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CLIENT MEMORANDUM

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The SEC's New Short Sale Rule: Implications and Ambiguities

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Introduction

After months of deliberation and consideration of several alternatives, the Securities and Exchange Commission (the "**SEC**" or "**Commission**") announced on February 24, 2010 the adoption of a new short sale rule — Rule 201 of Regulation SHO (the "**Rule**" or "**Rule 201**"). The Rule institutes what the marketplace has termed a "circuit breaker with a passive upbid requirement" rather than a full-time restriction on short sales. The restriction goes into place upon a 10% decline in the price of an NMS stock from its previous day's closing price. Rule 201 effectively restricts the display or execution by exchanges and other trading centers of a short sale order in such stock to a price above the national best bid for the remainder of the trading day and the next trading day (the "**Price Restriction**"). The Rule will be implemented through policies and procedures of trading centers and broker-dealers that are not, themselves, trading centers.

There are limited exceptions from the basic requirement, including for arbitrage and odd lot transactions, but far fewer exceptions than market participants had advocated. Notably, there is no exception for market making in NMS stocks or options market making.

In its 334 page adopting release (the "**Release**"), the SEC states that the Rule strikes a balance between the goal of preventing short selling from being used to exacerbate a declining market in a security and the need to allow for the smooth functioning of the markets, including the provision of liquidity and price efficiency. In the view of the SEC, such a balance is achieved through limiting the scope of the Price Restriction to those stocks experiencing drastic price declines, while temporarily restricting short sellers from further pushing down the stock's price by requiring them to sell above the national best bid.

According to an SEC staff study cited in the Release, on an average day between April 9, 2001 and September 30, 2009, 6% of covered securities would have been subject to the Price Restriction. The percentage of securities subject to the restrictions can vary dramatically based on market volatility.

Rule 201 is the first permanent restriction on the price of short sales since the repeal in 2007 of Rule 10a-1 ("**Rule 10a-1**") under the Securities Exchange Act of 1934 (the "**Exchange Act**"). Its adoption followed the release of two SEC rule proposals that generated extensive comment, as well as a 2009 Commission roundtable. The Rule was approved by the Commission in a 3-2 vote, with Commissioners Casey and Paredes strongly dissenting based largely on the lack of empirical data supporting the Rule's adoption.

This Client Memorandum summarizes the key provisions of Rule 201, explores the practical implications of the Rule for market participants and identifies certain ambiguities in the Rule for which further guidance may be needed.

Operation of the Rule

The Price Restriction

Rule 201 requires that "trading centers," as defined in the sidebar, establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order in a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security at the end of regular trading hours on the prior day. "Covered securities" are defined as NMS stocks and therefore exclude stocks listed only on over-the-counter bulletin boards and pink sheets.

The Price Restriction remains in effect for the rest of the day in which the circuit breaker is triggered and the following day. The Price Restriction only applies at such times as a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan (*i.e.*, the CT/CQ and NASDAQ UTP Plans, each a "**Plan**"). Rule 201 applies whether the trade is effected on an exchange or in the over-the-counter market. Options and other derivatives used to create synthetic short positions are not themselves subject to a short sale order display or execution restrictions, though covered securities used to hedge such transactions remain subject to the Rule.

The Rule differs in a number of material respects from former Rule 10a-1, including:

- While former Rule 10a-1 restricted short sales at all times, Rule 201 bans the display and execution of short sales in covered securities on an individual basis and only upon a 10% decline in the price of that stock from its previous day's closing price (the "**circuit breaker**"), unless an exemption applies. For this purpose, the 10% decline is measured from the closing price at the end of the previous day's regular trading hours as determined by the covered security's listing market. The Price Restriction only remains in effect during the remainder of the day in which the circuit breaker is triggered and the next trading day. In addition, it only applies during the time that an effective national market system plan calculates and disseminates the national best bid.[1] If the price of a stock subject to Rule 201's Price Restriction continues to fall such

[1] In general, the CT/CQ Plan (for securities primarily listed on the NYSE and AMEX) operates from 9:30 am to 6:30 pm ET, while the NASDAQ UTP Plan (for securities primarily listed on NASDAQ) generally operates from 4:00 am to 8:00 pm ET, though both may be modified or extended by the participants. As a result, the Price Restrictions apply at different hours depending on the listing market of the stock.

Rule 201: Key Provisions

- Restriction on short selling triggered by a 10% drop in the price of a covered security from the prior trading day's closing price
- Restricts the display and execution of short sale orders to prices above the national best bid
- Applicable to NMS stocks only
- Restriction remains in effect during current quotation hours for the day in which the decline occurs and the following day
- Effected through required policies and procedures of trading centers and broker-dealers

Rule 201: Key Terms

Covered Security: any NMS stock

NMS Stock: any NMS security other than an option; i.e., stocks listed on NYSE, Amex, and Nasdaq

Listing Market: the "listing market" defined in the effective transaction reporting plan for the covered security, which, for dual-listed securities, is the original listing market under the CTA Plan and the market with the greatest number of transactions or volume in the past year under the NASDAQ UTP plan

Trading Center: a national securities exchange or national securities association that operates a trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent that the circuit breaker is re-triggered, the restriction period will restart. Therefore, rapidly declining securities may be subject to the price restrictions for more than two trading days.

- While former Rule 10a-1 permitted short sales of covered securities to be effected only above the previous transaction price or at the previous transaction price when such price was above the last different transaction price, Rule 201 more stringently allows short orders in a security subject to the Price Restriction to be displayed or executed only at prices above the national best bid. Because of these differences, the Price Restriction under Rule 201 will be more restrictive than former Rule 10a-1 in some circumstances and less restrictive in others. Specifically, as stated above, the new Rule only restricts short sales once the circuit breaker has been triggered. However, since short sales may only be effected above the national best bid, short sales will be more difficult to execute when bids drop continuously.[2]

- Rule 201 is to be implemented through policies and procedures adopted by trading centers and broker-dealers, rather than through the "flat prohibition" of former Rule 10a-1.

Logistically, Rule 201(b)(3) requires a covered security's listing market to determine when the price of a covered security has declined 10% or more from its previous closing price. A listing market that has made such a determination must immediately notify the appropriate Plan processor. The Plan processor must then disseminate this information.

Broker-Dealer Marking Requirement

The SEC has also amended Rule 200 of Regulation SHO to require all brokers and dealers to mark all orders for sale of an equity security as "long," "short," or "short exempt." Short sale orders may only be marked "short exempt" under two scenarios. First, an order can be marked "short exempt" under Rule 201(c) if it is at a price above the current national best bid at the time of submission. Second, orders may be marked "short exempt"[3] pursuant to one of the exceptions from Rule 201, described in the sidebars on the following two pages. In order to mark orders as "short exempt," a broker-dealer must have written policies and procedures that are reasonably designed to prevent inaccurate marking and it must regularly monitor for and remedy any problems with the policies and procedures.

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[2] It should be possible for non-exempt short sales to be executed on "dark pools" against bids that are superior to the then-disseminated national best bid.

[3] Broker-dealers are not required to mark any orders "short exempt" and, as a result, are not required by the Rule to implement the resultant policies and procedures. However, brokers who are unprepared to mark orders "short exempt" may suffer business consequences from clients wishing to use the Rule's exceptions.

Exceptions to Rule 201

Seller's delay in delivery: The short sale is by a person that is deemed to own the covered security under Rule 201 of Regulation SHO, provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed

Odd lot transactions: The short sale is by a market maker to offset customer odd-lot orders or to liquidate an odd-lot position that changes such broker's or dealer's position by no more than a unit of trading

Domestic arbitrage: The short sale is for a good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold. The sale must be effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities

International arbitrage: The short sale is for a good faith account and submitted to profit from a current price difference between a security on a foreign market and a security on a U.S. market (including depository receipts), provided the seller has an offer to buy on the foreign market that allows the seller to immediately cover the short sale

Exceptions

Exceptions to the Rule are effected through provisions allowing broker-dealers to mark "short exempt" those orders that it reasonably believes fall into certain defined categories. Upon receiving an order marked "short exempt," a trading center must display or execute the order regardless of the Price Restriction.

The exceptions to Rule 201 are narrow and can be found in the sidebars on this and the following page. There are no exceptions from Rule 201 for bona fide hedging, bona fide market making (including market making in OTC and listed derivatives, options, convertible securities, or exchange-traded funds), benchmark trades otherwise exempted from Regulation NMS, sales effected in connection with capital raising transactions, "exchange for physicals," exchange traded fund transactions or market on close or market on open transactions.

Implementation Issues

Policies and Procedures

Trading Centers

Compliance with Rule 201 will require trading centers to institute policies and procedures to ensure that orders are not displayed or executed in contravention of the Rule. Trading centers will be required to determine whether a short sale order may be executed or displayed and avoid the display and execution of impermissibly priced short sale orders while a Price Restriction remains in effect. To comply with Regulation NMS' Quote Rule, such policies and procedures must be reasonably designed to allow display of an order permissibly priced at the time it is initially received. In addition, trading centers must have policies and procedures in place to display or execute all short sale orders marked "short exempt." Trading centers are required to take whatever steps are necessary to enforce their policies and procedures, regularly monitor their policies and procedures to ensure their effectiveness and remedy any problems.

The Release identifies a number of policies and procedures that trading centers *may consider* adopting on a voluntary basis. First, trading centers may develop policies and procedures to continuously reprice impermissible short sale orders, which gives a trading center flexibility in how to deal with non-exempt short sale orders at prices such that they could not be displayed or executed. Second, trading centers may capture a "snapshot" of the national best bid when a short sale order is displayed or executed as a form of demonstrating compliance with the Rule. Snapshots are routinely used to show compliance with Regulation NMS and will be a key procedure under Rule 201.

Broker-Dealer Marking Requirements

As described above, a broker-dealer may mark an order "short exempt" if the order is permissibly priced at the time it is submitted. Rule 201(c)

Exceptions to Rule 201 *(Cont.)*

Over-allotments and lay-off sales: The short sale is by an underwriter or member of a syndicate in connection with an over-allotment of securities or for purposes of a lay-off sale

Riskless principal transactions: The short sale is by a broker or dealer effecting the execution of a customer purchase or long sale on a riskless principal basis, provided that certain additional conditions are satisfied

VWAP transactions: The short sale is effected at the volume weighted average price ("**VWAP**"), calculated in accordance with detailed requirements in the Rule

Implementation Timeline

The Release provides for a six month implementation period, which will begin upon the Rule's effectiveness. Rule 201 becomes effective on May 10, 2010. Therefore, the Rule's limitations on short sales will not be in effect until November 10, 2010.

requires that, in order to mark such an order "short exempt," the broker-dealer establish, maintain and enforce policies and procedures reasonably designed to prevent incorrect identification of orders. Like the policies and procedures applicable to trading centers, these must be regularly monitored by the broker-dealer and problems must be remedied immediately. The Release does not discuss the extent to which a broker-dealer may rely on its customer to mark orders "short exempt." Under Regulation NMS, broker-dealers allow customers to mark orders as "intermarket sweep orders," subject to taking reasonable steps to establish that such order meets the Regulation NMS' definition of "intermarket sweep order." Similar procedures may also ultimately be acceptable under Rule 201(c).

Given the importance of short exempt orders, many other questions regarding the timing and characteristics of short exempt orders will need to be clarified. For example, if an order is marked short exempt based on its price being in compliance with the Price Restriction at the time of submission and is routed through several trading centers before execution, do the trading centers need to assess the exempt status of the order before executing it?

Application of Existing Guidance

Interpretations have developed under Regulation SHO, largely gathered in the Division of Trading and Markets' Frequently Asked Questions ("**FAQs**") on Regulation SHO, that have an important impact on applying Rule 201 as it currently exists.[4] Key among these is the use of aggregation units, which should continue unchanged, and the appropriate marking of short sale orders.

In August of 2009, the SEC staff generated significant controversy by publishing FAQs 2.4 and 2.5, which reversed many firms' practices regarding marking short sale orders. The staff has engaged in extensive discussion with securities firms regarding the application of these FAQs, and interpretive relief is expected soon that would substantially affect the application of the marking requirements.

Market-Maker Exception and Options Market Study

Commenters argued both for and against market-maker exceptions from Rule 201. Proponents suggested that such exceptions were crucial for ensuring that equity, options and other derivatives markets remain liquid and efficient, while the detractors saw the possibility of market participants "gaming" the system. The SEC decided not to include such exceptions in Rule 201, but the Release states that the SEC Staff will study the effect of Rule 201 on the options markets and submit a written report within two years of the implementation of the Rule.

Rule 201 and Convertible Securities

A number of comments received by the SEC noted that short sales are frequently used in the issuance and hedging of convertible securities and any restrictions on such use of short sales could dampen the ability to raise

[4] *See* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

capital through convertible securities. While the SEC admits that the resultant "indirect costs could, at the margin, reduce the attractiveness and, therefore, the volume of certain types of offerings," the SEC argues in the Release that since the Price Restriction is time-limited and short sales are not completely banned upon triggering of the circuit breaker, the increased cost will not significantly affect capital formation.

Whether the SEC or the commenters are right about the effect of the Rule on convertible securities is an empirical question that will be of interest in the coming years.

Enforcement and Exemptive Authority

In response to concerns that a policies and procedures approach is more susceptible to manipulation than an outright ban, the Release notes that both the SEC and SROs will monitor trading centers' policies and procedures and may bring enforcement actions against trading centers with unreasonable policies and procedures that allow execution and display of short sales in contravention of Rule 201. Specifically, the Release mentions the possibility of enforcement action against trading centers or other market participants based on theories of aiding and abetting or causing violations of Regulation SHO, or under Sections 9(a), 10(b) and 15(c) of the Securities Exchange Act of 1934 as well as Rule 10b-5.

Rule 201(f) grants the SEC broad exemptive authority. At the Commission meeting adopting Rule 201, the SEC staff said that they would consider exemptive requests that could demonstrate a lack of manipulative impact. The SEC staff has delegated authority to issue exemptions.

Additional Issues

Overseas Transactions

The extent to which the Rule will change fundamental trading behavior, as opposed to simply moving trades offshore, depends crucially on the nexus to the United States required for the Rule to be invoked. In the Release, in response to a specific comment received, the SEC confirmed that Rule 201 and Regulation SHO generally apply to all trades "agreed to" in the United States, regardless of where the trade is ultimately executed. As an example, the Release notes that a U.S. money manager who decides on a sale price with a U.S. broker-dealer, which sends the order ticket to a foreign desk to be executed, is subject to the Price Restriction for that trade. Further, the SEC stated its view that all broker-dealers using U.S. jurisdictional means to effect short sales in securities traded in the United States, including broker-dealers exempt from registration with the SEC, are subject to Regulation SHO.

By contrast, since foreign exchanges and market markets that do not hold themselves out as market makers in the United States are not included in the definition of "trading centers" and therefore are not directly subject to the Rule, there should be some latitude for short sale orders to be routed to bona fide foreign exchanges for execution, even if they would otherwise be subject to the Price Restriction. However, the SEC will certainly be on the lookout for schemes to abuse the jurisdictional limitations expressed in the Release and the definitions by making it appear that trades that were agreed to in the United States are being executed on foreign exchanges or markets.

It seems likely that various permutations of cross-border transactions and practices will generate ongoing questions for resolution through further SEC guidance or market practices. The SEC's ultimate stance on such questions, whether provided through further rules, other guidance, or its enforcement actions, will play an important role in determining the extent to which the Rule fosters offshore markets in NMS stocks.

Timing Issues

The Price Restriction instituted upon a 10% decline in stock price remains in effect for the remainder of the trading day and the next trading day, but only during those hours when a Plan processor calculates and disseminates quotations. As a result, between the end of quoting on a day in which the circuit breaker is triggered and the start of quoting on the subsequent morning, short sales are unrestricted by Rule 201. In addition, an overnight price decline outside of the hours in which transaction reporting plans are operating would not, itself, trigger a circuit breaker. This is particularly noteworthy because significant company announcements are often made after the close of trading. As a result, short selling after the close of the relevant Plan could push the price of a covered security down considerably without the circuit breaker being triggered.

Conclusion

The adoption of Rule 201 is a major change to the equity markets that will have a number of important practical implications on all market participants. The significance of such regulation is underscored by the fact that the SEC received nearly 3,900 unique comment letters in response to its April proposal. Yet, as outlined above, the resolution of a number of remaining questions will have an important impact on the effectiveness of the Rule and the extent to which it changes existing market trading structures and strategies.

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