New Federal Initiatives Project

SEC Adopts Curb on Short Sales

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EDITOR'S NOTE: *The earlier version of this paper titled "Proposed Reinstatement of the 'Uptick Rule'" was published on November 9, 2009, and has been updated by the author to include recent developments.*

On February 24, 2010, the Securities and Exchange Commission (the "SEC"), by a 3-2 vote, adopted a rule[1] restricting short sales of a public company's stock if the price of the stock has fallen ten percent (10%) or more from the price the shares closed at the previous day. Under the final rule, a short sale, after such a price drop, would only be executed at a price above the market's best bid and that requirement would remain in effect the balance of the trading day and all of the next trading day.

On April 10, 2009, the SEC had proposed two approaches to restrictions on short selling[1] and, on August 17, 2009, re-opened the comment period until September 21, 2009 and solicited additional feedback on an aspect of the original proposal.

In July, 2007, the SEC eliminated all short sale price restrictions, one of which was its Rule 10a-1, the so-called "uptick rule", which, for almost 70 years, prohibited short sales of publicly traded securities except on a price increase. The repeal of the uptick rule followed seven years of studies and public comment as to the rule's effectiveness.

As the subprime mortgage crisis and credit crisis developed in 2007, market volatility and steep price declines, particularly in financial service stocks, increased markedly, and the SEC subsequently received requests that it consider reimposing restrictions on short selling to help restore investor confidence. The April 10 proposal was a response to those requests and came at a time of extreme market conditions.

The two approaches proposed last April included, first, a form of uptick rule, i.e., restrictions based on a price test on a market-wide permanent basis controlled by either the last sale price or by a national best bid price, and, second, a form of "circuit-breaker rule", i.e., restrictions that would only apply to a particular security during a severe market decline in that security, but which could either halt short sales or trigger an uptick rule. The SEC has adopted the latter approach. It favored the national best bid price control form of uptick rule over the last sale price because delays can occur in reporting last sales price information.

The SEC received almost 4,000 unique comment letters. It also hosted a roundtable on this subject on May 5, 2009.

The August 17, 2009 action by the SEC requested comment on what it is calling "the alternative uptick rule" that would allow short selling only at a price above the then-current national best bid price, subject to limited exceptions, such as for odd lots[2]. That is the final rule that the SEC adopted February 24. It was thought that such a rule would be easier to monitor more quickly and less costly to implement than other rules, because it would be easier to program into trading and surveillance systems. It would also restrict short selling to a greater extent than the other proposed rules.

The final rule is to be implemented by requiring firms to have policies and procedures reasonably designed to prevent execution or display of short sales at impermissible prices and regular surveillance to ascertain the effectiveness of those policies and procedures rather than by a straight prohibition against any person effecting short sales at impermissible prices.

The final rule is to be implemented in combination with a short selling "circuit breaker". The alternative uptick rule does not go into effect until it would be triggered by a decline in the price of an individual stock by a 10% from the stock's closing price the prior day as determined by the listing market. Of course, that is less restrictive than an absolute halt in trading in a particular stock where there is a severe decline in price.

Thus, the final rule does not affect or impose the "uptick rule" on routine or even abusive short selling except in the cases of a 10% drop in price.

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[1] The final rule is actually an amendment to the SEC's Regulation SHO (17 C.F.R.242).

Related Links:

SEC's "Spotlight On: Short Sales": http://www.sec.gov/spotlight/shortsales.shtml

Speech by SEC Chairman: "Statement at SEC Open Meeting — Short Sale Restrictions" by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission: http://www.sec.gov/news/speech/2010/spch022410mls-shortsales.htm

"In 3-2 Vote, SEC Limits Short Sales" By Fawn Johnson, Wall Street Journal, February 25, 2010: http://online.wsj.com/article/SB10001424052748704240004575085344139674042.html

"Proposed Reinstatement of the 'Uptick Rule'" by Julius L. Loeser, New Federal Initiatives Project, November 9, 2009: http://www.fed-soc.org/publications/pubid.1694/pub_detail.asp