

## SEC Proposes Restoring Uptick Rule or Adopting Other Restrictions on Short Sales

The Securities and Exchange Commission (SEC) recently proposed amendments to Regulation SHO that would restrict certain short selling transactions. The SEC's proposal contains several alternative restrictions, which fall into two groups: (1) price test rules and (2) circuit breaker rules. The proposed rules would generally apply to short sales of all securities, except options, listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market. Each proposed rule would exclude certain short sales (marked "short exempt") from its restrictions. To ensure uniformity in the marketplace, the proposed rules would prohibit self-regulatory organizations from having rules that conflicted with the proposed rules.

A more detailed summary of each proposed alternative appears below.

### Proposed Uptick Rule

One alternative proposed by the SEC (the "proposed uptick rule") is to largely restore former Rule 10a-1, the uptick rule eliminated by the SEC in 2007. The proposed uptick rule would prohibit short selling a security below its last reported sale price or, where the last sale price was not above the preceding different sale price (*i.e.*, where the security's price decreased), at or below such last sale price. For example, where a sale of a security was executed at \$47.00 and a subsequent sale was executed at \$47.04, the security could not be sold short at a price *below* \$47.04 but could be sold short *at* \$47.04 or above. If a subsequent sale in the security was executed at \$47.00, the security could not be sold short at a price *at* or *below* \$47.00 but could be sold short at a price *above* \$47.00 because \$47.00 is now the last sale price.

The restrictions of the proposed uptick rule would not apply to certain short sales specifically excluded from the rule, as described below under "Exceptions to the Proposed Uptick and Modified Uptick Rules."

### Proposed Modified Uptick Rule

Recognizing that in today's markets last sale price information is sometimes published with a delay and hence could be reported out of trading sequence, the SEC proposed a separate uptick rule (the "proposed modified uptick rule") based on the last national best bid, as opposed to last sale price. In addition, unlike the proposed uptick rule (which would prohibit all persons from executing certain short sales), the proposed modified uptick rule would require trading centers (defined broadly to encompass all entities that may execute short sales) to establish, maintain and enforce "policies and procedures" reasonably designed to prevent the execution or display of restricted short sales. The proposed modified uptick rule would restrict all short sale orders in a covered security at prices less than (or, if the last differently priced national best bid was greater than the current national best bid, less than or equal to) the current national best bid.

In addition, the proposal would require a trading center's policies and procedures to be reasonably designed to permit the execution or display of a short sale order of a covered security marked "short exempt." A broker-dealer could generally mark a short sale order "short exempt" if it satisfied the bid test described above or if the broker-dealer reasonably believed that the

order fell into one or more of the exceptions described below under “Exceptions to the Proposed Uptick and Modified Uptick Rules.”

### Exceptions to the Proposed Uptick and Modified Uptick Rules

Certain short sales would be exempt from the restrictions of both the proposed uptick rule and the proposed modified uptick rule. Neither proposal would restrict the following short sales, among others:

- 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 restricted from delivering the security being sold due to circumstances outside the seller’s control but intends to deliver the security as soon as such restrictions have been removed.
- A short sale for bona fide domestic arbitrage (generally defined as a 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 (generally defined as a short sale of a security in order to profit from different prices for a security on foreign and domestic exchanges).

The proposed uptick and modified uptick rules would also have exceptions for short sales in connection with odd lot transactions, over-allotments and lay-off sales from underwritten offerings and riskless principal transactions.

Several additional exceptions would be available only under the proposed uptick rule (but not under the proposed modified uptick rule). These include:

- Short sales of actively traded securities (or securities that are part of a basket of transactions) in electronic trading systems that meet certain criteria (such as that sellers and buyers are not assured of receiving a matching order and do not know when a match occurs; that while the trading system is matching orders there can be no solicitation of customer orders or any communication with customers that the match has not yet occurred; and that persons short selling on the trading system may not be represented in a primary market offer or otherwise able to influence a primary market bid or offer). A short sale pursuant to this exception could not be effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.
- Short sales where an unaffiliated broker erroneously marks the short order as “long.”

The proposed uptick rule would also exempt short sales in connection with trade-throughs (to prevent a potential conflict between the proposed uptick rule and the “firm quotation requirement” of Regulation NMS) and short sales in connection with facilitation of customer buy orders by market makers or specialists.

### Circuit Breaker Rules

In addition to the price test rules described above, the SEC proposed three alternative circuit breaker rules. Each of the circuit breaker rules would apply to short sales of a specific security if the price for such security decreased by 10 percent or more from that security’s last price reported during regular trading hours the previous day. Each circuit breaker rule would apply to such security for the remainder of the day during which it is triggered.

One proposed alternative, the “circuit breaker halt rule,” would prohibit all short selling of a security after the circuit breaker for such security was triggered. The proposed circuit breaker halt rule would not apply, however, if the decrease in the price of

the security reached 10 percent during the last 30 minutes of trading. The circuit breaker halt rule would be subject to limited exceptions, such as exceptions for market makers and for certain short sales resulting from automatic exercise or expiration of equity options or futures contracts.

Specifically, the following short sales would be exempt from the proposed circuit breaker halt rule:

- Certain short sales in connection with the automatic exercise, assignment or expiration of equity options or future contracts held prior to the triggering of the circuit breaker.
- A short sale by the writer of a call option where the short sale results from the assignment following exercise by the holder of the option.
- Certain short sales in connection with bona fide market making, including in derivatives based on a security triggering the circuit breaker.
- A short sale where an unaffiliated broker erroneously marks the short order as “long.”

The circuit breaker halt rule could be implemented either in place of, or in addition to, one of the short sale price test restrictions described above.

As further alternatives, the SEC proposed two circuit breaker rules which, instead of halting all short sales of a security that experiences a 10 percent decline from the prior trading day’s last price, would apply the proposed uptick rule or the proposed modified uptick rule (together with all exceptions described above) to such security following a 10 percent price decline. The SEC has requested comments from the public on the proposed price test and circuit breaker rules. Comments should be received by the SEC on or before June 19, 2009.

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

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