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US Securities and Exchange Commission Considers New Short Selling Regulation

On April 10, 2009, the US Securities and Exchange Commission (SEC) issued five alternative proposed amendments to Regulation SHO, which, according to the SEC, are aimed at curbing short sales under certain circumstances and increasing overall investor confidence (the "Proposing Release").[1] The Proposing Release comes at a time when the SEC is under intense pressure from members of the US Congress, many of whom have taken an increased interest in short selling in light of the ongoing market crises. In addition, the SEC has announced that it will be convening a roundtable on May 5, 2009, to discuss short sale regulation. The Proposing Release and the roundtable represent the first steps taken regarding the regulation of short sales by the SEC under Chairman Schapiro.

The Proposing Release

Two of the proposed alternatives in the Proposing Release would establish permanent, market-wide "price tests" (as described below) in "covered securities."[2] The other three alternatives would create "circuit breakers" (as described below) that would impose certain additional requirements or even prohibitions on short sales in a particular covered security if triggered after a significant intraday decline in the price of that covered security. The Proposing Release calls for public comments within 60 days of its publication in the *Federal Register*.[3] Assuming one or more of the five alternatives is ultimately adopted, the SEC envisions a three-month implementation period after the effective date of such changes to Regulation SHO.

The Price Tests

THE PROPOSED TICK TEST

One alternative being considered by the SEC would essentially revive much of old Rule 10a-1 under the Securities Exchange of 1934 (Exchange Act).[4] The new, revived tick test is referred to in the Proposing Release as the "Proposed Tick Test." The Proposed Tick Test would, like former Rule 10a-1, prohibit anyone from effecting a short sale for one's own account, or for the account of another, except where the price of such short sale is *above* the last sale price (an "uptick"), or where the price is *equal* to the last sale price, if that price is greater than the last different sale price (a "zero-plus tick"). However, unlike former Rule 10a-1, the Proposed Tick Test would only be in effect during times when sale price information is being collected and disseminated on a real-time basis. The Proposed Tick Test would reinstate many, but not all, of the exceptions from former Exchange Act Rule 10a-1.[5]

THE PROPOSED MODIFIED TICK TEST

The other price test being considered has more in common with the old NASD Rule 3350,[6] which was an analog to the tick test under Exchange Act Rule 10a-1 and was known as the "bid test." Rather than being concerned with the last sale price of a security, the "Proposed Modified Tick Test" makes reference to the current national best bid for a security at the time the short sale order is entered. Unlike the old bid test and the Proposed Tick Test, the Proposed Modified Tick Test would *not* impose a flat prohibition on effecting a short sale at an impermissible price.

Instead, the Proposed Modified Tick Test would require "trading centers" to implement policies and procedures reasonably designed to prevent the execution or display of a short sale order in a covered security at a price 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").[7] Like the Proposed Tick Test and the old NASD bid test, the Proposed Modified Tick Test would only apply during times that national best bids are calculated and disseminated. Also similar to the Proposed Tick Test, the Proposed Modified Tick Test would reinstate many, but not all, of the exceptions, from former Exchange Act Rule 10a-1.[8]

The Circuit Breakers

The concept behind the proposed circuit breaker alternatives in the Proposing Release appears to be that added short sale protections should be put in place to prevent so-called "bear raids" in particular covered securities and to allow time for the market to process the information and remove downward panic from the process of price discovery. In the Proposing Release, the SEC set the "trigger" for the circuit breakers to be a decline of at least 10 percent from the prior day's closing price, although this triggering point is subject to change based on feedback from commenters. The Proposing Release contemplates that the circuit breakers would *not* trigger if the 10 percent decline threshold is reached within 30 minutes of the end of the regular trading.

PROPOSED CIRCUIT BREAKER HALT RULE

Under the "Proposed Circuit Breaker Halt Rule" in the Proposing Release, once a circuit breaker is triggered for a particular covered security, short sales would be prohibited in that covered security for the remainder of the day, even if the security later recovers to a level above the previous day's closing price.

The SEC has proposed to incorporate several exceptions to the circuit-breaker triggered complete halt on short sales that are similar in fashion to the exceptions allowed under the temporary ban that was imposed on short sales of equity securities of financial companies by emergency order issued by the SEC last year.[9] For example, the Proposed Circuit Breaker Halt Rule would provide an exception for short sales in connection with *bona fide* market making activity in a particular halted covered security.[10] In addition, short sales occurring as a result of automatic exercise or assignment of an equity option or futures contract held *before* the circuit breaker is triggered would be permitted. The Proposed Circuit Breaker Halt Rule could operate in place of, or in addition to, a short sale price restriction.

PROPOSED CIRCUIT BREAKER PRICE TEST RULES

Alternatively, the SEC proposed two circuit breakers that would impose price tests (i.e., the "Proposed Tick Test" or the "Modified Proposed Tick Test") on covered securities that had triggered the circuit breaker rather than halting short sales altogether in those covered securities. These triggered price tests may create compliance difficulties, and they seem unlikely to garner much support from commenters.

Concluding Observations

Throughout the Proposing Release, the SEC acknowledged that it was open to other alternatives. For example, the SEC noted that it could apply a policies and procedures approach to the Proposed Tick Test, or alternatively replace (or supplement) the Proposed Modified Tick Test's policies and procedures approach with a flat prohibition. It appears the SEC is not strongly wedded to any particular approach, thus feedback from commenters and generated by the upcoming roundtable will be important is shaping the form of future short sale regulation.[11]

Endnotes

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

2 Each of the five alternatives would apply to short sales of "covered securities," which include any "NMS securities" other than options. Regulation NMS, 17 C.F.R. § 242.600(b)(46), (47) (2008). If adopted, the price tests and/or the circuit breakers effectively will apply to all securities (except options) listed on a national securities exchange, whether traded on an exchange or in the over-the-counter (OTC) market. As drafted, the price tests and circuit breakers would not cover non-NMS securities quoted on the OTC Bulletin Board, or elsewhere in the OTC market.

3 Although the Proposing Release is available on the SEC's web site, it has not been published in the *Federal Register* as of the date of this client update.

4 Exchange Act Rule 10a-1, which had been in place for more than 70 years, was formally repealed in 2007 after

extensive study of the effects of short sale price tests on the market. Securities Exchange Act Release No. 55,970 (June 28, 2007), available at http://www.sec.gov/rules/final/2007/34-55970.pdf.

5 These exceptions include, among other things, (1) sales which would normally be marked "short" due to a known delay in delivery by the seller (e.g., in the case of formerly restricted securities pursuant to Rule 144 of the Securities Act of 1933), (2) odd-lot transactions, (3) certain domestic and international arbitrage, (4) over-allotments and lay-off sales, (5) riskless principal transactions, and (6) transactions on a volume-weighted average price basis.

6 This rule was rescinded on August 17, 2007. Exchange Act Release No. 56,279 (Aug. 17, 2007), available at http://www.sec.gov/rules/sro/nasd/2007/34-56279.pdf. NASD is now known as the Financial Industry Regulatory Authority (FINRA).

7 Proposed Rule 201 would defined 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."

8 Unlike the Proposed Tick Test, the Proposed Modified Tick Test does *not* provide exceptions for, among other things, orders incorrectly marked as "long" or short sales by registered market makers, or specialists, to facilitate customer buy limit orders.

9 *See* Securities Exchange Act Release 58,592 (Sept. 18, 2008) available at http://www.sec.gov/rules/other/2008/34-58592.pdf.

10 This is in contrast to the two proposed price tests, which do not provide an exception for *bona fide* market making activities.

11 The SEC did give some indications that as between a "sale"-based test and a "bid"-based test, they believe that the bid-based approach would be more accurate.

If you have questions regarding the Proposing Release, the roundtable or short selling in general, please contact the Mayer Brown attorney with whom you normally communicate or any of the attorneys below.

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