

SEC Amends Regulation SHO to Impose a Circuit Breaker/ Price Test Restriction on Short Sales

The Securities and Exchange Commission (SEC) adopted a final rule on February 24 amending Regulation SHO and restricting certain short selling transactions following a 10% intraday decline in the price of a security subject to the rule. The new rule effectively reinstates a modified version of the “uptick rule” that applied to short sales generally prior to the elimination of Exchange Act Rule 10a-1 in July 2007, but only with respect to short sales of securities that have experienced a 10% intraday price decline. Upon becoming effective, the rule will generally apply to all securities, except options, listed on a national securities exchange (*i.e.*, NMS stocks), whether traded on an exchange or in the over-the-counter market. Certain short sales (marked “short exempt”) will be exempt from the restrictions otherwise imposed by the rule.

Amended Rule 201 under Regulation SHO requires trading centers (defined broadly to encompass all entities that may execute short sales) to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of short sale orders at a price that is less than or equal to the current national best bid price, but only if the security’s price has decreased by 10% or more from that security’s closing price (as determined by its listing market) at the end of trading on the prior day. Once triggered, the price restriction remains in effect for the remainder of the day and the following day.

In addition, a trading center’s policies and procedures must be reasonably designed to permit the execution of a displayed short sale order at a price above the current national best bid and the execution or display of a short sale order of a covered security marked “short exempt.” A broker-dealer can generally mark a short sale order “short exempt” if it is at a price above the national best bid at the time of submission or if the broker-dealer has reasonable basis to believe that the short sale order falls into an exempted category, including:

- A short sale at the volume-weighted average price of a security for the trading day. The security so sold must either be actively-traded or part of a basket of transactions.
- A short sale where the seller of a security is deemed to own the security being sold and intends to deliver the security as soon as all restrictions on delivery have been removed.
- A short sale for bona fide domestic arbitrage (*i.e.*, the short sale of a security sold for the *bona fide* purpose of profiting from a price differential between a convertible security and the stock underlying it).
- A short sale for international arbitrage (*i.e.*, the short sale of a security in order to profit from different prices for a security on foreign and domestic exchanges).

Amended Rule 201 also contains exemptions for short sales in connection with odd lot transactions, over-allotments, and lay-off sales from underwritten offerings, and riskless principal transactions.

The rule contains certain additional requirements for trading centers' and broker-dealers' policies and procedures and requires trading centers and broker-dealers to conduct surveillance to ascertain the effectiveness of their policies and procedures and to act promptly to remedy any deficiencies.

To ensure uniformity in the marketplace, Rule 201 prohibits self-regulatory organizations from having rules that conflict with Rule 201. The amendments to Regulation SHO become effective on May 10, 2010, after which date market participants have six months to comply with their requirements.

If you would like to learn more about the issues raised by this update, please contact your usual Ropes & Gray adviser.