SEC Adopts Amendments to Regulation SHO

As we advised in our alert of February 25, 2010, “SEC Adopts New Short Sale Rule,” the Securities and Exchange Commission (“SEC”) has adopted a short sale circuit breaker rule, under which a security trading on a national securities exchange (a “covered security”) whose price has declined by 10% or more from the prior day’s closing price may only be sold short for the remainder of that day and the following trading day at an increment above the current national best bid. In a split 3-2 vote, the SEC adopted new Rule 201 and amended Rule 200(g) to better address harmful shortselling practices. The final rule release has been published in the Federal Register,¹ and the new rule becomes effective May 10, 2010, with a compliance date of November 10, 2010.

Summary of Rule 201

Rule 201(b)(1) requires that trading centers² 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 that has declined 10% or more from the prior day’s closing price at a price that is less than or equal to the current national best bid for the remainder of that trading day and the following trading day when a national best bid is calculated and disseminated on a continuing basis by a plan processor pursuant to an effective national market system plan. The prior day’s closing price is determined as of the end of the prior day’s regular trading hours on the security’s listing market.

The rule contains a number of exceptions similar to those that applied under Rule 10a-1, which was eliminated in July 2005. In addition, in an amendment to Rule 200(g), a broker-dealer will be permitted to mark certain orders “short exempt” if they qualify pursuant to an exception contained in the rule, including the “broker-dealer exception,” under which a broker-dealer can rely on its own determination that the short sale order is being submitted to a trading center at a price that is above the current national best bid at the time of submission.³

² “Trading center” is defined under Rule 201(a)(9) as having the same meaning as in Rule 600(b)(78) of Regulation NMS (“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”).
³ Rule 201(c).
Background

After a long public process, the SEC reimposed a form of “alternative uptick rule” that is intended to balance its interest in restoring investor confidence after the significant recent market turmoil with its recognition of the benefits of short selling in providing liquidity and price efficiency and in correcting upward stock price manipulation. It appears that the adoption of the new rule is an attempt to impose the least restrictive option among those the SEC had proposed. 4

The alternative uptick rule will apply only upon the triggering of a “circuit breaker” caused by a rapid decline in individual stocks and will impose short sale price restrictions rather than an outright ban for a limited time period. These restrictions are primarily intended to target potential “bear raids” and other forms of manipulation that are used to exacerbate price declines in covered securities. Requiring covered securities to be sold short only at an increment above the current best bid is consistent with the SEC’s former policy under Rule 10a-1 of allowing long sellers to sell first in a declining market. By permitting short sellers to continue to sell above the current bid, rather than adopt an outright prohibition on short selling after the imposition of a circuit breaker, short sellers will continue to perform a valuable function in declining markets as “liquidity providers,” rather than “liquidity takers.” It is the SEC’s view that giving long sellers preference to “sell at the bid” in a declining market promotes capital formation, “since investors should be more willing to hold long positions if they know they may have a preferred position over short sellers if they wish to sell” and more likely to sell based on fundamentals rather than a desire for a quick gain.

Covered Securities

“Covered security” is defined under Rule 201 by reference to “any NMS stock” other than options under Regulation NMS. 5 Rule 201 generally will apply to all securities, other than options, listed on a national securities exchange, whether traded on an exchange or in the OTC market. It will not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere, such as the pinksheets. Despite the SEC’s recognition that synthetic short positions can be created in the OTC derivatives and other markets, Rule 201 will not apply to those markets due to the differences in market structure and the difficulty in implementation of a rule applying to those instruments. Short sales to hedge derivatives transactions are, however, subject to the rule.

5 Rule 600(b)(47) of Regulation NMS defines “NMS stock” as “any NMS security other than an option.” “NMS security” is defined under Rule 600(b)(46) of Regulation NMS 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.”
Pricing Increment and National Best Bid

The new rule does not impose a minimum pricing increment above the national best bid at which a short sale may be executed, but such increment must be in compliance with applicable rules, including Regulation NMS.

The national best bid, rather than the last sale price as under former Rule 10a-1, was chosen as the basis for the execution of short sales during a circuit breaker period. The SEC noted that changes in trading markets, including the increasing use of automated matching trading systems that offer price improvement based on national best bid and offer, and the difficulty of tracking sequences of bids and actual last sale prices under current trade reporting systems make the national best bid a more reliable indicator of the real time market. Ease of implementation was a significant factor in using the national best bid as the measuring standard for execution of short sale orders. In order to ensure that uniform information is available, the price test restrictions of the rule only will apply when the national best bid is calculated and disseminated on a current and continuing basis by a plan processor. The listing market for each covered security will be responsible for determining that a covered security has become subject to Rule 201, and the single plan processor responsible for consolidation of information for the covered security under Regulation NMS must disseminate the information that the security has become subject to the short sale price restrictions of Rule 201.

Policies and Procedures Approach

The SEC determined to adopt a policies and procedures approach with new Rule 201, rather than the straight prohibition approach of former Rule 10a-1, to allow trading centers to tailor their policies to their particular markets and to permit broker-dealers to manage their order flows. Such policies and procedures must require that a trading center be able to determine when a covered security becomes subject to the short sale price restrictions under Rule 201, and whether a short sale order can be executed or displayed in accordance with the provisions of Rule 201(b)(1). If immediately marketable, the order can be presented for immediate execution or, if not, repriced upwards or held for execution later at its specified price. Further, Rule 201(b)(1)(iii)(A) permits a trading center to execute a displayed short sale order at a price that is less than or equal to the current national best bid provided that, at the time the order was initially displayed, it was permissibly priced. Under this exception, the rule will not conflict with the “Quote Rule” of Rule 602 under Regulation NMS. By providing for a flexible policies and procedures approach, the SEC intends to allow trading centers to maintain a more efficient market.

Finally, under the policies and procedures approach, a trading center will be required to have a surveillance system to monitor the continuing effectiveness of such policies and procedures. These may include maintaining records, such as market “snapshots,” identifying the national best bid at the time of
execution or display of a short sale order, which will aid in verifying compliance with the rule during times of rapid and repeated changes in the national best bid ("bid flickering"). Since the SEC did not mandate the receipt of the national best bid from a single data source, such a "snapshot" approach will assist in dealing with time lags on the receipt of national best bid information. A trading center’s policies and procedures do not, however, need to include mechanisms to determine the exceptions under Rule 201(c) or (d) that a broker-dealer is relying on in marking an order "short exempt" under Rule 200(g).

“Short Exempt”

Rule 200(g), the Regulation SHO marking provision, has been amended to reinsert “short exempt” as a category broker-dealers may include on an order, in addition to “long” and “short.” A broker-dealer may mark an order “short exempt” if any of the provisions of Rule 201(c) or (d) apply. Under Rule 201(b)(1)(iii)(B), a trading center’s policies and procedures must be reasonably designed to permit the execution or display of a short sale order of a covered security marked “short exempt” regardless of whether the order is at a price that is less than or equal to the current national best bid. An order may be marked “short exempt” under either the “broker-dealer exception” of Rule 201(c) or the enumerated exceptions under Rule 201(d).

The exceptions under Rule 201(d) are similar to those under former Rule 10a-1. In general, the SEC has determined not to include all such prior exceptions because of the limited circumstances and the short time periods during which the short sale price restrictions under Rule 201 are expected to apply. In other words, the SEC wanted to have fewer and narrower exceptions to the short sale price restrictions because they likely will apply only in times of extreme declines in a few securities and during the trading day on which the circuit breaker occurs and the following trading day, whereas Rule 10a-1 applied to all securities at all times.

Broker-Dealer Provision

Rule 201(c) provides that a broker-dealer submitting a short sale order after the circuit breaker is triggered may mark the order “short exempt” if the broker-dealer identifies the order as being at a price above the national best bid at the time of submission. This provision will assist broker-dealers in managing their own order flow, rather than relying on their trading centers to do so. Such a process will require a broker-dealer to have written policies and procedures reasonably designed to enable it to identify, on a real-time basis, the national best bid, in order to determine that an order was permissibly priced at the time of submission to a trading center. The procedures will need to include surveillance to monitor the effectiveness of its policies and procedures and the maintenance of records, such as “snapshots,” used in identifying the national best bid at the time of the submission of the order.

6 Plan processors include the CQ Plan, the CTA plan for exchanges other than Nasdaq, and the Nasdaq UTP Plan for securities listed on Nasdaq.
General Exceptions

The following exceptions also allow a broker-dealer to mark an order “short exempt” in the case of a short sale order where:

- The broker-dealer has a reasonable basis to believe the seller owns the covered security pursuant to Rule 200, but is subject to restrictions on delivery, provided that the seller intends to deliver the security as soon as all restrictions on delivery have been removed. This exception is intended to apply to sales subject to Rule 144 restrictions or where convertible securities, options or warrants have been tendered for conversion or exchange, but the underlying security is not expected to be received prior to settlement date of the short sale.

- The broker-dealer has a reasonable basis to believe the sale is by a market maker to offset customer odd-lot orders or to liquidate an odd-lot position that changes such broker’s or dealer’s position by no more than a unit of trading.

- The sale is connected to a bona-fide domestic arbitrage transaction.

- The sale is connected to an international arbitrage transaction.

- The short sale is (i) by an underwriter or member of a syndicate or group participating in the distribution of a security in connection with an over-allotment of securities; or (ii) is for purposes of a lay-off sale by an underwriter or member of a syndicate or group in connection with a distribution of securities through a rights or standby underwriting commitment.

- The short sale is by a broker or dealer effecting the execution of a customer purchase or the execution of a customer “long” sale on a riskless principal basis. For purposes of this exception, a broker or 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) the broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which a broker or dealer relies pursuant to this exception.

- The short sale order is for the sale of a covered security at the volume weighted average price (VWAP) that meets the following criteria:
  
  (i) the VWAP for the covered security is calculated by:
(A) 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;

(B) compiling an aggregate sum of all values; and

(C) dividing the aggregate sum by the total number of reported shares for that day in the security;

(ii) the transactions are reported using a special VWAP trade modifier;

(iii) the VWAP matched security:

(A) qualifies as an “actively-traded security” under Regulation M; or

(B) the proposed short sale transaction is being conducted as part of a basket transaction of twenty or more securities in which the subject security does not comprise more than 5% of the value of the basket traded;

(iv) 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

(v) where a broker or dealer acts as principal on the contra-side to fill customer short sale orders only if the broker’s or dealer’s position in the covered security, as committed by the broker or 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.

Market Making

It should be noted that absent from the final rule is an exception for market making activities, as was provided in the proposal. Although the SEC proposed allowing a broker-dealer to mark an order “short exempt” where the sale was made in connection with bona-fide market making activity, the SEC opted not to include such an exception in the final rule, as such a broad market exception was seen as inconsistent with the limited nature of the new rule.

Implementation Period

The SEC determined that a six-month implementation is sufficient, despite its recognition that market centers, including broker-dealers, will need to develop detailed policies and procedures and implement systems changes to ensure compliance with Rule 201. In making this determination, the SEC relied on
the fact that, unlike the proposal to reinstate an uptick rule based on last sale price, Rule 201 will not require monitoring of the sequence of last bids or sales, therefore simplifying the process. Further, the policies and procedures requirements are seen as similar to those currently required of market centers under Regulation NMS, and these market centers should also be able to leverage the systems changes that have already been implemented under Regulation NMS.

We expect that, despite the SEC’s assumptions, broker-dealers and other market centers will need to dedicate significant compliance and systems resources to develop the policies and procedures and systems enhancements necessary to comply with the rule, and that such efforts should begin as soon as possible to meet the compliance effective date.

* * * *

If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or any of the attorneys listed below:

**Authors and Contributors:**

**New York**

Jessica Forbes  
+1.212.859.8558  
jessica.forbes@friedfrank.com

Gregory P. Gnall  
+1.212.859.8201  
gregory.gnall@friedfrank.com

Christine M. Lombardo  
+1.212.859.8077  
christine.lombardo@friedfrank.com