

SEC Proposes Five Short Sale Price Rules

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Client Advisory

April 30, 2009 by Morris Simkin, Steven J. Glusband and Guy P. Lander

On April 10, 2009, the Securities and Exchange Commission (SEC) proposed five separate rules to determine the price at which a national market system stock may be sold short, Release No. 34-59748 (74 Federal Register 18042 (April 20, 2009)) <http://edocket.access.gpo.gov/2009/pdf/E9-8730.pdf>.^[1]

The five proposals would only apply to national market system stocks, and not options. A national market system stock is one where current bid and ask prices and recent transaction reports are disseminated. Each proposed rule would require that a trade be designated as long, short or short exempt, and in each proposal categories of short sales that may be designated as short exempt are set forth. Orders marked short exempt would be entitled to be displayed and executed notwithstanding any limitations on displaying or executing short sales invoked by a specific proposal.

The five proposals fall into two categories— market wide, which includes the Modified Uptick Rule and the Uptick Rule, and security specific, which includes the Circuit Breaker Halt Rule, Circuit Breaker Modified Uptick Rule, and Circuit Breaker Uptick Rule.

Comments are due by June 19, 2009. The SEC said in the Release that whatever rule is adopted, it will not be effective until 90 days after adoption to allow time for the parties to make the necessary programming and other changes.

Modified Uptick Rule

Each trading center^[2] will be required to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale at a down bid price and to permit the execution and display of a short sale order marked short exempt without regard to whether the order is at a down bid price. A down bid price is a price that is less than the current national best bid as displayed in a national market system plan such as the CTA/CQ Plan or if the last differently priced national best bid, e.g., the preceding best bid if it was higher than the current first bid, was greater than the current national best bid a price that is that is less than or equal to the current national best bid, i.e. above the current national best bid. Market centers could execute a displayed short sale at a down bid price if at the time the order was displayed it was permissibly priced, i.e. not a down bid price. Trading centers would also be authorized to re-price and display a previously impermissibly priced short sale order (e.g., at a down/bid price) to be permissibly priced (e.g., at the current best bid) unless the customer refused the re-pricing.

In the proposing release the SEC discussed what constitutes satisfactory policies and procedures. Among other things, the trading center needs to monitor on a real time basis the national best bid and whether it is an up or down bid to determine whether it may execute or display a short order. The SEC suggests taking a snapshot of a short sale bid at the time of entry showing the national best bid as well as the last differently priced national best bid. The market center needs to regularly surveil to ascertain the effectiveness of the policies and procedures and take prompt

action to remedy any deficiencies. The market center must regularly assess the continuing effectiveness of its policies and procedures and take prompt action to remedy any deficiencies. Among the procedures would include regular exception reports to evaluate their trading practices and that their policies are being followed by its personnel and properly coded into its automated systems, and if not to take remedial action. Trading centers would not have to have policies and procedures to determine the exception relied upon by a broker dealer submitting an order marked as short exempt or that the broker-dealer properly marked such order as short exempt. The market center would also have to have policies and procedures to deal with latencies– the late receipt of national best bid information.

Broker-dealers submitting orders to a market center would have to establish, maintain and enforce written policies and procedures reasonably designed to prevent incorrect identification of an order as being priced in accordance with the marking requirements– e.g. marked short exempt when it wasn't, or a short sale submitted when it was at a down bid price. These policies and procedures should take a snapshot or some other type of record of the national best bid at the time of order submission as well as the last differently priced national best bid. It must surveil to see if it is satisfying its legal obligations, and should use exception reports to evaluate its trading practices. The policies and procedures must also address latencies. The broker-dealer must regularly assess the effectiveness of its policies and procedures and take prompt action to remedy any deficiencies.

The rule proposal sets forth seven instances where a broker-dealer may mark an order as short exempt:

- The broker-dealer reasonably believes the customer owns the security and intends to deliver it as soon as restrictions on delivery have been removed, e.g. Rule 144 sales (Customer Owns Exception);
- Sales by a market maker to offset a customer odd-lot order or liquidate an odd lot position which changes the broker-dealer's position by no more than one unit of trading (Odd Lot Exception);
- A sale order for the good faith account of a person who owns another security by virtue of which he is or will be entitled to acquire an equivalent number of securities of the same class as the securities sold, and the trade is effected for the bona fide purpose of profiting from the difference between the price of the securities and the price of the securities owned or with right to acquire the security sold (Domestic Arbitrage Exception);
- If the broker-dealer has a reasonable basis to believe the short sale is for a good faith account submitted to profit from a current price difference between a security on a foreign securities market and a security on a U. S. securities market provided the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it was made (International Arbitrage Exception);
- Short sales by an underwriter or syndicate member participating in a distribution in connection with an over-allotment and any short sale orders with respect to lay-offs by such person in connection with a distribution of securities through a rights or stand-by underwriting commitment (Over-allotment and Lay-off Exception);
- A transaction in which a broker-dealer after having received an order to buy a security, purchases the security as principal at the same price to satisfy the buy order or after having received an order to sell, sells the security as principal at the same price as the customer order to sell. The broker-dealer must have policies and procedures reasonably designed to assure that (a) the customer order was received prior the offsetting transaction, (b) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution, and (c) a supervisory system is in place to enable the broker-dealer accurately and readily to reconstruct, in a time sequenced manner, all orders in which the broker-dealer relies on this provision (Riskless Principal Exception);

- Sell orders executed on a volume weighted average price (VWAP) if the broker-dealer has a reasonable basis to believe the short sale meets the following: (1) VWAP is calculated by calculating the values for every regular way trade reported for the security during the trading session by multiplying each price by the total number of reported shares traded at that price, compiling the aggregate and dividing by the total number of reported shares; (2) trades are reported using a special VWAP trade modifier; (3) no short sales marked short exempt are used to calculate the VWAP (4) the subject security is either an actively traded security as defined in Regulation M (average daily trading volume for the last two months or preceding 60 days of at least \$1 million and a public float of at least \$150 million) or is part of a basket of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (5) trade is not effected for the purpose of creating actual or apparent active trading in or otherwise affecting the price of any security; and (6) the broker-dealer acts as principal on the contra-side to fill the customer short sale order only if the broker-dealer's position in the subject security as committed during the pre-opening of a trading day and aggregated across all of its customers who propose to sell short the same security on a VWAP basis does not exceed 10% of the security's average trading volume using the preceding two months average daily trading volume or using average trading volume for the 60 days preceding the trade date of the order. (VWAP Exception).

The modified tick rule does not apply to after hours trading. The consolidated quotation system for quotations on all the stock exchanges and FINRA's ADF operates from 9:00 AM to 6:30 PM Eastern Time. The Nasdaq UTP Plan operates from 9:30 AM to 4:00 PM Eastern Time and also operates from 4:00 AM to 9:30 AM and 4:00 PM to 8:00 PM Eastern Time for after hours trading, and the NYSE ARCA trades equities and ETFs from 9:30 AM to 4:00 PM and from 4:00 PM to 8:00 PM Eastern Time, the latter session for after hours trading.

Proposed Uptick Rule

No short sales would be permitted in an NMS security if trades in that security are reported pursuant to an effective transaction reporting plan and information as to such trading is made available in accordance with such plan on a real time basis to vendors of market transaction information (i) below the price at which the last sale thereof, regular way, was reported or (ii) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was reported. In other words, no short sale order may be effected below the last sale price or if the last trade price is below the preceding price at the preceding trade's price.

Exceptions permitting an order to be marked short exempt include:

- Customer Owns Exception;
- Odd Lot Exception;
- Domestic Arbitrage Exception;
- International Arbitrage Exception;
- Over-allotment and Lay-off Exception;
- Riskless Principal Exception; and the
- VWAP Exception;

Another exception is where a broker-dealer effects a short sale for an account other than that broker-dealer's account that was marked long by another broker-dealer, even if the order was mis-marked.

The uptick rule will not apply to short sales in an electronic trading system that matches buying and selling interest at various times throughout the day if: (1) matches occur at an externally derived price within the existing market and above the national best bid; (2) sellers and purchasers are not assured of receiving a matching order; (3) sellers and purchasers do not know when a match will occur; (4) persons relying on this exception are not represented in the primary market bid or offer at the time of the transaction; (5) transactions in the electronic trading system are not made for the purpose of creating actual or apparent trading in, or depressing or otherwise manipulating the price of any security; (6) the security is an actively traded security— average daily trading volume for the preceding two months or 60 days of at least \$1 million and a public float of at least \$150 million, or the transaction is part of a basket of 20 or more securities in which the subject security is not more than 5% of the value of the basket; and (7) during the period in which the system may match buying and selling interest, there is no solicitation of customer orders, or any other communication with customers that the matching has not yet occurred (Electronic Order Matching Exception).

The uptick rule will not apply to trade throughs by a registered specialist or registered exchange market maker for its own account on any exchange with which it is registered for such security or by a third market maker for its own account in the over-the-counter market effected at a price equal to the most recent offer communicated by such registered specialist, registered exchange market maker or third market maker for the security to an exchange or national securities association, i.e. FINRA's ADF, if such offer, when communicated, was equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan, and the sale is for no more than the quotation size associated with such offer, provided, however, any self-regulatory organization, by rule, may prohibit its registered specialist, registered exchange market maker or over-the-counter market maker from availing themselves of this exception.

Another instance where the uptick rule will not apply is in the case of facilitation of customer buy orders. This will be available to registered market makers or specialists publishing a two-sided quote to sell short at the offer to facilitate customers' market and marketable buy limit orders regardless of the last sale price.

The uptick rule will only apply when a last sale price for an NMS stock is collected and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan, e.g. the CTA/CQ Plan.

Proposed Circuit Broker Halt Rule

This proposal would halt all short sales for the remainder of the regular trading day when there was a 10% decline in a security's price as measured from the prior day's closing price as reported in the consolidated system. However, if this or any other proposed circuit breaker was tripped within 30 minutes of the close of regular trading no short sale halt or other circuit breaker would occur.

Exceptions that would allow a broker-dealer to mark an order short exempt include:

- Customer Owns Exception;
- Sale of a covered security by a person that is a market maker, if the sale is part of a bona fide market making and hedging activity related directly to bona fide market making in (i) derivative securities based on the covered security, or (ii) exchange traded funds and exchange traded notes of which the subject security is a component;
- Sale of a covered security by any person that is the writer of a call option, if the sale is as a result of assignment following exercise by a holder of the call;
- Sales by a registered market maker, block positioner or other market maker obligated to quote in the over-the-counter market, in each case that are selling short as part of bona fide market making in such security; and

- Sale of a security as a result of automatic exercise or assignment of an equity option or in connection with a futures contract that is held prior to the trigger or the circuit breaker due to the expiration of the option or futures contract.

Circuit Breaker Modified Uptick Rule

Each trading center would be required to adopt, maintain and enforce written policies and procedures reasonably designed to prevent, when the price of a covered security decreased by 10% or more from that security's last price reported during regular trading hours the prior day, the execution or display of a short sale order at a down-bid price for the remainder of the day so long as national best bid prices for that security are calculated and disseminated on a current and continuing basis. The policies and procedures requirements for the trading center and for broker-dealers reporting orders to a trading center would be the same as those described in the earlier discussion of a market wide modified uptick rule.

Exceptions from the modified uptick rule that would allow a broker-dealer to mark a short sale as short exempt include:

- Customer Owns Exception;
- Odd Lot Exception;
- Domestic Arbitrage Exception;
- International Arbitrage Exception;
- Over-allotment and Lay-off Exception;
- Riskless Principal Exception; and
- VWAP Exception.

Circuit Breaker Uptick Rule

If the price of a covered security decreases by more than 10% from the last sale price reported during regular trading hours the prior day no short sales may be effected for the rest of the day below the price at which the last trade, regular way, was reported or at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was effected.

Exceptions from the uptick rule that would allow a broker-dealer to mark a short sale as short exempt include:

- Customer Owns Exception;
- Odd Lot Exception
- Domestic Arbitrage Exception;
- International Arbitrage Exception
- Over-allotment and Lay-off Exception;
- VWAP Exception;
- Sale by a broker-dealer of a security for an account in which it has no interest pursuant to an order marked long;

- Electronic Order Matching System Exception

Transactions Executed Abroad

Under all five proposals if the short sale is agreed to in the United States but will be executed outside of the United States, it must be effected in accordance with the requirements of the proposed rules unless otherwise excepted.

Exemptions

The SEC on written request or on its own motion may grant an exemption from the rule's provisions, either unconditionally or on specified terms and conditions, if the SEC determines that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.

Questions regarding this advisory should be addressed to **Steven J. Glusband** (212-238-8605, glusband@clm.com) or **Guy P. Lander** (212-238-8619, lander@clm.com).

Endnotes

[1] We apologize for the length of this Client Advisory. However, the SEC proposal as published in the Federal Register was 73 pages, and as published on the SEC's web site was 273 pages.

[2] The affected trading centers are the currently registered ten national securities exchanges, the Financial Industry Regulatory Authority's Automatic Display Facility (FINRA's ADF), the some 325 registered equity market makers or specialists, the 47 Automated Trading Systems and all other broker-dealers that execute orders internally by trading as principal or crossing orders as agent.

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