



Regulatory Update – The SEC Issues New Proposals to Restrict Short Selling

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On April 10, 2009, the Securities and Exchange Commission (“SEC”) published for a 60-day comment period a set of five proposals to amend Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”) to restrict short selling.¹ Two of these proposals would restrict short selling on a market-wide and permanent basis (“market-wide proposals”), and three of them would restrict short selling of a particular security for the remainder of the day if that security experiences a severe price decline (“circuit breaker proposals”).

These proposals are intended to generate comment on whether to reverse the SEC’s rulemaking in July 2007 when it eliminated all restrictions on the price at which short sale orders could be executed (*i.e.*, “short sale price test restrictions”).² At that time, short sale price test restrictions included Rule 10a-1 under the Exchange Act, also known as the “uptick rule” or “tick test” (“former Rule 10a-1”), that applied to exchange-listed securities, and the National Association of Securities Dealers, Inc.’s (“NASD”) bid test, that applied to certain Nasdaq securities.³

In the release announcing the five proposals (“proposing release”), the SEC observed that during 2007 and into 2008, market volatility, including steep price declines, particularly in the stocks of certain financial services issuers, has increased markedly in the U.S. and in every major stock market around the world (including markets that continued to operate under short sale price test restrictions).⁴ As market conditions have continued to worsen, the SEC asserted that investor confidence has eroded, and noted that it has received requests from many commenters to consider imposing restrictions with respect to short selling, in part in the belief that such action would help restore investor confidence.⁵ Accordingly, the SEC determined to seek public comment on the five proposals to restrict short selling. These proposals are summarized below.

¹ See Exchange Act Release No. 59748 (Apr. 10, 2009), 74 FR 18042 (Apr. 20, 2009).

² See Exchange Act Release No. 55970 (Jun. 28, 2007), 72 FR 36348 (Jul. 3, 2007).

³ NASD is now known as the Financial Industry Regulatory Authority, Inc. (“FINRA”).

⁴ 74 FR at 18043.

⁵ *Id.*

I. The Short Sale Proposals

A. Market-Wide Proposals

1. The Proposed Modified Uptick Rule

The first of the SEC’s market-wide proposals would establish a market-wide short sale price test that would be based on the national best bid (the “proposed modified uptick rule”). Under the proposed modified uptick rule, trading centers such as exchanges would be required to adopt policies and procedures that are reasonably designed to prevent the execution or display of a short sale order at a “down-bid price,” which is defined as 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 (“bid test”).⁶ The proposed rule also would allow broker-dealers to determine whether short sale orders could be executed consistent with the bid test, rather than having to rely on trading centers to make this determination, provided the broker-dealers have in place policies and procedures reasonably designed to properly identify orders as not being on a down-bid price when those orders are submitted to trading centers.⁷ The proposal is very similar to a uniform bid test rule that the SEC proposed several years ago but abandoned in favor of removing all short sale price test restrictions.⁸ It is also similar to the NASD’s former short sale restrictions.

The proposed modified uptick rule would apply to all short sales in 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 (“covered securities”).⁹ Thus, the proposed

⁶ See proposed Rule 201(b) of the proposed modified uptick rule for the policies and procedures requirement, and proposed Rule 201(a)(2) of the proposed modified uptick rule for the definition of “down-bid price.”

⁷ See proposed Rule 201(c) of the proposed modified uptick rule.

⁸ See Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003) (proposing a uniform bid test as part of its proposal of Regulation SHO).

⁹ See proposed Rule 201(a)(1) of the proposed modified uptick rule, which defines a “covered security” as an “NMS stock” under Rule 600(b)(47) of Regulation NMS. Rule 600(b)(47) of Regulation NMS defines an “NMS stock” as “any NMS security other than an option.” Rule 600(b)(46) of Regulation NMS defines an “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an

rule generally would cover short sales in all securities, except options, listed on a national securities exchange (whether traded on an exchange or in the over-the-counter ("OTC") market), but would not cover short sales in non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. In addition, unlike former Rule 10a-1, the proposed rule would not apply to after-hours trading.¹⁰

The proposed modified uptick rule contains exceptions to the bid test that generally track the exceptions to and exemptions granted from the tick test in former Rule 10a-1.¹¹ For instance, the proposed rule contains an exception for short sale orders executed in connection with certain bona fide domestic arbitrage transactions.¹² In addition, the proposed rule contains an exception for short sale orders executed as part of a riskless principal transaction in which each side of the transaction is executed at the same price.¹³ The proposed rule also contains an exception for certain short sale orders executed on a volume weighted average price ("VWAP") basis.¹⁴

Unlike relief granted under former Rule 10a-1, the proposed modified uptick rule does not contain an exception for systems that offer price improvement based

effective national market system plan for reporting transactions in listed options."

¹⁰ See proposed Rule 201(f) of the proposed modified uptick rule.

¹¹ Orders excepted from the bid test would be required to be marked "short exempt" under proposed Rule 200(g) of the proposed modified uptick rule.

¹² See proposed Rule 201(d)(3) of the proposed modified uptick rule.

¹³ See proposed Rule 201(d)(6) of the proposed modified uptick rule. Proposed Rule 201(a)(6) of the proposed modified uptick rule defines "riskless principal" as a transaction in which a broker-dealer, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell.

¹⁴ See proposed Rule 201(d)(7) of the proposed modified uptick rule. This proposed exception for VWAP transactions is slightly different than the relief granted under former Rule 10a-1 for such transactions in that it would not be limited to VWAP transactions that are arranged or "matched" before the market opens at 9:30 a.m., or that are not assigned a price until after the close of trading when the VWAP value is calculated. See, e.g., Letter re: *Rule 10a-1; Exemptive Relief under Short Sale Rule* (Feb. 12, 2003) (granting Via Institutional Services exemptive relief from former Rule 10a-1 for VWAP transactions).

on the national best bid and offer (e.g., midpoint matching systems).¹⁵ The SEC believes that relief for such systems is not necessary because they are designed to execute orders above the current national best bid.¹⁶ In addition, the proposed rule does not contain an exception for bona fide market making activity. The SEC noted, among other things, that such an exception may undermine the goals of the SEC's proposed short sale price test restrictions at this time in that for the proposed modified uptick rule to have the effect of helping to prevent declines in securities prices and restore investor confidence, exceptions to the proposed rule should be limited in scope.¹⁷ The SEC also noted that the exception for riskless principal transactions would provide broker-dealers (including market makers) with the flexibility to facilitate customer orders.¹⁸

In describing the proposed modified uptick rule, the SEC expressed a preference for a bid test as opposed to a last sale test if it were to impose a short sale price test restriction.¹⁹ The SEC believes, among other things, that bids generally are a more accurate reflection of current prices for a security because changes in the national best bid are sequenced across trading centers, whereas last sale transactions may be reported within a 90-second window, which can easily result in out-of-sequence last sale reports.²⁰ Thus, the SEC asserted that for those covered securities for which a significant amount of trading occurs manually, or in multiple trading centers, a bid test may be a fairer and more effective means of regulating short selling than a last sale test because the manner in which trades are reported may create up-ticks and down-ticks that may not accurately reflect actual price movements in the security for the purpose of a test based on the last sale price.²¹

¹⁵ See, e.g., Letter re: *Rule 10a-1; Exemptive Relief under Short Sale Rule* (Apr. 23, 2003) (granting exemptive relief to ITG, Inc. from former Rule 10a-1 for trades executed through its POSIT system).

¹⁶ 74 FR at 18053.

¹⁷ 74 FR at 18059.

¹⁸ *Id.*

¹⁹ 74 FR at 18053.

²⁰ *Id.*

²¹ *Id.*

2. The Proposed Uptick Rule

The second of the SEC's market-wide proposals would establish a market-wide short sale price test, similar to former Rule 10a-1, that would be based on the last sale price (the "proposed uptick rule"). Under the proposed uptick rule, no person may effect a short sale of a covered security at a price below the last sale price for that security ("new tick test").²² In other words, under the proposed rule, short sales of a covered security must be effected at a price \$.01 better than the last sale price for that security, or at the last sale price for that security if the last sale price is above the last different sale price.

Like the proposed modified uptick rule, the proposed uptick rule would apply to all short sales in covered securities.²³ Thus, the proposed modified uptick rule would not cover options or short sales in non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. In addition, like the proposed modified uptick rule (and unlike former Rule 10a-1), the proposed uptick rule would not apply to after-hours trading.²⁴

The proposed uptick rule contains exceptions to the new tick test that track the exceptions to and exemptions granted from the tick test in former Rule 10a-1.²⁵ For example, in addition to containing the same exceptions as the proposed modified uptick rule (some of which are discussed above), the proposed uptick rule contains an exception for short sales in electronic trading systems that match and execute trades at various times and at independently-derived prices above the current national best bid (*e.g.*, midpoint matching systems).²⁶ In addition, the proposed uptick rule contains exceptions for short sales to address a potential conflict between the operation of the new tick test and the firm quote requirement of Rule 602 of

²² See proposed Rule 201(b) of the proposed uptick rule.

²³ The proposed uptick rule applies to a "covered security," which is defined in proposed Rule 201(a)(4) of the proposed uptick rule as an "NMS stock" under Rule 600(b)(47) of Regulation NMS. See *supra* note 9.

²⁴ See proposed Rule 201(e) of the proposed uptick rule.

²⁵ Orders excepted from the new tick test would be required to be marked "short exempt" under proposed Rule 200(g) of the proposed uptick rule.

²⁶ See proposed Rule 201(c)(8) of the proposed uptick rule.

Regulation NMS in situations where execution of an offer quotation by a broker-dealer would be prohibited by the new tick test because of a trade-through of that offer, even though that offer had been at a price permitted under the new tick test at the time that the broker-dealer had communicated it to its exchange or association for inclusion in the consolidated quotation system.²⁷ The proposed uptick rule also includes an exception to allow market makers or specialists publishing two-sided quotes to sell short at the offer to facilitate customer market or marketable limit buy orders regardless of the last sale price.²⁸

B. Circuit Breaker Proposals

1. The Proposed Circuit Breaker Halt Rule

The first of the SEC's circuit breaker proposals would establish a ban on short selling a particular security for the remainder of the trading day if that security experiences a severe price decline (the "proposed circuit breaker halt rule"). Under the proposed circuit breaker halt rule, short sales of a particular covered security would be prohibited for the remainder of the trading day if the price of that security declined by at least 10% from the prior day's closing price.²⁹ The proposed rule, however, would not apply if the decline occurs within 30 minutes from the close of trading.³⁰

Similar to the proposals discussed above, the proposed circuit breaker halt rule would only apply to covered securities.³¹ Thus, the proposed circuit breaker halt rule would not cover options or short sales in non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. In addition, like the proposals discussed above, the proposed circuit breaker halt rule would not apply to after-hours trading.³²

²⁷ See proposed Rules 201(c)(10) and (11) of the proposed uptick rule.

²⁸ See proposed Rule 201(c)(12) of the proposed uptick rule.

²⁹ See proposed Rule 201(b) of the proposed circuit breaker halt rule.

³⁰ See proposed Rule 201(c) of the proposed circuit breaker halt rule.

³¹ The proposed circuit breaker halt rule applies to a "covered security," which is defined in proposed Rule 201(a)(1) of the proposed circuit breaker halt rule as an "NMS stock" under Rule 600(b)(47) of Regulation NMS. See *supra* note 9.

³² See proposed Rule 201(b) of the proposed circuit breaker halt rule.

The proposed circuit breaker halt rule contains several exceptions.³³ For example, the proposed rule contains an exception for short sales by stock and options market makers engaged in bona fide market making activities, as well as an exception for short sales by market makers in exchange traded funds and exchange traded notes engaged in bona fide market making activities.³⁴ In addition, the proposed rule contains an exception that addresses short sales that occur as a result of an automatic exercise or assignment of an equity option, or in connection with a futures contract, that is held prior to the 10% threshold being triggered, due to expiration of the option or futures contract.³⁵ The proposed rule also contains an exception that addresses short sales by any person that is the writer of a call option if the sale is caused by an assignment following an exercise by the holder of the call.³⁶

2. The Proposed Circuit Breaker Modified Uptick Rule

The second of the SEC's circuit breaker proposals would establish a short sale price test based on the national best bid for a particular security for the remainder of the trading day if that security experiences a severe price decline (the "proposed circuit breaker modified uptick rule"). Under the proposed circuit breaker modified uptick rule, short sales of a particular covered security would be subject to the same bid test as the bid test in the proposed modified uptick rule for the remainder of the trading day if the price of that security declined by at least 10% from the prior day's closing price.³⁷ The proposed circuit breaker modified uptick rule, however, would not apply if the decline occurs within 30 minutes from the close of trading.³⁸

³³ Orders excepted from the halt requirement would be required to be marked "short exempt" under proposed Rule 200(g) of the proposed circuit breaker halt rule.

³⁴ See proposed Rules 201(d)(1) and (4) of the proposed circuit breaker halt rule.

³⁵ See proposed Rule 201(d)(2) of the proposed circuit breaker halt rule.

³⁶ See proposed Rule 201(d)(3) of the proposed circuit breaker halt rule.

³⁷ See proposed Rule 202(b) of the proposed circuit breaker modified uptick rule.

³⁸ See proposed Rule 201(c) of the proposed circuit breaker modified uptick rule.

Except for only applying to a covered security that experiences a 10% price decline, the bid test in the proposed circuit breaker modified uptick rule would operate in the same manner as, and contain the same exceptions as, the bid test in the proposed modified uptick rule. In this regard, unlike the bid test in the proposed modified uptick rule, which would apply all covered securities on a market-wide and continuing basis, the bid test in the proposed circuit breaker modified uptick rule would only apply to an individual covered security that experiences a 10% price decline from the prior day's closing price, and would be time-limited in that it would only apply to short sales in that security for the remainder of the trading day.

3. Proposed Circuit Breaker Uptick Rule

The last of the SEC's circuit breaker proposals would establish a short sale price test based on the last sale price for a particular security for the remainder of the trading day if that security experiences a severe price decline (the "proposed circuit breaker uptick rule"). Under the proposed circuit breaker uptick rule, short sales of a particular covered security would be subject to the same tick test as the new tick test in proposed uptick rule for the remainder of the trading day if the price of that security declined by at least 10% from the prior day's closing price.³⁹ The proposed circuit breaker uptick rule, however, would not apply if the decline occurs within 30 minutes from the close of trading.⁴⁰

Except for only applying to a covered security that experiences a 10% price decline, the tick test in the proposed circuit breaker uptick rule would operate in the same manner as, and contain the same exceptions as, the new tick test in the proposed uptick rule. In this regard, unlike the new tick test in the proposed uptick rule, which would apply all covered securities on a market-wide and continuing basis, the tick test in the proposed circuit breaker uptick rule would only apply to an individual covered security that experiences a 10% price decline from the prior day's closing price, and would be time-limited in that it would only apply to short sales in that security for the remainder of the trading day.

³⁹ See proposed Rule 202(b) of the proposed circuit breaker uptick rule.

⁴⁰ See proposed Rule 201(c) of the proposed circuit breaker uptick rule.

II. Solicitation of Comments

In the proposing release, the SEC devotes a significant number of pages to questions on the five proposals.⁴¹ In general, these questions are focused on whether the SEC should restrict short selling through short sale price test restrictions, as well as on technical aspects of each of the five proposals. One area that is emphasized in these questions, and in statements by certain SEC Commissioners during the open meeting at which the SEC voted on issuing the proposing release, is a request for commenters to provide empirical data supporting their positions.⁴² Similar to prior SEC proposals on short sales, this proposal is sure to generate a lot of comments. In fact, as of April 30, 2009, the SEC has already received hundreds of comments on the proposals. Comments on the five proposals are due by June 19, 2009.

⁴¹ See, e.g., 74 FR at 18070 – 18082.

⁴² See, e.g., opening statement of Commissioner Kathleen L. Casey (<http://www.sec.gov/news/speech/2009/spch040809klc.htm>)

For Further Information

If you have any questions concerning this update, or if you would like to discuss preparing a comment letter on the SEC's proposed rules, contact any of the following members of our Securities and Futures Regulation Group:

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