

Legal Update

SEC Approves New Short Selling Restrictions, Adopts Alternative Uptick – Circuit Breaker Rule

April 2010

On February 24, 2010, the Securities and Exchange Commission (the “SEC”) voted to approve curbs on short selling, a move aimed at promoting market stability and restoring investor confidence by placing restrictions on short selling when a stock is under significant downward pressure. (The vote was 3-2 and along party lines.)

Background

In 2007, the SEC repealed Rule 10a-1 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), commonly known as the “uptick rule,” which prohibited short sales of a security below that security’s last reported sales price. However, since then, market turmoil and the financial crisis caused the SEC to take emergency temporary action targeting short selling activity.

Now, under pressure from lawmakers and investors to combat abusive short selling and to reinstate permanent comprehensive short sale restrictions, the SEC adopted Rule 201 of Regulation SHO, combining certain features of the prior uptick rule with a “circuit breaker” approach.

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The New Rule – Key Features

Rule 201 applies to all equity securities listed on a national securities exchange, except options, regardless of whether they are traded on the exchange or over-the-counter. The new mechanism (the “Alternative Uptick Rule”) provides that a circuit breaker will be triggered for a security if the price of that security declines intra-day by 10% or more from the prior day’s closing price. Once the circuit breaker has been triggered, short sales would be prohibited in that security at any price equal to or below the national best bid (the highest reported bid) for the remainder of that day and the following trading day.

The Alternative Uptick Rule’s restrictions favor long sellers in a down market, allowing them to sell before short sale orders are permitted once the circuit breaker has been triggered unless such short sales are above the national best bid. The Rule 201 regime is based on bids instead of the last sale price, originating from the SEC’s view that bids are a more accurate reflection of current prices due to delays and the manner of reporting such sale prices.

The rule requires that trading centers (national exchanges, FINRA market makers and individual broker-dealers executing orders internally) establish and maintain policies and procedures reasonably likely to ensure that short sales in violation of the new amendments are not displayed or submitted to the national system. Upon determination that a security has triggered the circuit breaker, the listing market must immediately notify the single prime processor responsible for consolidating information about that security, which in turn will be responsible for dissemination of that information to the broader market.

In addition, the Rule 200(g) of Regulation SHO has been amended to require that broker-dealers mark all orders as “long,” “short,” or “short-exempt.” Broker-dealers will need to implement policies and procedures to ensure and document accurate order marking and exceptions.

There are several exceptions to Rule 201 under which a broker or dealer may mark a short sale order “short-exempt.” The exceptions include, among others:

- Any short sale order submitted by a broker-dealer that is above the national best bid at the time of submission
- Riskless principal transactions
- Short sales where the seller may be deemed to “own” a security, but may be technically considered a short seller due to the delayed delivery of the security

- Domestic and international arbitrage transactions
- Odd-lot transactions
- Syndicate transactions in connection with over-allotments of securities or lay-off sales
- Eligible volume weighted average price (VWAP) trades

There are several activities the SEC has not yet addressed, including market-making activities, non-U.S. transactions, basket transactions and trades made before and after market hours. The SEC noted that going forward it may reconsider the scope of the exceptions and exemptions to Rule 201 to improve its workability.

Likely Effect

The SEC attempted to estimate what percentage of securities could be affected. According to the SEC, had the Alternative Uptick Rule been in effect from April 2001 through September of 2009, Rule 201 would have been triggered, on an average day, for approximately 4% of covered securities. The SEC dismissed concerns about a possible “magnet effect,” the possibility that short sellers may drive down prices in a rush to execute short sales before a circuit breaker may be triggered.

Implementation

The Alternative Uptick Rule will become effective May 10, 2010. However, in recognition of the requirements related to the development of the new policies and procedures Rule 201 requires, the actual compliance date will be November 10, 2010, six months later.

The SEC acknowledged many comments regarding the use of derivative products to generate synthetic short sales, which could undermine some of the goals of Rule 201. The SEC noted that the former uptick rule, repealed in 2007, also did not apply to derivative securities, and that Rule 201 was formulated specifically with equity securities in mind. The SEC believes that applying a Rule 201-type restriction to derivative securities would substantially complicate the implementation process.

Short Selling Defended

In adopting the Alternative Uptick Rule, the SEC noted that short selling does provide benefits to the market, providing liquidity and price efficiency. The new rule is intended to be sufficiently narrow as to limit any potentially unnecessary impact on legitimate short selling.

Chairman Schapiro expressed the belief that the Alternative Uptick Rule would limit the potential for abusive short selling and enable long sellers to sell ahead of short sellers once the circuit breaker has been triggered. The SEC believes that during periods of great uncertainty, the preference for long sellers would be more likely to result in price declines related to the underlying fundamentals of issuers, rather than the influence of other outside factors. Commissioners Casey and Paredes were vocal in their opposition to the new rule, arguing that there is a lack of evidence implicating short selling in last year's market volatility, and expressed doubt that the new restrictions would increase investor confidence. In addition, they voiced concerns that Rule 201 may reduce liquidity and market efficiency, distort trading strategies, increase the costs of derivative transactions, and artificially support the prices of the securities impacted by the rule.

To address these concerns, the SEC will closely monitor the impact of the rule during the implementation period, and potentially adopt additional exemptions.

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