New Federal Initiatives Project

Proposed Reinstatement of the "Uptick Rule"

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PROPOSED REINSTATEMENT OF THE "UPTICK RULE"

On April 10, 2009, the Securities and Exchange Commission (the "SEC") 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 rules could work in combination or separately, or the new uptick rule could even be triggered by the circuit-breaker rule. The SEC 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 would be the case in either an advancing or declining market. It is thought that such a rule would be easier to monitor quicker 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 proposed rule could be implemented either by requiring firms to have policies and procedures reasonably designed to prevent execution or display of short sales at impermissible prices or by a straight prohibition against any person effecting short sales at impermissible prices.

Such a rule also could be implemented in combination with a short selling circuit breaker. For example, the alternative uptick rule might not go into effect until it would be triggered by an intraday decline in the price of an individual stock by a set percentage (e.g. 10% or 15% or 20%) from the stock's closing price the prior day. Of course, that would be less restrictive than an absolute halt in trading in a particular stock where there is a severe decline in price.

It is not at all certain that the SEC will adopt a form of uptick rule or circuit-breaker rule, and it is not inconceivable that the SEC would not adopt any short selling regulations at this time. While the extreme market conditions that were prevalent when the SEC issued its original proposals last April appear to have subsided, conventional wisdom seems to be that the SEC will act promptly, one way or the other, after the comment period closes on September 21.

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[1] Short selling is the practice of selling securities one does not own with the expectation that prices will drop and the seller will be able to "cover" the short sale by purchasing the sold securities later at a lower price. The SEC sees public benefits in short selling, i.e. the provision of liquidity to the markets and contributing to pricing efficiency.

[2] An odd lot is a transaction for the purchase or sale of less than 100 shares of stock.

Related Links:

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