

SEC ADOPTS SHORT SALE PRICE TEST

Reversing in part its July 2007 elimination of short sale price test restrictions, the Securities and Exchange Commission (the “SEC”) has adopted Rule 201 (the “Rule”) as part of Regulation SHO under the Securities Exchange Act of 1934 (the “Exchange Act”). The Rule restricts the prices at which securities may be sold short when the price of a security decreases by 10% or more from the prior day’s closing price.¹

The Rule does not directly prohibit such short selling by market participants in these circumstances. Rather, trading centers² must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a security subject to the Rule (“Covered Security”) at a price that is less than or equal to the current national best bid (“NBB”)³ if the price of that security decreases by 10% or more from its closing price as determined by the listing market for the security as of the end of regular trading hours on the prior day.⁴ Once a Covered Security triggers this 10% price decline circuit breaker, no further short sales in that Covered Security may be effected at a price that is at or below the NBB for that Covered Security for the remainder of the trading day on which the circuit breaker is triggered and for the next full trading day. The applicable period for the Rule will reset each time the price of the Covered Security drops 10% or more below the closing price on the previous day. If, for example, the price of a Covered Security drops 10% on Monday, the Rule

¹ Securities Exchange Act Release No. 61595 (Feb. 26, 2010). Before July 2007, short sale price test restrictions included Rule 10a-1 under the Exchange Act, also known as the “uptick rule” or “tick test” (“former Rule 10a-1”), which applied to exchange-listed securities, and the National Association of Securities Dealers, Inc.’s bid test, Rule 3350, which applied to certain Nasdaq securities.

² Rule 201(a)(9) states that the term “trading center” shall have the same meaning as in Rule 600(b)(78) of Regulation NMS, which defines a “trading center” 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.” The SEC states that that definition encompasses all entities that may execute short sale orders.

³ The term National Best Bid is defined in Rule 600(b)(42) of Regulation NMS.

⁴ 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. *See* Amendments to Regulation SHO, Securities Exchange Act Release No. 59748, 74 FR 18042 (Apr. 20, 2009) (the “Proposal”). More information on the 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_Period_For_Proposed_Amendments.pdf. The “alternative uptick rule” was not one of the original alternatives set out in the Proposal. The SEC proposed the alternative uptick rule in an August 2009 release re-opening the comment period on the 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>.

would apply to that security for the remainder of the trading day on Monday and the entire trading day on Tuesday. If the price of the Covered Security were to drop an additional 10% or more on Tuesday, the effective period of the Rule would extend through the trading day on Wednesday. The SEC determined not to specify a particular increment above the NBB at which a Covered Security may be sold short, and merely requires that all short selling must be at a price above the current NBB, unless an exception applies. The restrictions will apply only to the particular Covered Security whose price drop triggered the circuit breaker.

The Rule will be effective May 10, 2010, and then market participants will have until November 10, 2010 to comply with the requirements.

Covered Securities

The Rule will apply to any equity security or class of equity securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.⁵ As a result, the Rule will generally cover all securities, except options, listed on a national securities exchange and will apply to all trades in such securities whether on an exchange or in the over-the-counter market. It will not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market, although the SEC indicated it may reconsider that in the future.

The Rule, however, will not apply to derivatives even though the Commission recognized that the ability to obtain an economic equivalent of a short position through the use of derivative products such as options, futures, contracts for differences, warrants, credit default swaps or other swaps or other instruments (such as inverse leveraged exchange traded funds) may undermine the goals for adopting the Rule and that such synthetic short positions may increase as a result of its adoption.⁶

The SEC emphasized that short sales in the equity markets to hedge derivatives transactions are subject to the Rule and indicated it may reconsider, at a later time, whether additional regulation of derivative securities and the use of “synthetic” short positions may be appropriate.

⁵ The Rule applies to NMS stock. Rule 600(b)(47) of Regulation NMS defines an “NMS stock” as “any NMS security other than an option.” Rule 600(b)(46) of Regulation NMS defines an “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” Notably, this would include exchange-traded funds.

⁶ The SEC stated that the Rule is formulated with the specific structure of the equity markets in mind and not for the substantially different market structure applicable to many derivative securities, and that applying a similar rule to derivative securities would significantly complicate the implementation process.

Determining the Circuit Breaker

The Rule provides that the listing market for each Covered Security must determine whether its price has declined by 10% or more from the closing price, as determined by the listing market as of the end of regular trading hours on the prior day⁷ and is therefore subject to the short sale price test restrictions of the Rule. The Rule defines the term “listing market” to have the same meaning as that term has in the effective transaction reporting plan for the Covered Security.⁸

Once the listing market has determined that a security has become subject to the requirements of the Rule, the listing market is required to immediately notify the single plan processor responsible for consolidation of information for the Covered Security in accordance with Rule 603(b) of Regulation NMS of the fact that a Covered Security has become subject to the short sale price test restriction of the Rule. The plan processor must then disseminate this information.

Policies and Procedures Approach

Rather than directly prohibiting short sales in violation of the Rule, the SEC instead chose to require trading centers to implement policies and procedures designed to prevent short sales in violation of the Rule. The SEC stated that this approach is consistent with the approach taken in Regulation NMS and, therefore, familiar to market participants. According to the SEC, a policies and procedures approach provides “flexibility to trading centers and their customers in managing order flow because it allows trading centers, together with their customers, to determine how to handle orders that are not immediately executable or displayable by the trading center because the order is impermissibly priced.” This suggests, for example, that a broker-dealer could accept an order for a short sale that, at the time the order is entered, is at or below the NBB, but that could be executed automatically upon a decrease in the NBB to a price below the price of the short sale order.

⁷ The Proposal would have used the Covered Security’s last price reported in the consolidated system during regular trading hours on the prior day to measure the price decline. The SEC indicated it believed that listing markets generally have in place specific procedures designed to ensure the accuracy and reliability of their closing prices and that the last price reported in the consolidated system is more likely to reflect a trade that is not consistent with the current market due to, for example, the 90-second reporting window, or an uncorrected error.

⁸ Currently, there are two effective transaction reporting plans, the CTA Plan, which disseminates transaction information for securities primarily listed on an exchange other than Nasdaq, and the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for securities primarily listed on Nasdaq. Under both plans, the listing market for a Covered Security listed on a single exchange would be that exchange. For a dually listed Covered Security, the CTA Plan provides that the listing market is the exchange on which the security was originally listed. Under the Nasdaq UTP Plan, the listing market for a dually listed Covered Security is the exchange on which the security is listed that also has the highest number of the average of the reported transactions and reported share volume for the preceding 12-month period, as determined at the beginning of each calendar quarter. Although there are differences between how the two plans determine the listing market for dually listed securities, the SEC takes the position that this difference will not impact the operation of the Rule because market participants are already familiar with the process of determining the applicable listing market for a Covered Security.

While the policies and procedures approach affords trading centers flexibility in complying with the Rule, it also adds a level of uncertainty that would arguably not be present had the SEC adopted a direct prohibition under the Rule. If the SEC or self-regulatory organizations were to determine, in hindsight, that a trading center's policies and procedures are not sufficient to prevent execution of displays of short sales in violation of the Rule, the trading center could be subject to enforcement action. Moreover, conduct by a trading center or other market participant that facilitates short sales in violation of the Rule could expose the trading center or market participant to liability for causing, aiding or abetting a violation of Regulation SHO or violations of SEC anti-fraud or anti-manipulation rules.

Exceptions

The Rule provides the following exceptions, which would permit short sales in a Covered Security that had triggered a circuit breaker at a price at or below the NBB in certain circumstances. Rule 200(g) of Regulation SHO was also amended to require short sales subject to an exception to the Rule to be marked as "short exempt."

Short Sales Above NBB at Time of Submission

A trading center may execute short sales for Covered Securities that were above the NBB at the time submitted by a broker-dealer to the trading center.⁹ The Rule will also permit a broker-dealer submitting a short sale order for a Covered Security to a trading center to mark the order "short exempt" if the broker-dealer identifies the order as being at a price above the current NBB at the time of submission.¹⁰

Sales of Securities that a Person Owns, but for Which There Is a Delay in Delivery

A broker-dealer may mark a short sale order "short exempt" if the broker-dealer has a reasonable basis to believe the short sale order of a Covered Security is by a person that is "deemed to own" the Covered Security pursuant to Rule 200 of Regulation SHO, *provided that* the person intends to deliver the security as soon as all restrictions on delivery have been removed. This would allow for sales of securities that, although owned, are subject to the short sale rules solely because the seller is unable to deliver the Covered Security to its broker-dealer prior to settlement due to circumstances outside the seller's control.¹¹

⁹ Rule 201(b)(3)(iii).

¹⁰ Rule 201(c). The Rule requires the broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to prevent incorrect identification of orders for purposes of the exception and regularly "surveil" to check the effectiveness of the policies and procedures and correct any deficiencies promptly.

¹¹ Rule 201(d)(1). The SEC explains that Rule 200(g)(1) of Regulation SHO provides that a sale can be marked "long" only if the seller is deemed to own the security being sold and either (i) the security is in the broker-dealer's physical possession or control; or (ii) it is reasonably expected that the security will be in the broker-dealer's possession or control by settlement of the transaction. Therefore, a sale must be marked "short" even where a seller owns a security if delivery will be delayed (e.g., formerly restricted securities pursuant to Rule 144 under the Securities Act of 1933).

Odd-Lot Transactions

A broker-dealer may mark a short sale order as “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker-dealer’s position by no more than a 100-share lot.¹²

Bona Fide Domestic Arbitrage Transactions

The SEC states the exception is “designed to permit the execution or display of such orders in connection with bona fide domestic arbitrage transactions involving convertible, exchangeable, and other rights to acquire the securities sold short, where such rights of acquisition were originally attached to, or represented by, another security, or were issued to all the holders of any such class of securities of the issuer.”¹³

International Arbitrage

An exception applies if, at the time of the short sale, there is a corresponding offer in a foreign securities market, so that the immediate covering purchase will have the effect of counteracting the market effect of the short sale.¹⁴

Short Sales in Connection With Over-Allotments

Short sale orders by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any short sale orders for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment, may be marked as “short exempt” because such activity is covered by Regulation M under the Exchange Act.¹⁵

¹² Rule 201(d)(2). The SEC believes that odd-lot transactions by market makers to facilitate customer orders are not of a size that could facilitate a downward movement in the particular security.

¹³ Rule 201(d)(3). The SEC provides a broker-dealer may mark a short sale order of a Covered Security “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is “for a good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities of the issuer.”

¹⁴ Rule 201(d)(4). For the purposes of this exception, a depository receipt of a security will be deemed to be the same security as the security represented by the receipt. The SEC believes this exception is necessary to facilitate arbitrage transactions in which a position is taken in a security in the U.S. market which is to be immediately covered in a foreign market.

¹⁵ Rule 201(d).

Riskless Principal Transactions

A broker-dealer may mark as “short exempt” short sale orders if it is facilitating 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 a riskless principal. The term “riskless principal” is defined as “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.”¹⁶

In addition, if it marks an order “short exempt” under this provision, the broker-dealer must have written policies and procedures in place to assure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) it has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker-dealer relies pursuant to the exception.

Volume-Weighted Average Pricing (“VWAP”) Sales

A broker-dealer may rely on the VWAP exemption¹⁷ and mark a short sale order of a Covered Security “short exempt” if the broker-dealer has a reasonable basis to believe that the short sale order is for the sale of a Covered Security that meets the following conditions: (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) either (i) 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 (ii) the short sale transaction is 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; (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-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. In contrast to the

¹⁶ Rule 201(d)(6), and Rule 201(a)(8).

¹⁷ Rule 201(d)(7).

Proposal, the SEC has not required that short sale orders marked “short exempt” be excluded from the VWAP calculation.¹⁸

No Exception for Market Makers

The SEC determined not to include an exception for equity or options market makers citing concerns that the inclusion of an exception for equity or options market makers could (i) create an opportunity for potential misuse, (ii) undermine the goals of the Rule if it resulted in a large volume of excepted short selling, and (iii) result in significant additional surveillance and compliance costs.

Exemptive Authority

The Rule as adopted includes provisions establishing procedures for the SEC, upon written request or its own motion, to grant an exemption from the Rule’s provisions, either unconditionally or on specified terms and conditions.¹⁹

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¹⁸ The SEC notes that Rule 201(d)(7) differs from former Rule 10a-1 in that it is not limited to VWAP transactions that are arranged or “matched” before the market opens at 9:30 a.m., or that are not assigned a price until after the close of trading when the VWAP value is calculated.

¹⁹ Rule 201(f).