Client Advisory

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# SEC Adopts New Short Sale Price Test Rules

On February 24, the SEC amended Regulation SHO to adopt a short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold short (hereafter, the "short sale price test").[1] More specifically, SEC Rule 201 requires that a trading center establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of 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 its closing price on the prior day. In addition, Rule 201 requires that the trading center establish, maintain and enforce written policies and procedures reasonably designed to impose this restriction for the remainder of that day and the following trading day. As discussed in more detail below, the short sale price test will apply to transactions effected during the time that the consolidated tape is open. Rule 201 will be effective 60 days after the publication of the release in the Federal Register and will have a six-month implementation period.

The short sale price test will not apply to a number of transactions, including short sale orders priced above the current national best bid at the time of submission, riskless principal transactions and arbitrage transactions. However, there is no general exemption for market-maker transactions.

The SEC believes that Rule 201 will help restore investor confidence during times of substantial uncertainty because, after the circuit breaker has been triggered, long sellers will have preferred access to bids for the security. Therefore, any price decline for the security will more likely be due to long selling and the underlying fundamentals of the issuer, rather than other factors. The SEC also believes that Rule 201 will help promote capital formation since investors should be more willing to hold long positions if they know that they may have a preferred position over short sellers when they wish to sell.

## Covered Securities

Rule 201 will 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. As a result, Rule 201 generally will cover all securities, except options, listed on a national securities exchange (whether traded on an exchange or in the OTC market). Rule 201 will not apply to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere on the OTC market. However, the SEC noted that it may reconsider whether to apply Rule 201 to these securities at a later date.

[1] See Securities Exchange Act Release No. 34-61595 (February 26, 2010) (the "Release").

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## Circuit Breaker Trigger Level and Duration

Under Rule 201, the reference point for determining whether the price of a covered security has declined by 10% is the closing price on its listing market at the end of regular trading hours on the prior day. This differs from the SEC's original proposal, under which this price decline would have been measured from the covered security's consolidated last sale price. In addition, because the short sale price test will only be applied on a temporary basis, (i.e., the remainder of the day and the following trading day), the SEC did not adopt a proposed provision that would have kept the short sale price test from becoming effective if the 10% trigger level was reached during the last 30 minutes of regular trading hours.

## Operational Concerns

The short sale price test will apply during periods when the national best bid is calculated and disseminated on a current and continuing basis by a plan processor. As noted in the Release, market information for quotes in covered securities is disseminated pursuant to two different national market system plans, the CQ Plan and the Nasdaq UTP Plan. Quotation information is made available under the CQ Plan between 9:00 a.m. and 6:30 p.m. Eastern Time, while such information is made available under the Nasdaq UTP Plan between 4:00 a.m. and 8:00 p.m. Eastern Time. The SEC stated that it may reconsider whether it would be necessary to apply Rule 201 to short sales that occur during other times in light of any new information it may receive.

As noted above, the listing market for each covered security must determine whether the covered security has reached the price trigger. Once the listing market has determined that a security has reached the price trigger, it must notify the exclusive plan processor responsible for the covered security, and this plan processor must then disseminate this information to the market.

## Policies and Procedures Approach

As noted above, Rule 201 will require trading centers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of the security decreases by 10% or more from the covered security's closing price. In addition, such policies and procedures must be reasonably designed to impose this short sale price test restriction for the remainder of the day on which it is triggered and on the following day. Further, in order to permit market participants to utilize the exemptions discussed below, these policies and procedures must permit the execution and display of short sale orders that are marked "short exempt" without regard to whether these orders are priced at or below the current national best bid.

In order to comply with this requirement, the SEC noted that a trading center must also take steps to enforce these policies and procedures effectively and take any necessary remedial action. Trading centers also will be required to conduct regular surveillance of their policies and procedures to ascertain their effectiveness and must take prompt action to remedy any deficiencies in such policies and procedures. Thus, trading centers may not merely establish policies and procedures that may be reasonable when created and assume that they are in compliance with Rule 201. Instead, trading centers will be required to assess the continuing effectiveness of their polices and procedures on a regular basis and take prompt action when necessary to remedy any deficiencies.

## Exemptions

**A. Broker-Dealer Exemption**

Rule 201 permits a broker-dealer to mark a short sale order as "short exempt" if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission. As the SEC noted in the Release, Rule 201 does not require a broker-dealer to obtain this information from any one particular data feed and thus may rely on its own internal view of the market for this purpose.

Any broker-dealer relying on this exemption must establish, maintain and enforce written policies and procedures that are reasonably designed to prevent the incorrect identification of orders as being priced in accordance with this requirement,

must regularly analyze the effectiveness of these policies and procedures, and must take prompt action to remedy any deficiencies therein. Thus, at a minimum, these policies and procedures must be reasonably designed to permit a broker-dealer to monitor the national best bid on a real-time basis and keep records identifying the current national best bid at the time of submission of a short sale order. A broker-dealer also must monitor any latencies it experiences in receiving national best bid data on a continuing basis and to take remedial action if necessary.

**B. Seller's Delay in Delivery**

Rule 201 permits a broker-dealer to mark an order as "short exempt" if it has a reasonable basis to believe that the seller owns a security being sold and that the seller intends to deliver the security as soon as all restrictions on delivery have been removed.

**C. Odd-Lot Transactions**

Rule 201 permits a broker-dealer to mark a short sale order as "short exempt" if it has a reasonable basis to believe that the short sale order is by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker-dealer's position by no more than 100 shares.

**D. Domestic Arbitrage**

Rule 201 permits a broker-dealer to mark a short sale order as "short exempt" if the order is associated with certain bona fide domestic arbitrage transactions. Specifically, Rule 201 provides that a broker-dealer may mark a short sale order of a covered security "short exempt" if the broker-dealer has a reasonable basis to believe that the short sale order is for a good faith account (as defined in Regulation T) of the seller who owns another security that is convertible into an equivalent number of securities of the same class as the securities sold. This exemption is only available if the transaction was effected for the purpose of profiting from a current difference between the price of the security sold and the security owned and the conversion right was originally attached to or represented by another security, or was issued to all the holders of any such securities of the issuer.

**E. International Arbitrage**

Rule 201 permits a broker-dealer to mark a short sale order as "short exempt" if the order is associated with certain international arbitrage transactions. Specifically, Rule 201 provides that a broker-dealer may mark a short sale order of a covered security "short exempt" if the broker-dealer has a reasonable basis to believe that the short sale order is for a good faith account (as defined in Regulation T) of the seller and is effected for the purpose of profiting from a current difference between the price of a security on a foreign securities market and a security on a U.S. securities market so long as 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. The requirement for the transaction to be "immediately" covered on a foreign market requires the foreign market to be open for trading at the time of the transaction. For purposes of this exemption, a depository receipt for a security is deemed to be the same security represented by the receipt.

**F. Over-Allotments and Lay-Off Sales**

Rule 201 exempts short sales by underwriters or syndicate members participating in a distribution in connection with an over-allotment. It also exempts lay-off sales by these persons in connection with a distribution of securities through a rights or standby underwriting commitment.

**G. Riskless Principal Transactions**

Rule 201 exempts short sale orders by broker-dealers that are facilitating customer buy orders or sell orders where the broker-dealer is acting as riskless principal. To utilize this exemption, a broker-dealer must have written policies and procedures in place to ensure that, at a minimum: (i) the customer order was received prior to the offsetting transaction; (ii) the offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) its records can reconstruct all transactions effected under this exemption in a time-sequenced manner.

**H. Transactions on a Volume-Weighted Average Price Basis**

Rule 201 exempts certain short sale orders effected on a volume-weighted average price (VWAP) basis. Thus, a broker-dealer may mark a short sale order of a covered security at the VWAP "short exempt" if the order meets the following conditions:

(1) the VWAP for the covered security is calculated by: calculating the values for every regular way trade reported in the consolidated system for the security during the regular trading session, multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (2) the transactions are reported using a special VWAP trade modifier; (3) the covered security qualifies as an "actively-traded security" under Regulation M;[2] (4) the transaction is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; and (5) the broker-dealer's position in the covered security, as aggregated across all of its customers who propose to sell short the same security on a VWAP basis, does not exceed 10% of the covered security's average daily trading volume. As the SEC notes in the Release, this exemption differs from the relief granted under former Rule 10a-1 in that it is not limited to VWAP transactions that are arranged or "matched" before the market opens at 9:30 a.m., or to VWAP transactions that are not assigned a price until after the close of trading.

## Lack of Exemption for Market Making Activity

Rule 201 does not contain a general exemption for market making transactions, and the SEC gave a number of reasons for the lack of such an exemption in the Release. First, the SEC noted that former Rule 10a-1 did not contain such an exemption. In addition, the SEC believes that any potential adverse impact arising from the lack of such an exemption will be limited because equity market makers generally sell at the offer. The SEC also noted that any potential adverse impact will be limited in scope and duration due to the structure of Rule 201.

The SEC separately acknowledged that a number of commenters expressed concerns regarding a potential exemption for options market makers. The SEC expressed its reluctance to create an un-level playing field between options market makers and market makers in other derivatives that sell short to hedge their positions. The SEC has, however, instructed its staff to assess the impact of Rule 201 on options market makers and complete this study within two years.

## Order Marking

In conjunction with the adoption of the short sale price test, the SEC has amended Rule 200 of Regulation SHO to impose a "short exempt" order marking requirement. As amended, Rule 200 will now require a broker-dealer to mark its sell orders "long," "short" or "short exempt." This order marking requirement will indicate to a trading center whether it must execute or display a short sale order without regard to whether the order is at a price that is less than or equal to the current national best bid. A broker-dealer may only mark an order as "short exempt" after the circuit breaker has been triggered for a covered security, and the SEC noted that it would be a violation of Rule 200 to mark a short sale order as "short exempt" when the relevant security is not subject to the short sale price test order.

With respect to inter-market sweep orders (ISOs) that are used to facilitate the execution of a customer's long sale in compliance with SEC Rule 611, the Release states that such ISOs may be marked as "short exempt" but may not be marked "long." This will allow trading centers to execute these orders against better-priced protected quotations without regard to the short sale price test restrictions of Rule 201.

[2] If the security is not an "actively-traded security," this exemption will be available only if it is conducted as part of a basket transaction of 20 or more securities in which the covered security does not comprise more than 5% of the value of the basket traded.