

## Regulation and Compliance—Proposed Changes to Regulation SHO

The SEC has extended the time for commentary on its proposed changes to Regulation SHO (short sales). Fed. Reg. Vol. 74, No. 160, August 20, 2009. The proposed regulations, initially made public in April (Fed. Reg. Vol. 74, No. 74, April 20, 2009), have been the subject of considerable comment. According to the SEC, to date there have been over 4,000 unique comments to its proposal.

### Background

Short sales occur when investors sell stock they do not currently own. If the price of the stock drops, short sellers buy the stock at the lower price, close out their short position, and make a profit. If the price of the stock rises, short sellers incur a loss.

#### *Example 1*

Mike believes that there will be a decline in the stock price of Company A. Company A is trading at \$50 a share, so he borrows shares of Company A stock at \$50 a share and immediately sells them in a short sale. Later, Company A's stock price declines to \$40 a share, and Mike buys shares back on the open market to replace the borrowed shares. Since the price has fallen to \$40 per share, Mike profits on the difference—in this case \$10 a share. However, if the price goes up from the original price, Mike loses the money.

Unlike a traditional stock sale—where risk is limited to the amount invested—a short sale leaves an investor open to the possibility of unlimited losses, because the price of stock purchased to close out the investor's short position has no upper limit. Furthermore, short selling may actually place downward pressure on stock prices, particularly in times of economic uncertainty.

The SEC regulated short selling through enforcement of the “uptick rule” for nearly 70 years from 1937 until 2007. The basic concept was that short sales could be executed only when a stock's price was moving up, thus limiting the ability of short sellers to initiate and profit from downward spirals of a stock's price.

Then, in 2007, due to perceived changes in the market place and following considerable study and a pilot program, the SEC eliminated “price testing” including the uptick rule for short sales.

However, citing the market volatility of 2008, the precipitous drop in prices experienced by certain financial stocks in particular, and a lack of consumer trust and confidence, the SEC proposed in April 2009 to reinstate some form of regulation in connection with short sales.

### **The Proposed Rule Change**

The SEC is proposing two alternatives for regulating short sales. The first of these is a *price test*, the second is a *circuit breaker*. There are variations within each.

#### *Price Testing*

**Proposed Modified Uptick Rule**—One variation would create a short sale price test that would use the national best bid as a reference point for short sale orders. Specifically, the proposed modified uptick rule would require that “[a] trading center shall 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 down-bid price.” The proposed modified uptick rule defines a “down-bid price” 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.”

Like the uptick rule of years past, this rule seeks to limit short sales to an up market for a particular stock. The SEC believes that such a rule could help prevent short sellers from driving stock prices down.

*The proposed regulation would regulate short sales using price testing, a circuit breaker, or both*

**Proposed Uptick Rule**—A variation on price testing involves the “proposed uptick rule.” Unlike the “proposed modified uptick rule,” which references the “current national best bid” as the measure for price testing, the proposed uptick rule would use the last sale price as the reference point for short sale orders. Thus, under the proposed uptick rule, no short sale order may be effected below the last sale price. Short sale orders may be effected at the last sale price only if the last sale price is above the last different price. Otherwise, all short sale orders must be effected above the last sale price.

Again, the SEC believes that this proposed rule, which is similar to the “uptick rule” in place from 1937 to 2007, would prevent downward market spirals of a stock due to short selling.

Alternative Modified Uptick Rule—Although it was not one of the proposed approaches, the SEC also sought comment in April on what it refers to as the “alternative modified uptick rule.” This approach is more restrictive and would permit short selling only at a price *above* the current national best bid.

#### *Circuit Breaker Rules*

Circuit Breaker Halt Rule—The proposed “circuit breaker halt rule” would, when triggered by a specified decline in the price of a particular security, temporarily prohibit any person from selling short a particular stock during severe market declines in that security, subject to certain exceptions.

Circuit Breaker Modified Uptick Rule—The proposed “circuit breaker modified uptick rule” would, when triggered by a specified (and, presumably, significant) decline in the price of a particular security, temporarily impose the proposed modified uptick rule for that security.

Unlike proposed price testing rules, which are permanent and apply market wide, a short selling circuit breaker rule targets only those securities that experience rapid severe intraday declines. The expectation is that circuit breaker rules would help 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.

#### **Comments to Proposed Rule**

In general, in the wake of the market decline in 2008 and the resulting loss of investor confidence, comments overwhelmingly favor restrictions on short selling. The August 20, 2009 SEC Release seeks additional feedback regarding the alternative modified uptick rule, which would allow short selling only at a price above the current national best bid.

Comments should be received on or before September 21, 2009.

#### **Bottom Line**

It is highly likely that we’ll see additional regulation of short sales in the near future. However, it is unclear whether this means a return to price testing or imposition of a new circuit breaker test, or some combination of both. In any event, the SEC does not want to be seen as having its head in the sand and the public, in general, wants regulation. Many believe that the fall of Fannie Mae and Freddie Mac in 2008 was due, in part, to panic selling fueled by unregulated short selling.

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