Securities Alert: New SEC Rule Regarding Short Selling — The “Alternative Uptick Rule”

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On February 24, 2010, the Securities and Exchange Commission (SEC) adopted a new rule (the “Alternative Uptick Rule”) restricting the execution or display of short sale orders for certain securities under certain market conditions. Under the Alternative Uptick Rule, a circuit breaker would be triggered any time a stock has dropped 10% or more in one day from the prior day’s closing price. At that point, the Alternative Uptick Rule would permit short selling only at a higher price than the current national best bid, unless an applicable exception applies. Once the circuit breaker has been triggered, the Alternative Uptick Rule would apply to short sale orders in that security for the remainder of the day, as well as the following day.

The Alternative Uptick Rule generally would apply to equity securities that are listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market.

Under the rule, trading centers would be required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale. A “trading center” is defined as a national securities exchange or national securities association that operates a self-regulatory organization’s 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.

Covered broker-dealers and other trading centers will need to develop the processes, systems, and internal controls necessary to implement the new requirements, including:

- real-time monitoring of the national best bid
- methods of allowing short sales at the current national best bid or below when such short sales are properly marked “short exempt” under various exceptions to the new requirements (see below)
- regular exception reports to evaluate compliance with the new requirements
- recordkeeping that would identify the current national best bid at the time of execution
- methods of addressing latencies in obtaining data regarding the national best bid
- surveillance to assess regularly the continuing effectiveness of the newly required policies and procedures and remedies for any deficiencies detected through such surveillance.

Exceptions to the Alternative Uptick Rule as Proposed

Under the Alternative Uptick Rule proposal orders marked "short exempt" are not subject to the new short sale restrictions. Subject to various conditions, the following types of short sales may be marked "short exempt" by a broker-dealer:

- seller's delay in delivery
- odd lots
- domestic arbitrage
- international arbitrage
- over-allotments and lay-off sales
- riskless principal transactions
- volume-weighted average price basis (VWAP) transactions

SEC issuance of the Alternative Uptick Rule in final form will confirm whether the SEC will, as anticipated, include these exceptions from the Proposal in the final rule.

Absence of Market Maker Exemption

Significantly, dealers who act as market makers will not be exempt, but rather will only be permitted to effect short sales at a price higher than the national best bid.

Implementation Timeframe

Covered broker-dealers and other trading centers will have a six-month implementation period beginning 60 days after the finally adopted Alternative Uptick Rule is published in the *Federal Register*. We expect that industry groups, broker-dealers, trading centers, and asset managers will have opportunities during this period to seek clarifying guidance from the Division of Trading and Markets.

Other Short Sale Restrictions Considered

Prior to adopting the new Alternative Uptick Rule, the SEC considered and rejected five other options for restricting short sales:

- *Price Test Modified Uptick Rule.* This option would have prevented, subject to certain exceptions, short sales on a permanent, market-wide basis at a "down-bid price" (*i.e.*, a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid).
- *Price Test Uptick Rule.* This option would have prevented, subject to certain exceptions, short sales on a permanent, market-wide basis below the last reported price or at the last reported price unless such price is above the next reported price. The Price Test Uptick Rule option was similar to the prior uptick rule, Rule 10a-1, which the SEC put in place in part to address the stock market crash of 1929 and repealed in 2007.

- *Circuit Breaker Halt Rule.* This option would have prohibited short sales in a stock that had declined by the specified percentage in a single trading day.
- *Circuit Breaker Modified Uptick Rule.* This option would have applied the same restrictions as the Price Test Modified Uptick Rule just in situations where the covered security had declined by the specified percentage in a single trading day.
- *Circuit Breaker Uptick Rule.* This option would have applied the Uptick Rule just in situations where the covered security had declined by the specified percentage in a single trading day.

After initially proposing these five options in April 2009, the SEC reopened the proposal for comment in August 2009 and added the Alternative Uptick Rule as a sixth option at that time. The Alternative Uptick Rule is similar to the proposed Modified Uptick Rule in that both would use the current national best bid as a reference point for short sale orders. The Alternative Uptick Rule is more restrictive than the proposed Circuit Breaker Modified Uptick Rule and the proposed Circuit Breaker Uptick Rule because the Alternative Uptick Rule would not allow short selling at the current national best bid or last sale price. Instead, in an advancing or declining market, the Alternative Uptick Rule would only permit short selling at an increment above the current national best bid, unless an applicable exception applies.

Other Recent SEC Actions Relating to Short Selling

In 2008, the SEC passed four temporary emergency orders, including orders that imposed pre-borrow requirements on short sales for 19 different stocks, a ban on short sales for almost 1,000 financial stocks, certain short sale disclosure requirements, and certain measures related to "naked" short selling. The Commission subsequently adopted certain of these measures as final rules, including a "naked" short selling anti-fraud rule. The SEC also adopted amendments to Regulation SHO that requires broker-dealers to promptly purchase or borrow securities to deliver on a short sale.

Key Take-Aways

For covered broker-dealers and other trading centers:

- Analyze final rule when published.
- Identify resources to develop and implement newly required policies and procedures and to enhance trading and Regulation NMS compliance systems.
- Prepare to develop project plans and to scope development efforts for required systems, processes and internal controls (preventing execution or display of prohibited short sales, allowing "short exempt" orders, monitoring national best bid, generating exception reports, performing surveillance and remedying deficiencies, etc.).
- Identify and address questions about how to interpret and apply the new requirements to products, services and operations.
- Follow industry efforts to get clarification and/or additional exceptions.

For hedge funds and other asset managers that use short selling:

- Analyze impact of restrictions and "short exempt" exceptions on trading strategies.
- Identify potential needs for clarification or additional exceptions from SEC, coordinating with prime and executing brokers and industry.

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