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## New Regulatory Approaches to Short Selling in the U.S. and the EU

Changes in the regulatory approach to the short selling of listed securities have recently been announced in both the United States (“U.S.”) and the European Union (“EU”). In the U.S., rule amendments were recently adopted by the Securities and Exchange Commission (“SEC”) that generally restrict market participants’ ability to sell short listed securities whose price has dropped by at least 10% in a single day. In the EU, a new regulatory proposal would (to the extent adopted by the EU member states) require private disclosure of net short positions above a 0.2% threshold to the applicable regulator, and public disclosure to the market of such positions above a 0.5% threshold. We summarize in this alert what these changes entail and what each will mean for market participants.

### Background

The turbulent markets of the past two years and the associated risk of market manipulation and abuse have led a significant number of countries (including the U.S. and many EU countries) to take emergency measures to restrict and/or impose conditions on short selling. These measures have taken various forms, including prohibiting or restricting all short selling of specified shares or specified categories of shares (*e.g.*, those in the financial sector), restricting naked short selling,<sup>1</sup> and imposing disclosure obligations of different kinds. Some of these measures still remain in place, having been extended, renewed or modified. (For a country-by-country list of short selling measures in place in the EU, please refer to the most recent report<sup>2</sup> of the EU Committee of European Securities Regulators<sup>3</sup> (“CESR”).)

### U.S. Rule Changes: SEC Imposes New Limitations on Short Sales by Adopting Alternative Uptick/Circuit Breaker Rule

On February 24, 2010, the SEC voted to adopt amendments to Regulation SHO restricting short sales of certain equity securities when a “circuit breaker” is tripped. As amended, Rule 201 (the “Alternative Uptick Rule” or the “Rule”) under Regulation SHO generally provides that, if the price of a security listed on a “national securities exchange”<sup>4</sup> drops intra-day by 10% or more from its prior day’s closing price, short sales, with certain exceptions, will only be permitted at a price above the national best bid for that security for the remainder of the day and through the end of the next trading day.

The SEC adopted the Rule following what it referred to as a careful and deliberative rule making process. However, the SEC itself noted that there was little or no specific empirical evidence that manipulative short selling contributed to the increased volatility in U.S. markets during the financial crisis of 2008. Indeed, in 2007 the SEC eliminated Depression-era short sale price tests (the so-called “uptick rule,” which prohibited short sales except (1) at a price above the last sale or (2) at the last sale if it was above the prior sale), after another careful and deliberative

process that included numerous empirical studies, a pilot program, and many opportunities for public comment; this prior rulemaking was based on findings that the uptick rule had little effect on security prices.

Nonetheless, in April 2009, almost two years later, the SEC proposed instituting a new price test rule and offered five variations on two approaches to restrict short sales. The first approach would have imposed a market-wide permanent price test on short selling, and the second approach would have been based on “circuit breakers” that would trigger temporary security-specific restrictions on short selling, including potentially price tests or even a prohibition on short-selling. Subsequently, in August 2009, the SEC re-opened the comment period on these proposals and proposed an alternative to the first approach (an alternative uptick rule) that would function either as a permanent market-wide restriction or in conjunction with a “circuit breaker.” In voting to adopt the Alternative Uptick Rule with the “circuit breaker” feature, the SEC noted that the Rule is intended to promote market stability and preserve investor confidence. The SEC claimed that many members of the public associate short sellers and the elimination of the uptick rule with the dramatic volatility and loss of investor confidence in the marketplace that occurred in 2008 and 2009, and the SEC pointed out that the Rule would allow investors who hold long positions to sell before short sellers in a declining market. The SEC also stated that it believes that the Rule will preserve market participants’ ability to respond to volatility in the markets and will help to better target short selling that may be related to potential bear raids and other forms of manipulation.

The SEC did admit that short selling contributes to price efficiency and the provision of liquidity, and it emphasized that, in adopting the Rule, it was attempting to strike a balance between its goal of preventing potential manipulative and abusive short selling and the need to allow the continued smooth functioning of the market. The Rule as adopted will impede the activity of market participants to a much lesser degree than the other proposals would have and than the prior uptick rule did. However, the SEC did not cite any empirical evidence that the Rule will foster public confidence in the markets, and the two Commissioners who voted against

adopting the Rule argued that, by impeding price efficiency and lessening liquidity, the Rule will undermine public confidence. Some observers have made the point that, in adopting the Rule, the SEC was not acting out of conviction but rather responding to congressional and public pressure in order to preserve its political capital for other matters.

### **Covered Securities**

The Alternative Uptick Rule will apply to any “covered security,”<sup>5</sup> which generally includes any security listed on a national securities exchange, whether traded on an exchange or over-the-counter (“OTC”), and to any entity that executes short sale orders. The Rule will not apply to options listed on a national securities exchange, whether traded on an exchange or in the OTC market. The Rule also will not apply to non-NMS stocks quoted on the OTC Bulletin Board or elsewhere on the OTC market because a national best bid and offer are currently not required to be collected, consolidated and disseminated for such securities. Finally, the Rule will not apply to derivatives positions, despite the ability of market participants to create “synthetic” short positions that are economically equivalent to a short sale, which the SEC admitted may undermine the effectiveness of the Rule.

### **Policies and Procedures Approach**

The trading center<sup>6</sup> where the applicable covered security is listed will be responsible for determining when a 10% decrease occurs and for notifying the appropriate securities information processors (who in turn are responsible for disseminating that information to other markets) for that covered security. Under the Alternative Uptick Rule, trading centers are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale and to impose the “circuit breaker” restriction in accordance with the Rule. Trading centers also must have policies and procedures that are reasonably designed to permit the execution or display of a short sale order of a covered security marked “short exempt” (see below) while the “circuit breaker” price restriction is in effect.

### Exceptions

The Alternative Uptick Rule includes certain limited exceptions to permit a broker-dealer to execute certain short sales while the “circuit breaker” price restriction is in effect. A broker-dealer relying on any such exception is required to mark such an order as “short exempt.” These exceptions include:

- short sale orders submitted by broker-dealers that are priced above the national best bid, at the time of submission to a trading center; broker-dealers relying on this exception are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the incorrect identification of orders as “short exempt” and to take prompt action to remedy deficiencies;
- short sales by a seller whom a broker-dealer reasonably deems to “own” a security but who is technically considered a short seller due to delivery delays;
- certain odd-lot transactions;
- short sales in connection with certain *bona fide* international and domestic arbitrage;
- over-allotments and lay-off sales;
- short sales where broker-dealers act in a riskless principal capacity; and
- short sales on a “value-weighted average price” basis.

There is no exception for market making activity under the new Rule. The Rule does, however, include provisions establishing procedures for the SEC to grant an exemption from the Rule’s provisions under certain circumstances.

### Implementation

The Alternative Uptick Rule will take effect on May 10, 2010, after which date trading centers will have six months to implement policies and procedures designed to comply with the Rule. According to the adopting release (the “Release”), the SEC does not believe that a longer implementation period is necessary because the Rule will require the implementation of policies and procedures similar to those already required for trading centers under Regulation NMS, and because broker-dealers

already have experience implementing a “short exempt” marking requirement, since Regulation SHO included such a requirement when originally adopted.

### Industry Reaction

In response to the adoption of the Rule, the Managed Funds Association (the “MFA”) issued a statement praising the SEC’s deliberative approach, but expressing its disappointment that the short selling restrictions adopted were not supported by empirical data. The MFA also indicated that the SEC failed to draw the appropriate distinction between legitimate short selling and manipulative short selling.

### EU Rule Changes: Proposal for Pan-European Short-Selling Disclosure Regime

#### CESR Proposals

On March 2, 2010, CESR published a final report outlining its proposed model for a pan-European short selling disclosure regime (the “Report”).<sup>7</sup> The Report follows CESR’s July 2009 short selling consultation (for more information please refer to our July 2009 client alert<sup>8</sup>).

The short selling regime proposed in the Report is a two-tier model for the disclosure of significant individual net short positions in all shares that are admitted to trading on a European Economic Area (“EEA”)-regulated market and/or an EEA multilateral trading facility, when the primary market of those shares is located in the EEA. This relates to the whole market rather than just one particular sector (*e.g.*, financial sector companies), as CESR is of the opinion that “the risks posed by short selling are not confined to the financial sector and it is not possible to predict with any certainty how the next crisis might develop or which sector might become vulnerable to abusive short selling or disorderly markets.”<sup>9</sup>

Under the proposed regime, a short seller would be required to make:

- a *private disclosure* to the relevant regulator of any net short position in a company’s issued share capital that reaches a threshold of 0.2% of the issuer company’s issued share capital. Any

increases or decreases of 0.1% above the 0.2% threshold would trigger further disclosure obligations, meaning that, for example, notifications would need to be made to the relevant regulator at 0.3% and 0.4% and so on; and

- a *public disclosure* to the market as a whole as well as to the relevant regulator once the short seller's net short position reaches 0.5%, and at every 0.1% above that (for both increases and decreases).

Disclosures would include the identity of the short position holder, the identity of the issuer, the size of the position held, and the date on which the position was either created or no longer held.

In calculating whether a disclosure is required, market participants will be required to aggregate any position providing them with an economic exposure to a particular share. Positions held in exchange-traded and OTC derivatives will be included, as will short positions in cash markets. Disclosure calculations and reports are to be required on a net basis, with any positions involving long economic exposures to a share deducted from aggregate short positions. Disclosure reports of short positions (to the market and/or to the regulator) will be required to be made on the trading day following the day on which the relevant threshold has been crossed. CESR recognizes that intra-day positions that breach a disclosure threshold, but that return below that same threshold before the end of the trading day, will not be captured. Market makers will be exempt from the disclosure requirements.

### Anticipated Developments

CESR comments in the Report that it is continuing to work on a number of outstanding issues, such as the mechanism of reporting and the content of disclosure reports that must be made. CESR will publish its determinations as soon as it is able.

CESR also comments in the Report<sup>10</sup> that, although the design of a common disclosure regime has been prioritized so far, CESR is continuing to consider whether further harmonized measures for the regulation of short selling, beyond disclosure, are required and feasible. CESR does consider that

enhanced transparency has real, justifiable benefits and, accordingly, has decided to prioritize development of a pan-European disclosure regime.

### Implementation

CESR states in the Report that CESR members that already have powers to introduce a permanent disclosure regime will now begin the process of implementing the regime. Those CESR members that do not have the necessary legal powers to bring new rules into force in their jurisdiction are expected to aim toward implementing it on a best efforts basis. CESR also expresses its support<sup>11</sup> for a new EU directive or regulation to give all EEA securities regulators explicit stand-alone power to require disclosure in respect of short selling.

CESR recognizes that individual CESR members may need to impose temporary emergency measures (such as bans or partial bans or the imposition of special conditions on short selling). CESR is currently examining whether all its members have the necessary powers to introduce such measures and, if not, what steps may be required to remedy any deficiencies.

We set out below the position in Germany and the UK. We also comment on the Greek Prime Minister's recent comments on short selling and related matters.

### Germany

On March 4, 2010, the German Federal Financial Supervisory Authority, Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"), issued a general decree loosely based on the CESR proposal, which requires that market participants and holders of net short positions in any of 10 selected financial stocks (primarily banks) must make disclosure to BaFin when the net short position reaches, exceeds or falls below a threshold of 0.2% of the issued share capital of that company and every 0.1% thereafter. BaFin has also announced that it will publish (in an anonymous format) all short positions that reach or exceed 0.5%.

For German purposes, the "net short position" definition generally follows the CESR recommendations referred to above and, also in conformity with CESR, there is an exemption from the disclosure requirements for market makers.

BaFin's new rules come into force on March 25, 2010 and will initially apply up to and including January 31, 2011.

In addition to the BaFin disclosure requirements, the German Ministry of Finance has also recently announced that it will propose legislation in April to ban naked short selling. The Ministry of Finance intends to create a statutory framework for regulatory transparency rules covering all shares traded on a regulated market and to provide for effective sanctions to ensure that such reporting requirements can be enforced.

## UK

The current UK Financial Services Authority ("FSA") rules<sup>12</sup> require that disclosure must be made to a regulatory information service in the UK by 3:30 p.m. (UK time) on the business day following the date on which a disclosable short position is reached or exceeded. A disclosable short position is any net short position in one of a defined list of UK financial services companies where the position reaches, exceeds or falls below 0.25% of the issued share capital of the company and each 0.1% threshold thereafter (*i.e.*, the net short position reaches 0.35%, 0.45%, and so on).

The FSA has not yet published any comment on when or how it will amend its current short selling rules to reflect the position advocated by CESR. The FSA's current rules were brought into force on June 30, 2009, as a temporary regime to cover short selling in the UK until such time as consensus was reached on a wider international short selling regime.

In addition, the UK's draft Financial Services Bill<sup>13</sup> would, if implemented as it is currently drafted, provide the FSA with much wider powers to make rules to prohibit or require disclosure of short selling. The proposals would also permit the FSA to make rules relating to short sales engaged in before any new rules are made but where a short position remains open when the rules come into force.

## Greece

The Greek Prime Minister George Papandreou, who recently met with President Obama and Secretary of State Hillary Clinton regarding the crisis in Greece, has said that he wants to see the U.S. and the rest of

the G-20 develop "clear rules on shorts, naked shorts and credit default swaps," as he believes that many hedge funds have bet against Greece's ability to repay its debts. Despite the Greek Prime Minister's aspirations for wider regulation, Anastassios Gabrielides, chairman of Greece's Capital Market Commission (and chairman of the CESR committee that prepared the Report), said: "The regime [proposed by CESR] would help to identify and restrain potentially abusive behavior at an early stage and allow regulators to take timely preventive measures. While private notifications to the regulators would be used for daily market supervision activities, public disclosure of short positions is considered to provide informational benefits to the market." It is not yet clear whether, or in what manner, Greece proposes to implement the CESR proposals.

## Industry Reaction

Andrew Baker, the chief executive officer of UK's Alternative Investment Management Association ("AIMA"), stated that he agrees with CESR that consistent rules for short selling throughout the EU are required, saying that consistent rules for short selling throughout the EU were "desirable" and were preferable to banning the practice (as happened in the UK in September 2008 in relation to certain financial stocks). However, he has also called for improvements to the proposed CESR reporting regime. In AIMA's view, any reporting of short positions should be in aggregate form only, and disclosure of individual positions should only be made privately to the regulator to prevent potentially serious market distortions. AIMA's view is that the 0.2% (private) and 0.5% (public) disclosure thresholds are too low.

The MFA has expressed support for the general approach taken in Germany by BaFin but has registered concern regarding the lack of detail in the reporting requirements and the potential additional costs that could be shouldered by investors.

## Conclusion

While both the new rules in the U.S. and the EU proposals are intended to promote market stability and preserve investor confidence, the U.S. rules restrict market participants' ability to engage in short selling, whereas the EU proposals instead

require transparency – both private disclosure to the regulator and, at a higher threshold, public disclosure to the market. Another key distinction is that, while the EU proposals treat as a short sale any derivative contract giving economic exposure

equivalent to a short sale, the U.S. Rule does not. It will be illuminating in the future to compare the operation of the U.S. and the EU markets given these different approaches.

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<sup>1</sup> “Naked short selling” is the practice of selling a financial instrument short without first borrowing the security or ensuring that the security can be borrowed.

<sup>2</sup> <http://www.cesr.eu/popup2.php?id=5238>.

<sup>3</sup> An independent committee of European securities regulators established by the European Commission to improve coordination among securities regulators, to act as an advisory group to assist the European Commission and to work on the implementation of EU legislation across all EU member states.

<sup>4</sup> For these purposes, a “national securities exchange” is a securities exchange that has registered with the SEC under Section 6 of the U.S. Securities Exchange Act of 1934.

<sup>5</sup> “Covered security” means any NMS stock as defined under Rule 600(b)(47) of Regulation NMS. The SEC noted in the Release that the Alternative Uptick Rule applies to any short sale effected using the United States jurisdictional means, without regard to the jurisdiction in which the short sale is executed. For example, one commenter to the initially proposed rules noted that “[g]enerally speaking, the Commission has taken the position that the provisions of Regulation SHO apply to transactions in covered securities ‘agreed to’ in the United States,” even when sent to a foreign market for execution. Additionally, any short sale agreed to in the EU but executed in the U.S. will also likely be subject to the Rule.

<sup>6</sup> “Trading center” includes all entities that may execute short sale orders, such as a national securities exchange or national securities association that operates a self-regulatory organization trading facility, an alternative trading system, an exchange market maker, an over-the-counter market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

<sup>7</sup> <http://www.cesr.eu/popup2.php?id=6487>

<sup>8</sup> <http://www.klgates.com/newsstand/Detail.aspx?publication=5774>.

<sup>9</sup> See paragraph 26, section 3 of the Report.

<sup>10</sup> See paragraph 14, section 2 of the Report.

<sup>11</sup> See paragraph 57, section 3 of the Report.

<sup>12</sup> FSA Code of Market Conduct MAR 1.9.2D (<http://fsahandbook.info/FSA/html/handbook/MAR/1/9>).

<sup>13</sup> This bill is currently being debated at committee stage in the House of Lords.