

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 43 No. 13 July 21, 2010

REGULATION OF SHORT SELLING IN THE U.S.

After some interim and emergency measures, the SEC has issued a new rule restricting short sales of "covered securities" when the current price for the security has declined by 10 percent or more from the previous day's close. The rule does not apply to derivatives and includes a variety of exceptions for transactions that in the Commission's judgment tend to play a very minor role in short-selling manipulation.

By Kay A. Gordon *

This article will discuss recent developments in the area of short-selling regulation and will also summarize the recently adopted regulations and their potential impact on broker-dealers and other market participants. The term "short sale" is defined in Regulation SHO as "a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller."¹ Short selling requires a seller to borrow a security for delivery to the purchaser, subject to an obligation to replace the borrowed security at a later date, typically by purchasing an equivalent security on the open market.² Short selling allows the seller to profit from declines in market prices to the extent such decline exceeds the transaction costs and the costs of borrowing the securities. It is also used to provide liquidity with respect to a security in

response to unanticipated demand for that security, or to hedge the risk of a long position.

After a series of interim steps, proposals, and public comments, the SEC has amended Rule 201 of Regulation SHO, effective May 10, 2010, restricting short sales of a covered equity security if the price for the security has declined by 10% or more from the previous day's closing price (the "New Uptick Rule").³ To appreciate the operation and effect of this new rule, it is useful to begin by briefly reviewing the SEC's history of regulating short sales.

THE BACKGROUND

Short selling has long been a target of both Congressional and public interest and SEC regulation. Section 10(a) of the Securities Exchange Act of 1934, as amended,⁴ gives the SEC plenary authority to regulate short sales of securities registered on a national securities exchange, as necessary or appropriate in the

¹ Rule 200(a) of Regulation SHO.

² "In a 'naked' short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a 'failure to deliver' or 'fail.'" See SEC, Naked Short Sales, available at <http://www.sec.gov/answers/nakedshortsale.htm>.

³ Exch. Act Rel. No. 34-61595 (the "Release").

⁴ 15 U.S.C. 78j(a).

* KAY A. GORDON is a partner in the investment management group of the New York office of K&L Gates LLP. Her e-mail address is kay.gordon@klgates.com.

IN THIS ISSUE

- REGULATION OF SHORT SELLING IN THE U.S.
- CLE QUESTIONS, Page 190