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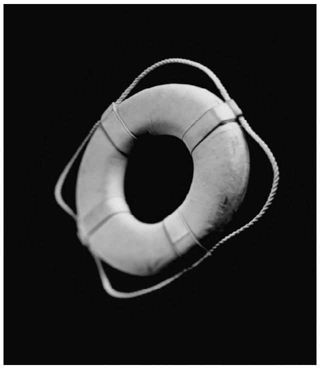

The Fed/Treasury gave us TARP – How will the SEC Protect the Market from Exposure to Naked Short Sales and other Abusive Transactions?

The Securities and Exchange Commission (SEC) adopted a number of measures during the second half of 2008 that limited short selling, particularly the short selling of the stock of financial companies. The SEC's stated purpose in adopting these measures was to stabilize the financial markets in the United States at a time of unprecedented market turmoil.

The measures enacted by the SEC include: (i) a temporary ban (which expired in the fall 2008) on short selling in the securities of Fannie Mae, Freddie Mac and 17 financial institutions, including, among others, Lehman Brothers, Morgan Stanley, Goldman Sachs and Merrill Lynch; (ii) a hard T+3 closeout requirement; (iii) eliminating the options market maker exception of Regulation SHO; (iv) measures to target fraud involving short sales; (v) a temporary ban (which expired in the fall 2008) on short sales of securities of financial companies; and (vi) requiring disclosure of short sales and short positions of certain investment managers.

While market participants, attorneys, government officials and others may disagree whether the measures taken were necessary or advisable, it is clear that the SEC enacted the measures in response to particular events. The measures were not the result of reasoned rulemaking. In March 2008, Bear Stearns, then the fifth largest investment bank in the United States, crashed. The cause of Bear Stearns' crash may be debated for generations and will probably be the subject of future business school courses. However, it appears clear that rumors regarding Bear Stearns' liquidity accompanied by substantial short selling in Bear Stearns' stock played some role in the demise of Bear Stearns. Many of the rumors were either unsubstantiated or false. Similar events were occurring at the same time with respect to other financial institutions, both within the United States and worldwide. The public began to blame short sellers for adverse market conditions, especially for the volatility associated with the securities of financial institutions. The SEC chose to act against the short selling quickly in order to prevent continuing rumors from leading to other financial institution failures.

Before the Crisis (B.C.)

The financial crisis of 2008 was not the first event that inspired public criticism of short sellers. In 2003, the SEC began to act against abusive short selling. The SEC commenced a number of enforcement actions against various market participants and adopted new regulations to address short selling. The SEC adopted Regulation SHO to limit the level of fails-to-deliver caused by excessive naked short selling in the securities of particular companies. Particularly with respect to small cap and micro cap PIPE issuers, there were high volumes of short selling, and many issuers and investors complained that hedge funds and other market players had destroyed the market value of a number of small cap and micro cap companies that were exposed to an excessive volume of naked short selling. The amount of shares being sold short often exceeded the market capitalization of the issuers in question.

The complaints were that the extreme high volume of shorting activity made it all but impossible for the market price of any given issuer to sustain itself.

In October 2007, the SEC amended Regulation M to prohibit the purchase of securities in a public offering by a person that sold the same securities short immediately before the offering, subject to certain exceptions. This amendment limits short selling activity surrounding a follow-on offering.

However, not all of the measures adopted by the SEC with respect to short selling were adverse to short sellers. In 2007, there were two developments that facilitated short selling. In July 2007, the SEC eliminated the uptick rule. The uptick rule provided that securities may be sold short only at a price that is above the price at which the immediately preceding sale was effected (plus tick) or at the last sale price if it was higher than the last different price (zero-plus tick), subject to certain exceptions. Securities could not be sold short at a declining price. When the SEC eliminated the uptick rule, it also adopted Rule 201 of Regulation SHO that prohibited any price tests, including those of the self regulatory organizations, for short sales. The uptick rule was originally adopted in 1938 with the stated purpose of, among other things, preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers. The SEC elected to abolish the uptick rule after the SEC performed a pilot program in which the uptick rule was suspended for one-third of the Russell 3000 Index constituent stocks with higher levels of liquidity from May 2, 2005 through July 3, 2007. A number of third-party researchers were commissioned by the SEC to analyze the data produced by the pilot program, and a number of studies were performed. The results of such studies provided the SEC with the basis upon which to eliminate the uptick rule. Among other findings, the studies found no evidence that prices of stocks subject to the uptick rule declined at a slower speed than prices of exempted stocks at times of stress. However, as noted by the SEC and by the researchers performing the studies, there was not a severe market-wide decline in the market during the pilot program and, thus, the studies did not include an evaluation of the performance of the uptick rule, or the lack thereof, in such a market environment. Notwithstanding the results of the studies, the uptick rule limited short selling activity, and many believe that the elimination of the uptick rule facilitated the short selling that, at least in part, played a role in the financial crisis of 2008.

Another development in 2007 that favored short sellers was the SEC's decision not to include a tolling provision related to hedging transactions when it amended Rule 144 late in that year. Prior to 1990, the holding period for securities under Rule 144 was tolled if and to the extent that the holder of securities engaged in short sales, puts or other options to sell securities. The tolling provision was eliminated in 1990. In 1995, 1997 and 2007 the SEC issued rule proposals that contemplated the reinstatement of a tolling provision, but in each instance determined not to reinstate the tolling provision. Reinstating the tolling provision would have had a material adverse effect on short sales effected by purchasers of restricted securities.

Developments outside the United States

In 2008, regulators outside the United States also adopted measures designed to limit short selling. This occurred after the collapse of Lehman Brothers, an event that short sellers were again said to have precipitated. In September 2008, at the same time that the SEC adopted an emergency order to temporarily ban short sales in 799 selected financial firms, foreign regulators were busy adopting similar bans. Temporary bans on short sales of securities of designated firms were adopted in the United Kingdom, Belgium, France, Germany, Switzerland, Australia and other countries. In addition to the temporary ban on short selling, the United Kingdom adopted disclosure obligations with respect to net short positions in the securities of designated issuers.

Next Steps

We anticipate that the SEC will adopt new measures regarding short selling in 2009. The SEC has had time to reflect on the measures adopted in 2008. In addition, the new administration is anxious to be proactive, especially in light of recent scandals. The interesting question is what types of measures the SEC will adopt, or be forced to adopt. In a speech by SEC Commissioner Troy A. Paredes at "The SEC Speaks in 2009" held in

Washington, D.C. on February 6, 2009, Commissioner Paredes discussed the SEC's actions in 2008 but did not provide any hints regarding the future. In adopting various regulations that limited short selling and naked short selling, the SEC has been careful to assert its position that the goal is to prevent abusive short selling, not short selling in general. The SEC has stated numerous times that short selling is an important tool in the market and contributes to the liquidity of securities. Accordingly, it is our expectation that the SEC will adopt a number of actions that allow it to take a stand against abusive short selling without creating an obstacle for legitimate hedging transactions.

Reinstatement of the Uptick Rule

In her confirmation hearing in front of the Senate Banking Committee on January 15, 2009, SEC Chairman Mary Schapiro stated that she was willing to reinstate the uptick rule. On March 11, 2009, Representative Barney Frank (D. MA) reported that Chairman Schapiro told him that she is moving toward reinstating the uptick rule. Rep. Frank told the press that he is hopeful that the SEC may issue formal proposals to reinstate the uptick rule as early as April 2009. John Nester, the SEC spokesman, made a similar statement on the same day.

The SEC should be able to reinstate the uptick rule without creating any obstacles to legitimate hedging transactions and the reinstatement of Rule 201 of Regulation SHO. As mentioned above, the SEC moved to abolish the uptick rule after it determined, based upon studies of data collected during the SEC's pilot program, that there was no evidence that prices of stocks subject to the uptick rule declined at a slower speed than prices of exempted stocks at times of stress. In addition, the SEC's position was that the modernization of trading systems, including the use of the decimals in the pricing of securities, made the uptick rule obsolete. However, when proposed, there were opponents to the abolition of the rule. Notably, the New York Stock Exchange opposed the lack of any price restrictions that the exchanges could use to prevent a market panic during a major market collapse. In the adopting release issued by the SEC in connection with the abolition of the uptick rule and the adoption of Rule 201, the SEC noted such concerns but stated that in the event market conditions call for it, the exchanges could request an exemption from Rule 201.

In 2008, after the fall of Bear Stearns and Lehman Brothers, there were renewed calls for the reinstatement of the uptick rule from various parties, including the U.S. Chamber of Commerce, politicians, legal practitioners, academics and others. Many believe that the abolition of the uptick rule facilitated short selling, especially during times of severe market turmoil. More recently, Representative Gary Ackerman (D. N.Y.) reintroduced a bill to reinstate the uptick rule, which is backed by Charles Schwab, the CEO of Charles Schwab Corp. Rep. Ackerman introduced a similar bill in July 2008 which died in committee. Rep. Ackerman's efforts were bolstered by a letter from then SEC Chairman Christopher Cox dated January 20, 2009, in which Chairman Cox proposed the reinstatement of the uptick rule. This was one of his final acts as Chairman. Others, including the U.S. Chamber of Commerce, have called for a modified uptick rule that would go into effect for a particular security if the security experiences significant downward pressure or a free fall. Considering the pressure to reinstate the uptick rule, the SEC could reinstate the uptick rule without creating too much controversy. On a political level, considering the support for the reinstatement of the uptick rule, the SEC may have a hard time defending the status quo. One of the findings of the SEC studies on the uptick rule was that parties were able to quickly find other execution opportunities when the uptick rule prevented them from effecting certain transactions. If so, those short sellers that are adversely affected by a reinstatement of the uptick rule can take advantage of the other execution opportunities.

Eliminate Fails-to-Deliver

The SEC originally adopted Regulation SHO under the Exchange Act in order to address failures-to-deliver, among other matters. Rule 203(b)(3) of Regulation SHO generally requires participants in a registered clearing agency to close short positions in threshold securities that have failures-to-deliver 10 days after the normal settlement date by purchasing securities of like kind and quantity. Although this rule applies to broker-dealers, it affects investors in many private transactions by making it more difficult for investors to establish short positions in a security. This is especially true if the security is thinly-traded or if there is a relatively small number of outstanding securities. In addition, broker-dealers may be unable to execute short sales quickly given other provisions of Regulation SHO that impose strict find-and-deliver requirements with respect to the cover shares. The NYSE and other self regulatory organizations have similar rules in place with respect to their registered broker-dealer members.

In 2007, the SEC adopted amendments to Regulation SHO to address fails-to-deliver associated with naked short selling. Acknowledging that high fail levels existed only with respect to a small percentage of issuers, the SEC was still concerned that manipulative naked shorting could be used to drive down stock prices and undermine investor confidence. The amendments eliminated a grandfather provision in the original Regulation SHO that applied to open positions at the time Regulation SHO was adopted. On September 17, 2008, the SEC issued an emergency order adopting Rule 204T which imposed a penalty on any participant of a registered clearing agency and any broker-dealer from which it receives trades for clearance and settlement, for having a fail-to-deliver position at a registered clearing agency in any equity security, not just "threshold securities." In other words, the SEC created a "hard" T+3 closeout requirement. The amendments also eliminated the exception for options market makers from Rule 203(b) of Regulation SHO. As a result, option market makers are to be treated in the same way as all other market participants, and are required to abide by the new hard T+3 closeout requirements of Rule 204T with respect to threshold securities. The SEC stated that it adopted the amendments because it concluded that there continued to exist a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets. These provisions were made final with certain technical changes, effective October 17, 2008. Rule 204T, however, is set to expire on July 31, 2009.

We anticipate that the SEC may consider adopting actions designed to force currently open fails-to-deliver to be closed within a short time and further inhibit the ability of persons to cause failures-to-deliver. At minimum, we anticipate that Rule 204T will be made permanent. Former SEC Chairman Harvey L. Pitt, currently the chief executive officer of Kalorama Partners LLC, has stated that the most effective way in which the SEC can control illegal naked short selling would be to put in place legally enforceable rights to require sellers in short sale transactions to deliver the shorted securities. Rule 204T focuses on the clearing agencies, not the sellers, but if the clearing agencies must close out in T+3, one would expect greater diligence on the sell orders accepted. Mr. Pitt also has called on the SEC to adopt regulations that eliminate any ambiguity with respect to the illegality of naked short sales. We do not anticipate that the SEC will go that far. The SEC has stated on a number of occasions that not all naked short sales are illegal, only those that are abusive. As long as a seller does not violate the antifraud provisions of the federal securities laws or any other laws, rules or regulations, naked short selling is not illegal at this time. While we anticipate SEC actions to address fails-to-deliver, we do not anticipate an express prohibition on naked short sales.

Disclosure

On September 18, 2008, the SEC issued an emergency order requiring institutional investment managers with more than $100 million invested in "Section 13(f)" securities to begin reporting their daily short positions promptly. Institutional investment managers were not required to report short positions with respect to any Section 13(f) security if (i) the short position in the Section 13(f) security constituted less than 0.25% of that class of the issuer's Section 13(f) securities issued and outstanding as reported on the issuer's most recent annual or quarterly report, and any current report subsequent thereto, unless the manager knows or has reason to believe the information contained therein is inaccurate and (ii) the fair market value of the short position in the Section 13(f) security was less than $1,000,000. On October 15, 2008, the SEC made the filing requirement "temporarily" final by adopting an interim final temporary rule that required institutional investment managers to file a Form SH in connection with short sale transactions until August 1, 2009. The interim rule provides certain exemptions. The temporary rule did not include a grandfathering provision; rather, it applies to all existing or outstanding positions held prior to the effective date of the original order (September 22, 2008). Last, the interim final rule modified the second clause of the de minimis threshold to exempt the filing and reporting of short sales or a short position in a class of Section 13(f) securities, other than options, with a fair market value of less than $10 million.

We anticipate that the SEC may consider adopting actions that will enhance the required disclosure of short sale transactions and the maintenance of short positions by certain persons. The class of persons subject to the regulation may be expanded. Considering the growing calls for the registration of hedge funds and related legislative efforts in Congress, we do not believe that the SEC would be ready to allow these disclosure obligations to expire. At minimum, we anticipate that the temporary final rule will be made a final rule. On the other hand, we expect that the SEC will allow the filers to maintain some flexibility with respect to the substance of the disclosure. While the market has an interest in greater transparency with respect to short positions and short transactions in the market, the short sellers are entitled to some confidentiality with respect to their short selling transaction strategies. In fact, providing the market-at-large free short selling strategies may not be in the best interests of the public markets.

Enforcement

We anticipate enforcement initiatives will represent the SEC's greatest efforts against short selling. Without strong enforcement, regulatory actions have little value. In a speech by Chairman Schapiro at "The SEC Speaks in 2009" held in Washington, D.C. on February 6, 2009, Chairman Schapiro made very clear her intentions that enforcement will be a top priority of the SEC under her watch. Many of the popular critiques of the SEC's actions against abusive short selling focus on the SEC's lack of enforcement of existing and newly adopted regulations, not on the lack of necessary regulations. With that in mind, we anticipate that the SEC will focus its resources more on enforcing existing regulations rather than drafting a new regulatory scheme to address abusive short selling.

Other Regulatory Authorities

As discussed above, there have been actions against short selling in other countries. Most of said actions involve temporary short selling bans on the securities of designated financial firms. In the UK, the Financial Services Authority, the FSA, imposed a temporary ban on all short selling in publicly-quoted UK financial sector companies, as well as a heightened obligation to disclose net short positions in the shares of such companies. On January 5, 2009, the FSA published a consultation paper proposing to lift the short-selling ban as of January 16, 2009 but to extend the disclosure obligation, in a slightly relaxed version, until June 30, 2009. The FSA reserved the right to reinstate the ban if it considers it warranted. The FSA's decision came after heated, public debate between the Liberal Democrats and the Torys, among others. In its announcement, the FSA stated that market conditions had become less extreme and, thereof, the ban was no longer relevant. Opponents of the shorting ban cited studies that questioned the effectiveness of the ban. The FSA did announce that it was extending the disclosure obligations because although it did not regard short selling in itself to be abusive, certain short-selling strategies could be employed in an abusive manner. The disclosure regime would mitigate the risk of price overshoots and disorderly markets and enhance transparency.

Other countries have not yet caught up to the United States and the UK. Similar bans in Belgium, France, Germany, Australia and Switzerland have been extended until further notice or through various dates in March 2009. Germany's ban was originally scheduled to expire on December 31, 2008. In an order dated December 17, 2008, the German ban was extended until March 31, 2009. The stated reason for the German extension was that the extended ban was necessary to prevent continued market manipulation. By that time, most practitioners in the U.S. and the UK had decided that bans were no longer necessary to prevent market manipulation.

A recurring theme discussed with respect to further international securities regulations is an emphasis on disclosure and delivery requirements. A short-selling task force chaired by the Securities and Futures Commission of Hong Kong is concentrating on regulatory approaches to naked short selling, including delivery requirements and disclosure obligations. It intends to minimize adverse impacts on legitimate securities lending, hedging and other transactions. The Unregulated Financial Markets and Products Task Force, co-chaired by the Australian Securities and Investments Commission and the Autorité de Marché Financiers of France, intends to examine ways to introduce greater transparency and oversight to unregulated market segments, such as OTC markets for derivatives and other structured financial products. The Unregulated Financial Entities Task Force, chaired by the CONSOB of Italy and the FSA, intends to examine issues surrounding unregulated entities such as hedge funds, including the development of recommended regulatory approaches to mitigate risks associated with their trading and traditional opacity.

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