling in a particular stock that is a “covered security” only when that stock’s price declines on any day by 10% or more from the prior day’s closing price, thereby

triggering a circuit breaker. Once the circuit breaker is in effect, as determined by the listing market for the security, short sale orders in that particular stock are generally only permitted if the sale price is *above* the current national best bid for that stock.² This restriction remains in effect for the remainder of the day on which the circuit breaker is triggered and the following trading day.

How is “national best bid” defined?

With respect to quotations for an NMS security, the “national best bid” means the best bid for such security that is calculated and disseminated to the market on a current and continuing basis by a plan processor. In the event two or more market centers transmit to the plan processor identical bids for an NMS security, the best bid is determined by ranking all such identical bids first by size (giving the highest ranking to the bid associated with the largest size), and then by time (giving the highest ranking to the bid received first in time).

Must the short sale order be entered at a certain increment above the “national best bid”?

No. Although the short sale must be priced above the “national best bid,” the new rule does not state that the short sale be entered at a particular increment above the “national best bid.” However, any such execution or display must be in compliance with applicable rules regarding minimum price increments.

Are the last sale price, the bid or the ask relevant for purposes of determining permissible short sales under the rule?

No. The new rule references only the current national best bid in determining permissible short sales. The rule does not require monitoring of the sequence of bids or last sale prices (i.e., whether the current national best bid or last

¹ See SEC Commissioner Kathleen L. Casey, Statement at Open Meeting, Short-Sale Restrictions, Feb. 24, 2010; SEC Commissioner Troy A. Paredes, Statement at Open Meeting and Dissent Regarding the Adoption of Amendments to Regulation SHO (the Alternative Uptick Rule), Feb. 24, 2010.

² The SEC’s new rule effectively combines the “alternative uptick rule” proposed in August 2009 with a circuit breaker to temporarily prohibit short selling in a particular security when there has been a severe decline in the price of that security. The SEC’s prior proposals are discussed in our August 2009 advisory, “SEC Seeks Comments on Alternative Short Sale Rule,” available at http://www.arnoldporter.com/public_document.cfm?id=14634&key=21E2 and our April 2009 advisory, “SEC Proposes and Seeks Comments on New Short Selling Regulations,” available at http://www.arnoldporter.com/public_document.cfm?id=14272&key=24C0.

sale price is above or below the previous national best bid or last sale price).

What is the duration of the short sale restriction?

The price test restriction, if triggered, applies for the remainder of the trading day and the following day, during periods when the national best bid is calculated and disseminated on a current and continuing basis by a plan processor.

Can the short selling restriction be re-triggered while the price restriction is in effect?

Yes. If the price of a covered security declines intra-day by at least 10% on a day on which the security is already subject to the short sale price test restriction, the restriction will be re-triggered and will continue in effect for the remainder of that day and the following day.

For example, if on Day 1 the price of a covered security declines intra-day by at least 10%, the security will be subject to the alternative uptick rule for the remainder of that day and for the following day, Day 2. If on Day 2, the price of the security again declines intra-day by at least 10%, the circuit breaker will be re-triggered for that security and the alternative uptick rule will apply for the remainder of that day and for the following day (Day 3).

What is a “covered security”?

Rule 201 will apply to any security or class of securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan (NMS stocks). As a result, Rule 201 generally will cover all securities, except options, listed on a national securities exchange whether traded on an exchange or in the OTC market. The rule does not apply to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market, although the SEC indicated that it may consider this at a later time. The SEC has not provided an exception for exchange-traded funds (ETFs) from the short sale price restrictions. Although Rule 201 does not cover short positions through the use of derivative products such as options, futures, contracts for differences, warrants, credit default swaps (CDS) or other swaps (so-called synthetic short sales), or other instruments (such as

inverse leveraged ETFs), the SEC may consider whether additional regulation is needed at a later time.

Who determines whether the price of a covered security has decreased by 10% or more from the prior day’s close for purposes of the circuit breaker trigger?

The listing market for each covered security determines whether the price of a covered security has decreased by 10% or more from the covered security’s closing price as of the end of regular trading hours on the prior day. If such decrease has occurred, the listing market must immediately notify the single plan processor responsible for consolidation of information for the covered security that the security has become subject to the short sale price test restriction. The plan processor must then disseminate this information.

What exceptions apply under the rule (i.e., under what circumstances may a broker or dealer mark an order as “short exempt”)?

A broker or dealer submitting a short sale order for a covered security to a trading center after the circuit breaker has been triggered may mark the order “short exempt” if the broker or dealer identifies the order as being at a price above the current national best bid at the time of submission. A broker or dealer relying on this provision must establish, maintain, and enforce written policies and procedures reasonably designed to prevent incorrect identification of these orders. The broker or dealer must regularly monitor its policies and procedures to ascertain whether they are effective and take prompt action to remedy any deficiencies.

In addition, a broker or dealer may mark a short sale order of a covered security “short exempt” after the 10% circuit breaker is triggered for that security if the broker or dealer has a reasonable basis to believe that:

- the short sale order is by a person who is “deemed to own” the security under Regulation SHO, provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed;³

³ Under Regulation SHO, a sale can be marked “long” only if the seller is deemed to own the security being sold and either (i) the security

- the short sale order is by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker's or dealer's position by no more than a unit of trading;
- the short sale order is associated with certain bona fide domestic arbitrage transactions;⁴
- the short sale order is associated with certain bona fide international arbitrage transactions;⁵
- the short sale order is by underwriters or syndicate members participating in a distribution in connection

is in the broker or dealer's physical possession or control; or (ii) it is reasonably expected that the security will be in the broker or dealer's possession or control by settlement of the transaction. Thus, even where a seller owns a security, if delivery will be delayed, such as in the sale of formerly restricted securities pursuant to Rule 144 of the Securities Act of 1933, or where a convertible security, option, or warrant has been tendered for conversion or exchange but the underlying security is not reasonably expected to be received by settlement date, such sales must be marked "short." Therefore an exception to Rule 201 is necessary to allow for sales of securities that, although owned, are subject to Regulation SHO due solely to the seller being unable to deliver the covered security to its broker or dealer prior to settlement based on practical reasons.

- 4 The broker or dealer must have a reasonable basis to believe that (i) the short sale order is for a good faith account (a type of special purpose account under Regulation T which a broker or dealer may use to effect or finance certain types of customer transactions, including bona fide arbitrage transactions) of a person who owns another security that gives the seller the right to acquire an equivalent number of securities of the same class as the securities sold (e.g., convertible or exchangeable securities); (ii) the sale or the purchase which it offsets is for the bona fide purpose of profiting from a current price difference between the price of the security sold and the security owned; and (iii) such right of acquisition was originally attached to, or represented by, another security, or was issued to all the holders of any such securities of the issuer. The exemption appears to be narrow in scope and may not cover a number of arbitrage activities, such as delta neutral hedging, certain index arbitrage strategies, and strategies that do not involve immediate convertibility.
- 5 The broker or dealer must have a reasonable basis to believe that the short sale order is for a good faith account (as defined in Regulation T) and is submitted to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States. This exception only applies if at the time of the short sale the seller has a corresponding offer to buy on a foreign securities market that allows the seller to immediately cover the short sale at the time it was made. The requirement that the transaction be "immediately" covered on a foreign market requires the foreign market to be open for trading at the time of the transaction. For purposes of this exception, a depository receipt of a security is deemed to be the same security as the security represented by such receipt.

with an over-allotment, or is for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment;

- the short sale order is by a broker or dealer to effect the execution of a customer purchase or the execution of a customer "long" sale on a riskless principal basis, and the broker or dealer relying on this provision has certain specified written policies and procedures in place; or
- the short sale order is for a sale at the volume weighted average price that meets specified criteria.

Are any exemptions available in addition to the exceptions described above?

The SEC is permitted, upon written application or upon its own motion, to grant an exemption from the short sale price restrictions, either unconditionally or on specified terms and conditions, to any person or class of persons, to any transaction or class of transactions, or to any security or class of securities to the extent that such exemption is necessary or appropriate, in the public interest, and is consistent with the protection of investors.

Is there a market maker exception?

No. The SEC decided not to include a provision to permit a broker or dealer to mark a short sale order "short exempt" in connection with certain bona fide market making activities in the equity or option markets. However, the SEC has instructed its staff to assess the impact of the rule on the options markets and to provide a written report of their assessment within the shortest time practicable, which the SEC expects will not exceed two years from the Compliance Date.

How many stocks are expected to be affected by the circuit breaker test at any one time?

The SEC believes that the short sale price test restriction is structured so that generally it will not be triggered for the majority of covered securities at any given time. The staff found that during the period covering April 9, 2001 to September 30, 2009, the price test restrictions of Rule 201 would have been triggered on an average day for approximately 4% of covered securities. The staff also

found that for a low volatility period, covering January 1, 2004 to December 31, 2006, the price test restrictions of Rule 201 would have been triggered on an average day for approximately 1.3% of covered securities.

What was the SEC's rationale for adopting the short sale price restrictions?

In the adopting release, the SEC states that short selling contributes to market liquidity, price discovery and market efficiency. However, the SEC gave several reasons for a short sale price test restriction, including the following:

- Because the rule is narrowly tailored, it will target only those securities that are experiencing significant intra-day price declines, to prevent short selling from causing further price declines;
- The rule will facilitate the ability of long sellers to sell first in a declining market for a particular security; and
- The rule will help address erosion of investor confidence in the securities markets generally, related to excessive downward price pressure on individual securities accompanied by the fear of unconstrained short selling.

As noted above, both SEC Commissioners Casey and Paredes dissented from the decision, in large part due to the lack of empirical evidence supporting adoption of the new rule. The adopting release notes that during the recent subprime mortgage and credit crises, US markets experienced increased volatility and steep price declines, particularly in the stocks of certain financial issuers. The release states that the SEC is "not aware, however, of any empirical evidence that the elimination of short sale price test restrictions contributed to the increased volatility in the US markets."⁶

Could trading centers and other market participants be subject to SEC enforcement action or securities law

liability in connection with the new rule?

The SEC and SROs will carefully monitor whether trading centers' policies and procedures are reasonably designed to prevent short selling in violation of Rule 201. To the extent that a trading center's policies and procedures permit any execution or display of a short sale order not in accordance with the requirements of Rule 201, such trading center's policies and procedures may not be reasonable and could subject the trading center to enforcement action. In addition, the SEC and SROs will evaluate a broker's or dealer's written policies and procedures related to marking an order "short exempt" for compliance with Rule 201.

In addition, any conduct by trading centers, or other market participants, that facilitates short sales in violation of Rule 201 could lead to liability for aiding and abetting or causing a violation of Regulation SHO, as well as potential liability under the anti-fraud and anti-manipulation provisions of the federal securities laws.

What requirements will be placed on trading centers to ensure compliance with the new rule?

A trading center is required to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order at a price that is less than or equal to the current national best bid when the price of a covered security decreases by 10% or more from the closing price, as determined by the listing market for the covered security, as of the end of regular trading hours on the prior day. In addition, such policies and procedures must be reasonably designed to impose the short sale price test restriction for the remainder of the day on which it is triggered and on the following day, during periods when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor. A trading center's policies and procedures must be reasonably designed to permit:

- the execution of a displayed short sale order of a covered security if, at the time of initial display of the short sale order, the order was at a price above the current national best bid; and

⁶ See Release No. 34-61595, Amendments to Regulation SHO (Feb. 26, 2010). The SEC also states in the adopting release that none of the empirical studies submitted by commenters had given it "reason to question the rigor or validity of the Pilot Results," which supported the repeal of the uptick rule in 2007. The release also notes that a recent SEC staff study of short selling during early September 2008, a volatile period that preceded the SEC's short selling ban, found that during periods of price declines, selling pressure was more intense from long sellers than from short sellers. *Id.* at fn. 87 (citing to Staff, Analysis of Short Selling Activity during the First Weeks of September 2008, Dec. 16, 2008, available at <http://www.sec.gov/comments/s7-08-09/s70809-369.pdf>).

- the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid.

A trading center is also required to regularly monitor its policies and procedures to ascertain whether they are effective and take prompt action to remedy any deficiencies.

Can a trading center adopt policies and procedures that will allow it to reprice a short sale order that is impermissibly priced and display it?

Rule 201 permits a trading center to display an order provided it is permissibly priced at the time the trading center displays the order. If an order is impermissibly priced, the trading center could, in accordance with policies and procedures reasonably designed to prevent the execution or display of a short sale order at a price that is less than or equal to the current national best bid, reprice the order upwards to the lowest permissible price and hold it for later execution at its new price or better.

For example, if a trading center receives a short sale order priced at US\$10.00 when the current national best bid in the security is US\$10.00, the trading center could reprice the order at the permitted offer price of US\$10.01, and display the order for execution at this new limit price. As quoted prices change, a trading center may repeatedly reprice and display an order at the lowest permissible price down to the order’s original limit order price (or, if a market order, until the order is filled). Thus, trading centers will have flexibility to offer their customers various order types regarding the handling of impermissibly priced orders such that a trading center can either reject an impermissibly priced order or reprice the order upwards to the lowest permissible price until the order is filled.

Do the restrictions apply to overseas transactions?

Consistent with the SEC’s prior positions, the SEC confirmed in the adopting release that the new rule applies to any short sale effected using US jurisdictional means, unless otherwise excepted, regardless of the jurisdiction in which the short sale is executed. This includes transactions in covered securities “agreed to” in the United States, but sent to a foreign market for execution. As an example, the

adopting release notes that in the SEC’s view, if a US money manager negotiates a price with a US broker or dealer for a block of shares in a covered security, and the US broker or dealer sends the order ticket to its foreign trading desk for execution, this trade was agreed to in the United States as much as if the trade had been executed by the broker or dealer at a US trading desk. In addition, the SEC notes that in the 2004 Regulation SHO adopting release, it stated that any broker or dealer using US jurisdictional means to effect short sales in securities traded in the United States would be subject to Regulation SHO, regardless of whether the broker or dealer is registered with the SEC or relies on an exemption from registration.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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