

Client Alert

SEC Adopts Major Changes to the Short Sale Rules

At an open meeting on June 13, 2007, the Securities and Exchange Commission (“Commission”) unanimously adopted a number of amendments to the short sale rules. The most significant change was the repeal of the tick and bid tests for short sales across all markets. In addition, the Commission adopted amendments to Regulation SHO to further tighten the close-out requirements of that rule. Finally, the Commission proposed additional amendments to Regulation SHO. The details of the amendments will be published shortly by the Commission. The following description is based on the discussions at the open meeting and the Commission press release announcing the changes.¹

Repeal of the Tick and Bid Test

The Commission approved amendments to Regulation SHO and SEC Rule 10a-1 repealing the tick test and bid test across all markets.² Broker-dealers and their clients will no longer have to trade on plus ticks or bids when executing short sales. The Commission stopped short, however, of prohibiting individual exchanges from adopting a bid or tick test for short sales in the future. The Commission stated that if changed circumstances warrant, the exchanges are free to propose a new price test, subject of course to approval by the Commission.

This amendment repeals a trading rule adopted almost 70 years ago to prevent manipulative bear raids in the market. The Commission found that the effectiveness of the rule had been eroded over time by the increasing liquidity and transparency of the markets, sophisticated surveillance techniques in the markets, the large number of exceptions granted to newer trading strategies, the introduction of decimal pricing, the use of different price tests in different markets, and the fact that less liquid, thinly traded securities were not covered by the rule. Earlier, the Commission had established a pilot program to temporarily exempt 1,000 securities from the price tests. The pilot program and subsequent studies clearly established that the price tests were no longer necessary to prevent manipulative short selling, and in fact caused certain inefficiencies in trading. The amended rule will also include a technical amendment to Rule 200(g) of Regulation SHO that will remove the “short exempt” marking requirement of that rule. These amendments will become effective immediately upon publication in the Federal Register.

¹ “SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate ‘Tick’ Test,” SEC Press Release 2007-114 (June 13, 2007).

² See, Securities Exchange Act Release No. 54891 (Dec. 7, 2006) (Proposed Amendments to Regulation SHO and 10a-1).

Amendments to Grandfather Exception in Regulation SHO

The Commission also repealed the grandfather exception to the close-out requirements in Rule 203 of Regulation SHO.³ Regulation SHO was intended, in large part, to prevent naked short selling by requiring the close-out of fails to deliver against short positions in certain securities, called threshold securities, within 13 days. Previously, fails to deliver against open short positions that existed when a security was added to the threshold securities list were exempt from the close-out provisions. The rationale was to prevent disruptive buying pressure when a security was first placed on the threshold security list. Under the amended rule, fails to deliver against previously grandfathered positions in threshold securities will have to be closed-out within 35 days of the effective date of the rule. Going forward, fails to deliver against open short positions will have to be closed-out within 13 days of the security being added to the threshold list. The Commission found that the possible disruption to the market caused by the required close-out of the positions was outweighed by the benefit of cleaning up the long standing fails to deliver caused by those positions. The Commission also extended the close-out period applicable to fails to deliver for Rule 144 securities to 35 days to be consistent with other requirements of the rule and to recognize the time necessary to clean the certificates and settle the transactions. Finally, the Commission adopted proposed technical modifications to the market decline provisions. These amendments will become effective 60 days after publication in the Federal Register.

Re-Proposal of Amendments to the Option Market Maker Exception

As enacted, Regulation SHO contained an exception to the close-out provisions for short positions established by option market makers hedging their risk in the equity market. The Commission noted that it received 900 comment letters on the proposed changes to Regulation SHO. Most of these letters were favorable to the proposal to remove the grandfather exception. On the other hand, the Commission noted that the comment letters were mixed on the proposed amendment to the option market maker exception. Therefore, the Commission decided to re-propose an amendment to Regulation SHO that would eliminate entirely the option market maker exception from the close-out provisions. As an alternative, the Commission proposed two different methods of applying the 13-day close-out requirement to option market maker positions. The Commission also proposed a change to the long sale marking requirements of Regulation SHO requiring a broker-dealer marking a sale as long to document the present location of the securities being sold. The Commission will seek public comment on these proposals before making a final decision on the proposed rule. Comments are due 30 days after publication in the Federal Register.

Conclusion

Taken as a whole, the amendments reflect the changing philosophy of the Commission in regulating short sales. While moving away from the price tests, which it found no longer necessary or effective in the marketplace, the Commission has strengthened the close-out requirements of Regulation SHO, which it believes will prevent abusive naked short selling. The proposed

³ See, Securities Exchange Act Release No. 55520 (Mar. 26, 2007) (Extending Comment Period on Proposed Amendments to Regulation SHO); Securities Exchange Act Release No. 54154 (July 14, 2006) (Proposed Amendments to Rule 203 of Regulation SHO).

amendments are also intended to strengthen the close-out provisions. Careful consideration should be given, however, to whether these proposals are necessary. The option market maker exception serves a valid purpose and any change should be weighed against the negative impact on market liquidity. The long sale marking requirement places substantial burdens on broker-dealers, particularly in the institutional and electronic trading markets, and should be weighed against the incremental benefit to short sale regulation.

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