Commentary: U.S. Wins Gold ... In Short Sale Restrictions

By Stephen J Nelson; The Nelson Law Firm, LLC

Originally Published in *Traders Magazine* on April 7, 2010

http://www.tradersmagazine.com/news/short-sales-sec-exchange-act-cesr-105315-1.html?zkPrintable=true

On February 24, 2010, the SEC adopted Exchange Act Rule 201, which it characterizes as the alternative uptick rule.

The final rule has not yet been released. So, all the details, especially its exemptions, remain to be revealed. But, from the discussion at the Commission's open meeting, and the SEC's press release, it seems that the Commission adopted the version of the rule proposed by my friend Glen Shipway, with a 10% circuit breaker. After the price of a stock has declined more than 10% from its previous close, short sales can only be made at prices higher than the current best bid. This test is more restrictive than the Commission's prior version of the alternative uptick rule, which would have permitted short sales on an upbid, but is much easier to program and monitor for compliance.

Notably, there is no bona fide market maker exception, even for options market makers. It will be interesting to see how the options markets deal with this impediment. The road test can be expected to occur shortly after the rule is implemented in about six months. On February 25, the market price for Palm declined about 20%, which would have tripped the 10% circuit breaker and resulted in the implementation of the alternative uptick rule. I would expect that on any trading day, some security can be expected to trip the circuit breaker, resulting in the application of the new short sale price test.

It is worth noting that, prior to the adoption of the alternative uptick rule, there were already stringent short sale regulations operating in the U.S. equity markets. The current rules effectively ban naked short selling. This prohibition is strengthened by a rule that requires short sellers to settle trades within three days. Substantial penalties are inflicted on persons who attempt to subvert these regulations. Last month, the SEC brought an action against two California investment advisory firms for short sale violations, which resulted in substantial fines.

As a result of the financial crisis, securities regulation is now recognized as an affair of state. No financial services regulation can be adopted without considering the actions being taken by our global competitors. Otherwise, financial services will relocate to a place where the regulations are less stringent, a behavior called

"regulatory arbitrage." For financial services regulation, the important competitors belong to the G-20 group of nations; when it comes to the equity markets, Europe is most important, and particularly the United Kingdom and Germany.

On February 1, 2010, the Committee of European Securities Regulators (CESR) produced another survey of the existing state of short sale regulations in the European Union, updating an earlier report from September 22, 2008, which was most recently updated on August 6, 2009. CESR is a college of regulators that advises the European Commission on proposed regulations. CESR has no independent regulatory authority of its own.

CESR's survey reports that the ban on short sales of stocks issued by financial services firms has been revoked in Germany and the United Kingdom. Neither Germany nor the United Kingdom prohibits naked short sales or imposes any short sale price tests. The United Kingdom does require disclosure of short positions, a regulation promulgated during the financial crisis that has remained in place.

In July 2009, CESR issued a "consultation," which resembles the notice and comment procedures used by the SEC and other government agencies when proposing a rule change. The consultation proposed rules that would require disclosure of short positions. Short positions greater than .1% of the issued share capital of an equity security would be reported to the regulator in the country where the primary market for the security was located. Positions greater than .5% would be disclosed to the public. Positions in derivative securities that were the equivalent of a short position in equities would be reportable, if they exceed the relevant threshold. CESR does not propose to prohibit naked short selling or impose short sale price tests.

Securities issued by companies outside the European Union would not be subject to this rule. So, the securities of U.S. issuers would not be subject to these disclosure requirements, even if the primary market for the securities were located within the European Union.

Comments were due on CESR's consultation by September 30, 2009. The consultation drew extensive comments from financial services firms. There is not a strong retail participation in Europe. As a result, no comments were received from retail investors, in contrast to the hundreds of comments from individual investors received by the SEC on its proposed short sale price tests.

CESR planned to publish a report by the end of 2009, which would have consisted of a specific recommendation to the European Commission for regulation. This report has not yet been produced. If CESR's proposed rule were adopted throughout the European Union, hardly a foregone conclusion, it would not come

close to the restrictions already in place in the United States prior to the adoption of the alternative uptick rule.

Institutions can already buy and sell U.S.-issued equity securities all day long in London and Frankfurt. Is it a good idea to offer yet another incentive to engage in regulatory arbitrage?

It is an understatement to say that the timing of all this smacks of political pressure. The SEC was under pressure from critics who cited the fact that no short sales price test had been implemented as proof that no meaningful reform would result from the financial crisis. However, the adoption of the alternative uptick rule has almost nothing to do with financial services reform.

Much needs to be done to avoid another financial crisis, particularly an event where the taxpayer has to bail out financial institutions. But, the financial crisis was a debt crisis, not a crisis in the equity markets. In fact, the equity markets performed rather well throughout the financial crisis. At all times, equity markets were orderly and every willing seller found a willing buyer. People may have been unhappy about the prices they received, but a free market can never assure that anyone will get the price they would like, no more than abundant riches are guaranteed to its participants.

The alternative uptick rule, like the dark pools proposal and the recent equity market structure concept release, is at best a precious fine tuning of the equity markets. While further refinements to equity market structure are surely beautiful things, I would have thought the SEC had much bigger fish to fry. The debt markets are as dark as night and astonishingly dysfunctional. When will we see the debt market structure concept release?

Doing something, even if it's wrong, just to prove you are actually doing something, is never a good idea and a terrible regulatory policy. Nonetheless, now that we have adopted the alternative uptick rule, let's hope the SEC will use its scarce regulatory resources to repair broken securities markets that are less interesting to the average voter, but much more important to the nation's economy.

* * * * * * *