Short Sale Regulation Update: SEC Adopts "Alternative Uptick Rule"

February 25, 2010

On February 24, 2009, the Securities and Exchange Commission (the "Commission") adopted Rule 201 of Regulation SHO, also known as the "alternative uptick rule", by a vote of 3 to 2, over spirited dissent by Commissioners Casey and Paredes. The adoption of Rule 201 is the latest action by the Commission relating to the regulation of short sales and represents culmination of a rulemaking process that began with the issuance by the Commission of a proposing release in April 2009,[1] followed by a supplemental request for comments issued in August 2009.[2] The final adopting release has yet to be issued.

BACKGROUND

The predecessor of the alternative uptick rule, Rule 10a-1 under the Securities Exchange Act of 1934, as amended, commonly known as the "uptick rule", was repealed by the Commission in 2007 after years of empirical study of the impact of short-selling on the markets and the implementation of a pilot program. Subsequent to the elimination of the "uptick rule", and in response to the extreme market volatility that occurred at the depth of the financial crisis, the Commission took a number of emergency actions targeting short selling activity and related disclosure. These actions included, among other things, temporary bans on short sales of certain financial stocks, rules regarding delivery and disclosure and certain measures related to "naked" short selling.

THE NEW RULE

Rule 201 will apply to equity securities listed on a national securities exchange (whether traded on the exchange or over-the-counter). Under the new Rule, once the price of such security declines by 10 percent or more from the previous day's closing price, a "circuit breaker" will be triggered for a covered security. Once the circuit breaker is triggered, for the remainder of the day that the circuit breaker is triggered and for the entire following day, no short sales may be displayed or executed for the security if the order price is at or below the national best bid (subject to limited exemptions referenced below). In order to ensure compliance with the new Rule, trading centers, including national securities exchanges and alternative trading systems, will be required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale.

Certain transactions will be exempt from Rule 201. Exempt transactions will include the following:

[1] Exchange Act Release No. 34-59748 (April 10, 2009).
[2] Exchange Act Release No. 34-60509 (August 17, 2009).

- any short sale order submitted by a broker-dealer that was above the national best bid at the time of submission,
- short sales where the seller may be deemed to "own" a security but who may be technically considered a short seller due to the delayed delivery of the security,
- certain odd-lot transactions,
- certain domestic and foreign arbitrage transactions,
- sales resulting from over-allotments and lay-off sales,
- riskless principal transactions and
- volume weighted average priced basis trades.

It is expected that the scope of these exemptions will be clarified in the final adopting release.

IMPACT ON HEDGING ACTIVITIES AND OPTIONS MARKET MAKERS

In their statements before the Commission, Commissioners Casey and Paredes questioned the assertions made by the Staff of the Division of Trading and Markets (the "Staff") that Rule 201 will enhance investor confidence and expressed concerns that Rule 201 may reduce liquidity and market efficiency, distort trading strategies, increase the cost of entering into derivative transactions and implementing hedging strategies and artificially support the prices of the securities impacted by the Rule. Members of the Staff responded that during the implementation period of the Rule, they will closely monitor the impact of the Rule on the markets, with particular attention paid to options market-markers, and potentially adopt additional exemptions to the Rule.

EFFECTIVENESS OF THE NEW RULE

Rule 201 will become effective 60 days after publication of the adopting release in the *Federal Register.* The new Rule will have a six month implementation period intended to enable trading markets and market participants to develop and implement policies and procedures to comply with the new requirements. Publication of such final rulemaking releases commonly occurs from several days to several weeks after the Commission approves a new rule.

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

LATIN AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000