

## SEC Proposes Alternative Short Sale Restrictions

At an open meeting on April 8, 2009, the Securities and Exchange Commission (“SEC”) voted unanimously to publish for public comment proposed rules that would impose restrictions on short sales under certain circumstances. In its press release on the proposals, the SEC noted that it had voted to eliminate short sale price restrictions in June 2007, but had “decided to re-evaluate the issue due to extreme market conditions and the resulting deterioration in investor confidence.”

At the open meeting, the SEC described five alternative rule proposals: two alternatives that would apply a short sale price test on a permanent, market-wide basis and three alternatives that would impose short sale restrictions with respect to securities that have experienced sharp, intra-day price declines. Specifically, the proposals described at the open meeting are:

### Proposed Market-wide, Permanent Short Sale Price Restrictions

The SEC is proposing two alternative rules that would apply to all short sales in covered securities at all times during the trading day. The first, the “Uptick Rule,” would restrict short sales by reference to the last sale price; and the second, the “Modified Uptick Rule,” would restrict short sales based on national best bid.

- *Uptick Rule.* This update of the former Exchange Act Rule 10a-1 price test would prohibit the execution of a short sale at (i) a price below the last sale price, or (ii) if the last sale was at a price below the last sale at a different price, a price less than or equal to the last sale price. It would permit short sales to be executed at (iii) a price above the last sale price, or (iv) if the last sale was at a price greater than the last sale at a different price, at a price equal to or greater than the last sale price. For example:

If the last sale price of a stock is \$100 and the immediately prior last sale at a different price was \$99, short sales of that stock at \$100 or more would be permitted;

If the last sale price of a stock is \$100 and the immediately prior last sale at a different price was \$101, short sales of that stock at \$100 would be prohibited, while short sales at \$100.01 or more would be permitted.

At the open meeting, Erik Sirri, Director of the SEC's Division of Trading and Markets, expressed concern about the operation of the proposed Uptick Rule in the current market environment. Because trades are published in the order in which trade information is received from multiple market centers and not necessarily in the order of execution, upticks and downticks in the reported trade data may not accurately reflect price movements in the security for purposes of the Uptick Rule.

- *Modified Uptick Rule.* The proposed Modified Uptick Rule would require all "trading centers" to establish, maintain and enforce policies and procedures reasonably designed to prevent the execution or display of any short sale order at (i) a price that is below the national best bid or (ii) if the national best bid is below the last differently priced national best bid, at a price less than or equal to the current national best bid. (The proposal to impose an obligation on "trading centers" to implement reasonably designed policies and procedures is patterned after Regulation NMS, which takes a parallel approach with respect to the prevention of transactions that "trade-through" protected bids and offers. "Trading center" is defined in Regulation NMS to include any national securities exchange, alternative trading system, market-maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.)

### **Proposed Circuit Breaker Restrictions**

The alternative proposed circuit breaker restrictions would not impose short sale restrictions with respect to a particular security unless the price of that security has dropped by more than a threshold amount in a single day. The release proposes that the circuit breakers be triggered with respect to a specific security by a 10% intra-day decline in the price of that security, but will request comment on the appropriate threshold. Three alternative circuit breakers were described at the open meeting:

- *Short Sale Ban Circuit Breaker.* Under this proposal, when the circuit breaker is triggered with respect to a security, short sales of that security would be prohibited for the remainder of the day. This circuit breaker could be adopted alone or in conjunction with a price test applicable to all short sales before the circuit breaker is triggered.
- *Uptick Rule Circuit Breaker.* Under this proposal, after the circuit breaker is triggered with respect to a security, short sales of that security would become subject to the Uptick Rule for the remainder of the trading day.
- *Modified Uptick Rule Circuit Breaker.* Under this proposal, after the circuit breaker is triggered with respect to a security, short sales of that security would become subject to the Modified Uptick Rule for the remainder of the trading day.

## Scope of the Proposed Short Sale Restrictions

The open meeting also provided some details regarding the proposed scope of the short sale restrictions:

- *Covered Securities.* These short sale restrictions are proposed to cover all stock listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market. The restrictions would not apply to non-NMS securities quoted on the OTC Bulletin Board or elsewhere in the OTC market and would not apply to options.
- *Overseas Transactions.* In response to a question from SEC Commissioner Kathleen Casey regarding the application of the proposed rules to overseas transactions, Director Sirri stated that the release will reiterate the SEC's historic position with respect to the former Rule 10a-1 that the short sale restrictions apply to any transaction fundamentally arranged in the United States, even if the transaction is consummated (*i.e.*, shares and cash change hands) outside the United States. If U.S. jurisdictional means are used to get parties together to do the trade, the transaction would be subject to the short sale restrictions.
- *After Hours Trading.* The proposed restrictions would not apply to after-hours trading. According to Director Sirri, the price tests would not make sense when the consolidated tape is not operating since there would be no single last sale price or best bid available as a basis for the restrictions. (This is in contrast to the former Rule 10a-1, which was interpreted to prohibit after-hours short sales below the last sale price reported to the tape.)
- *Exemptions.* The release will seek comment on whether to include exemptions from the short sale restrictions for sales of owned but restricted securities, certain riskless principal transactions, certain arbitrage transactions, syndicate offerings and odd lot transactions. No exemption is being proposed for market-maker transactions. The proposals would also reinstitute the requirement that a broker-dealer mark a short sell order "short exempt" if the seller is relying on an exemption from a short sale restriction.

Chairman Mary Schapiro also announced at the meeting that the SEC has tentatively scheduled a Commission Roundtable on the proposed short sale restrictions for May 5, 2009.

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The summary above is based on remarks at the open meeting and the SEC's press release; the SEC's full release, including the text of the proposed amendments, is not yet available. The webcast of the open meeting may be found at <http://sec.gov/news/openmeetings.shtml>.

If you have any questions about the proposals, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed on our website under "Capital Markets" ([http://www.clearygottlieb.com/capital\\_markets/](http://www.clearygottlieb.com/capital_markets/)) or "Banking and Financial Institutions" ([http://www.cgsh.com/banking\\_and\\_financial\\_institutions/](http://www.cgsh.com/banking_and_financial_institutions/)).

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