News Bulletin

February 24, 2010

The Alternative Uptick Rule

On February 24, 2010, the Securities and Exchange Commission announced that it adopted an alternative uptick rule as part of the SEC's continuing efforts to increase regulatory oversight over short selling. The vote in favor of the new uptick rule was 3-2, and was divided along party lines. The uptick rule had been eliminated in July 2007.

Background

In April 2009, the SEC voted unanimously to seek public comment on short sale price restrictions and "circuit breaker" restrictions. The SEC proposed two approaches to restrictions on short selling: one approach would apply on a market-wide and permanent basis and the other approach would apply only to a particular security during severe market declines in that security, or "circuit breakers." The SEC requested comments on two different proposals relating to market-wide and permanent restrictions and two proposals relating to circuit breakers. The two proposed uptick rules included the "proposed modified uptick rule," which was based on the current national best bid of a security, and the "proposed uptick rule," which was based on the last sale price of a security. The proposed circuit breakers involved either a prohibition on short selling after a severe decline in the price of a security or the imposition of a form of uptick rule after a severe decline in the price of a security. The SEC also requested comments on the "alternative uptick rule," which would only permit short selling at an increment above the current national best bid, unless an applicable exception were applicable, although the SEC was not making a proposal with respect to the alternative uptick rule. In August 2009, the SEC requested additional comments on the alternative uptick rule. The SEC collected over 4,000 comment letters and, in May 2009, held a public roundtable to discuss, among other things, short selling issues.

The Alternative Uptick Rule

The alternative uptick rule, as adopted, provides that a circuit breaker is triggered with respect to a stock if the stock's price declines by 10% or more from the prior day's closing price. At that point, short selling in the stock is permitted only if its price is above the current national best bid. Once triggered, the circuit breaker remains in effect with respect to the stock for the remainder of the day and for the following day. The alternative uptick rule generally applies to equity securities listed on a national securities exchange, whether traded on an exchange or on the over-the-counter market. The SEC noted that, under the rule, trading centers would be required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a prohibited short sale.

In her remarks delivered prior to the vote, Chairman Mary Shapiro said that the rule was the result of "a thorough and deliberative process" and noted that short selling can play an important and constructive role in the markets, such as by providing market liquidity and pricing efficiency. The alternative uptick rule balances the SEC's desire to regulate short selling and to prevent certain abusive and manipulative behavior while recognizing that short selling plays an important role in the market.

More on Short Selling

The uptick rule was originally adopted in 1938 with the stated purpose of, among other things, 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. Prior to its elimination in July 2007, the uptick rule generally prevented securities from being sold short at a declining price. When the SEC eliminated the uptick rule, it also adopted Rule 201 of Regulation SHO, which prohibited price tests, including those of the self regulatory organizations, for short sales. The SEC abolished the uptick rule after it performed a pilot program in which the uptick rule was suspended for one-third of the Russell 3000 Index constituent stocks with higher levels of liquidity from May 2, 2005 through July 3, 2007. A number of third-party researchers were commissioned by the SEC to analyze the data produced by the pilot program, and various other studies were performed. Among other findings, the studies found no evidence that prices of stocks subject to the uptick rule declined more slowly than prices of exempted stocks during times of stress. However, as noted by the SEC and by the researchers performing the studies, there was not a severe market-wide decline during the period in which the pilot program was conducted and, thus, the studies did not include an evaluation of the performance of the uptick rule, or the lack thereof, in such a market environment. Notwithstanding the results of the studies, the uptick rule limited short selling activity, and many believe that the elimination of the uptick rule facilitated the short selling that, at least in part, played a role in the financial crisis.

For a detailed discussion of issues relating to short selling, please consult our Client Alerts posted in the Short Selling Reform section of our Financial Crisis webpage located at http://www.mofo.com/resources/financial-crisis/#10.

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