

SEWARD & KISSEL LLP

October 17, 2008

Memorandum to Our Investment Management Clients and Friends

U.S. SECURITIES AND EXCHANGE COMMISSION ISSUES INTERIM AND FINAL RULES TO CURB NAKED SHORT SELLING AS EMERGENCY ORDERS EXPIRE

On September 17, 2008 the U.S. Securities and Exchange Commission (the “SEC”) issued new rules under its emergency authority (SEC Release No. 58572) to curb “naked” short selling by (i) instituting a hard close-out requirement (i.e., more stringent securities delivery, buy-in and pre-borrow requirements) and certain sanctions for persistent failures, (ii) eliminating the options market maker exception from Regulation SHO’s close-out requirements, and (iii) instituting a new antifraud rule to prohibit misrepresentations by short sellers of their intention to deliver securities at settlement. We previously reported these actions, the SEC’s subsequent guidance and its extension of the application of the related emergency orders to 11:59 p.m. on October 17, 2008.¹

As the SEC’s emergency orders relating to the above rules (the “Emergency Orders”) are expiring, the SEC adopted effective today the following rules to continue this regulatory initiative in force, with certain amendments:

- An interim final temporary rule that requires broker-dealers to deliver securities by settlement date and purchase or borrow securities to close out the fail to deliver positions (“Rule 204T”);
- Final rules that eliminate the options market maker exception to the close-out requirement of Regulation SHO; and
- A final rule imposing antifraud liability for deception in connection with a seller’s intent or ability to deliver securities in time for settlement (“Rule 10b-21”).

Set forth below is a brief summary of certain important provisions of these new rules that differ from the Emergency Orders and related guidance.

¹ See Seward & Kissel LLP’s *Private Funds and Capital Markets Bulletin* dated September 17, 2008 and *Memoranda to Investment Management Clients and Friends* dated September 26, 2008 and October 2, 2008.

Modified Deliver, Buy-In, and Pre-Borrow Requirements (Rule 204T)

- **Fails to Deliver – Bona Fide Market Making Activities.** If a broker-dealer has a fail to deliver position at a registered clearing agency in any equity security that is attributable to bona fide market making activities (*i.e.*, broker-dealer activities in the capacity of a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market), the broker-dealer is required to close out the position no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date (*i.e.*, T+6) by purchasing the securities.
- **Persistent Fails to Deliver – Exceptions to Pre-Borrow Requirement.** The new rules provide exceptions to the general requirement that a broker-dealer with an outstanding fail to deliver position in an equity security may not accept or effect a short sale in the security without first borrowing or entering into a bona fide arrangement to borrow the security.

A broker-dealer is not subject to the general prohibitions relating to persistent fails to deliver an equity security if it certifies to its clearing broker that it either (i) has not incurred a fail to deliver position on the settlement date for a long or short sale in an equity security for which the clearing broker has a fail to deliver position or (ii) is in compliance with a new rule that contains exceptions to buy-in and pre-borrow rules (see description below).

The new rules also provide that a broker-dealer that is a market maker is not subject to the general prohibitions relating to persistent fails to deliver an equity security if the broker-dealer can demonstrate that it does not have an open short position in that equity security at the time of any additional short sales.

- **Allocation of Fails to Deliver.** A clearing broker may allocate fail to deliver positions to a broker-dealer for which it trades or from which it receives trades for settlement based on such broker-dealer's short position. In that case, the SEC's rules applicable to fails to deliver the equity security would apply to the broker-dealer to whom the positions are allocated, rather than the clearing broker. Certain notification requirements apply in the case of such an allocation.
- **Exceptions to Buy-In and Pre-Borrow Rules.** The new rules contain exceptions for broker-dealers in the case of a bona fide purchase to close out an open short position if (i) the purchase is executed on or after the trade date, but not later than the end of regular trading hours on the settlement date, (ii) the purchase covers the entire amount of the open short position, and (iii) the broker-dealer can demonstrate on its books and records that it has a net long or net flat position on the settlement day.

- **Comment Period and Expiration.** Rule 204T expires in its entirety on July 31, 2009. After receiving public comments, we expect the SEC to adopt a final “Rule 204” that will become effective on that date.

Elimination of Options Market Maker Exception to Regulation SHO’s Close-Out Requirements (Rules 203(b)(3)(iii) & (v))

- These rules were adopted in substantially the same form as contained in the Emergency Orders. Like the Emergency Orders, these final rules contain a phase-in period whereby a market maker will have 35 settlement days to close out short positions in securities that are threshold securities as of the effective date of the rules; however, the SEC has clarified that (i) this period will relate back to the effective date of the Emergency Orders and (ii) the close out requirement continues to apply even if the subject security ceases to be a threshold security after the applicable effective date.
- Similar to Rule 204T, the new Rule 203 also contains a provision that effectively prohibits a market maker from accepting short sale orders in a security for which there exists a violation of the 35-day rule.

Antifraud Rule Prohibiting Deception In a Seller’s Intent or Ability to Deliver Securities in Time for Settlement (Rule 10b-21)

- Rule 10b-21 was adopted in substantially the same form as its predecessor contained in the Emergency Orders; however, the SEC has clarified that Rule 10b-21 is intended to convey both private and governmental rights of action in a manner consistent with the rights of action under the SEC’s general antifraud rule (Rule 10b-5) that have been recognized by the courts.

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If you have any questions concerning these matters please contact an attorney in the investment management or capital markets groups at Seward & Kissel.

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