SEC Adopts New Rule Imposing Limited Price Restrictions on Short Selling

March 2, 2010

On February 24, 2010, the Securities and Exchange Commission (the "SEC") adopted a new rule which, under certain circumstances, places restrictions on the price at which a short sale of security can be consummated.[1] The new rule, which the SEC is calling the "alternative uptick rule," will amend Regulation SHO, in part by eliminating what is currently Rule 201 of Regulation SHO.[2] Once it takes effect,[3] the alternative uptick rule will impose certain restrictions on the price at which a security can be sold short when the price of the security declines by at least 10 percent in one day.[4] The details of the alternative uptick rule will be described further in this Alert, but a short history of the SEC's regulation of short selling provides context for the SEC's new alternative uptick rule.

The SEC has had a long history of regulating short selling. In 1938, primarily in response to the severe stock market declines in 1937, the SEC adopted Rule 10a-1 and placed price restrictions on short selling. These price restrictions generally prohibited any person from effecting a short sale of a security sold on a national securities exchange at a price below (and sometimes at) the previous sale price of the security.[5] These price

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[1] The SEC's Regulation SHO defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Definition of "Short Sale" and Marking Requirements, 17 C.F.R. § 242.200 (2010). Typically, a short sale is used as a trading mechanism to create positive returns when the price of a security drops.

[2] Regulation SHO, 17 C.F.R. §§ 242.200-204 (2010). The SEC adopted the alternative uptick rule pursuant to its rule-making authority under the Securities and Exchange Act of 1934. Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 327 (Feb. 26, 2010).

[3] The alternative uptick rule will become effective 60 days after it is published in the Federal Register. Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 2 (Feb. 26, 2010). The rule has not yet been published in the Federal Register.

[4] As will be described below, the new alternative uptick rule's enforcement mechanism is through "trading centers," which are defined as "a national securities exchange or national securities association that operates [a self-regulated organization] trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes order internally by trading as principal or crossing orders as agent." NMS Security Designation and Definition, 17 C.F.R. § 242.600(b)(78) (2010).

[5] As adopted in 1938, Rule 10a-1 stated: "No person shall, for his own account or for the account of any other person, by the use of any facility of any national securities exchange effect a short sale of any security at or below the price at which the last sale thereof, regular way, was effect on such exchange." Rules for the Regulation of Short-Selling, 3 Fed. Reg. 213 (Jan. 26, 1938). The price restrictions in Rule 10a-1 effectively stayed the same when the rule was amended in 1975. Adoption of Amendments to Short Selling Rules, 40 Fed. Reg. 25,442 (June 16, 1975).

restrictions became known as the "uptick rule" because a short sale generally had to be consummated at a price on the stock ticker a "tick" above the last sale price of the security. The price restrictions on short selling contained in Rule 10a-1 remained largely unchanged from 1938 until 2007.[6]

However, in 2007, the SEC removed Rule 10a-1 and adopted Rule 201 of Regulation SHO, which repealed the application of any price test to short sales, thus eliminating the uptick rule.[7] The SEC repealed the use of a price test in part because it determined it was no longer necessary in light of advances in securities trading practices and technology that increased market transparency.[8] Additionally, the SEC concluded that there were costs associated with the price test, including costs from participants having to wait for an uptick in a security's price and costs related to the reduction in the pricing efficiency of securities. The SEC felt these costs outweighed the potential benefit of a price test, which was largely the belief that short sellers could (and did on occasion) cause rapid declines in the price of a security and that a price test would prevent this behavior.[9]

The 2008 market declines and volatility caused by the credit crisis led the SEC to once again revisit its position on price restrictions for short sales. In April 2009, the SEC released for public comment proposed rules to re-impose price restrictions.[10] The SEC proposed four different alternative rules. The first two alternatives were based on a "price test" approach which would have applied on a market wide and permanent basis, much like the old uptick rule from Rule 10a-1. The other two alternatives were based on a "circuit breaker" approach which would impose either a total short selling halt or a more limited price test after a security suffered a severe decline in price.[11] After receiving comments on the proposed alternatives, in August 2009 the SEC released for public comment a new proposed rule that the SEC referred to as the "alternative uptick rule,"

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[6] Amendments to Regulation SHO, Exchange Act Release No. 56,212 (Aug. 7, 2007)..
[7] Amendments to Regulation SHO, Exchange Act Release No. 56,212; Price Test, 17 C.F.R. § 242.201 (2010).
[8] Regulation SHO and Rule 10a-1, Exchange Act Release No. 55,970 (June 28, 2007).
[9] Regulation SHO and Rule 10a-1, Exchange Act Release No. 55,970; Short Sales, Exchange Act Release No. 42,037 (Oct. 20, 1999).
[10] Amendments to Regulation SHO, 74 Fed. Reg. 18,042 (April 20, 2009). Although the SEC stated in its proposed rule release that it was proposing new rules to "restore restrictions with respect to short selling," restrictions on "naked" short selling and other ownership requirements with respect to shorted securities were still in effect at that time. *See* Regulation SHO, 17 C.F.R. §§ 242.200, 242.203. Rather, the SEC was examining whether to reinstitute restrictions on the price at which a short sale could be made.
[11] Amendments to Regulation SHO, 74 Fed. Reg. 18,042.

which combined features from both the "price test" approach and the "circuit breaker" approach.[12]

The SEC adopted the alternative uptick rule on February 24, 2010. This new rule has the following key price restriction features:

- Restrictions on short sales will only be triggered if a security suffers an intra-day price decline of at least 10% from the prior day's closing price.[13] If a security does not suffer such a price decline, the alternative uptick rule will not impose any new short selling restrictions.
- If a security's price declines at least 10% in one day, the "circuit breaker" is triggered and short selling in that security is restricted for the remainder of that day as well as the following day.[14]
- Once the selling restrictions are triggered by a security's price decline, shorting that security is still permitted, but only at a price above the national best bid price.[15]
- The securities covered by the alternative uptick rule will be any national market system ("NMS") stock other than options, as defined in 17 C.F.R. § 242.600(b)(47). 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."[16]

Unlike Rule 10a-1, which applied to any person, the alternative uptick rule only imposes legal obligations on "trading centers" which are defined as "a national securities exchange or national securities association that operates [a self-regulated organization] trading facility, an alternative trading system, an exchange market marker, an OTC market maker, or any other broker or dealer that executes order internally by trading as principal or crossing orders as agent."[17] The alternative uptick rule requires these trading centers to "establish, maintain and enforce written policies and procedures reasonably designed to … [p]revent the execution

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[12] Amendments to Regulation SHO, 74 Fed. Reg. 42,033 (Aug. 20, 2009).
[13] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 5-7. 329-330. It is not clear if the price decline will be measured by the stock's sale price or bid price. As explained below, one new feature of the alternative uptick rule is that it bases price restrictions on bid prices, not sale prices. However, it is not clear if that applies to the 10% price-decline trigger.
[14] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 5-7. 329-330.
[15] *Id.*
[16] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 46.
[17] NMS Security Designation and Definition, 17 C.F.R. § 242.600(b)(78) (2010).

or display of a short sale order of a covered security" that would violate the price restrictions discussed above.[18]

Besides the critical difference in the enforcement mechanism, there are two other notable differences between the price restrictions in the new alternative uptick rule compared with the old uptick rule. First, the alternative uptick rule price restrictions look to national best bid prices, rather than last sale prices as in the old uptick rule.[19] Second, under the new alternative uptick rule, once the price restrictions are triggered, short sales can only be effected at a price *above* the national best bid price, unlike the uptick rule which sometimes allowed short sales *equal to* the last sale price. The effect of this provision is that in a declining market long sellers will be able to sell their securities before short sellers.[20] The SEC believes that this provision will potentially increase market efficiency because short sellers will become "liquidity providers" rather than "liquidity takers."[21]

The alternative uptick rule also contains a number of exemptions, including exemptions for short sales made in connection with the delayed delivery of the security, in furtherance of domestic and/or international arbitrage, and in connection with riskless principal transactions, among others.[22] These exemptions generally mirror the exemptions that previously applied to Rule 10a-1.[23] However, these exemptions only apply if a broker-dealer specifically marks a short sale order "short exempt" under one of the rule's exemptions.[24] Broker-dealers must be mindful that the alternative uptick rule places affirmative duties on a broker-dealer who identifies a short sale order as "short exempt." The alternative uptick rule requires such a broker-dealer to "establish, maintain, and enforce written policies and procedures reasonably designed to prevent incorrect identification of orders" as short exempt.[25]

Only a few days old, the SEC's new alternative uptick rule has already been met with criticism for being both too permissive and too restrictive. Senators Ted Kaufman (D-Delaware) and Johnny Isakson (R-Georgia) both criticized the SEC's new rule for not going far enough in imposing

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[18] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595 at p. 329-330.
[19] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595 at p. 62.
[20] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595 at p. 9, Amendments to Regulation SHO, Exchange Act Release No. 59,748 (Apr. 20, 2009).
[21] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595 at p. 58.
[22] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 331-332.
[23] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 108.
[24] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 328.
[25] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 331.

price restrictions on short selling.[26] However, *The New York Times* reported that the alternative uptick rule only passed on a 3-2 vote with the two dissenting votes coming from the two Republican members of the SEC who believed there was no justification for any price restrictions on short sales.[27]

When considering the new alternative uptick rule, one should recognize that the SEC's justifications for adopting the new rule differ from the justifications behind the old uptick rule. The justifications for the old uptick rule were primarily to "(1) [a]llow relatively unrestricted short selling in an advancing market; (2) [p]revent short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; [and] (3) [p]revent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[28]" Thus, with respect to the old uptick rule, the SEC was primarily concerned with what are sometimes termed "bear raids" on declining stocks by short sellers. In contrast, when the SEC proposed new price restrictions on short sales in April 2009, the SEC noted that it believes currently-existing empirical evidence does not support the conclusion that short sellers were the cause of the rapid price declines and market volatility experienced by the major stock markets in 2008.[29]

Rather, the SEC's adoption of the alternative uptick rules appears to be aimed largely at restoring and maintaining investor confidence in the markets without unduly hindering short selling.[30] Indeed, the SEC explains in its summary of the alternative uptick rule that it "believe[s] that addressing short selling in connection with [10% declines] in individual securities will help address erosion of investor confidence in our markets generally."[31] Further, the SEC noted that "during the period covering April 9, 2001 to September 30, 2009, the price test restrictions of [the alternative uptick rule] would have been triggered, on an average day, for approximately 4% of covered securities."[32] These differing justifications

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[26] Kaufman, Isakson Say SEC Action a "Step Forward" But Fails to Solve Naked Short Selling Concerns, Feb. 24, 2010, available at http://kaufman.senate.gov/press/press_releases.
[27] S.E.C. Moves to Put Limits on Short-Selling, New York Times (Feb. 24, 2010).
[28] Adoption of Amendments to Short Selling Rules, 40 Fed. Reg. 25,444 (June 16, 1975).
[29] Amendments to Regulation SHO, Exchange Act Release No. 59748, p. 27.
[30] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, pps. 2, 9, 13, 33; Amendments to Regulation SHO, Exchange Act Release No. 59748, pps. 18, 19, 21, 22, 23, 26.
[31] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 2.
[32] Amendments to Regulation SHO, Securities Exchange Act Release No. 61,595, p. 11. The SEC also noted that during periods of low volatility the price restrictions in the alternative uptick rule would have only "been triggered for approximately 1.3% of covered securities." *Id.*

explain why the SEC did not simply reintroduce the old uptick rule, but rather adopted more limited price restrictions on short selling.

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