SEC Adopts Short Sale Circuit Breaker and Uptick Rule

March 9, 2010

On February 26, 2010, a sharply divided Securities and Exchange Commission ("SEC") voted 3 to 2 to approve amendments to Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act") that impose new restrictions on short selling securities during periods of extreme decreases in price of a given security.[1] The need for limits on short selling in down markets has been debated for years, but in 2007 that debate appeared to be resolved when the SEC abolished all short sale price test restrictions.[2] However, a new chapter in the debate was opened in the wake of the financial crisis, and the SEC has since considered imposing new restrictions on short selling.[3]

Short Sale Price Test

Amended Rule 201 of Regulation SHO imposes a short sale related circuit breaker and an uptick rule that, when triggered, permits short selling only at a price above the current national best bid (the "Short Sale Price Test"). Specifically, Rule 201(b)(1) will require trading centers to establish, maintain and enforce written policies and procedures reasonably designed to:

- Prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day; and

- Impose the requirements of the paragraph above for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.

In the Adopting Release, the SEC made clear the need for trading centers to adopt and implement reasonable procedures, stating that if “a trading center’s policies and procedures permit any execution or display of a short sale order not in accordance with the requirements of the Rule, such trading center’s policies and procedures may not be reasonable and could subject the trading center to enforcement action.” At a minimum, a trading center’s policies and procedures must enable a trading center to:

- Determine when a covered security is subject to the Short Sale Price Test;

- Monitor, on a real-time basis, the national best bid, so as to determine the price at which the trading center may execute or display a short sale order;

- Execute a displayed short sale order at a price that is less than or equal to the current national best bid provided that, at the time the order was initially displayed by the trading center it was permissibly priced;

- Permit the execution or display of a short sale order of a covered security marked “short exempt” without regard to whether the order is at a price that is less than or equal to the current national best bid;

- Make a record of the national best bid at the time of execution or display of a short sale order (e.g., a “snapshot” of the market);

- Monitor and address latencies in obtaining data regarding the national best bid;

- Surveil to ascertain the effectiveness of the trading center’s policies and procedures and to take prompt action to remedy deficiencies in such policies and procedures; and

- Take reasonable steps to enforce the policies and procedures, including conducting regular post-trade analysis.

Key Defined Terms

Rule 201(a)(3) defines the term “listing market” to have the meaning ascribed to such term in the effective transaction reporting plan for the covered security. While the two reporting plans define the term “listing market” similarly, their treatment of dually listed securities differs. Specifically, the CTA Plan looks to where the security was first listed, while the Nasdaq UTP Plan looks to the market with the highest number of the average of the reported transactions and reported share volume for the preceding twelve ¬month period. The listing market is responsible for monitoring the trading in stocks listed on its marketplace and for notifying market participants when a circuit breaker has been imposed.

The Short Sale Price Test applies to “covered securities” which are “NMS Stocks” as defined under Rule 600(b)(47)[4] of Regulation NMS. Put simply, the Short Sale Price Test covers all securities, except options, that are listed on a national securities exchange whether traded on an exchange or in the OTC market, but does not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market. In addition, the SEC stated its position 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.”

Rule 201 applies to “trading centers,” which are defined in Rule 600(b)(78) of Regulation NMS[5] 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.” Consequently, any entity that executes a short sale order in a covered security must comply with the Short Sale Price Test.

Pricing Increment

The SEC declined to impose a price increment above the national best bid at which a short sale may be displayed or executed, provided that all requirements pertaining to minimum pricing increments are followed.

Exemptions to the Short Sale Price Test

The SEC adopted several exemptions to the Short Sale Price Test (many of which were previously available under Rule 10a-1 before short sale price restrictions were eliminated). When relying upon the following exemptions, a broker-dealer must mark the order ticket “short exempt.”

- **Broker-Dealer Provision.** Rule 201I permits a broker-dealer to mark certain qualifying sell orders as “short exempt” if the broker-dealer reasonably determines that it is submitting the short sale order to the trading center at a price that is above the current national best bid at the time of submission. In order to rely upon this exemption, a broker-dealer must establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the incorrect identification of orders as priced above the current national best bid at the time of submission. Such policies and procedures must address how a broker-dealer will monitor the national best bid on a real-time basis and may require that the broker-dealer record a “snapshot” of the national best bid at the time a short sale order is submitted in order to verify that the order was submitted in accordance with Rule 201. Broker-dealers are required to regularly surveil the effectiveness of their policies and procedures and to ensure that any deficiencies are corrected.

- **Sellers Delay in Delivery.** Orders may be marked “short exempt” when a broker-dealer has a reasonable basis to believe that a seller owns the securities, but is unable to deliver them prior to settlement because of circumstances outside of the seller’s control.

- **Odd Lot Transactions.** An odd lot short sale order may be marked “short exempt” by a market maker if it has a reasonable basis to believe that the order offsets a customer odd-lot order or liquidates an odd-lot position that changes such broker-dealer’s position by no more than a unit of trading.

- **Domestic and International Arbitrage.** Certain domestic or international arbitrage transactions may also be marked “short exempt.”

- **Over-Allotments and Lay-Off Sales.** Rule 201(d)(5) permits a broker-dealer to mark as “short exempt” short sale orders by underwriters or members of a syndicate in connection with over-allotments, or in connection with lay-offs by the same persons through a rights or standby underwriting commitment.

- **Riskless Principal Transactions.** Rule 201(d)(6) permits a broker-dealer to mark short sale orders “short exempt” when the broker-dealer facilitates customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal. Rule 201(a)(8) defines the term “riskless principal” to mean “a transaction in which a broker or dealer, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee, or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee.” In order to rely upon this exemption, the broker-dealer must have policies and procedures to ensure that at a minimum: (i) the offsetting transaction occurred after the customer order was received; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) it can produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders executed based on this exemption.

- **Transactions on a Volume-Weighted Average Price Basis.** Orders executed on a volume-weighted average price (“VWAP”) may be marked “short exempt” provided that they satisfy several conditions in Rule 201(d)(7).

Steps Firms Should Consider Taking to Comply with the Short Sale Price Test

The SEC provided for an extended implementation period of six months from the May 10, 2010 effective date. Accordingly, the compliance date for Rule 201 is November 10, 2010. In order to ensure compliance by that deadline, trading centers should consider taking the following steps:

- Determine default protocols for order handling. For example, the SEC stated that a firm may adopt procedures to automatically increase a customer's order above the national best bid so that it may be immediately executed. Before determining the default protocols, consider surveying a sample of existing customers (or critical customers) to determine how they want short sale orders handled.

- Review customer agreements to determine whether they will need to be amended to address any changes in customer order handling processes and determine whether any special notices should be provided to customers.

- Develop and implement procedures that are reasonably designed to comply with the Short Sale Price Test. Certain specific procedures that should be developed are discussed above.

- Test any automated procedures before implementing them to ensure that they function as designed.

- Within several months of implementing procedures to comply with the Short Sale Price Test, conduct a review to ensure that those procedures are being followed and that they continue to be reasonable.

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If you have any questions, please contact Chris Salter at (202) 383-5371 or Amena Piracha at (202) 383-5299.

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[1] *See Amendments to Regulation SHO*, Exchange Act Release No. 61595 (Feb. 26, 2010) [hereinafter the "Adopting Release"].
[2] *See Regulation SHO and Rule 10a-1*, Exchange Act Release No. 55970 (June 28, 2007).
[3] *See Amendments to Regulation SHO*, Exchange Act Release No. 59748 (Apr. 10, 2009); *Amendments to Regulation SHO*, Exchange Act Release No. 60509 (Aug. 17, 2009).
[4] 17 CFR §242.600(b)(47) (2009).
[5] 17 CFR §242.600(b)(78) (2009).