

April 28, 2009

## SEC Proposes Changes to Regulation SHO

In April 2009, the SEC proposed amendments to Regulation SHO under the Securities Exchange Act of 1934 (the "**Exchange Act**") that would place new limitations on short selling (the "**Proposal**"). The Proposal offers two alternative approaches to restricting short selling:

- The first approach would apply in all market conditions to all exchange-listed securities and would restrict short sales based on the price at which the sale could be made (a "**Short Sale Price Test**"). The SEC put forward two alternative types of Short Sale Price Tests. The first alternative would require trading centers to establish policies and procedures reasonably designed to prevent the execution or display of short sales of a covered security at a price below the national best bid price, unless an exemption applies. The second alternative would limit short sales based on the last sale price of the particular security, rather than the bid price.
- The second approach would only be triggered during a severe market decline in the price of a particular security and would restrict short sales of only that security (a "**Circuit Breaker Rule**"). The SEC proposed two alternative Circuit Breaker Rules, each of which would be triggered by a one-day ten percent decline in the price of a particular security. The first alternative, a circuit breaker halt rule, would prohibit any person from selling short that security, subject to certain exemptions, for the remainder of the day. The second alternative would invoke a price test for short sales of the relevant security for the remainder of the day.

The period for public comments will end on June 19, 2009.

### Background

Short selling involves a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Prior to July 2007, short selling was restricted by price tests: The SEC's former Rule 10a-1 under the Exchange Act, also known as the "uptick rule" or "tick test" ("**Former Rule 10a-1**"), applied to exchange-listed securities, and the National Association of Securities Dealers, Inc. (the "**NASD**") (now known as the Financial Industry Regulatory Authority, Inc. ("**FINRA**")) bid test (the "**NASD Bid Test**"), applied to certain Nasdaq securities.<sup>1</sup>

Former Rule 10a-1, which remained virtually unchanged for almost 70 years following its adoption in 1938, provided that, subject to certain exceptions, a listed security could be sold

<sup>1</sup> Former Rule 10a-1 did not apply to securities traded on Nasdaq because Nasdaq was not a national securities exchange. Nasdaq has since become a national securities exchange.

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short only at a price above the price at which the immediately preceding sale was effected (a “plus tick”), or at the last sale price if that price was higher than the most recent different price (a “zero plus tick”). Similarly, the NASD Bid Test, adopted in 1994, prohibited short sales in Nasdaq Global Market securities (then known as Nasdaq National Market securities) at or below the current bid price when the current best bid price was below the most recent best bid price in a security. The NASD Bid Test applied to Nasdaq Global Market securities traded on Nasdaq or the OTC market and reported to a Nasdaq facility.

Following a pilot program to evaluate Former Rule 10a-1 and the NASD Bid Test and a subsequent public comment period, the SEC, effective July 3, 2007, eliminated Former Rule 10a-1 and added Rule 201 of Regulation SHO, which prohibited any self regulatory organization (“**SRO**”) from maintaining a short sale price test.

Extreme market conditions, including turmoil in the financial sector and extreme volatility in security prices, led the SEC to take urgent actions to limit short selling in the summer and fall of 2008. In July 2008, the SEC issued an emergency order imposing borrowing and delivery requirements in connection with short sales of equity securities of certain financial institutions. In September, the SEC issued emergency orders prohibiting the short selling of equity securities of certain financial institutions and enhancing the delivery requirements for all equity securities. During last fall’s market turmoil, the SEC also promulgated rules requiring disclosure of short selling activity by certain investment managers. As a result of the extreme market conditions and the resulting deterioration in investor confidence, the SEC decided to propose new short selling restrictions.

### **Proposed Short Sale Price Test**

The Proposal puts forward two alternative Short Sale Price Tests. The first price test is based on the national best bid (the “**Proposed Modified Uptick Rule**”). The second price test, similar to Former Rule 10a-1, is based on the last sale price (the “**Proposed Uptick Rule**”).

#### **Scope**

Both Short Sale Price Tests apply in all market conditions and to all trading centers that execute or display a short sale order in a covered security. The proposed definition of “trading center” encompasses all entities that execute short sale orders, including exchanges, SRO trading facilities, alternative trading systems and broker-dealers executing orders internally. The proposed definition of “covered security” covers all securities for which trading is reported pursuant to a national plan, other than options, and thus effectively encompasses all securities listed on a national securities exchange, whether traded on an exchange or in the over-the-counter (“**OTC**”) market. The covered security definition does not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market.

Unlike Former Rule 10a-1, which the SEC interpreted to apply to after-hours trading, neither the Proposed Modified Uptick Rule nor the Proposed Uptick Rule would apply to the after-hours market.

#### **Proposed Modified Uptick Rule**

Under the Proposed Modified Uptick Rule, trading centers would be required to establish procedures reasonably designed to prevent the execution or display of short sales at a “down-bid price” unless an exemption applied. A “down-bid price” is a price that is less than the current best reported bid, or if the current best reported bid is less than the most recent previously reported bid, a price that is equal to or less than the current best reported bid. The Proposed Modified Uptick Rule, like the Proposed Uptick Rule, includes exceptions that are based on exceptions to, or exemptions granted under, Former Rule 10a-1. The exceptions relate to (i) a seller’s delay in delivery, (ii) odd lots, (iii) domestic and international arbitrage,

(iv) riskless principal transactions, (v) over-allotments and lay-off sales, (vi) transactions on a volume-weighted average price basis and (vii) riskless principal transactions.

### ***Proposed Uptick Rule***

Under the Proposed Uptick Rule, which is similar to Former Rule 10a-1, the last sale price would be the reference point for limiting short sales. The Proposed Uptick Rule would prohibit any person from effecting a short sale at or below the last sale price unless such price is above the most recent different price.

The Proposed Uptick Rule includes the exemptions to the Proposed Modified Uptick Rule as well as additional exemptions for (i) errors in marking short sales, (ii) sales in certain electronic trading systems that match and execute trades at various times and independently derived prices, (iii) sales subject to the SEC's firm quote requirements and (iv) certain transactions in conjunction with facilitating customer buy orders.

### ***Preference for Proposed Modified Uptick Rule***

Although the SEC is seeking public comment on both alternatives, it expressed a preference for a bid price test (as under the Proposed Modified Uptick Rule) over a last sale price test (as under the Proposed Uptick Rule) because it believes firm bids to be a more accurate reflection of a security's current price than the last sale price, specifically for the following reasons. First, delays can occur in the reporting of last sale price information. Second, last sale price information is published to the markets in the order in which reports of transactions are received rather than the order in which the transactions actually occurred.

### ***Proposed Circuit Breaker Rules***

The Commission also proposed two alternative Circuit Breaker Rules, each of which would limit short sales of a particular security following a one-day ten percent decline in the price of that security. The first alternative would be a halt rule, which would prohibit short selling in a particular security for the remainder of the trading day in which the decline occurs. Such a Circuit Breaker Rule could operate in place of, or in addition to, any of the Short Sale Price Tests. The second alternative Circuit Breaker Rule would trigger a Short Sale Price Test (i.e., either the Proposed Modified Uptick Rule or the Proposed Uptick Rule) with respect to a particular security for the remainder of the trading day following the specified price decline.

The proposed Circuit Breaker Rules would not be triggered if the ten percent price decline first occurs during the final thirty minutes of regular trading hours. Such a limitation, in the SEC's view, is necessary to avoid potential market disruptions resulting from the triggering of the circuit breaker rules late in the trading day.

As with the Short Sale Price Tests, the proposed Circuit Breakers Rules also include several exceptions that promote liquidity without undermining their effectiveness. The exceptions are substantially similar to those included in the SEC's emergency order temporarily banning short sales in 2008. The exceptions include: (i) bona fide market making activities in equities and derivatives, (ii) automatic exercises or assignments of equity derivatives or the expiration of futures contracts where the derivative or futures contract was held prior to the triggering of the circuit breaker and (iii) sales of owned securities (such as sales under Rule 144).

### ***Overseas Transactions***

The SEC had interpreted Former Rule 10a-1 to apply to trading in securities where the trade was "agreed to" in the United States even though the trade was booked overseas. The SEC has also interpreted the existing short sale rules in Regulation SHO to apply to any broker-dealer using the instrumentalities of U.S. commerce to effect short sales, regardless of whether

the broker-dealer is registered with the SEC or relying on an exemption from registration. In the Proposal, the SEC indicates that whichever of its alternative proposals it decides to follow, it will continue to treat the short sale rules as applying to all short sales agreed to in the United States between a customer and a broker-dealer, even if the order is sent to the broker-dealer's foreign trading desk for execution.

### Implementation

The SEC indicated that were it to adopt any of the above mentioned proposals, it would provide for a three-month implementation period from the effective date of such amendments.

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This Memorandum is a summary of the Proposed Amendment to Regulation SHO (Release No. 34-56748; File No. S7-08-09), available from the Securities and Exchange Commission website at <http://www.sec.gov/rules/proposed/2009/34-59748.pdf>.

This Memorandum is not intended to provide legal or accounting advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this Memorandum should be directed to any member of the Paul, Weiss Securities Group, including:

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