WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

# SEC REQUESTS COMMENT ON NEW SHORT SELLING PRICE TESTS

At a meeting on April 8, 2009, the Securities and Exchange Commission ("SEC") decided to publish proposals to reinstitute "price test" regulation for short sales of equity securities.[1] Price tests permit short sales to occur only when the sale price equals or exceeds a reference price. Reintroduction of this type of regulation would represent 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. At the SEC meeting, SEC representatives stated that rules adopted in 2008 had substantially reduced failures to deliver[3] and that they accordingly believed that naked short selling also had declined significantly.

However, the recent precipitous decline in the stock markets has generated calls by investors and legislators for regulation to restore investor confidence by curtailing short selling.[4] In response, the SEC voted to request comment on a variety of rules that would reverse its 2007 decision to end 70 years of price-related regulation of short selling in United States securities markets. At that time, the SEC rescinded the "uptick" test of former Rule 10a-1 under the Securities Exchange Act of 1934 and adopted Rule 201 of Regulation SHO, which prohibits self-regulatory organizations (such as securities exchanges) from applying any price test to short sales in any security.[5]

The SEC is expected to issue a very detailed release containing about 200 questions requesting comment on a variety of approaches to price tests for short sales. The comment period will run for <u>60 days</u> after publication of the release, and the SEC plans to convene a roundtable discussion of the issues, tentatively set for <u>May 5, 2009</u>.

The basic proposals are: two versions of price tests that would operate continuously, a "bid test" based on the current national best bid ("NBB") for a security and a "last sale test" based on the last reported transaction price for a security; and three versions of "circuit breakers" that would impose short selling restrictions following a significant decline in the market price of a security.

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1 SEC Press Release 2009-76 (Apr. 8, 2009).

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

3 In particular, Rule 204T of Regulation SHO.

4 For example, on March 11, 2009, 27 members of the Committee on Financial Services of the U.S. House of Representatives sent a letter to SEC Chairman Schapiro urging the SEC to consider the reintroduction of a price test for short sales.

5 SEC Release No. 34-55970 (Jun. 28, 2007).

**Bid test.** The proposed bid test is similar to one version of a price test that the SEC proposed in 2003.[6] Essentially, it would prevent short sales at or below the NBB for a security if that bid was a "downbid," *i.e.*, a price below the level of the immediately preceding NBB. That means that a short sale could occur at the NBB (but not below it) only if the NBB was higher than the immediately preceding different NBB price.

A bid test for short sales would not be completely novel. Before they were rescinded in 2007, NASD Rule 5100 and Nasdaq Rule 3350 prohibited short sales in certain Nasdaq securities at a bid price that was lower than the immediately preceding bid price. Once the bid ticked up in a security, however, those rules permitted short sales in the security at any price. Significantly, those rules did not apply to market makers engaged in bona fide market making activity, whereas the SEC is not proposing to include an exception for market makers in its proposal.[7]

**Last sale test.** The price test based on the last sale price would be essentially the same as the uptick test in former Rule 10a-1. This test would require that, subject to certain exceptions, a short sale be priced higher than the price of the most recent transaction ("last sale") in the security (an "uptick"), or at least equal to the last sale price if that price was higher than the immediately preceding different last sale price (a so-called "zero plus tick").

**Circuit breakers.** If the market price of a security declined by a specified amount, tentatively proposed to be ten percent, a restriction on short selling would be instituted for the remainder of the trading day. During that period, short selling would be: (1) banned; or (2) subject to the bid test; or (3) subject to the last sale test.

**Important features of the proposals.** The SEC proposals would require "trading centers"[8] to establish and enforce reasonable policies and procedures designed to prevent the execution or display of a short sale order of a National Market System ("NMS") stock, absent an exception, at a price that contravened a specified price test. This means:

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6 SEC Release No. 34-48709 (Oct. 28, 2003).

7 When it proposed a uniform bid test in 2003, the SEC was of the view that an exception for market makers was not appropriate. SEC Release 34-48709 (Oct. 28, 2003). A group of exchanges recently submitted a letter to the SEC proposing a price test with two features: a short sale could be initiated only above the highest prevailing bid by posting a quote above that bid; and this price test would be triggered only after the price of a stock had experienced a precipitous decline by a certain percentage, perhaps ten percent. Letter to Mary Schapiro, Chairman, SEC (March 24, 2009) ("Exchanges Letter"). The exchanges suggested that such a rule would have to include exceptions, for example, for "bona fide market making" (which would have to be defined), and that the rule would present a number of operational issues.

8 "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."

1. The rules would not be a flat prohibition on short sales that contravened the price test. Rather, trading centers would be required to have reasonable policies and procedures to prevent such short sales.[9] The policies and procedures could vary, and short sales could occur that did not comply with the price test.

2. The proposals are limited to NMS stocks. They would not apply to OTC Bulletin Board or Pink Sheet securities.

3. The price tests would not apply to short sales that occur when current quotes and trades are not disseminated by national market system plans.

4. The SEC release will discuss a variety of proposed exceptions that apparently will include sales of restricted stock, riskless principal trades, arbitrage, syndicate short sales, odd lots, and other transactions. Any broker-dealer executing such a trade would have to mark the order as "short exempt."

**International aspect.** Chairman Schapiro directed the SEC staff to consult with regulators in foreign jurisdictions that have short sale price tests, because that may provide useful information to the SEC in its consideration of additional short selling regulation.[10]

## Observations

When the SEC adopted the uptick test, it sought to achieve three objectives: (1) allowing relatively unrestricted short selling in an advancing market; (2) preventing short selling at successively lower prices, thereby eliminating short selling as a tool for driving the market down; and (3) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[11] Beginning in at least 1976, the SEC questioned the efficacy of the uptick test in achieving these goals, and conducted an unprecedented empirical study of the uptick test from May 2005 to August 2006 ("Pilot"). Following extensive commentary on the Pilot's results, the SEC concluded that removal of price test restrictions would not have a significant impact on market quality, that there was no evidence of manipulative short selling during the time period studied, and that, in the absence of a price test, the general anti-fraud and anti-manipulation

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9 The SEC is adapting 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.

10 The Technical Committee of the International Organization of Securities Commissions has published a consultation paper urging market authorities to follow certain principles in developing short selling regimes. Among other concerns, the report notes that new types of cross-border market manipulation require financial regulators to strengthen their cooperation with foreign counterparts. "Regulation of Short Selling," Consultation Report of the Technical Committee of the International Organization of Securities Commissions (Mar. 2009).

11 Such pressured price declines are often referred to as "bear raids."

provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security.[12]

Short sale regulation before 2007 was a patchwork quilt. Exchange-listed and -traded securities were subject to the SEC's uptick test, and the rule applied to all persons engaging in short sales in those securities. Short sales in certain Nasdaq securities were governed by NASD Rule 5100 and Nasdaq Rule 3350. A number of the exchanges had their own price tests for specific classes of securities trading on their markets, but the over-the-counter market (*i.e.*, the OTC Bulletin Board and the Pink Sheets) had no short sale price controls. The self-regulatory organization ("SRO") rules applied only to SRO members. The SEC's goal now is to have a uniform price test if any is required.

Some view price tests as largely psychological measures that provide a sense that a stock's price cannot be driven down by unrestricted short selling, but that have no substantial impact in today's market structure. Other critics claim that the SEC acted too hastily following its Pilot, that the markets were relatively buoyant during that period, and that the SEC had not adequately assessed the effectiveness of price tests on short sales of small capitalization securities. As discussed at the SEC meeting, economists are nearly uniformly of the view that price tests result in unnecessary costs in trading, and impede price discovery.[13]

The comment process on the SEC proposals will show that the devil is in the details, because many commenters will argue for exceptions to a uniform short selling restriction to accommodate trading that they consider to be beneficial.[14] Changes in market structure and regulation in recent years also will present challenges to the SEC in crafting price tests.[15] The development of Regulation NMS suggests that any monolithic price-based rule will require numerous interpretations and exceptions to accommodate conflicting policies and operational limitations.[16]

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12 SEC Release 34-54891 (Dec. 7, 2006).

13 *See*, *e.g.*, SEC Release 34-54891 (Dec. 7, 2006). Additionally, the SEC's Office of Economic Analysis issued an analysis of trading in September 2008 and concluded: "Our results are inconsistent with the notion that, on a regular basis, episodes of extreme negative returns are the result of short selling activity," and that the results of the study "support the intuition . . . that, in aggregate, short sellers act as contrarians." "Analysis of Short Selling Activity during the First Weeks of September 2008," Memorandum to Chairman Christopher Cox from Daniel Aromi and Cecilia Caglio (Dec. 16, 2008).

14 *See* Exchanges Letter, *supra* n.7; SEC Release 34-48709 (Oct. 28, 2003) (discussing exceptions from the uptick test in Rule 10a-1, and exemptions from the rule granted by the SEC).

15 *See*, *e.g.*, Division of Market Regulation, "Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS" (Apr. 4, 2008 Update), Questions 7.04 and 7.05 ("Rules 611 and 610 FAQs"); Division of Market Regulation, "Responses to Frequently Asked Questions Concerning Rule 612 (Minimum Pricing Increment) of Regulation NMS," Question 15.

16 *See*, *e.g.*, SEC Release 34-51808 (Jun. 9, 2005) (adopting Regulation NMS), and Rules 611 and 610 FAQs, which discuss, *inter alia*, exceptions to the so-called "trade-through" rule.

It was apparent at the SEC meeting that the Commissioners are skeptical about the need for short sale price regulation and are willing to consider it only if they are persuaded that doing so would enhance investor confidence in the securities markets. They repeatedly stated that a decision on whether to adopt any price test must be based on empirical data, especially data that shows whether short selling activity exacerbated the recent market decline, or simply correlated with that phenomenon. Moreover, they are also concerned that additional regulation might entail unintended consequences that would be detrimental to investor confidence. Because of this uncertainty, the document that will be published will be in the nature of a concept release on the need for a short sale price test. Given the number of price test permutations discussed in the release (one Commissioner suggested that she counted 14), it seems unlikely that the SEC would adopt a price test without first publishing a concrete proposal for additional focused comment.

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