Short Sale Proposals: Key Questions

May 4, 2009

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The SEC's Proposals

The Securities and Exchange Commission will hold a roundtable at its headquarters in Washington, DC on May 5, 2009 to discuss issues raised by its recent proposals to restrict short sales. Questions will be directed to three main topics: 1) Market Changes and Investor Confidence; 2) Bid versus Tick versus Circuit Breakers; and 3) Lessons and Insights from Empirical Data. In anticipation of the roundtable, this memorandum focuses on the structure of the SEC's recent proposals and the key questions raised by them.

In response to public outcries for a regulatory response to sharp declines in equity prices, on April 10, 2009 the SEC released a set of proposals to restrict short sales (the "Release"). The proposals would reverse the SEC's elimination – after extensive economic analysis and policy debate – of its prior uptick rule and other short sale restrictions in 2007.

For nearly seventy years – from 1938 to 2007 – Rule 10a-1 under the Securities Exchange Act of 1934 generally prohibited short sales on listed stocks unless they occurred in a rising market (*i.e.*, on an "uptick"). Specifically, short sales were permissible at or above the last sale price, with short sales at the last sale price permitted only if the last different sale price was below the last sale price. From 1994 to 2007, Nasdaq maintained a "bid test" for securities traded on its market. These rules were intended to prevent speculators from pushing down stock prices through short sales.

In response to clamor to restore the original uptick rule, the SEC has proposed, among other alternative approaches, a slightly updated version of the rule. Noting, however, that the operation of the market has changed dramatically since the abrogation of Rule 10a-1, the SEC also has proposed four alternative short sale rules to better accommodate the market realities of 2009. One proposal limits short sales into a declining bid price rather than a declining last sale price. The other three proposals employ "circuit breakers" that are triggered by a specified stock price drop and either temporarily halt short sales altogether or institute price restrictions based on last sales or bid price.

The SEC's proposals contain very limited exceptions. As written, these exceptions might not cover most convertible arbitrage and equity derivatives hedging as those activities are currently conducted. A companion memorandum focuses on the particular implications of the proposals for equity derivatives and equity-linked securities. See SEC Proposed Short Sale Restrictions: Implications for Equity Derivates and Equity-Linked Securities dated April 16, 2009.

The Release contains nearly 200 questions on which the SEC seeks comment. Also significant are the specific issues on which the SEC did not ask for comment, which may indicate the SEC is predisposed toward certain rule outcomes.

The SEC Roundtable

» **The SEC Roundtable will take place in the auditorium of the SEC's Headquarters in Washington, DC on May 5, 2009, from 10:00AM to 3:15PM. It is open to the public and will be webcast live on the SEC website, http://www.sec.gov. The panels include:**

» **Market Changes and Investor Confidence: Are short sale price tests or short sale circuit breakers necessary or effective?**

- Kevin Cronin, AIM Investments;
- Brian Conroy, Fidelity Investments;
- Richard Ketchum, FINRA
- John Kozak, Park National Bank Corporation
- Dan Mathisson, Credit Suisse
- Michael McAlevey, General Electric Corporation
- Justin Schack, Rosenblatt Securities

» **Bid versus Tick versus Circuit Breakers: Discussion of short sale price tests and views on short sale circuit breakers.**

- Jeff Brown, Charles Schwab Corporation
- Larry Leibowitz, The New York Stock Exchange
- John Nagel, The Citadel Group
- Bill O'Brien, Direct Edge
- Jerry O'Connell, Susquehanna International Group
- Brett Redfearn, JP Morgan Chase

» **Lessons and Insights from Empirical Data: Short sale price tests and short sale circuit breakers by the numbers.**

- Professor James Angel, Georgetown University
- Dr. Frank Hatheway, Nasdaq OMX Group
- Professor Charles Jones, Columbia University
- Dr. Robert Shapiro, Sonecon, LLC
- Professor Ingrid Werner, The Ohio State University

The Proposals

» **Uptick Rule**

- Would prohibit the execution of short sales at or below the last sale price, or below the last sale price if the last different sale price was below the last sale price (*i.e.*, no short sales on "**minus ticks**" or "**zero-minus ticks**")

» **Modified Uptick Rule**

- Would require policies and procedures prohibiting the execution and display of short sales at a price less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price less than or equal to the current national best bid (*i.e.*, a "**down-bid**")

» **Circuit Breaker Halt Rule**

- Would require policies and procedures halting short sales in a security when triggered by a 10% decline in the price of that security

» **Circuit Breaker Uptick Rule**

- Would impose the Uptick Rule for a security when triggered by a 10% decline in the price of that security

» **Circuit Breaker Modified Uptick Rule**

- Would impose the Modified Uptick Rule for a security when triggered by a 10% decline in the price of that security

The Terms of the SEC's Proposals

All five alternative proposals would restrict short sales of NMS stocks, a universe that includes almost all stocks listed on a national securities exchange regardless of whether short sales occur on an exchange or in the OTC market. The proposed rules would not apply to options or non-NMS stocks quoted only in the OTC market. The rules would apply to all trades executed in the U.S. and all trades agreed to in the U.S. regardless of where executed. The rules would apply only during regular trading hours, and would not apply to most after-hours trading, with one significant exception discussed below.

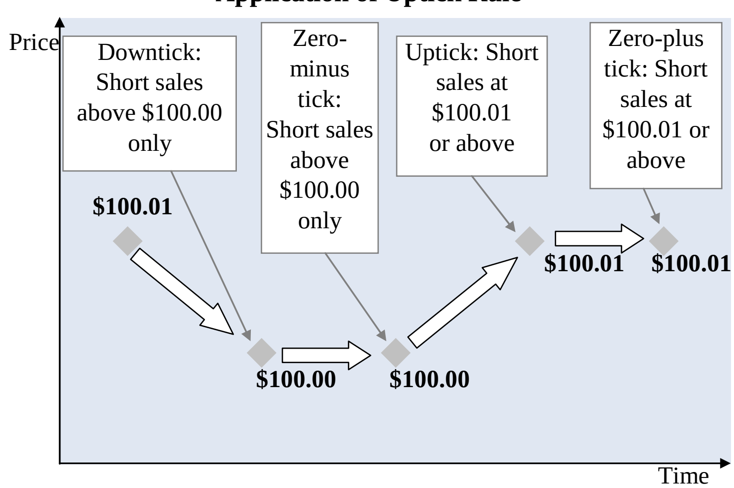
Price Test Proposals

The first set of SEC proposals, designated the "price test proposals," would limit short selling by restricting the price at which short sales may be effected. The two proposals, the "Uptick Rule" and the "Modified Uptick Rule," primarily differ in the price indicator used to limit short selling.

Uptick Rule

The proposed Uptick Rule closely mirrors the former Rule 10a-1. It precludes short sales when last sale prices decrease. Specifically, it precludes all persons from executing short sales below the last sale price, and also precludes short sales at the last sale price unless the last sale was on an uptick or a zero-plus tick. Like Rule 10a-1, the Uptick Rule bans the execution of short sales at prohibited prices unless an exception applies. The Uptick Rule differs from Rule 10a-1 primarily in referencing the consolidated prices from all markets rather than permitting each market to reference its own last sale price.

Application of Uptick Rule



Trading Centers

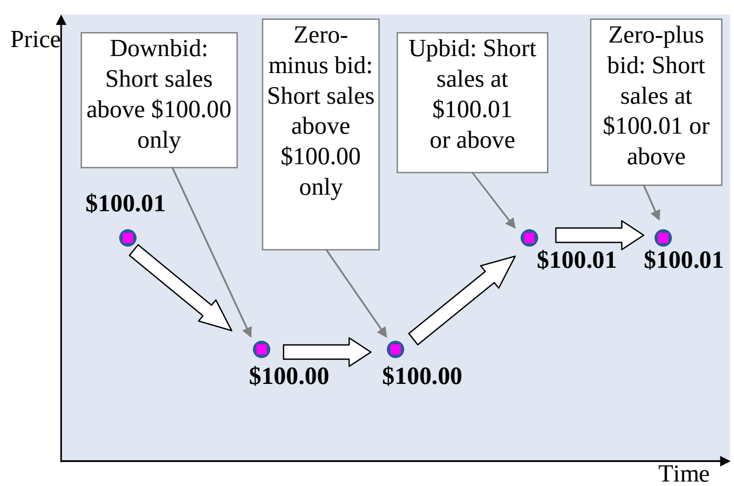
- "Trading Center" is defined as "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent."

Modified Uptick Rule

The proposed Modified Uptick Rule uses the national best bid instead of the last sale price as a reference point for short sale restrictions. The proposal restricts the display or execution of short sale orders at a down-bid price, defined as a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid. The Modified Uptick Rule requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order at a prohibited price. Thus, the Modified Uptick Rule employs a policies and procedures approach rather than the outright ban approach contained in the Uptick Rule.

The following example illustrates how the Modified Uptick Rule would work. If the current national best bid in a security is $100.00 and the immediately preceding national best bid was $100.01 (*i.e.*, the current bid is below the previous bid), a trading center could execute a short order at a price above $100.00. If the current national best bid is $100.01 and the immediately preceding national best bid was $100.00 (*i.e.*, the current bid is above the previous bid), a trading center could execute a short order at a price at or above $100.01. If the current national best bid and the immediately preceding national best bid are both at $100.00, then depending on whether the last differently priced national best bid was above or below $100.00, a trading center could execute a short order at a price above $100.00 or at a price of $100.00 or above, respectively.

Application of Modified Uptick Rule



Exception Approach

- Exceptions to the proposed Uptick Rule, Modified Uptick Rule, Circuit Breaker Uptick Rule, and the Circuit Breaker Modified Uptick Rule generally mirror those applicable to the old Rule 10a-1, with distinctions based on differences in implementation
- Exemptions to the proposed Circuit Breaker Halt Rule are modeled after those applicable in the 14-day ban imposed in September and October of 2008

The Modified Uptick Rule provides more flexibility than the Uptick Rule. A short sale order that is impermissibly priced can be repriced, at the option of the trading center, to the lowest permissible price and held for execution at the new price or better. This alternative permits a trading center to avoid persistent cancelation and rejection of impermissibly priced orders. The Modified Uptick Rule also permits the broker-dealer to mark the order "short exempt" which indicates that the order was not on a down-bid at the time it was submitted. The broker-dealer must have policies and procedures reasonably designed to ensure its compliance with the rule.

The Modified Uptick Rule also permits the broker-dealer to mark the order "short exempt" which indicates that the order was not on a down-bid at the time it was submitted.

Circuit Breaker Proposals

Unlike the price test proposals, the three circuit breaker proposals each limit short sales in affected securities only if the security trades below a pre-specified "trigger point." The proposed circuit breaker is a 10% decline from the previous day's closing price, which would trigger differing short sale restrictions depending on the specific proposal. Each proposal contemplates that once the trigger is reached, the short selling restrictions for a security would apply for the remainder of the trading day, unless the trigger is reached within 30 minutes of the end of regular trading hours.

Circuit Breaker Halt Rule

The proposed Circuit Breaker Halt Rule imposes a temporary *halt* on the short selling of a particular security – and only on that security – if the price of that security declines by 10% or more from its prior day's closing price.

Circuit Breaker Uptick Rule

The proposed Circuit Breaker Uptick Rule combines a circuit breaker with the Uptick Rule. It imposes the Uptick Rule for a particular security if the price of that security declines by 10% or more from its prior day's closing price. Like the Uptick Rule, the Circuit Breaker Uptick Rule would impose an outright ban on short selling at a prohibited price rather than a requirement that trading centers establish, maintain, and enforce written policies and procedures.

Exceptions Specific to the Circuit Breaker Halt Rule

- Bona fide market making in securities;
- Bona fide market making in derivatives;
- Expiration of option and futures contracts held before the circuit breaker was triggered; and
- Assignment to call writers of the exercise of call options.

Circuit Breaker Modified Uptick Rule

The proposed Circuit Breaker Modified Uptick Rule combines a circuit breaker with the Modified Uptick Rule. It imposes the Modified Uptick Rule in a particular security for the remainder of the trading day if the price of that security declines by 10% or more from its prior day's closing price. Like the Modified Uptick Rule, the Circuit Breaker Modified Uptick Rule would be instituted through policies and procedures of trading centers.

Proposed Exceptions to Short Sale Restrictions

Of critical importance to the SEC's proposals are the exceptions. These exceptions aim to minimize the disruptive effect that short sale restrictions have on market liquidity, efficiency and price discovery. The exceptions proposed in the Release are set forth in Appendix A to this memorandum.

Consideration of the short sale exceptions themselves, the differences among the exceptions applicable to the various rules, and the determination not to propose or even request comment on certain exceptions provide insight into the SEC's thoughts on the nature of the various proposals. The proposed Uptick Rule, Modified Uptick Rule, Circuit Breaker Uptick Rule, and Circuit Breaker Modified Uptick Rule all include many exceptions imported directly from the historical Rule 10a-1 uptick rule and SEC no-action letters. That said, the proposal omits certain exceptions from the Uptick Rule where they were unnecessary under the policies and procedures approach contemplated for the Modified Uptick Rule and the Circuit Breaker Modified Uptick Rule. For example, the exception for executed short sales mistakenly marked long by another broker-dealer would not apply in a policies and procedures framework. The use of historical exceptions in the four proposals is strong evidence that the SEC views these proposals as consistent with the spirit of the past rule, albeit with some differences in the details.

The set of exceptions is markedly different, however, for the Circuit Breaker Halt Rule, indicating a very different mindset on the part of the SEC in offering it for comment. The Circuit Breaker Halt Rule's exceptions, the SEC notes, are modeled on the exceptions to the short sale ban implemented in September and October of 2008 rather than the exceptions to the Rule 10a-1 test. This is largely because the Circuit Breaker Halt Rule, if triggered, would totally prohibit short sales in affected securities rather than impose limits on short sales in declining markets. In particular, the Circuit Breaker Halt Rule proposal, unlike the other four proposals, includes exceptions for short sales as part of: 1) bona fide market making in equity securities; 2) bona fide market making in derivatives; 3) the expiration of option and futures contracts held before the circuit breaker was triggered; and 4) assignment to call writers of the exercise of call options.

Key Questions in the SEC Short Sale Restriction Proposals

During the open meeting in which the SEC approved the Release, SEC Chairman Mary Schapiro implored the public to comment on the proposals by stating: "I urge all those within the sound of my voice to actively participate in the rulemaking process."[1] The SEC's commitment to actively engage public comment is further signaled by lengthy specific questions in the Release. This section of the memorandum highlights certain key questions for market participants to consider in deciding whether and how to comment and how the different proposals might affect their businesses.

Are Short Sale Restrictions Necessary?

- While the SEC has formally proposed five short sale alternatives, it made clear that it has not decided whether it should institute any short sale restriction at all. In fact, the Commission's attitude toward restating a short sale regulation can be best described as ambivalent. Even though the Release cites "bolstering investor confidence" as a leading basis for the proposed short sale restrictions, Commissioner Kathleen Casey expressed significant skepticism about the proposals, calling them a mere "political exercise" and questioning whether their potential benefits would outweigh the costs.[2] Commissioner Troy Paredes also warned that "the failure of a short sale restriction to serve its intended goals . . . actually might erode investor confidence over the long term, whatever the immediate positive impact might be."[3] Commissioner Luis Aguilar noted that "[t]his proposal is very much a

[1] Chairman Mary L. Schapiro, Statement Before the United States Securities and Exchange Commission Open Meeting on April 8, 2009.

[2] Commissioner Kathleen L. Casey, Statement Before the United States Securities and Exchange Commission Open Meeting on April 8, 2009.

[3] Commissioner Troy A. Paredes, Statement Before the United States Securities and Exchange Commission Open Meeting on April 8, 2009.

response to the vocal calls for the Commission to consider short sale restrictions."[4]

» In February of 2007 the SEC released results of its Regulation SHO Pilot Program, which studied the effect of removing short sale restrictions on one-third of the stocks in the Russell 3000 index. See Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot. Among positive results found by the pilot were that removal of the price restrictions 1) increased short selling but did not increase short interests of market participants; 2) increased trading volume; 3) did not change the amount of options trading; 4) increased quote depth; and 5) did not promote "bear raids." In 2007 the SEC used the results of this study to justify repealing the short sale restrictions. The Commission noted this study in the Release, but independently cited the fact that "many members of the public currently associate the removal for former Rule 10a-1 with the recent volatility" as an explanation for nonetheless proposing short sale restrictions again.

Other Short Sale Initiatives Have Effectively Addressed Fails to Deliver

- **Rule 204T of Regulation SHO requires delivery of securities for clearance and settlement by the settlement date**
- **Rule 10b-21 is an anti-fraud rule that addresses naked short selling**

» Interim Final Temporary Rule 204T of Regulation SHO, introduced in September 2008, changed delivery rules in an attempt to "protect investors against 'naked' short selling abuses."[5] The Rule requires delivery of securities for clearance and settlement by the settlement date. Failure to so deliver requires a close out of the fail to deliver position by the beginning of regular trading hours on the day after the settlement date. According to studies by the SEC's Office of Economic Analysis, "the average daily number of aggregate fails to deliver for all securities decreased from 1.1 billion to 582 million for a total decline of 47.2% when comparing a pre-Rule to post-Rule period." The rule was extended until August 1, 2009 by Rule 204T. The SEC could choose to extend it permanently, with some modifications in response to comments. The SEC also may find that Rule 204T combined with the "naked" short selling anti-fraud Rule 10b-21 have served to address concerns about short selling. The

[4] Commissioner Luis Aguilar, Statement Before the United States Securities and Exchange Commission Open Meeting on April 8, 2009.

[5] *See* Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against "Naked" Short Selling Abuses, http://www.sec.gov/divisions/marketreg/204tfaq.htm.

Davis Polk & Wardwell Memoranda Related to 2008 Short Sale Regulations

- September 18: SEC Issues New Rules on Naked Short Sales and Plans Further Actions to Combat Market Abuses
- September 19: SEC Issues Order Temporarily Banning Short Sales of Public Securities of 799 Financial Institutions
- September 22: SEC Amends Order Temporarily Banning Short Sales of Financial Companies to Modify Scope of Covered Securities and Expand Exemption for Derivatives Market Makers
- October 3: SEC Extends Short Sale Emergency Orders
- October 20: SEC Issues Interim Final Temporary Rule Extending Short Sale Reporting

success of these prior actions may temper the SEC's views on the necessity to impose further restrictions on short selling.

- During the 14 day short sale ban in September and October of 2008, bid/ask spreads more than doubled for those financial stocks in which short sales were banned compared to those stocks in which short sales were not banned, indicating a decrease in market liquidity. The Release does not contain any data or economic study of the experience during this period, discussing instead the potential importance of the proposals for public confidence.

If Short Sale Restrictions Are Introduced, Should They Employ Price Tests or Circuit Breakers?

- A primary stated aim of any short sale restriction is limiting harmful "bear raids" while not overly interfering with market efficiency, liquidity and price discovery. The SEC, in proposing a circuit breaker approach as an alternative to a price test approach, notes that "[a] short selling circuit breaker rule would be designed to target only those securities that experience rapid severe intraday declines and, therefore, might help to prevent short selling from being used to drive the price of a security down or to accelerate the decline in the price of those securities. In line with the Commission's position that market impediments should be minimized, a short selling circuit breaker when applied might benefit the market as a narrowly tailored response to extraordinary circumstances."

- One concern regarding circuit breakers expressed in the Release is that the presence of the circuit breaker may accelerate trading in down markets until the trigger is reached. The SEC notes that some academic studies have questioned this "magnet effect," yet the SEC requests comment on whether a short sale circuit breaker in particular will have magnet qualities.

- In one question, the SEC quietly raises the possibility of a Modified Uptick Rule or an Uptick Rule that would trigger a circuit breaker halt if a certain threshold were reached. This would be potentially more onerous than any of the five proposals specifically outlined in the Release. Commenters may wish to specifically address the implications were such a rule to be adopted.

» The SEC asks in detail whether a circuit breaker should be applied on a pilot basis, suggesting active consideration of this possibility.

Should a Price Test Use Last Sale or Bid Information?

» The Release clearly indicates the SEC's preference for the bid-based Modified Uptick Rule over the Uptick Rule and, correspondingly, the bid-based Circuit Breaker over the last sale-based Circuit Breaker. The SEC argues that Regulation NMS, which had the effect of fostering trading across many markets and alternative trading systems, combined with different latencies for reporting trades, would lead to incorrect sequencing of trade reports. This would defeat the purpose of a rule based on relative price levels of consecutive trades occurring in the real time.

» One possible result of using a bid-based rule would be a sharp increase in cancel and replace orders, as short sale limit orders are entered successively one increment above a declining bid price.

How Should Circuit Breakers Be Triggered?

» The circuit breaker approach to short sale restrictions would represent a shift from the pre-2007 uptick rule and could have implications for market liquidity, efficiency and price discovery. As a result, the Release encourages empirical data on the effects of the proposed circuit breakers, including the level at which the restrictions are triggered. While proposing a 10% circuit breaker, the SEC specifically requests comment as to whether the circuit breaker should be set at 5% or 20%; whether a 20% fall should trigger a longer short sale restriction; and whether this should be a rolling circuit breaker over subsequent days.

Which Exemptions Should Apply?

» Instituting short sale restrictions without appropriate exceptions would impair markets and decrease efficiency, liquidity and price discovery. Yet making exceptions too broad would eviscerate the rule. The SEC requests comments on many individual exceptions in an attempt to strike an appropriate balance.

» The Uptick Rule and Circuit Breaker Uptick Rule, like the original 10a-1 Rule, are outright bans on short sales at certain prices. The Modified Uptick Rule and the Circuit Breaker Modified Uptick Rule, in contrast, are designed to be instituted as policies and procedures of individual institutional trading centers. The variance in applicable exceptions to these rules, in most cases, results from this implementation difference. The exceptions to the Circuit Breaker Halt rule, however, are primarily taken from the 14 day ban on short selling in certain securities during September and October of 2008 and include a bona fide equity market maker exception, a bona fide derivative market maker exception, a seller's delay in delivery exception, and an exception for assignment to call writers upon exercise of an option. In particular, the SEC does not even ask about including the derivative market maker exception in any other proposal, suggesting a distaste for this exception that commenters favoring this exception may have to overcome.

» One result of a policies and procedures approach to short sale restrictions is that an upbid could unleash a flood of short sale orders, as many order entry firms conclude that the upbid warrants marking their orders as short exempt. There is no discussion of this likely outcome in the Release or what its implications would be.

Should After-Hours Short Sales Be Restricted?

» In the past, the SEC interpreted Rule 10a-1 to apply to short selling at all times, and thus limited after-hours short selling to prices above the closing last sale price. In contrast, the proposed rules would not apply to after-hours trading in the United States. Specifically, the rules would only apply when best bid or last sale prices are collected, calculated and disseminated pursuant to a national market system plan. At present, three plans provide such market information on NMS stocks: the CQ Plan, the CTA Plan, and Nasdaq UTP Plan. The CQ Plan provides such market information i) from 9:00 a.m. to 6:30 p.m. Eastern time Monday through Friday when at least one covered market

> The SEC's choice to tie the application of the short sale restrictions to operation of the national market plan processor allows certain plan participants, if they wish, to extend the proposal's effective period by paying to operate the plan processor for a longer period.

participant is open and ii) at any other time that these covered market participants provide the Plan with such information and pay relevant costs. The CTA Plan provides such market information i) when at least one covered market participant is open and ii) at any other time that these covered market participants provide the Plan with such information and pay for its dissemination. The Nasdaq UTP plan provides such market information from 4:00 a.m. to 8:00 p.m. Eastern time when plan participants are open for trading. Note that the SEC's choice to tie the application of the short sale restrictions to operation of the national market plan processor allows CQ and CTA plan participants, if they wish, to extend the proposal's effective period by paying to operate the plan processor for a longer period.

What is an Appropriate Implementation Period?

» Implementation of any approach other than a Circuit Breaker Halt would seem to require substantial computer coding issues, yet the SEC proposes a 3 month implementation window. This is perplexing given the SEC's experience with implementation of Regulation SHO, which was extended from its original 5 month implementation period to 9 months due to the complexity of the process. Likewise, Regulation NMS involved substantial coding issues and took the industry nearly 27 months to implement. The short time proffered by the SEC may indicate a need for broker-dealers and markets to document the implementation challenges in detail in their comment letters. Commenters should also quantify the costs of implementation of each proposal.

» The SEC indicates in the Release that any instituted proposal may, but will not necessarily, contain a pilot period.

Conclusion

The SEC has presented a broad range of alternatives to address perceived problems with short-selling. While it appears that the SEC staff favors the Modified Uptick Rule, the SEC has clearly indicated that it will analyze market reaction to the proposals through comment letters, providing market participants with a voice in whether short sale restrictions are instituted and, if so, what form they will take. The SEC's May 5 roundtable on short sales will provide the SEC with additional input on a host of issues, including the need and effectiveness of short sale restrictions, the relative costs and benefits of the different proposals, and empirical data related to the proposals. Davis Polk & Wardwell will continue to monitor new developments on this front and will prepare additional analysis as further details become available about these proposals, the market's reaction to the proposals, and the implications of the proposals on our clients.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk & Wardwell contact.

Daniel N. Budofsky, Partner
212-450-4907 | daniel.budofsky@dpw.com

Joseph A. Hall, Partner
212-450-4565 | joseph.hall@dpw.com

Mark M. Mendez, Partner
212-450.4829 | mark.mendez@dpw.com

Annette L. Nazareth, Partner*
202-962-7075 | annette.nazareth@dpw.com

James T. Rothwell, Partner
212-450-4806 | james.rothwell@dpw.com

Lanny A. Schwartz, Partner
212-450-4174 | lanny.schwartz@dpw.com

Linda A. Simpson, Partner
212-450-3332 | linda.simpson@dpw.com

Gerard Citera, Counsel
212-450-4881 | gerard.citera@dpw.com

Robert L. D. Colby, Counsel
202-962-7121 | robert.colby@dpw.com

* Admission pending in DC; practicing in DC under the supervision of partners of the firm.

References

- » SEC Proposed Amendments to Regulation SHO (April 10, 2009)
- » SEC Press Release Seeking Comments on Short Sale Price Test and Circuit Breaker Restrictions (April 8, 2009)
- » SEC Temporary Order Banning Short Sales in Public Securities of Financial Companies (September 18, 2008)

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Proposed Exceptions to Short Sale Price Restrictions Rules

» **Modified Uptick Rule**

- Seller's Delay in Delivery
- Domestic Arbitrage
- International Arbitrage
- Over-Allotments and Lay-Off Sales
- Riskless Principal Transactions
- VWAP Transactions

» **Uptick Rule**

- Same exceptions as the Modified Uptick Rule, plus:
- Error in Making a Short Sale
- Electronic Trading Systems
- Firm Quote
- Facilitation of Customer Buy Orders

Appendix A: Summary of Proposed Exceptions

The Release proposes the following exceptions for the Modified Uptick Rule, the Uptick Rule, the Circuit Breaker Modified Uptick Rule and the Circuit Breaker Uptick Rule, all of which were in former Rule 10a-1 or applicable no-action letters:

» ***Seller's Delay in Delivery.*** The proposed rule would not apply if the seller owns the security being sold and will deliver the security as soon as all delivery restrictions have ended.

» ***Odd Lot Transactions.*** The proposed rule would not apply to short sales by a market maker made to offset a customer's odd-lot order or liquidate that market maker's odd-lot positions, assuming such a transaction would change the broker-dealer's position by no more than one unit of trading.

» ***Domestic Arbitrage.*** The proposed rule would not apply to domestic arbitrage transactions in which simultaneous purchases and sales are effected in order to lock in profit from differences in the pricing of two related securities. The Release cites to Regulation T's narrow definition of bona fide arbitrage.

» ***International Arbitrage.*** The proposed rule would not apply to international arbitrage transactions in which a U.S. market position is immediately covered in a foreign market to lock in profit from differences in the pricing of two related securities, including depository receipts.

» ***Over-Allotments and Lay-off Sales.*** The proposed rule would not apply to short sales by underwriters or syndicate members participating in a distribution in connection with over-allotments. Similarly, it would not apply to any short sale order with respect to lay-off sales by underwriters or syndicate members in connection with a distribution of securities through rights or standby underwriting commitments.

» ***Riskless Principal Transactions.*** The proposed rule would not apply to short sales where the customer is net long and the broker-dealer is net short but is effecting the sale for the customer as a riskless principal.

» ***VWAP Transactions.*** The proposed rule would not apply to certain short sale orders executed on a volume-weighted average price

Proposed Exceptions to Short Sale Circuit Breaker Rules

» **Circuit Breaker Halt Rule**

- Seller's Delay in Delivery
- Market Makers
- Derivative Market Makers
- Assignment to Call Writers Upon Exercise of an Option

» **Circuit Breaker Uptick Rule**

- Same exceptions as Uptick Rule

» **Circuit Breaker Modified Uptick Rule**

- Same exceptions as Modified Uptick Rule

("VWAP") basis. The Release asks for comment on use of a broader Regulation NMS "benchmark" exception in place of the narrower VWAP exception.

The Release proposes the following additional exceptions to the Uptick Rule and the Circuit Breaker Uptick Rule:

» ***Error in Marking a Short Sale.*** The proposed rule would not apply to short sales effected by a broker-dealer for an account in which it has no interest when the order is incorrectly marked "long" by another broker-dealer that should have marked it "short." This exception is unnecessary under the policies and procedures approach applied in the Modified Uptick proposals.

» ***Electronic Trading Systems.*** The proposed rule would not apply to electronic trading systems that passively match and execute trades at prices between the quotes. This price condition obviates the need for an exception under the Modified Uptick proposals.

» ***Firm Quotes.*** The proposed rule would not apply to short sales by registered specialists, registered exchange market makers, or third-party market makers executed at the most recent communicated offer price for the security if that offer was greater than or equal to the last reported sale price for the security when communicated. This exception is intended to ensure market maker public quotes would be firm. This exception is unnecessary under the Modified Uptick proposal.

» ***Facilitation of Customer Buy Orders.*** The proposed rule would not apply to short sales by market markers at their quoted offer made to facilitate customer buy limit orders.

The following exceptions originally included in the Emergency Orders are unique to the Circuit Breaker Halt Rule:

» ***Market Maker Exception.*** The proposed rule would not apply to registered market makers, block positioners, or other equity market makers required to quote in the OTC market selling short a publicly traded security covered by the proposed rule as part of bona fide market making in that security.

» ***Bona Fide Market Making in Derivatives.*** The proposed rule would not apply to short sales by market makers related directly to market making in derivatives on publicly traded securities covered by the rule.

» ***Options and Futures Contract Expiration.*** The proposed rule would not apply to automatic short sales at the expiration of options and futures contracts held before circuit breaker is triggered.

» ***Assignment to Call Writers Upon Exercise of an Option.*** The proposed rule would not apply to short sales that result from assignments to call writers when an option is exercised.