April 16, 2009

INVESTMENT FUNDS ALERT

SEC PROPOSES UPTICK RULES AND CIRCUIT BREAKERS

On April 8, 2009, the Securities and Exchange Commission (SEC) proposed five separate versions of new Rule 201 of Regulation SHO to limit short sales in declining stocks: (1) a modified uptick rule based on the national best bid, (2) a traditional uptick rule, (3) a circuit breaker rule that would result in a short sale prohibition after a decline in the share price, (4) a circuit breaker that would result in the imposition of the modified uptick rule and (5) a circuit breaker that would result in the imposition of the traditional uptick rule. The SEC published its rule proposals on April 10, 2009[1], and has solicited comments relating to the advantages of each proposal.

BACKGROUND

The SEC originally adopted Rule 10a-1 under the Securities Exchange Act of 1934, as amended (the Exchange Act) in 1938 to prevent short selling activity from exacerbating the downward trend of a security. Rule 10a-1 prohibited any person from effecting a short sale for any exchange-traded securities or securities with unlisted trading privileges on an exchange if the short sale price would be below the last regular way reported sale of such security on an effective transaction reporting plan or unless the short sale price was above the next preceding different price at which a regular way sale was reported on an effective transaction reporting plan.

The SEC began to reconsider the benefit of the Rule 10a-1 in October 2003 in connection with the proposal of Regulation SHO and launched a pilot program to study the effect of short selling on certain liquid securities. After completing the study, the SEC concluded that there was little empirical justification for a short sale price test and repealed the uptick rule in June of 2007.

UPTICK RULE PROPOSALS

In response to the recent market downturn and proposed legislation in the U.S. Congress that would mandate the restoration of Rule 10a-1, the SEC proposed two alternative uptick rules: a marketwide short sale price test based on the national best bid (the modified uptick rule) and a marketwide short sale price test based on the last sale price or tick (the traditional uptick rule). Both proposed uptick rules would preclude a self-regulatory organization, such as a national securities exchange or a registered securities organization, from adopting an uptick rule that is not in conformity with or contradicts the SEC's rule. Each version of the new rule would only apply to NMS stock[2] during

[1] SEC Release No. 34-59748 (April 10, 2009).

[2] An NMS stock is generally any security, except options, listed on a national securities exchange, regardless of the venue through which such security is purchased or sold.

regular trading hours and would apply to any transaction agreed to in the United States regardless of where the transaction is booked.

Modified Uptick Rule

The modified uptick rule would require any "trading center"[3] to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order related to NMS stock at a "down-bid price." A "down-bid price" 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 national best bid. A trading center may, however, hold a short sale order until it is no longer a down-bid price and may execute a short sale order if the order was not a down bid price at the time the order was displayed.

Broker-dealers submitting orders to trading centers may mark orders as "short exempt" to represent that the order is not on a down-bid price at the time of submission to the trading center or that the broker-dealer had a reasonable basis to believe that the short sale was subject to an exemption. The SEC established exemptions for orders related to (1) securities that a seller is deemed to own under Rule 200 of Regulation SHO, (2) market makers' transactions to offset or liquidate odd-lot transactions, (3) special arbitrage transactions, (4) international arbitrage transactions including through arbitrage or depository receipts versus underlying securities, (5) short sales by underwriters in connection with over-allotments of securities or a distribution of securities through a rights or standby underwriting commitment, (6) a short sale effecting the execution of a customer long sale or a customer purchase on a riskless principal basis subject to certain conditions or (7) a short sale at the volume weighted average price (VWAP) subject to certain conditions. The SEC also reserves the right to grant other exemptions in the public interest.

Traditional Uptick Rule

The traditional uptick rule, like the uptick rule contained in former Rule 10a-1 under the Exchange Act, prohibits effecting a short sale at a proscribed price instead of requiring trading centers to establish policies and procedures designed to prevent violative short selling. If adopted, the traditional uptick rule would prevent short sales of NMS stock at any price below the price at which the last sale thereof, regular way, was reported pursuant to an effective national market system plan or unless the short sale price is above the next preceding different price at which that securities, regular way, was reported pursuant to an effective national market system plan. The prohibition would apply if trades in that security are reported pursuant to an effective national market system plan and information is available on a real-time basis.

The traditional uptick rule includes exemptions for short sales that are similar to those included for orders in the modified uptick rule and also includes additional exemptions necessary for a short sale price test based on the last sale price. The additional exemptions apply to short sales for (1) electronic trading systems that match buy and sell interests throughout the day meeting certain criteria,[4] (2) sales on behalf of a customer account pursuant to an order marked long, (3) any sale of a covered security by a registered specialist or a market maker on an exchange on which it is registered at a price equal to the most recent offer made by the specialist, market maker or a third market maker to an exchange or national securities association under Rule 602 of Regulation NMS if such offer, when communicated, was equal to or above the last sale, regular

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[3] Trading centers are defined under Rule 600(b)(78) of Regulation NMS 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."

[4] In order to use the electronic trading system exemption, (i) the trading system must occur at an externally derived price within the market above the current national best bid, (ii) buyers and sellers must not be assured of receiving a matching order or know when the match will occur, (iii) persons relying on the exemption shall not be represented in the primary market or otherwise influence the primary market bid or offer, (iv) transactions cannot be made for the purpose of market manipulation, (v) the VWAP-matched security is an actively traded security or the proposed short sale transaction is part of a basket of 20 or more securities of which the subject security comprises 5 percent or less and (vi) no solicitation of customer orders has occurred or communication with customers that the match has not yet occurred.

way, reported for the subject security reported pursuant to an effective national market system plan,[5] (4) a sale by a broker-dealer effected at a price equal to the most recent offer price communicated to an exchange or association under Regulation NMS if the amount sold was not more than the quote so communicated and the offer, when communicated, would have satisfied the traditional uptick rule[6] and (5) any sale of a security by a registered market maker or specialist publishing two-sided quotes.

CIRCUIT BREAKER RULES

The SEC also proposed three alternative "circuit breaker rules" that would have an effect on short sales once a certain threshold decline in price occurs—either banning short selling after the threshold is crossed (the circuit breaker halt rule), imposing the modified uptick rule after the threshold is crossed or imposing the traditional uptick rule once the threshold is crossed. All three circuit breaker rule proposals apply to NMS stock during regular trading hours and are triggered by a decrease of 10 percent or more as compared to the last price reported during trading hours for the prior day.

Circuit Breaker Halt Rule

The circuit breaker halt rule would prohibit any person from effecting short sales for the remainder of the day after the 10 percent trigger is crossed. The SEC exempted short sales (1) by registered market makers, block positioners or other market makers obligated to quote in the over-the-counter market, so long as that short seller is engaging in bona fide market making, (2) by any person as a result of an automatic exercise or assignment of an equity option or in connection with a futures contract that was held prior to the 10 percent trigger being crossed, (3) by a writer of a call option if the sale is a result of assignment following exercise, (4) by a market maker if the market maker's short sale directly relates to bona fide derivatives market making or exchange-traded funds or exchange-traded notes market making if the relevant security is a component or (5) by any person deemed to own the security pursuant to Rule 200 of Regulation SHO, so long as the person intends to deliver the security as soon as restrictions have been removed. The SEC also reserves the right to grant other exemptions in the public interest.

Circuit Breaker with Modified Uptick Rule and Circuit Breaker with Traditional Uptick Rule

The final two proposals are circuit breakers that would trigger the application of the modified uptick rule and a circuit breaker that triggers the application of the traditional uptick rule for the remainder of the day. The alternative rules incorporate the exemptions from the modified uptick rule and the traditional uptick rule, respectively.

OPEN QUESTIONS

The SEC still has many open questions relating to the various short sale price tests and/or circuit breakers discussed above. It posed several questions relating to the scope of the rules, including whether to expand the rules to cover over-the-counter securities and trading on the after-hours market or whether to limit the operation of the proposed rules to the financial industry only.

Specific to the uptick test, the SEC asked if it should adopt a "policies and procedures" approach or a flat prohibition of short selling at a prohibited price. It also solicited comment on whether (i) the penny increment of a price test was sufficient, (ii) different increments should apply for different industries and (iii) a market maker exemption should extend to the modified uptick rule.

[5] A self-regulatory organization may, however, prohibit its member from taking advantage of this exemption. The exemption is also not available to transactions in violation of Rule 104 of Regulation M.
[6] The exemption is not available to transactions in violation of Rule 104 of Regulation M.

Specific to the circuit breaker rules, the SEC asked about changing the penalties and triggers. It asked if rules should apply progressively longer consequences for crossing a 20 percent threshold. It also solicited comments regarding whether the 10 percent was the correct threshold for the rules to apply or whether a dollar amount or varying amount depending on trading activity would be a better threshold. Finally, the SEC asked if it should apply an index as the threshold for application of a circuit breaker instead of applying the circuit breaker on a security by security basis.

CONCLUSION

Although the SEC is considering all five of the proposals, it has expressed a preference for some of the proposals and has not made a final decision to proceed with regulation. The SEC preliminarily seems to prefer a sale price test based on a national best bid, for the stated reason that bids "generally are a more accurate reflection of current prices for a security than last sale prices 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 expressed some concern that a circuit breaker rule resulting in a ban of short selling could cause a "magnet effect," i.e., the incentive to sell securities short when a threshold is close to being crossed to ensure that the short sale order would be honored.

During the open meeting where the rule proposals were discussed, several SEC commissioners recognized the role of short selling related to providing liquidity and price discovery to the marketplace. The SEC is also considering if it should conduct a new pilot program before promulgating final rules.

We will keep clients and readers informed as the regulatory process develops.

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