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May 18, 2009

Short Sale Restrictions

SEC Releases Short Sale Rule Proposals: Seeks Comments on Price Test and Circuit Breaker Proposals

SUMMARY

On April 17, the SEC issued a release proposing and seeking comment on two approaches to restricting short sales: a market-wide approach that would reinstate short sale restrictions in a manner similar to former Rule 10a-1 (a price test) and a security-specific approach that would be activated upon the occurrence of a triggering event (a circuit breaker rule). The market-wide approach would ban short sales below a particular price determined by reference to either the last sale price (an uptick rule) or the national best bid (a "modified uptick" rule). The security-specific approach would take effect if the price of a particular security fell by 10% on any trading day and would, for that security for the remainder of the trading day, either ban short selling (a circuit breaker halt rule) or impose an uptick rule (a circuit breaker uptick rule) or a modified uptick rule (circuit breaker modified uptick rule).

The proposal was voted on by the SEC on April 8, 2009, and a roundtable was held on May 5, 2009. Written comments are due on June 19, 2009. Because there are five different proposals, with additional permutations possible, the SEC is particularly interested in receiving comments that help it to select among approaches. The SEC urges commenters to present empirical evidence to support whichever approach they recommend and requests that comments weigh the benefits of reform against the possible adverse effects on legitimate short sales. The comments at the SEC's roundtable were widely divergent, with many persons opposing any restriction and a few expressing support for one proposal or another. Of persons expressing support for a restriction, the proposed circuit breaker modified uptick rule was the most favored approach.

BACKGROUND

Short-selling

A short sale is a sale of securities that the seller does not own.[1] In order to make delivery, the short seller borrows securities in the quantity sold, typically from a facilitating broker-dealer or institutional investor. To close the position, the short seller buys, in the open market, the same quantity of securities that were borrowed and delivers them to the lender. Short sales may be used to profit when an investor perceives that a security is overvalued; when the security declines in value, the investor repurchases it at a lower price. Short sales are also used to effect a hedge on the same or a related security.

Bear Raids

Concern about the negative effects of short selling on securities markets has a long history. Following the 1929 crash, periodicals and prominent individuals, including reportedly President Hoover, cited “bear raids” as reasons both for the crash and for the long recovery period.[2] A “bear raid” is the name given to a strategy that attempts to manipulate the market price of a particular security by, first, initiating short sales to generate an imbalance of sellers over willing buyers, thereby causing a decline in the market price; next, spreading rumors that the bear raider hopes will, in conjunction with the price decline, cause other investors to sell; and, finally, closing out the short position by purchasing at a depressed price, capitalizing on the low prices resulting from the rumors. Congress considered short selling at length in enacting the Exchange Act but was unable to decide how to regulate it; the Senate Banking and Currency Committee observed that “few subjects relating to exchange practices have been characterized by greater differences of opinion than that of short selling.”[3] Accordingly, Congress granted the SEC authority in Section 10(a) of the Exchange Act to regulate short selling to “purge the market of the abuses” connected with short selling practices.[4]

Rule 10a-1

The SEC did not regulate short selling immediately but, in 1935, asked the exchanges to regulate it. The exchanges responded by adopting general rules prohibiting all sales that had the effect of “demoralizing” the market, including a short sale below the previous sale price. Following a study of the market break of 1937, the SEC invoked its authority under Section 10(a) of the Exchange Act in 1938 and adopted Rule 10a-1, which provided that, with certain exceptions, a listed security could be sold short only (i) at a price

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1 As discussed below, a sale that is consummated by delivery of a borrowed security may also be a short sale, even if the seller is deemed to own the security being sold.

2 7 Louis Loss and Joel Seligman, Securities Regulation 3203–04, n. 213 (3d ed. 1989).

3 S. Rep. No. 1455 at 55. *See also* H.R. Rep. No. 1383, 734 Cong., 2d Sess. 11 (1934).

4 Id.

above the price at which the immediately preceding sale was effected (plus tick) or (ii) at the last sale price if it was higher than the last different price (zero-plus tick). In enacting the tick test, the SEC cited three objectives: (i) allowing relatively unrestricted short selling in an advancing market, (ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down, and (iii) preventing short selling from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[5]

SEC Reconsiders and Repeals Rule 10a-1

In 1999, the SEC issued a release questioning whether the utility of Rule 10a-1 had been diminished by developments in the markets. Pointing to increased transparency of the markets and technologies used by SROs to detect manipulation, and emphasizing the benefits of short selling on market efficiency, liquidity, correction of asset bubbles and upward price manipulation, the SEC proposed eight possible reforms: (1) suspending the short sale rule when the security or market is above a threshold price, (2) providing an exception for actively traded securities, (3) focusing short sale restrictions on certain market events and trading strategies, (4) excepting hedging transactions from short sale regulation, (5) revising the short sale rule in response to certain market developments, (6) revising the definition of "short sale," (7) extending the short sale rule to non-exchange listed securities and (8) eliminating Rule 10a-1.

In January 2005, the SEC announced a pilot program temporarily suspending the uptick test and any SRO price test restrictions on short sales of certain actively traded securities. The SEC performed its own analysis of the pilot program and solicited studies and comments. Among the 27 comment letters, two opposed removal of the uptick test and one suggested that short selling restrictions take effect only after a 10% decline in the price of the security. On July 3, 2007, the SEC removed Rule 10a-1 and added Rule 201 of Regulation SHO, which prohibits SROs from having any short sale price test.

Recent Market Conditions Lead SEC to Propose Reinstituting Short Selling Restrictions

In 2008, in response to severe declines in market prices, especially affecting financial institutions, the SEC imposed emergency prohibitions on short sales of equity securities of specified financial institutions. The SEC also adopted temporary Rule 10a-3T, requiring weekly reporting of short sales by hedge funds and other market participants, and temporary Rule 204T of Regulation SHO, imposing stricter delivery requirements on sales of all equity securities. Designed to prevent the abusive practice known as "naked short selling," or selling short without borrowing the securities needed to settle the trade, Rule 204T requires participants of a registered clearing agency to close out "fails to deliver" resulting from short

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5 *See Securities Exchange Act Release No. 11468* (40 FR 25443) at n. 8 and accompanying text (December 21, 1976) (*citing* 2 Securities and Exchange Commission, Special Study of Securities Markets. H.R. Doc. No. 96, 88th Cong., 1st Sess., at 251 (1963)).

sales by purchasing or borrowing the security by no later than the day after the fail to deliver occurs. According to the SEC, preliminary results from its Office of Economic Analysis ("OEA") indicate that fails to deliver declined significantly after adoption of Rule 204T.[6] Notwithstanding this emergency rule making, a number of media outlets, institutions and prominent individuals, including George Soros and Representative Barney Frank, have suggested that the SEC reconsider its position on short sale price test restrictions. Persons urging reconsideration have generally referred to the need to restore investor confidence. On April 8, 2009, the SEC voted to seek public comment on the proposals discussed in this memorandum. On April 17, 2009, the SEC issued its proposing release ("Release").[7]

In the Release, the SEC requested comments, with supporting empirical data, on the costs and benefits of reinstating short sale price test restrictions or imposing circuit breaker rules. The SEC requested that commenters address the harm to legitimate short selling which might follow from the proposed rules, the compliance costs of short sale price tests and distortions that a circuit breaker test might cause. The SEC has also asked commenters to address whether the SEC should adopt new regulations at all or should instead continue to rely on current short sale regulations and the anti-fraud and anti-manipulation provisions of the federal securities laws to address issues raised by potentially abusive short selling. The comment period on the proposals will close on June 19, 2009.

DEFINITION OF SHORT SALE

The SEC proposes to use, without change, the present definition of "short sale" in Rule 200 of Regulation SHO, which defines a "short sale" as any sale of a security that the seller does not own or that is consummated by the delivery of a borrowed security. For this purpose, a person is deemed to own securities if he or she (or an agent) has title to the security, has entered into a binding agreement to purchase the security or has exercised an option or conversion right to acquire the security. In addition, a person is deemed to own securities only to the extent that he or she has a net long position in the securities. Broker-dealers may be deemed to own a security without being net long if the security was acquired or the sale occurs in connection with block positioning or index arbitrage activities meeting specified requirements.

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6 74 FR 18048 at n. 81 and accompanying text. The OEA reported that the average daily number of aggregate fails to deliver for all securities decreased from 1.1 billion to 582 million for a total decline of 47.2% when comparing a period before Rule 204T to a period after.

7 Securities Exchange Act Release No. 59748 (74 FR 18042).

PERMANENT PRICE TEST RESTRICTIONS

In the Release, the SEC proposes two alternative permanent price test restrictions: an uptick rule, based on the last sale price, and a modified uptick rule, based on the national best bid. If adopted, the selected price test restriction (subject to certain exemptions) would apply to all covered securities on all trading days and is therefore referred to as a "permanent" price test restriction. The SEC believes that the modified uptick rule would be preferable to the uptick rule because it believes that bids generally are a more accurate reflection of current prices than last sale prices due to delays in the reporting of last sale price information and because last sale price information is published in whatever sequence it is reported by multiple trading centers rather than in the actual trading sequence.

Policies and Procedures Approach vs. Straight Prohibition Approach

The two proposed rules also differ in that the uptick rule based on last sale price would use a straight prohibition approach, prohibiting all persons from effecting short sales that do not comply with the price test, while the modified uptick rule would use a policies and procedures approach, imposing obligations on trading centers[8] to adopt policies and procedures to prevent impermissible short selling. The SEC seeks comment not only on which price test to use, but also which approach to follow, and the final rule could use either the straight prohibition approach, the policies and procedures approach or a combination of the two.

The policies and procedures approach is a form of principles-based regulation. By requiring 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 down-bid price," for example, the SEC gives trading centers the flexibility, within reasonable limits, to determine how to deal with special situations and interpretive questions without requiring SEC rulemaking on each point. Thus, a trading center could establish procedures to handle short sale market or limit orders that cannot be executed at the current national best bid under the modified uptick rule by allowing customers the option of having the order rejected or re-priced at the lowest permissible price until the order is filled.[9] When a rule using the policies and procedures approach is violated, the violation is technically not the display or execution of a short sale at an impermissible price, for example, but rather the failure to establish, maintain and enforce policies and procedures that would have prevented the display or execution. The

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8 "Trading center" is defined in Rule 600(b)(78) of Regulation NMS 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."

9 74 FR at 18051 at n. 112 and accompanying text.

person subjected to penalties is the responsible trading center rather than the person who placed the impermissible short sale order.

Rules using the straight prohibition approach are characteristic of traditional rules-based regulation. The person whose conduct is addressed by the rule is, in the first instance, the person who placed the short sale order at an impermissible price. However, the conduct of the relevant trading center can also be implicated if it either knowingly or recklessly aided the violative conduct, or failed to establish, maintain and enforce reasonable policies and procedures to prevent the entry of a prohibited short sale order. Thus, trading centers would have a policies and procedures burden even if the SEC adopts a straight prohibition. The SEC notes that, when compared to a policies and procedures approach, a straight prohibition may actually be more burdensome for trading centers in that it would not allow any short sale at an impermissible price, even if effected in error or inadvertently, unless an exception applied. The SEC suggests that an exception for inadvertent errors might reduce the differences in cost between the two approaches.[10]

Although there may be an appearance of unfairness in a rule that results in penalties only to the trading center and not to the person who places the short sale order,[11] the SEC may conclude that the policies and procedures approach, on balance, may be more effective than the straight prohibition approach, due to the inability of traders to determine the last sale price as compared with the ability of trading centers to program computer equipment to compare order prices to contemporaneous bid prices being displayed by them. The SEC indicates in the Release that it proposes to allow trading centers a period of three months to implement the necessary policies and procedures.

Covered Securities

The SEC proposes to apply the permanent uptick rule only to "covered securities," which would be defined as including all securities or classes of securities, other than options, for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan – or, in other words, all securities, except options, listed on a national securities exchange whether traded on an exchange or in the over-the-counter ("OTC") market.[12] Non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market would not be included. NMS stocks include common stocks as well as exchange traded funds ("ETFs"), preferred stocks and other equity securities, if listed on a national securities exchange.

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[10] 74 FR 18062. *See also*, 74 FR 18074, Question 27.

[11] The SEC also requests comment on whether it should use "an approach that imposed a policies and procedures requirement on some or all of the entities regulated by the commission *and* a prohibition on 'any person'" (74 FR 18072, Question 7).

[12] The definition is taken from Rule 600(b)(47) of Regulation NMS.

The SEC seeks comments on whether the rule should cover options or securities traded in the OTC market, and whether ETFs or other classes of securities should be excluded.[13] Additionally, the SEC seeks comment as to whether an uptick rule should be limited to specific industries or sectors, such as the financial services sector.

Modified Uptick Rule – National Best Bid

Under the modified uptick rule proposal, Rule 201 of Regulation SHO would be amended to 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 in a covered security at a down-bid price." A "down-bid price" would be defined as "a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid." The Release provides the following example to demonstrate the operation of the proposed modified uptick rule:

> If the current national best bid in a security is $47.00, and the immediately preceding national best bid was $46.99 (*i.e.*, the current bid is above the previous bid), a trading center could immediately execute a short sale order at $47.00 or above. Similarly, a trading center could display a short sale order priced at $47.00 or above. If the current national best bid in a security is $47.00, and the immediately preceding bid was $47.01 (*i.e.*, the current bid is below the previous bid), a trading center could execute or display a short sale order at a price above $47.00. If the current national best bid in a security is $47.00, and the immediately preceding national best bid was $47.00, but that bid was above the prior national best bid (*i.e.*, the last differently priced national best bid), a trading center could execute a short sale order at $47.00 or above. Similarly, a trading center could display a short sale order priced at $47.00 or above. If the current national best bid is $47.00, and the immediately preceding national best bid was $47.00, but that was below the prior national best bid (*i.e.*, the last differently priced national best bid), a trading center could execute or display a short sale at a price above $47.00.[14]

Short sale orders may be displayed and executed as described in the example subject to compliance with locking and crossing requirements of any SEC or SRO rule[15] and applicable minimum pricing increments.

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[13] 74 FR 18074, Question 23.

[14] Securities Exchange Act Release No. 59748 at n. 98 – n. 101 and accompanying text.

[15] For example, Nasdaq Rule 4613 defines a crossing quotation as the display of a bid for an NMS stock during regular trading hours at a price that is higher than the price of an offer for that stock previously disseminated, or the display of an offer for an NMS stock during regular trading hours at a price that is lower than the price of a bid for that stock previously disseminated. Similarly, a locking quotation is the display of a bid at the same price as an offer for the same stock previously disseminated or the display of an offer at the same price as a bid for the same stock previously disseminated. As required by SEC Rule 610 of Regulation NMS, Nasdaq Rule 4613 provides that its exchange members must reasonably avoid displaying quotations that lock or cross a protected quotation (*i.e.*, the current national best bid or offer that is displayed by an automated trading center and meets other requirements of Regulation NMS). A short sale order that satisfies the modified

The modified uptick rule would require a trading center to have policies and procedures reasonably designed to enable it to determine whether or not a short sale order can be executed or displayed in accordance with the rule, and to prevent the execution or display of a short sale order of a covered security at a down-bid price. However, the policies and procedures must also be reasonably designed to permit:

- the execution of a displayed short sale order if, at the time the short sale order was displayed, the order was not at a down-bid price; and
- the execution or display of a short sale order marked "short exempt" without regard to whether the order is at a down-bid price.[16]

The exception for short sale orders permissibly priced at the time displayed is intended to help avoid a conflict between the modified uptick rule and the so-called Quote Rule under Rule 602 of Regulation NMS. The Quote Rule provides that, with certain exceptions, a broker-dealer responsible for communicating a quotation is obligated to execute any order to buy or sell presented to it, other than an odd-lot order, at a price at least as favorable to the buyer or seller as that broker-dealer's published bid or published offer in any amount up to its published quotation size. Thus, this exception would permit a trading center to comply with the firm quote requirement of Rule 602 by executing an order to buy presented to it against the offer to sell that it displays as long as the displayed offer was permissibly priced at the time first displayed, even if the execution of the transaction would be at a down-bid price at the time of execution.

The policies and procedures approach would afford trading centers the flexibility to design reasonable policies and procedures permitting them to hold orders for later execution or re-price orders at a permissible price within the limits fixed by the customer. Trading centers could offer their customers various alternatives to deal with impermissibly priced orders, including rejection of the order or re-pricing at the lowest permissible price until the order is filled.

The modified uptick rule would require trading centers to regularly test the effectiveness of their policies and procedures and take prompt action to remedy deficiencies. The Release suggests that reasonable policies and procedures could use regular exception reports to determine whether the policies and procedures have been followed by its personnel and properly coded into the trading center's automated systems. Accordingly, under the policies and procedures approach not every non-compliant short sale would necessarily be a rule violation.

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uptick rule would not cross a national best bid (since it cannot be lower) but it could lock a national best bid if, to use the SEC's example, it is displayed at $47.00.

16 Orders that may be marked "short exempt" are discussed below in the section entitled "Short Exempt Transactions."

The Release also suggests that the policies and procedures of trading centers should provide for the creation of "snapshots" of the market: records identifying the current national best bid at the time of execution or display of each short sale order, as well as the last differently priced national best bid. The SEC believes that snapshots of the market at the time of execution or display of an order would aid trading centers in dealing with time lags ("latencies") in receiving data regarding the national best bid from different data sources. Trading centers would be expected to monitor latencies on a continuing basis to address problems that occur.

Uptick Rule – Last Sale Price

As an alternative to a short sale price test based on the national best bid, the SEC is proposing a modified version of former Rule 10a-1, using a test based on the last sale price. The Release states that the SEC is offering this alternative proposal primarily to provide opportunity to comment on the utility of such a price test in light of changes in market conditions. These changes include the volatility in market prices generally, declines in some stocks in particular, and erosion of investor confidence.

The uptick rule would be based on the straight prohibition approach, and would provide that "[n]o person shall, for his own account or for the account of any other person, effect a short sale of any covered security, if trades in such security are reported pursuant to an effective transaction reporting plan and information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information: (i) below the price at which the last sale thereof, regular way, was reported pursuant to an effective transaction reporting plan; or (ii) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was reported pursuant to an effective transaction reporting plan."[17] Thus, under the uptick rule, no short sale may be effected below the last sale price. A short sale order may be effected at the last sale price only if the last sale price is above the last different price. Otherwise, all short sale orders must be effected above the last sale price.

Since the uptick rule would be based on former Rule 10a-1, it will be familiar to many market participants. However, it would also apply to securities traded on Nasdaq, which were not subject to former Rule 10a-1. As with the modified uptick rule, this rule would apply only to "covered securities."

The Release notes that the SEC believes that the spread of more fully automated markets may make a test based on the last sale price less effective at regulating short selling than one based on the national best bid due to delays in reporting of last sale price information, and because last sale price information is published in reporting sequence from multiple trading centers and not in trading sequence. The lack of

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[17] Proposed Rule 201(b).

coordination between reporting and trading sequence may create up-ticks and down-ticks that do not accurately reflect contemporaneous price movements in the security.[18] This is particularly true now that shares are, for the most part, traded in penny increments rather than increments of one-eighth of a dollar, as was the case during most of the time when Rule 10a-1 was in effect.

Short Exempt Transactions

Both the modified uptick rule and the uptick rule would provide exceptions for certain categories of transactions, many of which are common to both rules. Each rule would amend Rule 200 of Regulation SHO to require that broker-dealers mark all sell orders for equity securities as "long," "short" or "short exempt." Sell orders could be marked "short exempt" only if the transaction were excluded from the price restrictions under the provisions of the applicable rule.

Exceptions Common to Both Proposals. The following exceptions, permitting an order to be marked "short exempt," are common to both price test proposals. These exceptions are based on former Rule 10a-1, either a specific provision in that rule or an interpretation of the rule.

- ***Seller Owned Securities.*** A short sale by a person who is deemed to own the security and has the right to sell it, provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed. This applies, for example, where the person owns securities that were restricted and are now saleable pursuant to Rule 144 and the restrictive legends on the certificates have not been removed, or where a convertible security, option or warrant has been tendered for conversion or exercise, but the underlying security is not expected to be received by the settlement date.
- ***Odd-Lot Orders.*** A short sale by a market maker to offset a customer odd-lot order[19] or to liquidate an odd-lot position that changes the broker-dealer's position by no more than one unit of trading.
- ***Domestic Arbitrage.*** A short sale by a person who then owns another security by virtue of which the person is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold, if the short sale is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned. This applies, for example, where a person sells securities short to profit from a current price differential based on a convertible security that entitles the person to acquire an equivalent number of securities as those sold short.
- ***International Arbitrage.*** A short sale submitted to profit from a current price difference between a security on a foreign securities market and a security traded in the United States, provided that the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it is made. A depositary receipt (*e.g.*, an American Depository Receipt or "ADR") would be deemed to be the same security as the security represented by the receipt.
- ***Overallotments.*** A short sale by an underwriter or member of a syndicate participating in the distribution of a security in connection with an over-allotment of securities.
- ***Lay-Off Sales.*** A lay-off sale by an underwriter or member of a syndicate in connection with a distribution of securities through a rights or standby underwriting commitment.

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[18] Securities Exchange Act Release No. 59748 at n. 130 and accompanying text.

[19] Odd-lot orders are orders in an amount less than a round lot (typically, 100 shares).

- ***Riskless Principal Transactions.*** A short sale by a broker-dealer effecting the execution of a customer purchase or long sale on a riskless principal basis, provided that the short sale is executed at the same price per share at which the broker-dealer purchased shares to satisfy the facilitated order, exclusive of any explicitly disclosed markup or markdown, commission equivalent or other fee. A broker-dealer using this exception would have to have in place certain policies and procedures to ensure that the transaction qualifies as a riskless principal trade and that records of the relevant orders can be produced.
- ***VWAP Sales.*** A short sale at a volume weighted average price (VWAP) that meets certain conditions, including (i) the manner in which the VWAP is calculated; (ii) the use of a special VWAP trade modifier to report the transaction; (iii) no short sales used to calculate the VWAP were marked "short exempt;" (iv) the VWAP matched security is an "actively traded security" (as defined under Rules 101(c)(1) and 102(d)(1) of Regulation M) or the short sale is being conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (v) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of the security; and (vi) a broker-dealer may 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.

Other Exceptions. Under the modified uptick rule (national best bid), a broker-dealer that submits a short sale order to a trading center for execution may mark the order "short exempt" if the broker-dealer dealer determines that the order is not on a down-bid at the time it submits the order to the trading center. This exception is intended to give broker-dealers the option to manage their order flow themselves, without having to rely on their trading centers to do so for them. In order for a broker-dealer to use this exception, it must establish, maintain and enforce written policies and procedures reasonably designed to prevent incorrect identification of orders for purposes of the exception, and must regularly surveil to ascertain the effectiveness of the policies and procedures and take prompt action to remedy deficiencies.

The uptick rule (last sale price) would also permit the following additional exceptions:

- ***Customer Orders.*** Any sale by a broker-dealer for an account in which it has no interest, pursuant to an order marked long. This protects the executing broker-dealer from order-marking errors made by the submitting broker-dealer.
- ***Electronic Trading Systems.*** Any sale in an electronic trading system that matches buying and selling interest at various times throughout the day if (i) matches occur at an externally derived price within the existing market and above the current national best bid; (ii) sellers and purchasers are not assured of receiving a matching order; (iii) sellers and purchasers do not know when a match will occur; (iv) persons relying on this exception are not represented in the primary market offer and do not otherwise influence the primary market bid or offer at the time of the transaction; (iv) transactions are not made for the purpose of creating actual, or apparent, active trading in, or depressing or otherwise manipulating the price of, any security; (vi) the covered security qualifies as an "actively traded security" or the proposed short sale transaction is being conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; and (vii) during the period in which the electronic trading system may match buying and selling interest, there can be no solicitation of customer orders or any communication with customers that the match has not yet occurred.

- ***Sales by Market Maker or Specialist.*** Any sale by a registered market maker or specialist publishing two-sided quotes to facilitate customer market or marketable limit buy orders. This exception is effectively limited to short sales at the national best offer.

Application of Uptick Rules in After-Hours Trading

Former Rule 10a-1, which used as a reference point the last sale price reported to the consolidated tape, prevented any person from effecting a short sale in a listed security at a price lower than (or in some cases equal to) the last sale reported to the consolidated tape. The SEC proposes that if the modified uptick rule is adopted, it should not apply to covered securities during periods when the national best bid is not collected, calculated and disseminated, and that if the uptick rule is adopted, it should not apply to covered securities when last sale price information is not collected, processed and disseminated.

Overseas Transactions

The SEC requests comment on the application of the proposed rules to overseas transactions, referencing its statement in the 2004 Release adopting Regulation SHO that "any broker-dealer using the United States jurisdictional means to effect short sales in securities traded in the United States would be subject to Regulation SHO, regardless of whether the broker-dealer is registered with the Commission or relying on an exemption from registration."[20] The SEC gives the example of a U.S. money manager who decides to sell shares of an NMS stock and negotiates a price with a U.S. broker-dealer, which sends the order ticket to its foreign trading desk for execution. In the view of the SEC, the transaction will have occurred in the U.S. just as if the trade had been executed by the broker-dealer in the U.S. Adoption of a policies and procedures approach, however, could have the effect of permitting U.S. persons other than trading centers to place short sale orders in NMS stocks with foreign brokers at prices below the applicable rule limits without penalty under the rule. U.S. persons would be free to place such orders from the U.S., provided that they did not place the orders through a trading center, because the modified uptick rule uses the policies and procedures approach that applies only to trading centers and not to persons submitting orders. In this example, however, if the foreign broker-dealer submitted the order to a trading center for execution, the trading center could not execute the order unless the order complied with the rule.

Price Restrictions as Impeding Legitimate Short Selling

The SEC states in the Release that short sellers perform legitimate market functions, including aiding price discovery and providing liquidity, a view that was expressed in more pointed arguments by participants in the roundtable discussion on May 5, 2009. Accordingly, the SEC suggests that, if a restriction is to be placed on short selling activity, it should be as narrow as possible, and therefore a circuit breaker rule may be preferable to a permanent, market-wide price restriction.

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[20] 69 FR at 48104, n. 54.

CIRCUIT BREAKER RULE

The Release also proposes a circuit breaker approach to regulating short sales. In contrast to the permanent price test restrictions discussed above, a circuit breaker approach would address regulation of short sales by selectively applying restrictions to a particular covered security only when a decline in the market price of the security has reached 10%, assessed from the previous day's closing price. The circuit breaker test could be used in conjunction with a halt rule or in conjunction with a price test rule (either the uptick rule or the modified uptick rule), and would apply to the particular security for the remainder of the trading day. A circuit breaker halt rule would prohibit all short selling of the security following a 10% decline (subject to certain exemptions), whereas a circuit breaker price test rule would trigger either the uptick rule or the modified uptick rule with regard to the security. The Release indicates that one alternative the SEC is considering is whether to adopt both a permanent, market wide, price test restriction together with a circuit breaker halt rule; if both were adopted, the price test rule would apply at all times to all covered securities but a complete ban on short selling would take effect only for a particular covered security for the remainder of the trading day following a 10% decline in the value of the security. The SEC cites the targeted nature of a circuit breaker rule as an advantage over a permanent price test rule and seeks comment on whether the circuit breaker approach might offer protection against attempts to use short selling to drive prices down while minimizing impediments on short selling as part of the regular operation of the market.

Current SRO Circuit Breaker Rules

All stock exchanges, FINRA and options markets already have rules or policies to implement coordinated circuit breaker trading halts. Under current SRO circuit breakers, a 10% decline in the Dow Jones Industrial Average ("DJIA") prior to 2 p.m. will result in a one hour halt in all trading in the relevant market, and a decline of the same magnitude after 2 p.m. but before 2:30 p.m. will prompt a 30 minute halt (a later decline will not halt trading). In addition, a 20% decline in the DJIA before 1 p.m. will result in a two hour halt and after 1 p.m. but before 2 p.m. in a one hour halt. A decline of 20% after 2 p.m. or a 30% decline at any time will suspend all trading for the remainder of the day. Although the Release makes reference to SRO circuit breaker rules, it does not put forward the SEC's expectations regarding the interplay between a short sale circuit breaker rule and the existing SRO circuit breakers.

Circuit Breaker Halt

Under the circuit breaker halt rule, Rule 201 of Regulation SHO would be amended to provide that "[i]f the price of a covered security, as reported in the consolidated system, decreases by ten percent or more from that covered security's last price reported during regular trading hours the prior day, as reported in the consolidated system, no person shall . . . effect a short sale of that covered security, wherever traded . . . for the remainder of the day." The circuit breaker halt rule as proposed would use a straight prohibition rather than a policies and procedures approach. The SEC proposes that the halt persist for the remainder of the trading day but seeks comment on the costs and benefits of a circuit breaker that would result in a temporary halt for a shorter period of time. The SEC is concerned that a period of time less than through the end of the day would not be sufficient to reestablish an orderly market, and requests comments as to whether an even longer period of time might be appropriate.

To avoid market disruption, the SEC is proposing that the halt would not be triggered if the market decline threshold were reached within thirty minutes before the end of regular trading, but it asks for comment regarding whether thirty minutes is the right period to reduce the potential for market disruption toward the close of regular hours.

Circuit Breaker Halt – Proposed Exceptions

- ***Market-Makers Excepted.*** The SEC proposes to except registered market makers, block positioners and other market markers obligated to quote in the over-the-counter market who sell short a publicly traded security, derivative or option or futures contract as part of bona fide market making in such security. The exception reflects the SEC's concern that short selling provides liquidity and market efficiency. The SEC has emphasized that these functions would be particularly important following a halt rule because of the greater disruption of a halt on liquidity and price discovery as compared with an uptick or modified uptick rule. The Release suggests that, should the SEC adopt a circuit breaker halt rule, previously issued guidance, provided in connection with the October 2008 short-selling restrictions, would likely reflect the Commission's position regarding bona fide market making.
- ***Option Exercise Exception.*** The SEC proposes an exception to allow for the creation of long call options. When such options are exercised, call writers may sell short in order to deliver the securities required under the contract. The SEC suggests that because short sales made pursuant to this exception would be executed in order to fill buying demand, the exception would benefit the market without opening the door to the behavior that the proposed rules are designed to counteract.
- ***Rule 144 Exception.*** The SEC proposes to except sales of Rule 144 securities from the proposed short sale halt restriction when the seller is unable to deliver the security to its broker-dealer prior to settlement because of circumstances outside the seller's control.

The short sale restrictions that the SEC imposed in 2008 included rules that prohibited a market marker from effecting a short sale of a derivative if the market maker knew that the order was executed to effect an economic net short position. The Release indicates that the SEC does not view this provision as necessary for the proposed circuit breaker halt rule because of the short duration of the restriction, which would last only through the end of the trading day.

Circuit Breaker Price Test

The proposed circuit breaker price test would impose short sale price test restrictions, either an uptick rule or a modified uptick rule (as discussed above), for a security that experienced a 10% decline in price from the previous day's reported closing price. The restriction would be imposed only for the remainder of the trading day on which the 10% decline occurred but would apply to the security wherever it is traded. In addition, as with the proposed circuit breaker halt, the rule would not be triggered by a 10% decline that occurred during the last 30 minutes before the close, to facilitate an orderly end to the trading day. The Release points to the narrowly tailored nature of a circuit breaker price test as a principal advantage relative to other proposals. The circuit breaker price test would also include the exceptions applicable to the price tests (uptick or modified uptick) discussed above. The SEC is considering pursuing a policies and procedures approach if the circuit breaker price test is based on a modified uptick rule but a straight prohibition if it is based on the uptick rule.

Circuit Breaker Tests – Magnet Effect

The Release expresses concern about the potential "magnet effect" that might arise as a result of a circuit breaker rule. The effect might occur if short sellers rush to execute short sales before the circuit breaker triggering condition is reached. Additionally, the SEC expresses concern that unexecuted short-sales may accumulate during the pendency of a short sale halt. The SEC is seeking comments on this potential issue. Several panelists at the May 5, 2009 roundtable expressed a view that magnet effects are unlikely to occur, and that the available data do not reflect a real risk of magnet effects.

Comparing Costs of Circuit Breaker Rule Proposals

The SEC has requested comments on the relative costs of implementing a circuit breaker halt as compared with implementing a circuit breaker price restriction. Many trading centers, when changing their systems to comply with Regulation NMS, eliminated processes previously used to comply with the Rule 10a-1 price restrictions.[21] The SEC believes that a circuit breaker halt could limit the ability of short sellers to act in cases when the stock price begins to rise during the same trading day following imposition of the halt. At the same time, information provided by trading centers in the comment process may indicate that the costs of implementing a circuit breaker price restriction are greater than the costs of a circuit breaker halt rule.

IMPLEMENTATION OF THE RULES

The SEC has proposed that the implementation date would be three months from the effective date of the rule, at least in the case of the modified uptick rule, which would require adoption of appropriate policies and procedures. The SEC asks for comment on whether a shorter or longer implementation period would be manageable or preferable.

[21] 74 FR 18042 at 18062, n. 208 and accompanying text.

SEC REQUEST FOR COMMENTS

The SEC has requested comment on a variety of issues and has posed specific questions to guide responses. Some key areas on which the SEC has emphasized a need for comment include:

- ***Effectiveness.*** The SEC has requested comments as to whether the proposed rules would address potentially abusive short selling. The SEC asks whether there is a need for short sale restrictions.
- ***Investor Confidence.*** The SEC has requested comments discussing the extent to which short sale restrictions are necessary in light of changes in market conditions and with regard to investor confidence.
- ***Price Increments.*** The SEC asks whether the proposed uptick rules should be measured in penny increments, whether a larger increment would be appropriate, and at what size an increment would effectively function as a short sale ban.
- ***Empirical Data.*** The SEC seeks empirical data regarding the effect of its proposed rules on market liquidity and pricing efficiency, and any empirical data concerning investor confidence.
- ***Comparison with Harm to Legitimate Short Selling.*** The Release indicates that past requests for reconsideration of the short sale rule have not weighed the benefits of new regulation against the harm to the benefits from legitimate short selling. The SEC requests that commenters frame their analysis by weighing cited benefits of regulation versus the impact of regulation on market liquidity and pricing efficiency.
- ***Regulatory Burden.*** The SEC has requested comments about the readiness of institutions to comply with the various types of proposed new regulations – for instance, their ability to monitor national best bid and the last differently priced national best bid on a real time basis – and about differences in the cost of implementing the various proposals in light of current systems.

The deadline for comments is June 19, 2009.

ROUNDTABLE DISCUSSION

On May 5, 2009 the SEC held a roundtable discussion on short sale restrictions.[22] There were three panel discussions, featuring panelists representing academic institutions, financial institutions, broker-dealers and SROs. A majority of roundtable panelists opposed any new regulation of short selling, but multiple and varying viewpoints were presented. Many of the panelists who opposed regulation argued that the SEC should not adopt rules to bolster investor confidence unless those rules have been shown to be effective, especially if they are likely to increase costs to investors. Those who supported regulation generally expressed a preference for a circuit breaker price test. The questions posed by the Commissioners reflected concerns about rule-making where the most frequently cited benefit – investor confidence – is difficult to measure while the costs of regulation are highly visible.

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22 The roundtable discussion agenda is available at http://www.sec.gov/news/press/2009/2009-88-prelim-agenda.htm; and the roundtable webcast is archived at http://www.connectlive.com/events/secroundtable050509/ .

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