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Short Sales: A New Circuit Breaker

On February 24, 2010, the U.S. Securities and Exchange Commission (“SEC”) adopted a short sale circuit breaker that, when triggered, will impose a restriction on the prices at which securities can be sold short (the “Rule”).¹ The new restriction will be triggered if the price of the covered security decreases by 10% or more from its closing price on the previous day, as determined by the listing market for the covered security. Once the circuit breaker is triggered, it will prohibit the execution or display of a short sale in that security at a price that is less than or equal to the current national best bid. The restriction will remain in effect the remainder of that trading day and the next trading day.

The Rule will become effective on May 10, 2010. The securities industry must implement systems, policies and procedures in respect of the new Rule by November 10, 2010.

Background

Short selling is generally defined as selling securities that an investor does not own. A short seller settles its sale with the delivery of borrowed securities, and then attempts to repurchase those securities at a lower price at some future time.² Short selling can be used to speculate that the price of a security will fall, to hedge the risk of an economic long position in the same security, or to provide liquidity in response to unanticipated demand.

The SEC’s has recognized that short selling provides market liquidity and pricing efficiency. However, the SEC has taken steps to regulate short selling in an attempt to

discourage excessively speculative short selling.³ At the heart of recent SEC actions to date has been an attempt to curtail so-called “naked” short selling, which occurs when a person sells a security short without borrowing, and without an intention to borrow, the security for delivery on the settlement date.

¹ The Amendment is described in the SEC’s adopting release, “Amendments to Regulation SHO” (the “Adopting Release”) SEC Release 34 61595 (Feb. 26, 2010), 75 Fed. Reg. 11232 (March 10, 2010), currently available at: http://www.sec.gov/rules/final/2010/34_61595.pdf

² See “SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules” (March 2005), currently available at: http://www.shearman.com/cm_0305/

³ For example, on September 17 and 18, 2008, the SEC adopted three emergency orders to temporarily halt all short selling in certain securities. These orders were extended on October 14 and 15, 2008. The SEC also enacted an interim final temporary rule, Rule 204T, relating to “close out” of failed settlements. In July 2009, the SEC made permanent Rule 204T to Regulation SHO, adopting it as Rule 204 of Regulation SHO: see “Amendments to Regulation SHO” (July 27, 2009), SEC Release 34-60388, currently available at <http://sec.gov/rules/final/2009/34-60388.pdf>. SEC releases are available at the SEC’s Internet website, www.sec.gov. The SEC also enacted antifraud Rule 10b-21 relating to “naked” short selling. For more information regarding SEC actions, please see “Short Sale update: SEC extends emergency actions through temporary and final rulemaking; short selling ban expires” (November 2008), currently available at: http://www.shearman.com/am_110308/, and see also “Global Clampdown on Short Selling: an Overview (v6)” (February 2010), available at <http://www.shearman.com/global-clampdown-on-short-selling-an-overview-v6-02-12-2010/>.

Historically, the SEC has also been concerned about the possibility of speculative short selling that is not, strictly speaking, “naked” short selling. For example, the SEC has expressed concern about the “bear raid”, where short sellers create a market imbalance through the generation of an excess short interest resulting in dramatic price declines. In 1938, in part with respect to such concerns, the SEC adopted Rule 10a-1, which was commonly known as the “uptick rule”.

The uptick rule provided that, subject to certain exceptions, a listed security may only be sold short (i) at a price above the price at which the immediately preceding sale was effected (a “plus tick”); or (ii) at the last sale price if it is higher than the last different price (a “zero-plus tick”). On July 6, 2007, the SEC eliminated the “uptick rule”.⁴

On April 8, 2009, the SEC voted unanimously to seek public comment on two proposed approaches to restrictions on short selling, one on a permanent, market-wide basis and another that would apply to a particular security when there was a significant decline in the price of that security.⁵

Adopted Final Rule

In the Adopting Release adopting the Rule, the SEC stated that it is appropriate to adopt a targeted short sale price test restriction that will apply the alternative uptick rule, which permits short selling only at an increment above the national best bid, for the remainder of the day and the following day if the price of an individual security declines intra day by 10% or more from the prior day’s closing price. By not allowing short sellers to sell at or below the current national best bid while the circuit

breaker is in effect, the short sale price test restriction in Rule 201 is intended to allow long sellers, who will be able to sell at the bid, to sell first in a declining market for a particular security.

One stated purpose of the Rule is to help restore investor confidence during times of substantial uncertainty. Once a circuit breaker has been triggered for a particular security, long sellers will be able to sell first in the marketplace, and therefore a security’s continued price decline will following the triggering of a circuit breaker will, in theory, be more likely due to long selling reflecting views regarding the underlying fundamentals of the issuer, rather than to other factors.

The remainder of this publication describes the amendments to Regulation SHO in greater detail.

Description of the adopted amendments to Regulation SHO

When and how long do the price restrictions remain in force?

The Rule imposes a price test restriction on short selling in a particular covered security for the day in which the circuit breaker is triggered and for the following trading day, when there is a fall of at least 10% in a single trading session from the prior day’s closing price. The Rule allows short selling of a particular security to continue at a price higher than the national best bid⁶ in that security. Under the Rule, the prohibitions of the circuit breaker will be in

⁴ See “Regulation SHO and Rule 10a-1” (July 3, 2007), SEC Release 34-559970, currently available at: <http://www.sec.gov/rules/final/2007/34-55970.pdf>.

⁵ See “SEC Seeks Comments on Short Sale Price Test and Circuit Breaker Restrictions”, SEC Press Release 2009-76 (April 8, 2009), currently available at: <http://sec.gov/news/press/2009/2009-76.htm>. The Amendments are described in the SEC’s adopting release, “Amendments to Regulation SHO” (April 10, 2009), SEC Release 34-59748, currently available at: <http://www.sec.gov/rules/proposed/2009/34-59748.pdf>.

⁶ See Rule 600(b)(42) of Regulation NMS. The “national best bid” means, with respect to quotations for an NMS security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time).

place at any time the national best bid must be collected, consolidated and disseminated to market participants.⁷

Procedures-based compliance approach

The Rule requires “trading centers”⁸ to establish policies and to enforce and maintain corresponding procedures intended to prevent execution or display of short sale orders at a time when the circuit breaker has been triggered by the 10% trigger level. Specifically, the procedures must enable the trading center to 1) monitor the national best bid on a real-time basis, 2) identify whether the price at which a trade is being proposed is a permissible price for purposes of the Rule,⁹ and 3) permit short sales of securities marked “short exempt”¹⁰ when an applicable exemption is available in respect of a specific short sale.

Trading centers are required to establish quality control measures, which evaluate the effectiveness of their short-selling procedures and facilitate the prompt remedy of deficiencies.

Application of the Rule

The Rule applies only to NMS securities, which include all securities, except options, listed on a national securities exchange whether traded on an exchange or in the OTC market.¹¹ The Rule does not apply to derivative products such as “synthetic” short positions, though the Adopting

Release does state that the SEC will monitor and consider the application of the Rule to derivatives.¹²

No self-regulatory organization may have a rule that is not in conformity with, or conflicts with, Rule 201.¹³ This is intended to minimize opportunity for regulatory arbitrage.

Exemptions and Exceptions

Under the Rule, the following types of transactions generally will be exempt (such orders may be marked as “short exempt” by the effecting broker-dealers) or excepted:

- If the broker-dealer effecting the order identifies that the short sale being effected was, at the time of submission, at a permitted price;¹⁴
- If the broker-dealer reasonably believes that the seller owns the security being sold and that the seller intends to deliver the security as soon as all restrictions on delivery have been removed;¹⁵
- Odd-lot orders (i.e., orders by a market maker to offset a customer odd-lot or to liquidate an odd-lot position);¹⁶
- Domestic and international arbitrage;¹⁷
- Syndicate transactions, such as over-allotments and lay-off sales;¹⁸
- Riskless principal transactions by a broker-dealer, provided that the broker-dealer’s customer has a net long position;¹⁹ and

⁷ Note that this aspect of the Rule may cause complexities for after-hours trading, since the times at which different market plans disseminate trading information are different. See the Adopting Release at pages 88-89. See also Rule 603(b) of Regulation NMS. Under Rule 603(b), if the price of a NMS security decreases more than 10%, then the listing market will immediately notify the single plan processor responsible for consolidation of information for the covered security.

⁸ A “trading center” means 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. See Rule 600(b)(78) of Regulation NMS.

⁹ Note that in order to determine whether the price at which a trade is being proposed is a permissible or impermissible price, the broker-dealer or trading center will need systems that will permit it to take and retain a “snapshot” of the national best bid at relevant times. The SEC discusses these issues at page 116 and 117 of the Adopting Release.

¹⁰ To be short exempt, all requirements set forth under Rule 201(c) must be met.

¹¹ See Rule 600(b)(46) of Regulation NMS.

¹² See the Adopting Release, page 51.

¹³ See Rule 201(e).

¹⁴ See Rule 201(c); see also the Adopting Release at page 114.

¹⁵ See Rule 201(d)(1).

¹⁶ See Rule 201(d)(2); see also Adopting Release at page 123.

¹⁷ See Rule 201(d)(3) and (4). These exemptions are designed to permit the *bona fide* purpose of profiting from a difference between a contemporaneous sale and purchase of the same or equivalent securities.

¹⁸ See Rule 201(d)(4) and (5).

¹⁹ See Rule 201(d)(6).

- Sale orders executed on a volume weighted average price basis.²⁰

These exemptions parallel exceptions to former Rule 10a-1 and exemptive relief granted pursuant to former Rule 10a-1.

In addition to marking the transactions above as “short exempt”, the Rule requires the broker-dealers to establish and maintain procedures that prevent short selling that takes place with a view to prevent abusive implementation of an exemption.²¹

No exemption for market making

Notably, however, the SEC has determined at this time not to adopt a provision that a broker-dealer may mark as “short exempt” a sale in connection with market making activities.²²

Extraterritorial application of the Rule

With respect to extraterritorial application of the Rule, the Adopting Release states that “...Rule 201 applies to any short sale effected using the United States

jurisdictional means, regardless of the jurisdiction in which the short sale is executed.”²³

New Compliance requirements

The Rule imposes new and additional reporting, recordkeeping, or compliance costs on trading centers and other broker-dealers.

As described above, trading centers are required to establish and maintain reasonable policies and procedures in advance so that they are able to monitor the status of any given security relative to the price restrictions, and comply with the proposed circuit breaker rule whenever triggered.

At a minimum, a broker-dealer’s policies and procedures need to be reasonably designed to enable a broker-dealer to monitor, on a real-time basis, the national best bid. Since a broker-dealer is permitted to mark a short sale as “short exempt” if that short sale was submitted at a permissible price, the systems of market participants will need to be designed so as to permit precise determination of the price at which orders are received and submitted. Further, since the SEC (and FINRA) are likely to examine broker-dealers and other trading centers for compliance with the Rule, systems will need to be developed to create and monitor records demonstrating the national best bid at critical times during any short sale transaction.

As well, a broker-dealer is required to regularly surveil to ascertain the effectiveness of the policies and procedures required under Rule 201 and must take prompt action to remedy deficiencies in such policies and procedures.

Conclusion

The adoption of the Rule by the SEC will impact market participants around the globe. In the U.S., exchanges, broker-dealers, automated trading systems and others will need to expend significant energy and resources on

²⁰ See Rule 201(d)(7). The following criteria must be met in order for a broker-dealer to mark as “short exempt” certain short sale orders executed on a volume-weighted average price (“VWAP”) basis: (1) the VWAP for the covered security is calculated by: calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (2) the transactions are reported using a special VWAP trade modifier; (3) the VWAP matched security qualifies as an “actively-traded security” (as defined under Rules 101(c)(1) and 102(d)(1) of Regulation M), or where the subject listed security is not an “actively-traded security,” the proposed short sale transaction will be permitted only if it is conducted as part of a basket transaction of twenty or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (4) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; and (5) a broker or dealer will act as principal on the contra-side to fill customer short sale orders only if the broker-dealer’s position in the covered security, as committed by the broker-dealer during the pre-opening period of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the covered security’s relevant average daily trading volume, as defined in Regulation M.

²¹ See the Adopting Release at page 157.

²² See the Adopting Release at page 141.

the design and implementation of systems that are reasonably designed to achieve compliance with the Rule and its exceptions, and that permit market participants to demonstrate compliance after-the-fact. In addition, market strategies involving short selling will need to be keenly monitored for a potential “magnet effect” that could arise as an unintended consequence of a circuit breaker that imposes a short selling price test restriction. A “magnet effect”, as described in the Adopting Release, could result in short sellers driving down the price of an

equity security in a rush to execute short sales before the circuit breaker is triggered.²⁴

Also, because “synthetic” short positions are not covered by the Rule, there may be additional incentives to structure certain transactions using derivatives.

The implementation of price restrictions on market trading will not be without challenges and unintended consequences, and market participants need to be vigilant in order to avoid corresponding unintended violations.

²³ This position was held and developed by the SEC as a means of describing the scope of the application of the former Rule 10a-1. See the Adopting Release at pages 157-58.

²⁴ See the Adopting Release at page 73.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this issue, please contact:

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

M. Holland West
New York
+1.212.848.4579
hwest@shearman.com

Jesse P. Kanach
Washington, DC
+1.202.508.8026
jesse.kanach@shearman.com

Michael J. Blankenship
New York
+1.212.848.8531
michael.blankenship@shearman.com

Steven R. Blau
New York
+1.212.848.8534
steven.blau@shearman.com