

SEWARD & KISSEL LLP

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Memorandum to Our Investment Management Clients and Friends

U.S. SECURITIES AND EXCHANGE COMMISSION CLARIFIES NEW RULES TO CURB NAKED SHORT SELLING

In our *Private Funds and Capital Markets Bulletin* dated September 17, 2008, we reported to you that the U.S. Securities and Exchange Commission (the “SEC”) had issued new rules to curb naked short selling¹ and announced a “zero tolerance” policy as regards abusive naked short selling. The new rules became effective on September 18, 2008 under an emergency order of the SEC (SEC Release No. 34-58572) (the “Order”), which will expire at 11:59 p.m. on October 1, 2008 (unless extended). The Order affects certain requirements of Regulation SHO governing the delivery of securities and settlement of both short and long sales.

When we prepared our bulletin, the final text of the Order had not yet been published by the SEC. In addition, the SEC has since issued guidance with respect to the Order, which is described below, as well as a number of additional orders that were directed at the reporting of short sales and prohibiting short sales in specific securities. These additional orders also are summarized below.

Introduction

The SEC has noted that it issued the Order to respond to concerns about the effects of “possible unnecessary or artificial price movements” in securities that have been “exacerbated by ‘naked’ short selling.” The Order provides emergency and temporary relief by adopting a new Rule 204T of Regulation SHO, amending Rule 203 of Regulation SHO, and adopting Rule 10b-21, a new antifraud rule.

Each of these requirements was effective as of 12:01 a.m. on September 18, 2008; *provided, however*, that fails to deliver resulting from trades that occurred before the effective date, which otherwise would be subject to Rule 204T, remain subject to Rule 203(b)(3) of Regulation SHO under the Order. This exception does not apply to Rule 203(b)(3)(iii) and (v) concerning options market makers.

¹ Under the SEC’s Regulation SHO, a short sale is either a sale of a security that is consummated by delivery of a security borrowed by (or for the account of) the seller, or where the seller does not “own” the security. This includes, among other things, any sale of a security in which the seller does not have a net long position.

New Delivery, Buy-In, and Pre-Borrow Requirements (Rule 242.204T)

Delivery Requirement – Generally. The first part of Rule 204T(a) sets forth the general requirement that any equity security sold long or short must be delivered to a registered clearing agency (e.g., the National Securities Clearing Corporation or NSCC) by the settlement date (i.e., T+3). The failure of a broker-dealer to meet this requirement results in a “fail to deliver.”

Fails to Deliver – Generally. Rule 204T(a) provides that if a broker-dealer has a fail to deliver position at a registered clearing agency in any equity security arising from either a long or short sale, the broker-dealer is required to close out the position no later than the beginning of regular trading hours on the settlement day following the settlement date (i.e., T+4) (the “Close-Out Time”) by borrowing *or* purchasing the securities.

Fails to Deliver – Long Sales. Rule 204T(a)(1) provides that if a broker-dealer has a fail to deliver position at a registered clearing agency in any equity security arising from a long sale and can evidence such long sale on its books and records, 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. The Order does not permit settlement of a fail to deliver resulting from a long sale by using borrowed securities.

Fails to Deliver – Rule 144 Sales. Rule 204T(a)(2) provides that if a broker-dealer has a fail to deliver position at a registered clearing agency in any equity security sold pursuant to Rule 144 (the SEC’s “safe harbor” rule for resales of restricted and control securities) that is outstanding for a period of thirty-five consecutive settlement days after the original settlement date, the broker-dealer is required to close out the position no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day after the original settlement date by purchasing the securities. The Order does not permit settlement of a fail to deliver resulting from a Rule 144 sale by using borrowed securities.

Persistent Fails to Deliver – Pre-Borrow Requirement. Rule 204T(b) provides that if a broker-dealer has a fail to deliver position at a registered clearing agency in any equity security and does not close out such position in accordance with Rule 204T(a), the broker-dealer and any broker-dealer for which it is a clearing broker (including any market maker) may not accept or effect a short sale in such equity security without first borrowing the security or entering into a bona fide arrangement to borrow the security. This restriction will no longer apply once the broker-dealer closes out the fail to deliver position by purchasing the securities and such purchase has cleared and settled at a registered clearing agency. The Order does not permit settlement of a persistent fail to deliver by using borrowed securities.

Persistent Fails to Deliver – Downstream Notification Requirement. Rule 204T(c) provides that a broker-dealer must notify any broker-dealer for which it is a clearing broker (including any market maker) that (i) it has a fail to deliver position in an

equity security that has not been closed out in accordance with Rule 204T(a) and (ii) the purchase to close out the position has cleared and settled at a registered clearing agency. The rule does not mention a specific time for compliance with these notification requirements, but presumably notification should occur prior to the broker-dealer's acceptance of an order in an affected security.

Repeal of Options Market Maker Exception (Rule 242.203(b)(3)(iii) & (v))

Existing Fails to Deliver – Buy-In Requirement. Rule 203(b)(3)(iii) provides that a broker-dealer that has a fail to deliver position at a registered clearing agency in a threshold security² and was previously excepted from the close out requirement in Rule 203(b)(3) (*i.e.*, an options market maker) is required to close out the position, including any adjustments thereto, within 35 consecutive settlement days from the effective date of the Order (*i.e.*, November 7, 2008) by purchasing the securities. The Order does not permit settlement of an existing fail to deliver by using borrowed securities.

Persistent Fails to Deliver – Pre-Borrow Requirement. Rule 203(b)(3)(v) provides that a broker-dealer that has a fail to deliver position at a registered clearing agency in a threshold security that is outstanding for 35 consecutive settlement days from the effective date of the Order (*i.e.*, November 7, 2008), and any broker-dealer for which the broker-dealer is a clearing broker (including any market maker), may not accept or effect a short sale in such equity security without first borrowing the security or entering into a bona fide arrangement to borrow the security. This restriction will no longer apply once the broker-dealer closes out the fail to deliver position by purchasing the securities. The Order does not permit settlement of a persistent fail to deliver by using borrowed securities.

Antifraud Rule – Deception in Connection with a Seller's Ability or Intent to Deliver Securities on the Date Delivery Is Due (Rule 240.10b-21)

Rule 10b-21 provides that the phrase “manipulative or deceptive device or contrivance” contained in Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), includes the submission of any order to sell any equity security by any person if (i) such person deceives a broker-dealer or a purchaser about the person's intention or ability to deliver the security by the settlement date and (ii) such person fails to deliver the security by the settlement date. While no guidance currently exists on the issue, it is possible that Rule 10b-21 will convey both private and governmental rights of action in a manner consistent with the rights of action available under the SEC's Rule 10b-5.

² In the Order, the SEC refers to a “threshold security” as that term is defined in the SEC's Regulation SHO, which includes, generally, any equity security of an SEC reporting issuer for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the total outstanding shares in the security.

Expiration of the Order and Anticipated SEC Actions

The Order was adopted by the SEC pursuant to its emergency authority in Section 12(k)(2) of the Exchange Act. Section 12(k)(2) provides that such an order shall not continue in effect for more than 30 business days, including extensions. However, many of the provisions detailed above have been the subject of long-standing rulemaking proposals and public comment. Therefore, the SEC may be within its existing authority to adopt the operative provisions contained in the Order by final rulemaking prior to the expiration of the Order without additional public notice and comment. Given the SEC's long standing views with regard to abusive naked short selling, we anticipate that final rules will be forthcoming.

SEC Guidance on the Order

On September 23, 2008, the Staff of the SEC's Division of Trading and Markets issued guidance on the Rule 204T requirements of the Order, which is summarized below (the "Guidance").

Clearing Broker Allocation of Fails to Deliver. The Guidance provides that a participant of a registered clearing agency (*i.e.*, a clearing broker) may allocate responsibility for Rule 204T's close-out requirement to another broker-dealer that is responsible for the fail position, *provided* that such allocation is "reasonable." Upon such allocation, the clearing broker would not be subject to the borrow and/or buy-in requirements of Rule 204T with respect to the allocated position and such requirements would be placed upon the broker-dealer receiving the allocation.

Pre-Fail Credit for Buy-Ins. The Guidance provides that a broker-dealer whose clearing broker has not closed out or allocated a fail position to the broker-dealer that is responsible for the fail position may receive credit for purchasing securities prior to the Close-Out Time (*i.e.*, T, T+1, T+2, and T+3) (a "Pre-Fail Credit"). In order to qualify as a Pre-Fail Credit, the broker-dealer must be able to demonstrate that the purchase was (i) bona fide, (ii) executed on or after the trade date (*i.e.*, T) but before the end of regular trading hours on the settlement date (*i.e.*, T+3), and (iii) of a quantity sufficient to cover the entire open short position in the security for which the broker-dealer is claiming a Pre-Fail Credit.

In addition, the broker-dealer must be able to demonstrate on its books and records that it has a net long or net flat position in the security on the settlement day for which it claims a Pre-Fail Credit. For example, if a broker-dealer had a short sale scheduled to settle on T+3 and executed a purchase on T+1 for which it intended to claim a Pre-Fail Credit, the broker-dealer would not be permitted to effect a subsequent short sale in that security on T+1, T+2 or T+3 without making a purchase to cover such short sale prior to the day on which the Pre-Fail Credit will be claimed (*i.e.*, the Close-Out Time, which is on T+4).

Pre-Fail Credit Avoidance of Pre-Borrow Requirement. In the event that a clearing broker is subject to the Rule 204T(b) pre-borrow requirement for a security and has not allocated the fail(s) to deliver in that security to another broker-dealer for which it clears securities transactions, the Guidance provides an exception to the pre-borrow requirement for other broker-dealers for which the clearing broker clears securities transactions. For a broker-dealer that has not been allocated a fail to deliver, the Guidance provides that the broker-dealer would not be subject to the pre-borrow requirement if it (i) is in compliance with the Pre-Fail Credit requirement for the security and (ii) certifies to the clearing broker on the settlement date that it has not incurred a fail to deliver in the security.

Additional Requirements for Market Makers with Fails to Deliver. The Guidance provides that any market maker to which a fail to deliver position at a registered clearing agency has been allocated must attest in writing to the market on which it is registered that the fail to deliver position at issue was established solely for the purpose of meeting its bona fide market making obligations. In addition, such written attestation must describe the steps the market maker has taken to deliver the securities to its registered clearing agency.

Tips for Broker-Dealers on Avoiding Failures to Deliver Securities. In addition to the Guidance, the Staff of the SEC's Division of Trading and Markets and the Office of Compliance Inspections and Examinations, along with the Financial Industry Regulatory Authority, has provided certain information intended to assist broker-dealer firms in preventing failures to deliver securities. These "Tips" are available on the SEC's website at: <http://www.sec.gov/about/offices/ocie/bdguidance.htm>

Subsequent SEC Emergency Orders

U.S. SECURITIES AND EXCHANGE COMMISSION EMERGENCY ORDER REQUIRING THE DISCLOSURE OF SHORT SALES OF CERTAIN PUBLICLY TRADED COMPANIES

On September 18, 2008, the SEC issued an emergency order (SEC Release No. 34-58591), as amended on September 21, 2008 (SEC Release No. 34-58591A) (the "Short Sale Reporting Order") requiring that institutional money managers (*i.e.*, those managers who filed a Form 13F for the quarter ended June 30, 2008) report certain information about daily short sales of publicly-traded securities. The emergency order became effective at 12:01 a.m. Eastern time on September 22, 2008, and will expire at 11:59 p.m. Eastern time on October 2, 2008, unless extended by the SEC.

These sales are to be reported on a weekly basis beginning Monday, September 29, 2008 on Form SH, which will include daily short sales for the previous week. We refer you to our memoranda of September 19, 2008 and September 22, 2008, for a summary description of the Short Sale Reporting Order. If you did not receive a copy of either or both of these memoranda, please contact us.

**U.S. SECURITIES AND EXCHANGE COMMISSION ISSUES EMERGENCY ORDER
PROHIBITING SHORT SALES OF CERTAIN PUBLICLY TRADED FINANCIAL COMPANIES**

On September 18, 2008, the SEC issued an emergency order prohibiting short selling of publicly traded securities of certain financial companies (SEC Release No. 34-58592) (the “Prohibited Short Sale Order”). We reported the issuance of the Prohibited Short Sale Order in our *Private Funds and Capital Markets Bulletin* dated September 19, 2008. On September 21, 2008 the SEC amended the Prohibited Short Sale Order (SEC Release No. 34-58611) (the “Amendments”). The Prohibited Short Sale Order became effective immediately upon its issuance and will expire at 11:59 p.m., Eastern time, on October 2, 2008, unless extended by the SEC.

The Prohibited Short Sale Order prohibits all persons from selling short³ the publicly traded common equity securities of financial companies that are designated by any national securities exchange (“Covered Securities”). Initially, the SEC had named securities of 799 issuers as covered by the Prohibited Short Sale Order. The Amendments provided that each such national securities exchange will compile its own list of Covered Securities, and publish that list on its website. The SEC noted that it expects these lists to cover the common equity securities of banks, savings associations, broker-dealers, investment advisers, and insurance companies, whether *domestic or foreign*, and their respective owners. The SEC has given the securities exchanges the authority to exclude from the lists an issuer that chooses to opt-out of coverage of the Prohibited Short Sale Order.

The Prohibited Short Sale Order contains a number of exceptions:

Bona Fide Market Maker Exception – Covers registered market makers, certain other market makers and block positioners of Covered Securities, in each case who sell short as part of their bona fide market making activities.

Options and Futures Expiration Exception – Covers short positions that are created by the automatic exercise or assignment of an equity option, or in connection with the settlement of a futures contract, that is held prior to the effectiveness of the Prohibited Short Sale Order due to the expiration of the option or futures contract.

Exception for Call Writers Upon Exercise – Covers short sales that are effected by the writer of a call option as a result of assignment following exercise of the call option by its holder. The SEC noted that this exception is intended to allow for creation of long call options.

Bona Fide Derivatives Market Maker Exception – Covers any short sale effected by a market maker (including an over-the-counter market maker) as part of bona fide

³ In the Prohibited Short Sale Order, the SEC refers to a “short sale” as that term is defined in the SEC’s Regulation SHO. We refer you to footnote 1 above.

market making and hedging activity related directly to bona fide market making in derivatives based on Covered Securities, or exchange traded funds and exchange traded notes of which Covered Securities are a component. However, such a market maker remains prohibited from effecting a short sale in the related Covered Security if it knows that its customer's or counterparty's transaction will result in such customer or counterparty establishing or increasing an economic net short position (*i.e.*, through actual positions, derivatives, or otherwise) in the issued share capital of a firm covered by the Prohibited Short Sale Order. The SEC has further mandated that all market makers relying on this exception publish a notice on their internet website that the market maker may not knowingly effect such a short sale.

Sales of Restricted Securities In Reliance on Rule 144 – The Prohibited Short Sale Order does not apply to any person that effects a sale pursuant to the SEC's Rule 144. The SEC noted that this is a necessary accommodation because sales of Rule 144 securities are sales of "owned" securities.

Expiration of the Additional Orders and Other Anticipated SEC Actions

Each of the Short Sale Reporting Order and Prohibited Short Sale Order (and the amendments thereto) was adopted by the SEC pursuant to its emergency authority in Section 12(k)(2) of the Exchange Act and is not permitted to continue in effect for more than 30 business days, including extensions. Unlike certain provisions in the Order, the provisions of the Short Sale Reporting Order and Prohibited Short Sale Order have not been the subject of prior rulemaking proposals and public comment. Currently, it appears that the SEC may pursue final rulemaking based upon the Short Sale Reporting Order and may permit the Prohibited Short Sale Order to expire.

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