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Short Sales: SEC Adopts Modified Uptick Rule Subject To Circuit Breaker

Investment Funds Alert

May 11, 2010

The Securities and Exchange Commission (SEC) recently adopted new Rule 201 of Regulation SHO. Rule 201 will require trading centers[1] to adopt policies and procedures that are reasonably designed to prohibit short sales of covered securities at a price that is less than or equal to the current national best bid during the day on which the price of the covered security has decreased by 10 percent or more (as determined by the listing market for the security) and the following trading day.

Rule 201 will only apply to "NMS stock"[2] and will apply to any transaction agreed to in the United States regardless of where the transaction is booked. Rule 201 will be effective on Monday, May 10, 2010, with required compliance by November 10, 2010.

Uptick Requirement

Rule 201 will require each trading center 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 price that is less than or equal to the national best bid (the "Uptick Requirement") during the day on which the listing market has determined that the price of the covered security has decreased by 10 percent or more versus the previous day's closing price and the following trading day.[3] The trading center will, however, be required to process trades marked "short exempt."

The restrictions of Rule 201 are limited to NMS stock, which generally includes any security listed on a national securities exchange,[4] regardless of the venue through which the security trades. Rule 201 specifically does not cover options (even if they are exchange traded), futures, contracts for differences, warrants or swaps. Also, the restrictions of Rule 201 are only effective while the national best bid is calculated and disseminated for the relevant NMS trading plan by the plan processor.

Exemptions

The SEC also amended Rule 200(g) of Regulation SHO to allow broker-dealers to mark orders as “short exempt” to indicate that the order is not at a prohibited price at the time of submission or that the broker-dealer had a reasonable basis to believe that the short sale was subject to an exemption. In order for a broker-dealer to report trading as “short exempt,” however, the broker-dealer also must have policies and procedures to prevent the incorrect marking of orders and must conduct surveillance to ensure the effectiveness of its policies.

The SEC established exemptions for orders related to (1) securities that a seller is deemed to own under Rule 200 of Regulation SHO that the seller intends to deliver as soon as all restrictions on delivery have been removed, (2) market makers’ transactions to offset or liquidate odd-lot transactions that change the broker’s or dealer’s position by no more than one unit of trading, (3) certain convertible arbitrage transactions, (4) arbitrage transactions to profit from the current price difference between a security on a foreign securities market and a United States securities market so long as the short seller has an offer to buy the security on a foreign market that allows the seller to immediately cover the short sale at the time it was made, (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) short sales effecting the execution of customer long sales or customer purchases on a riskless principal basis, subject to certain conditions or (7) short sales at the volume weighted average price (VWAP), subject to certain conditions. The SEC has also reserved the right to grant other exemptions in the public interest.

The significant exemptions provided in former Rule 10a-1 under the Securities Exchange Act of 1934 and in the SEC staff’s related guidance were included in Rule 201. Rule 201 also added exemptions for riskless principal transactions and VWAP transactions, but those transactions must comply with specified conditions in order to be exempt.[5] Like Rule 10a-1, Rule 201 does not provide a general market maker exemption, which may affect broker-dealers’ willingness to enter into synthetic positions related to an NMS stock that has declined more than 10 percent.

Conclusion

Rule 201 is designed to bolster confidence in the functioning of the markets by limiting short selling in a rapidly declining market, so that any further decline in prices is a result of only long selling. The “circuit-breaker” feature of the rule is designed to limit the impact on the liquidity provided by short selling, but events of extreme market disruption, such as those experienced on May 6, 2010, or during the latter half of 2008, could lead to the broad application of the Uptick Requirement.

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[1] 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."

[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.

[3] 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.

[4] Pink sheets and over-the-counter bulletin boards are not national securities exchanges.

[5] In order to use the VWAP exemption, (i) the VWAP must be computed according to a specified formula, (ii) the transactions must be reported using a VWAP trade modifier, (iii) 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, (iv) the transaction is not being executed to manipulate any security and (v) a broker or dealer only acts counter-party to fill customer short sale orders if the broker's or dealer's position in the subject security, together with its other customers who propose to sell the same security short on a VWAP basis, does not exceed 10 percent of that security's average daily trading volume. In order to use the riskless principal exemption, the broker-dealer must have systems in place to ensure that (i) the customer long order has been received prior to the offsetting transaction, (ii) the offsetting transaction has been allocated to a riskless principal or customer account within 60 seconds of execution and (iii) the broker-dealer has systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders under the riskless principal exception.