

**MEMO# 23407**

April 20, 2009

## **SEC Proposes Short Sale Regulation; Conference Call Scheduled for April 22**

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April 20, 2009

TO: SEC RULES COMMITTEE No. 18-09

EQUITY MARKETS ADVISORY COMMITTEE No. 17-09

ETF ADVISORY COMMITTEE No. 9-09

CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-09     RE: SEC PROPOSES SHORT  
SALE REGULATION; CONFERENCE CALL SCHEDULED FOR APRIL 22

The Securities and Exchange Commission ("SEC") has published for comment a proposal containing two general approaches to restrictions on short selling. [\[1\]](#) One approach would apply a price test on a market wide and permanent basis. The proposal sets forth two alternative price tests. The first, similar to the NASD's old "bid test," would be based on the national best bid (the "proposed modified uptick rule"). The second, similar to the former uptick rule under Rule 10a-1 of the Securities Exchange Act of 1934 ("Exchange Act"), would be based on the last sale price (the "proposed uptick rule"). The second approach would apply only to a particular security during a specified market decline in that security ("proposed circuit breaker rules"). With respect to this approach, the proposal sets forth two alternatives. First, the SEC proposes a circuit breaker rule that would temporarily prohibit any person from selling short that security, subject to certain exceptions ("proposed circuit breaker halt rule"). Second, the SEC proposes a circuit breaker rule that would trigger a temporary short sale price test for that security – either the proposed modified uptick rule or the proposed uptick rule. [\[2\]](#)

We will hold a conference call on Wednesday, April 22 at 2:30p.m. Eastern time. The dial-in number for the call will be 1-866-541-3298 and the pass code will be 6501781. If you plan to participate on the call, please contact Jennifer Odom by email at [jodom@ici.org](mailto:jodom@ici.org) or by phone at 202-326-5833.

The most significant aspects of each of the approaches are discussed below.

## **Proposed Modified Uptick Rule**

The proposed modified uptick rule would be similar to the old “bid test” under NASD rules applicable to Nasdaq securities. Specifically, the proposed modified uptick rule would use the national best bid as a reference point for short sale orders.

Unlike the old bid test and the proposed uptick rule discussed below, the proposed modified uptick rule would not impose a flat prohibition on effecting a short sale at an impermissible price. Instead, a trading center would be required to have policies and procedures reasonably designed to prevent it from executing or displaying any short sale order, absent an exception, [\[3\]](#) at a price that is below the national best bid. Because the proposed modified uptick rule would use the national best bid as its reference point, short selling could occur below the last sale price.

The proposed modified uptick rule would apply to any security or class of securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. The proposed rule therefore would generally cover all securities, except options, listed on a national securities exchange whether traded on an exchange or in the over-the-counter (“OTC”) market.

The proposal would require a trading center to take steps to enable it to enforce its policies and procedures effectively. Trading centers also would be required to conduct surveillance under the proposed modified uptick rule to ascertain the effectiveness of its policies and procedures and take prompt action to remedy any deficiencies.

## **Proposed Uptick Rule**

The proposed uptick rule would be similar to the former uptick rule under Rule 10a-1 of the Exchange Act. The proposed rule would use the last sale price as the reference point for short sale orders and would prohibit, absent an exception, [\[4\]](#) a short sale order from being effected below the last sale price. [\[5\]](#)

The scope of the proposed uptick rule would be similar to the proposed modified uptick rule, i.e., it would effectively cover all securities, other than options, listed on a national securities exchange whether traded on an exchange or in the OTC market. Unlike former Rule 10a-1, the proposed uptick rule would only be in effect during times when last sale price information is being collected and disseminated on a real-time basis.

## **Preliminary SEC Views on Proposed Price Tests**

The Release states that the SEC preliminarily believes that of the short sale price test proposals, a price test based on the national best bid (the proposed modified uptick rule) would have advantages over a test based on the last sale price (the proposed uptick rule) in today’s markets. Specifically, the SEC believes that bids generally are a more accurate reflection of current prices for a security than last sale prices due to delays that can occur in the reporting of last sale price information and the manner in which last sale price information is published to the markets. The SEC therefore preliminarily believes that if it were to adopt a short sale price test restriction, whether as a full-time rule or as part of a circuit breaker rule (discussed below), that it would be more appropriate for these

restrictions to be based on the national best bid rather than on the last sale price.

### **Proposed Circuit Breaker Halt Rule**

The proposed circuit breaker halt rule would prohibit any person from selling short a particular security, wherever it is traded, while the circuit breaker is in effect, subject to certain exceptions. Specifically, the proposed rule would, once triggered by a 10% decline in the price of a security from the prior day's closing price on any trading day, impose a short selling halt in the individual security at times when the last sale price is calculated and disseminated in the consolidated system. To avoid market disruption that may occur if a circuit breaker is triggered late in the trading day, the proposed circuit breaker rules would not be triggered if the specified market decline threshold is reached in a covered security within thirty minutes of the end of regular trading hours.

Like the proposed price tests, the proposed circuit breaker halt rule would apply to a broad category of stocks. The proposed rule also would include exceptions substantially identical to exceptions that were included in the SEC's 2008 short sale ban emergency order.

### **Proposed Circuit Breaker Price Test Rules**

Alternatively, the SEC proposes a short selling circuit breaker that, when triggered by a specified decline in the price of a particular security, would impose short sale price restrictions for that security wherever it is traded for the remainder of the trading day. Such a circuit breaker would be imposed in place of a permanent, market-wide short sale price test restriction.

Specifically, the proposed circuit breaker modified uptick rule would, once triggered by a 10% decline in the price of a security from the prior day's closing price, impose the modified uptick rule in the individual security at times when the national best bid is calculated and disseminated in the consolidated system, for the remainder of the trading day. Similarly, the proposed circuit breaker uptick rule would, once triggered by a 10% decline in the price of a security from the prior day's closing price on any trading day, impose the uptick rule in the individual security at times when the last sale price is calculated and disseminated in the consolidated system. The price decline would be based on the security's price during the trading day as reported in the consolidated system as compared to the prior day's closing price as reported in the consolidated system. The prior day's closing price would be the last price reported during regular trading hours the prior day.

To avoid market disruption that may occur if a circuit breaker is triggered late in the trading day, the proposed circuit breaker price test rules would not be triggered if the specified market decline threshold is reached in a covered security within thirty minutes of the end of regular trading hours.

### **Requests for Comment**

In addition to the specific requests for comment on the proposed approaches, the Release

requests comment on numerous other issues relating to short sales. The SEC specifically requests that commenters provide empirical data to support their views and arguments related to the proposals. Some of the requests for comment include:

- Should short sales be subject to a short sale price test restriction or should the SEC continue to rely on current short sale regulations and anti-fraud and anti-manipulation provisions of the securities laws to address potentially abusive short selling?
- Would reinstating a short sale price test restriction such as the proposed modified uptick rule or proposed uptick rule help restore investor confidence?
- Should the proposed modified uptick rule or proposed uptick rule be limited to specific sectors or industries, such as financials?
- How might market participants alter their trading systems and strategies in response to the proposals, if adopted?
- To what extent does the ability to obtain a short position through the use of derivative products such as options, futures, contracts for difference, warrants, credit default swaps or other swaps or other instruments (such as inverse leveraged ETFs) undermine the goals of short sale price test restrictions? Will synthetic short sales increase if the SEC adopts either alternative short sale price test?
- Before determining whether to adopt a short sale price test restriction on a permanent basis, should the SEC adopt a rule that would apply, on a pilot basis, the operation of a short sale price test restriction for specified securities?
- Should the proposed modified uptick rule include a “short exempt” marking provision for transactions in ETFs and similar products?
- Would circuit breakers pose any unique issues related to the daily opening of trading, the opening of trading after a trading halt, or the closing of trading?
- Should a short selling circuit breaker be limited in its application to specific industry sectors that are historically susceptible to extreme volatility or disproportionately high levels of short selling?
- Would a circuit breaker that when triggered halts short selling in a particular security result in increased selling pressure by short sellers in anticipation of the halt for securities experiencing large price declines?
- Could the short selling halt benefit investors by allowing the market to “cool off” with respect to that individual security?

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#### **endnotes**

[1] Securities Exchange Act Release No. 59748 (April 10, 2009) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/2009/34-59748.pdf>. Comments on the proposal are due to the SEC no later than June 19, 2009.

[2] For each of the proposed short sale price test restrictions and proposed circuit breaker rules, the SEC is proposing that the implementation period for these amendments would be three months from the effective date of the amendments.

[3] The proposed modified uptick rule would reinstate many, but not all, of the exceptions from the former uptick rule under Rule 10a-1 of the Exchange Act.

[4] Like the proposed modified uptick rule, the proposed uptick rule would reinstate many, but not all, of the exceptions from former Rule 10a-1 of the Exchange Act.

[5] As proposed, the proposed uptick rule would be a strict prohibition on short sales and would not incorporate the policies and procedures approach under the proposed modified uptick rule. The Release, however, states that in adopting a final rule, the SEC could take several different approaches, or a combination of approaches. For example, it could consider a straight prohibition approach prohibiting all persons from effecting short sales under a price test that references either the national best bid or the last sale price; a policies and procedures approach imposing obligations on market participants to adopt policies and procedures to guard against impermissible short selling; or a combination of a straight prohibition and a policies and procedures approach.