

WSGR ALERT

MARCH 2010

SEC ADOPTS RESTRICTIONS ON THE SHORT SELLING OF STOCKS THAT EXPERIENCE SHARP PRICE DECLINES

On February 24, 2010, the Securities and Exchange Commission (SEC) adopted a new rule that will limit the short selling of any stock that has declined in price by more than 10 percent in one day. In those circumstances, short sales will be permitted in a stock only if the price exceeds the current national best bid. The SEC stated that the purpose of adopting a short-sale-related "circuit breaker" was to prevent short selling from further driving down the price of the stock and to enable long sellers to be able to sell their shares prior to short sellers once the circuit breaker is triggered. The new Rule 201, an amendment to existing Regulation SHO, was adopted by a 3-2 vote of the SEC commissioners, with the dissenting commissioners arguing that Rule 201 was not necessary and could impair the proper functioning of the financial markets. In adopting Rule 201, the SEC reinstated a limited version of price restrictions on short sales that it had discarded only three years ago as antiquated and ineffective.

"Short selling" involves a sale of a security that the seller does not own or a sale that is completed by the delivery of a security borrowed by or for the account of the seller. A "short seller" seeks to profit from a decline in the stock price. The adoption of Rule 201 is the latest in a series of efforts by the SEC to curb the potentially harmful effects of short sales, particularly in the wake of the 2008 financial crisis. The SEC in 2005 adopted Regulation SHO in an effort to restrict abusive "naked short selling," the practice of selling short a security without first borrowing the security or ensuring that the security could be borrowed. The adoption of

Regulation SHO followed complaints by small- to medium-sized companies, particularly in the high-technology sector, that naked short selling was driving down their stock prices and harming their stockholders.

The SEC simultaneously undertook a study concerning the continued effectiveness of SEC Rule 10a-1, adopted in 1938, which provided that, subject to certain exceptions, a listed security could be sold short only at a price above the price at which the immediate preceding sale was effected ("plus tick") or at the last sale price if it were higher than the last different price ("zero plus tick"). Rule 10a-1 had been whittled away over time by exceptions and exemptions for relief from the rule's restrictions. The SEC's study, as well as outside commentators, concluded that the data showed that 1) Rule 10a-1 was not effective in preventing stock prices from being driven down; 2) developments in the financial markets had rendered the rule obsolete; and 3) short-sale execution price restrictions could undermine market efficiency. As a result, the SEC in 2007 abolished Rule 10a-1 and added Rule 201 of Regulation SHO, which prohibited any self-regulatory organization (SRO) from having a short-sale execution price test.

However, during the 2008 financial crisis critics of the SEC contended that unregulated short sales, including the elimination of any "uptick" requirement, had contributed to the sharp drop in the stocks of financial institutions and created excessive market volatility. In response to the financial crisis, the SEC temporarily suspended short selling in the securities of financial institutions;

imposed pre-borrow requirements on certain financial stocks; and ordered certain short-sale disclosure requirements. The SEC subsequently adopted a naked short selling anti-fraud rule and a rule requiring broker-dealers to promptly purchase or borrow securities to deliver on a short sale.

The SEC also requested commentators to provide empirical data concerning proposed new execution price restrictions on short sales. The SEC acknowledged that the "interpretations and results of the analyses submitted were mixed and sometimes conflicted with each other," and further stated that the study that led to the elimination of Rule 10a-1 "should continue to inform our decision-making where relevant." Nonetheless, the SEC decided to adopt the new Rule 201 as a limited, modified version of the previously discarded execution price restrictions, or, in the SEC's jargon, as an "alternative uptick rule."

Under Rule 201, the circuit breaker would be triggered for a security on any day when the stock price has declined by 10 percent or more from the prior day's closing price, as determined by the stock's listing market at the end of regular trading hours. Once the circuit breaker is triggered, the requirement would apply to short-sale orders in that stock for the remainder of the day, as well as the following day. Rule 201 also requires "trading centers"—which are defined elsewhere in the SEC rules as any national securities exchange, an exchange or over-the-counter (OTC) market maker, or any broker-dealer that executes orders internally by trading as principal or crossing orders as an agent—to

Continued on page 2...

SEC Adopts Restrictions . . .

Continued from page 1...

establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale. Rule 201 will apply to all securities (except options) that are listed on a national securities exchange, whether traded on an exchange or over the counter, but will not apply to non-National Market Stocks that are traded in the OTC Bulletin Board or elsewhere in the OTC market.

The SEC stated that the new Rule 201 would bolster the goals of preventing short selling, including potentially manipulative or abusive short selling, from being used to exacerbate a declining market and better targeting short selling that may be related to potential "bear raids." At the same time, by limiting Rule 201's short-sale restrictions only to stocks that have suffered an immediate, sharp price decline, rather than a more general decline,

short selling still would be available to provide liquidity and efficiency in the financial markets. In contrast, Commissioner Troy Paredes, one of the dissenting commissioners, contended that there was no evidence that Rule 201 would improve investor confidence; that current restrictions on short selling were adequate; and that Rule 201 potentially could undermine market efficiency.

Rule 201 will become effective 60 days after the date of publication of the release in the *Federal Register*. Market participants will then have six months to comply with the requirements.

For more information on Rule 201, please contact an attorney in Wilson Sonsini Goodrich & Rosati's corporate practice or securities litigation department.



Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

This WSGR Alert was sent to our clients and interested parties via email on March 2, 2010. To receive future WSGR Alerts and newsletters via email, please contact Marketing at wsgr_resource@wsgr.com and ask to be added to our mailing list.

This communication is provided for your information only and is not intended to constitute professional advice as to any particular situation. We would be pleased to provide you with specific advice about particular situations, if desired. Do not hesitate to contact us.

650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com

© 2010 Wilson Sonsini Goodrich & Rosati,
Professional Corporation
All rights reserved.