

SEC ADOPTS SHORT SALE PRICE TEST

On Wednesday, February 24, 2010, the Securities and Exchange Commission voted, 3-2, to adopt Rule 201 (the “Rule”), a short sale price test, as part of Regulation SHO under the Securities Exchange Act of 1934 (the “Exchange Act”). The Rule, referred to as the “alternative uptick rule,” was one of the six price test options on which the SEC had previously sought comment.¹ Reintroduction of this type of regulation represents a philosophical shift by the SEC, which since the adoption of Regulation SHO in 2004 has focused its attention on so-called “naked short selling”² and the associated problem of failures to deliver securities on a timely basis to settle trades.

The Rule will apply to “Covered Securities,” which are NMS stocks that trigger a so-called “circuit breaker.” The circuit breaker is triggered if an NMS stock’s price drops by at least ten percent from the previous day’s closing price on the principal market on which that stock is listed. The Rule will apply to all exchange-listed equity securities, whether the short sales are effected on an exchange or in the OTC market. It will apply only to the particular Covered Security whose price drop triggered the circuit breaker.

Once a Covered Security triggers a circuit breaker, no further short sales in that security may be effected at a price that is at or below the National Best Bid (the “NBB”) for that security for the remainder of the trading day on which the circuit breaker is triggered and for the next full trading day. When the restrictions on short selling become effective, long sellers gain priority, and short sellers may be only “liquidity providers,” not “liquidity takers.” That is, short sellers will be required to provide price improvement over the best available price. While the SEC has not yet published its release announcing the Rule’s adoption, it appears that the Rule does not prevent market participants from “getting long” by purchasing Covered Securities, hedging part or all of their economic long exposure through derivatives, and then effecting “long” sales of Covered Securities without regard to the Rule’s price test.

¹ Amendments to Regulation SHO, Securities Exchange Act Release No. 59748, 74 FR 18042 (Apr. 20, 2009) (the “April Proposal”). More information on the April Proposal is available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2948/SEC_Requests_Comment_On_New_Short_Selling_Price_Test.pdf and at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3083/Comment%20Period%20For%20Proposed%20Amendments.pdf.

The “alternative uptick rule” was not one of the original alternatives set out in the April Proposal. The SEC proposed the alternative uptick rule in an August, 2009 release re-opening the comment period on the April Proposal. See Amendments to Regulation SHO, Securities Exchange Act Release No. 60509 (Aug. 17, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60509.pdf>.

² “Naked short sales” are effected without any determination that the securities will be available for delivery on the settlement date of the trade.

The Rule requires trading centers³ to establish and enforce reasonable policies and procedures designed to prevent the execution or display of a short sale order for a Covered Security, absent an exception, at a price at or below the NBB. This means that the Rule is not a flat prohibition on short sales that contravene the price test. Rather, trading centers would be required to have reasonable policies and procedures to prevent such short sales.⁴ The policies and procedures could vary, and short sales that did not comply with the price test could occur.

The Rule includes specified exceptions similar to those that were contained in former Rule 10a-1, which imposed an “uptick test” on short selling. The exceptions would permit short sales in a Covered Security that had triggered a circuit breaker at a price at or below the NBB. Such exceptions would include: (1) a trading center receiving short sales that were above the NBB at the time submitted by a broker-dealer to the trading center; (2) sales of securities that a person owns, but for which there is a delay in delivery; (3) odd lot transactions; (4) riskless principal transactions; (5) transactions on a volume-weighted average pricing basis; and (6) short sales in connection with over-allotments. There is no exception for market makers.

The SEC also voted to adopt amendments to Rule 200(g) of Regulation SHO to require short sales subject to an exception to the Rule to be marked as “short exempt.”

The Rule will become effective 60 days after the date of publication of the release in the Federal Register, and then market participants will have six months to comply with the requirements.

The SEC has not yet published the release adopting the Rule. Once it is available, we will publish a more detailed description of the Rule and related issues.

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³ “Trading center” is defined in Rule 600(b)(78) of SEC Regulation NMS as “a national securities exchange or national securities association that operates a self-regulatory organization trading facility, an alternative trading system, an exchange market maker, an over-the-counter market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.”

⁴ The SEC is adopting the approach that it took in Rule 611 of Regulation NMS, which requires trading centers to adopt reasonable policies and procedures designed to prevent “trade-throughs” in NMS stocks.

February 24, 2010

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