DAVIS POLK & WARDWELL

Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

NOVEMBER 2008

INDUSTRY UPDATE

The SEC and FASB Issue Guidance on Determining Fair Value in an Inactive Market

On September 30, 2008, the SEC Office of the Chief Accountant and the FASB staff issued a joint press release ("**Joint Press Release**") aimed at providing financial statement users, preparers and auditors with further guidance in applying FAS 157, *Fair Value Measurements* ("**FAS 157**") to determine fair value in inactive markets. Subsequently, on October 10, 2008, the FASB issued FASB Staff Position No. FAS 157-3 ("**FSP FAS 157-3**"), which was intended to amplify the guidance contained in the Joint Press Release. FSP FAS 157-3 is effective upon issuance, including prior periods for which financial statements have not been issued.

Meanwhile, in address to an audience at an Investment Company Institute conference on October 6, 2008, John Walsh, associate director and chief counsel in the SEC Office of Compliance Inspection and Examinations, called for funds to carefully question and monitor their valuation process. He discouraged funds from relying on a single trader to value an asset. Thus, the collective guidance from the SEC and FASB requires close attention by funds in preparing upcoming financial statements and reports.

FAS 157

FAS 157 was issued in September 2006 and established a single definition of fair value and a framework for measuring fair value with respect to generally accepted accounting principles (GAAP). FAS 157 defines fair value as the price that would be received by the holder of a financial asset in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date. FAS 157 creates a three-tier hierarchy for inputs used in determining fair value. These inputs are:

- Level 1. "Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date."

- Level 2. Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data at the measurement date for substantially the full term of the assets or liabilities.

- Level 3. Unobservable inputs for the asset or liability that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration must be given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

FSP FAS 157-3

FSP FAS 157-3 clarifies the application of FAS 157, and the use of observable and unobservable inputs, in a market that is not active. In addressing these issues, FSP FAS 157-3 sets forth the following key principles:

- Management's Internal Assumptions. Management's internal assumptions, such as expected cash flows and risk-adjusted discount rates, can be used to determine fair value when observable inputs are unavailable or require significant adjustment in an inactive market. Thus, FSP FAS 157-3 calls for management to use significant judgment in making the determination of fair value in a dislocated market.

- Determining Whether a Market is Inactive. Examples of significant factors that management should consider in determining whether a market is inactive (and therefore that it may be appropriate to apply a discounted cash flow appraisal rather than use a quoted price or other observable input) include (i) the spread between the current "bid" and "ask," (ii) whether there has been a significant decrease in the volume of trades relative to historical levels, (iii) whether there are substantial price variations over time or among market makers and (iv) whether there are few observable transactions for the asset.

- Broker Quotes. Broker quotes (or pricing service quotes) are not necessarily determinative of fair value if an active market does not exist for the financial asset. In weighing the relevance of a broker quote as an input when determining fair value, management should place less reliance on quotes that are based on a broker's internal pricing models because such models do not reflect the result of market transactions. On the other hand, a broker quote in an active market is assumed to have been calculated based on real trades and thus is the proper measure of fair value.

The example used to illustrate the principles set forth in FSP FAS 157-3 is a hypothetical valuation of a fixed-income security as the market for that security becomes inactive over time. The example analyzes how the method for determining fair value could properly transition from a market valuation approach using observable inputs in an active market, to a discounted cash flow approach applying internal assumptions, such as expected cash flows and risk-adjusted interest rates, as markets become inactive.

- **See a copy of the joint press release issued by the SEC and FASB**
- **See a copy of FAS 157**
- **See a copy of FSP FAS 157-3**

Congressional Testimony of SEC Chairman Cox Concerning Lessons from the Credit Crisis

On October 23, 2008, SEC Chairman Christopher Cox testified before the U.S. House of Representatives Committee on Oversight and Government Reform (the "**Committee**") regarding the current financial crisis and the resultant need for more rigorous regulation. Cox began by tracing present economic woes to the erosion of lending standards by banks and mortgage originators, which resulted in a glut of near-worthless mortgage paper. Cox noted that securitization of these bad loans, while touted as a means of risk reduction, only spread the problem further afield. Cox faulted credit rating agencies for giving AAA ratings to mortgage-backed securities and helping engineer the securities to qualify for higher ratings. According to Cox, the ratings gave investors false comfort and "skewed computer risk models and regulatory capital computations." Cox added that the credit crisis was greatly exacerbated by the use of credit default swaps, which "further encouraged unsound lending practices" by enabling lenders to purchase inexpensive credit risk protection while exposing financial institutions to new risk from "often unknown counterparties."

Cox highlighted several items which, in hindsight, he would do differently. First, he stated that every regulator wishes he or she could have predicted the collapse of the U.S. mortgage market. Despite early indications, such as the deterioration of housing prices and the rise of credit spreads on mortgage-backed securities in October 2007, no banks or regulators used a risk scenario based on a total meltdown of the mortgage market. Second, Cox noted that he would have wanted to challenge the assumptions behind the Consolidated Supervised Entities ("**CSE**") program for investment bank holding companies. Cox remarked that he would have wanted the Division of Trading and Markets to challenge its reliance on the Basel standards for computing bank capital and the Federal Reserve's 10% well-capitalized bank test. As exemplified by the collapse of Bear Stearns, which had a capital cushion well above that required to meet the Basel and Federal Reserve standards, the CSE did not contemplate the possibility of secured funding becoming completely unavailable, even when backed by high-quality collateral. Consequently, the SEC is now working with various regulatory bodies, including the Basel Committee on Banking Supervision, to revise international capital and liquidity standards.

Third, and consistent with his remarks at an October 8, 2008, SEC roundtable (as discussed in "SEC Calls For Regulation of Credit-Default Swap Market" below), Cox testified that he should have worked more vigorously with Congress to repeal the swaps loophole in the 2000 Commodity Futures Modernization Act, which prohibits the SEC from regulating swaps. In light of the enormity of the credit default swap market, Cox has asked Congress to fill what he characterized as a "regulatory gap" by enacting legislation for regulation of the swaps market. Cox also indicated that he wished he had worked more aggressively for legislation requiring greater disclosure to investors in municipal securities. Cox emphasized that although individual investors own nearly two-thirds of all municipal securities, neither the SEC nor any other federal regulator has authority to impose disclosure requirements on such securities. Noting that "investors need to know what they own," Cox urged Congress to "bring municipal finance disclosure . . . up to par with corporate disclosure."

Turning to prospective measures, Cox stated that voluntary regulation is ineffective, and hence, mandatory regulation is required. Cox indicated that it was "a fateful mistake" that the Gramm-Leach-Bliley Act did not provide any regulator with statutory authority to mandatorily regulate investment bank holding companies. Indeed, Cox stressed that prior to the Federal Reserve's decision to provide funding for the acquisition of Bear Stearns, neither the SEC nor any other regulator was charged with protecting the viability of investment bank holding companies.

Cox testified that there are three lessons for legislators from the current financial crisis. First, legislators should eliminate the regulatory gap for investment bank holding companies. Second, legislators should recognize the core competencies of each regulatory body, and third, legislators should ensure that securities regulation and enforcement remain independent. In elaboration, Cox highlighted some of the core competencies of the SEC, namely, law enforcement, public company disclosure, accounting and auditing, and regulation of exchanges and other securities entities and products.

Cox also requested that Congress create an overarching statutory scheme to facilitate communication and coordination among regulators. Cox outlined initiatives implemented by the SEC during his tenure to enhance communication with other regulatory bodies, but reiterated that statutory coordination is required in place of ad hoc inter-agency arrangements. Cox stressed the importance of creating an overarching statutory framework to streamline "today's balkanized regulatory system" and eliminate what he characterized as a "hodge-podge of divided responsibility and regulatory seams." In this regard, Cox noted the growing importance of international coordination in light of rapid developments in global capital markets, emphasizing that the "new administration must open negotiations on a new global framework for regulations and standards."

Cox reiterated the importance of regulating products such as credit default swaps, which can be used as synthetic substitutes for regulated securities and can have profound adverse effects on regulated markets. Cox outlined several other regulatory anomalies which require rationalization, such as laws that treat broker-dealers differently from investment advisors, futures differently from economically equivalent securities, and derivatives differently from investment vehicles or insurance. Cox attributed these regulatory anomalies to archaic aspects of American financial law and a split in legislative jurisdiction that places banking, insurance and securities within the purview of Congressional financial services and banking committees, and futures within the province of Congressional agricultural committees. As a means towards overcoming this jurisdictional split, Cox proposed the creation of a select committee with representation from each standing committee currently responsible for financial services regulation.

In closing, Cox catalogued current SEC initiatives aimed at addressing the financial crisis, such as the SEC's use of new authority under the Credit Agency Reform Act to expose weaknesses in the credit ratings process and its examination of the effectiveness of broker-dealers' controls on preventing the spread of false information. Cox also pointed to new regulations which require the disclosure of short positions and strengthen investor protections against naked short selling. Furthermore, Cox noted that the SEC has approved orders requiring hedge funds, broker-dealers and institutional investors to file sworn statements concerning trading and market activity in the securities of financial firms (including both equities and credit default swaps). Finally, Cox detailed the SEC's efforts to create a common database of trading information, audit trail data and credit default swaps clearing data, and to analyze data across markets for possible manipulative patterns in equities and derivatives.

- **See a copy of SEC Chairman Cox's Written Testimony**

International Working Group of Sovereign Wealth Funds Releases Generally Accepted Principles and Practices

As discussed in the October 8, 2008, Investment Management Regulatory Update, the International Working Group of Sovereign Wealth Funds (the "**IWG**") has established a set of voluntary guidelines pertaining to sovereign wealth fund ("**SWF**") governance, accountability and investment practices. The IWG presented the guidelines, known as the Santiago Principles (the "**Principles**"), to a committee of the International Monetary Fund on October 11. Members of the IWG, which represents SWFs from 23 countries, have either implemented or intend to implement the Principles, subject to local legal requirements.

The Principles generally aim to promote transparency, efficiency and open investment through the implementation of sound practices. A summary of the Principles is set forth below.

Governance. SWFs should have sound and publicly disclosed legal frameworks that authorize their existence, provide investment mandates to managers and define asset owners. Within these frameworks, SWFs should establish sound governance structures that divide responsibilities, facilitate accountability and exclude political influence. In furtherance of these ideals, governments should set high-level objectives, governing bodies should set strategies and management should implement investment decisions. Additionally, to provide assurance that investment decisions are not politically motivated, SWFs should disclose the manner in which management is independent from ownership. Finally, SWFs should have a framework to identify, assess and manage operational risk (subject to independent audit).

Accountability/Integrity. To ensure transparency, SWFs should disclose their policy purposes and funding sources, produce financial reports (subject to recognized accounting and auditing standards) and disclose financial information such as asset allocation and rates of return. For integrity purposes, SWFs should adhere to clear ethical standards and comply with host country regulatory requirements. Moreover, with respect to investment managers, SWFs should disclose the extent of use, range of authority and applicable selection process.

Investment Practices. SWFs should have publicly disclosed investment policies that are consistent with objectives and strategies and are based on sound portfolio management principles. SWF investment decisions should aim to maximize financial returns based on economic grounds; investment decisions subject to non-economic considerations should be delineated in investment policies. Out of fairness, SWFs should not use privileged information or inappropriate government influence in competing with private entities. Finally, SWFs should exercise ownership rights in a manner consistent with investment policies and should disclose their approach to voting listed-entity securities.

- See a copy of the Principles and supporting commentary
- See a copy of Deputy Secretary of the U.S. Department of Treasury Robert M. Kimmitt's October 13, 2008, speech to the U.S. Council for International Business addressing the Principles

SEC RULES AND REGULATIONS

SEC Releases Enforcement Manual

On October 6, 2008, the SEC Division of Enforcement publicly released its first-ever Enforcement Manual (the "**Manual**"). The Manual is a 122-page document containing general policies and procedures to be followed by the SEC Division of Enforcement during every stage of the enforcement process. The Manual, formally known by practitioners as the "Red Book," had never been disclosed to the public before now.

It memorializes practices that have been developed over time and sets forth SEC policies on a number of issues, including the stages of informal and formal investigations, the "Wells" process, enforcement recommendations, investigative practices, attorney-client privilege, and cooperation with other agencies and organizations. SEC spokesman John Nester said that the manual was published and released based on the SEC's acceptance of a recommendation to do so in an August 2007 report of the minority staff of the Senate Finance and Judiciary Committees (the "**Senate Finance and Judiciary Committee Report**"). The Manual is designed to be a reference for the SEC Division of Enforcement and is not intended to create substantive or procedural rights in any civil or criminal matter.

The Manual was released during a period in which the SEC has been harshly criticized for its allegedly lax response to the early stages of the financial crisis. However, the SEC announced in an October 22, 2008, press release that it brought 671 enforcement actions during the 2008 fiscal year, which is the second-highest number of enforcement actions in agency history. The Manual will help bring transparency and consistency to the enforcement process during this period of numerous investigations and enforcement actions.

Of significant interest, the Manual sets forth the SEC's policy regarding waiver of attorney-client privilege. Waiver of attorney-client privilege is a controversial topic because often a person or entity under investigation feels compelled to waive such privilege in order to receive credit for cooperating with an investigation. The Manual states that **"[t]he staff should not ask a party to waive the attorney-client or work product privileges and is directed not to do so"** (emphasis included in original). Furthermore, the Manual states that all decisions involving potential waiver of privilege must be reviewed by supervisory personnel and involve senior members of management as deemed necessary. The Manual goes on to state that "[w]aiver of privilege is not a prerequisite to obtaining credit for cooperation. A party's decision to assert a legitimate privilege will not negatively affect their claim to credit for cooperation."

Other key aspects of the Manual are summarized below:

Opening Investigations

The Manual sets forth requirements for opening an informal investigation, known as a Matter Under Inquiry ("**MUI**"). The Manual states that in determining whether to open an MUI, the Enforcement Division should consider (i) "whether a sufficiently credible source or set of facts suggests that an MUI could lead to an enforcement action that would address a violation of the federal securities laws" and (ii) whether from a resources standpoint, "it is reasonable for the Enforcement Division to handle the investigation." Opening an MUI requires approval from senior Enforcement Division personnel. MUIs are automatically converted to formal investigations after 60 days.

Termination Notices

The Manual states that the Enforcement Division will notify individuals and entities at the earliest opportunity when the staff has decided not to recommend an enforcement action against them.

The Wells Process

Rule 5(c) of the SEC Rules on Informal and Other Procedures allows the SEC staff to provide notice of the nature of an investigation to persons involved in preliminary or formal investigations. Such notice is commonly referred to as a "Wells Notice." Recipients of Wells Notices are allowed to submit a statement to SEC staff prior to its decision on whether or not to recommend a formal proceeding. Often recipients of Wells Notices request to review non-privileged portions of the SEC's investigative file. The Manual does not set a definitive policy regarding whether the recipient of a Wells Notice should be permitted to do so. It does, however, state that "it is within the staff's discretion to allow the recipient of the notice to review non-privileged portions of the investigative file, including documents that the recipient likely would receive during discovery if the Commission were to file a recommended action or proceeding."

Document Production

The Manual encourages its staff to request document production in an electronic format and sets specific guidelines regarding form and procedure for delivering documents during the course of an investigation. The guidance set forth in the Manual is a good resource for individuals and entities to ensure that they will receive cooperation credit for properly responding to documents requests from the SEC.

- **See a copy of the SEC Enforcement Manual**
- **See a copy of the August 2007 report of the minority staff of the Senate Finance and Judiciary Committees**
- **See a copy of the October 22, 2008, SEC press release**

SEC Calls For Regulation of Credit-Default Swap Market

In an October 18, 2008, op-ed article published by the *New York Times*, and in his opening remarks at an October 8, 2008, SEC roundtable on modernizing the SEC's disclosure system, SEC Chairman Christopher Cox stressed the need for regulation and oversight of credit-default swaps. Similarly, Erik Sirri, Director of the SEC's Trading and Markets Division, recently testified before the House Committee on Agriculture regarding the need for government regulation of credit-default swaps. Chairman Cox and Director Sirri stressed the magnitude of the credit-default swap market (which is estimated to have been approximately $55 trillion at the end of the first half of 2008), the direct connection between the credit-default swap market and the overall securities market and the potential for further economic collapse in the absence of governmental regulation.

Currently, the SEC has no regulatory power over the credit-default swap market, except to enforce the anti-fraud provisions of the securities laws. Chairman Cox referred to this lack of regulatory oversight as "a cause for great concern" and "an unacceptable situation for a free market economy." Therefore, the SEC has established three regulatory agendas:

- <u>Public Disclosure</u>. Chairman Cox stated that legislation is required to require dealers in over-the-counter credit-default swap markets to publicly report both their trades and the value of those trades. The SEC believes that such a disclosure system (i) would clear up much of the confusion and lack of transparency surrounding credit-default swaps, (ii) reduce the chances of the systemic impact of the credit-default swap market and (iii) facilitate the investigation and enforcement of security laws in connection with credit-default swaps.

- Rule-Making Authority. The SEC has requested from Congress rule-making authority to issue rules against fraudulent, manipulative and deceptive acts in connection with credit-default swaps. Currently, the SEC has no rule-making authority with respect to credit-default swaps and is limited to enforcing anti-fraud rules under the securities laws.

- Central Counterparty ("**CCP**") and Exchange-Like Trading. The SEC has also encouraged Congress to mandate the use of (i) a CCP, where credit-default swap trades would be recorded and counter-party risk would be guaranteed and (ii) an organized market, such as an exchange trading system, for the credit-default swap market. Currently, SEC staff is coordinating with the Federal Reserve, the CFTC and other industry participants to create one or more CCPs for the credit-default swap market, as well as one or more electronic trading systems. However, absent additional legislation, use of CCPs or electronic trading systems would be voluntary, and over-the-counter credit-default swap trading would likely remain substantial.

  - **See a copy of Chairman Cox's op-ed article in the *New York Times***
  - **See a copy of Chairman Cox's opening remarks at the SEC roundtable**
  - **See a copy of Erik Sirri's testimony concerning credit-default swaps before the House Committee on Agriculture**

SEC Adopts New Short Selling Rules

As reported in previous Davis Polk communications (links to which are provided below), on October 14 and 15, 2008, the SEC adopted a number of new rules under the Securities Exchange Act of 1934 that extend certain measures initially adopted under the SEC's emergency orders related to short selling (the "**Emergency Orders**"). A summary of the currently effective rules follows below.

Reporting of short sales on Form SH. On October 15, the SEC adopted temporary Rule 10a-3T ("**Rule 10a-3T**"), which is effective through August 1, 2009. Rule 10a-3T extends the reporting requirements established by the Emergency Orders requiring institutional investment managers to report short sales in Section 13(f) securities on Form SH, subject to certain modifications:

- End of week filing. Rule 10a-3T requires Form SH to be filed on the last business day of the calendar week following a week in which reportable short sales were effected (as opposed to the first business day of such week, as previously required under the Emergency Orders). The change was implemented to allow more time for managers to collect and verify information for their reports.

- Decreased information requirements. Form SH no longer requires the disclosure of the value of securities sold short, the largest intraday short position or the time of day of the largest intraday short position (as previously required in columns 5, 7 and 8, respectively). The SEC noted that this information was difficult to obtain for some reporting managers.

- No grandfathering of short positions. Rule 10a-3T eliminates the Emergency Orders' grandfathering exception, which enabled a reporting manager to avoid disclosure of short positions established prior to September 22, 2008 (effectively treating a short position as "zero" as of that date).

The SEC eliminated the grandfathering provision in order to improve its ability to analyze short sale activity. The necessity of the provision, which addressed concerns about public disclosure of managers' pre-existing short positions under the Emergency Orders, was obviated by the SEC's October 2 announcement that Form SH filings would remain non-public.

- Increased de minimis threshold. Under Rule 10a-3T, managers are not required to report short sales or positions that would otherwise be reportable if (i) the short sale or position constitutes less than 0.25% of that class of the issuer's issued and outstanding Section 13(f) securities (as reported in the issuer's most recent SEC filings) and (ii) the fair market value of the short sale or short position is less than $10,000,000. Under the Emergency Orders, the fair market value threshold was $1,000,000.

- Who must file. Rule 10a-3T will apply to all institutional investment managers that were 13F filers as of the end of the previous calendar quarter.

Data provided in Form SH must be submitted in XML format pursuant to new technical specifications that the SEC intends to provide, which are expected to be effective for the November 7 reporting date.

Rule 10a-3T and its accompanying release address two questions that had been raised by reporting managers. The first involves reporting short sales or positions in a particular security that are below the de miminis threshold on a particular day during a week for which Form SH is required to be filed. Some managers were confused as to whether any information needed to be reported at all on such days with respect to such securities. Rule 10a-3T and the release indicate that once a filing is required, a manager may apply the de minimis exception on a day-by-day and element-by-element basis, but that reliance must be documented by disclosing "N/A" in the data element where information would otherwise be required to be reported. In other words, the name of the issuer and the CUSIP apparently need to be reported each day, even if the manager's short sales and/or short position in the security are de minimis.

The second question involves the confidentiality of submissions. We are aware that certain reporting managers who were concerned about public disclosure of their short positions on Form SH, even after the SEC's October 2 announcement that the information would remain non-public, submitted separate requests for confidential treatment along with their filings. In the Rule 10a-3T release, the SEC specifically states that a Form SH filer should not submit a confidential treatment request to the SEC and notes that the Freedom of Information Act provides at least two exemptions under which the SEC believes it may withhold Form SH information. Reporting managers should continue to label Form SH as non-public, as required by the form's instructions. Rule 10a-3T provides explicitly that Form SH shall be "nonpublic to the extent permitted by law."

Rule 204T close-out requirement. On October 14, the SEC adopted temporary Rule 204T ("**Rule 204T**"), which will be effective from October 17 through July 31, 2009. Rule 204T does not significantly modify the previous version of the rule adopted in the Emergency Orders, which imposed requirements and penalties for failures to deliver equity securities for clearance and settlement by the settlement date (ordinarily, T+3). Under Rule 204T, if a participant in a registered clearing organization does not make the required delivery on the settlement date, it must close out the position by the opening of business on the next settlement day by either purchasing or borrowing the security.

Rule 204T contains exceptions to the close-out requirement, applicable in instances where a failure to deliver (i) results from a documented long sale, (ii) occurs with respect to securities sold under Rule 144 pursuant to the Securities Act of 1933, or (iii) is attributable to market making activities by a registered market maker. In such scenarios, the participant may close out the position by purchasing securities of like kind and quantity, within three business days of the original settlement date in the case of long sales and market making activities, and within 36 business days of the original settlement date in the case of securities sold under Rule 144.

If a short sale violates Rule 204T's close-out requirement, then any broker-dealer acting on the short seller's behalf will be prohibited from further short sales in the same security – for *any* customer – unless the shares are pre-borrowed. There are, however, certain exceptions to this "pre-borrowing" requirement, including:

- <u>Allocation</u>. A participant in a registered clearing organization may reasonably allocate responsibility for failure to comply with the close-out requirement to a broker-dealer for whom it acts as clearing agent, based on such broker-dealer's short positions (*i.e.*, the participant may reasonably allocate failures to deliver to the broker-dealer determined to be at fault), in which case the broker-dealer, and not the participant, may be subject to the pre-borrow requirement.

- "Good Boys". If a broker-dealer certifies to the clearing organization participant that it is not responsible for the participant's fail to deliver (or that it will qualify for pre-fail credit, as described below), the broker-dealer will not be subject to the pre-borrow requirement.
- Market Makers. Market makers are exempt from the pre-borrow requirement under Rule 204T if they can demonstrate that they do not have an open short position in the security that experienced a fail to deliver at the time of any additional short sales.
- Pre-Fail Credit. Under Rule 204T(e), a broker-dealer will be deemed to have complied with the close-out requirements, despite a fail to deliver, if it makes a *bona fide* purchase of securities covering the entire amount of the open short position prior to the beginning of regular trading hours on the settlement day following the original settlement date for a long or short sale to close out an open short position as long as (i) the purchase is executed on or after the trade date but by the end of regular trading hours on the original settlement date and (ii) the broker-dealer can demonstrate that it has a net long position or net flat position on the settlement day for which the broker-dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

One important practical effect of Rule 204T is to temporarily override the existing close-out requirements in Rule 203(b)(3) of Regulation SHO, since Rule 204T's pre-borrow requirement will apply in a much shorter timeframe than the close-out requirement for threshold securities found in Rule 203(b)(3) (generally, T+13).

Permanent elimination of options market maker exception. On October 14, the SEC made permanent its previous amendment to Rule 203(b)(3) of Regulation SHO, which eliminated the exception from the short selling close-out provisions of the rule that permitted options market makers to maintain fail positions indefinitely. As a result of the amendment, options market makers are treated the same as other market participants with respect to the T+3 close-out requirements that effectively prohibit naked short selling.

Guidance on "Bona Fide Market Making." On October 14, the SEC provided additional guidance regarding "bona fide market making" for purposes of compliance with the market maker exception to the "locate" requirement of Regulation SHO. To qualify for the locate exception, it is necessary to be a market maker for the security sold and be engaged in bona fide market making activities in such security at the time of the short sale.

According to the SEC's guidance, certain factors tend to indicate that a market maker is engaged in bona fide market making activity, including: (i) economic or market risk with respect to the securities incurred by the market maker, (ii) a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customer or other broker-dealers and (iii) continuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to other investors and other broker-dealers.

Conversely, the SEC also identified activities that militate against a finding of *bona fide* market making, including: (i) activities that are related to speculative selling strategies or investment purposes of the broker-dealer and that are disproportionate to the usual market making patterns or practices of the broker-dealer in that security, (ii) continually posting at or near the best offer, but not also posting at or near the best bid and (iii) a market maker continually executing short sales away from its posted quotes.

Rule 10b-21 anti-fraud rule. On October 14, the SEC adopted the "naked" short selling anti-fraud rule, Rule 10b-21 ("**Rule 10b-21**"), effective October 17. The SEC had previously considered Rule 10b-21 to have been adopted on September 17 pursuant to the Emergency Orders. Rule 10b-21 provides that it will be a "manipulative or deceptive device or contrivance" under Section 10(b) of the Securities Exchange Act of 1934 for any person to deceive a broker-dealer, a clearing organization participant or a purchaser about their intention or ability to deliver securities in time for settlement and then fail to deliver such securities.

See the Davis Polk communications regarding the rules:

- **SEC Issues New Rules on Naked Short Sales and Plans Further Actions to Combat Market Abuses (September 18, 2008)**
- **SEC Issues Order Temporarily Banning Short Sales of Public Securities of 799 Financial Companies (September 19, 2008)**
- **New Short Sale Reporting Requirements (September 22, 2008)**
- **SEC Amends Order Temporarily Banning Short Sales of Financial Companies to Modify Scope of Covered Securities and Expand Exemption for Derivatives Market Makers (September 22, 2008)**
- **SEC Extends Short Sale Emergency Orders (October 3, 2008)**
- **SEC Issues Interim Final Temporary Rule Extending Short Sale Reporting (October 20, 2008)**
- **SEC Adopts Final Short Sale Rules (October 21, 2008)**

SEC Charges Lion Gate Capital with Illegal Short Sales in Violation of Regulation M

On October 7, 2008, the SEC charged Lion Gate Capital and its principal, Kenneth Rickel, with violating Rule 105 of Regulation M under the Securities Exchange Act of 1934 ("**Rule 105**"). The SEC alleges that Lion Gate and Rickel violated Rule 105 by using shares purchased in 14 public offerings to cover short sales that occurred during the five days before the pricing of those offerings. The SEC further alleges that Lion Gate and Rickel engaged in sham transactions to evade Rule 105, as described below.

The purpose of Rule 105 is to prevent manipulative short selling prior to registered offerings and to promote offering prices that are based upon supply and demand, rather than artificial forces. At the time of the conduct alleged in the complaint (January 2005 – September 2006), Rule 105 prohibited covering a short sale with securities purchased in a registered offering if the short sale occurred during the five days prior to the offering's pricing (the "**Restricted Period**"). Rule 105 was subsequently amended, effective October 9, 2007, and now generally prohibits a buyer from purchasing a security in a registered offering if it has effected a short sale of such security during the shorter of (i) the five-day period prior to pricing and (ii) the period between the filing of a registration statement or notification and pricing. The SEC contends that the conduct alleged in the complaint would violate amended Rule 105, as well.

Cross trading. The SEC first alleges that Lion Gate sold short during the Restricted Periods of various issuers' follow-on offerings and subsequently purchased shares in those offerings, thereby establishing a boxed position, or simultaneous long and short positions in shares of the same issuers. Lion Gate then bought and sold post-pricing shares of the same issuers, purportedly on the open market. Lion Gate's records reflected that the "open market" purchases were used to cover its Restricted Period short sales and the "open market" sales were of the shares acquired during the offerings, thereby "flattening" the boxed position. The use of shares purchased in the open market to cover short positions created during the Restricted Period would not have been a violation of Rule 105. However, the SEC charges that these post-pricing sales and purchases did not occur on the open market, but rather, were accomplished by Lion Gate placing orders to sell and purchase post-pricing shares with the same broker and then directing the broker to mark the orders as "cross trades." A cross trade, according to the SEC, occurs when a trader buys and sells the same shares to itself. Through this sham, Lion Gate allegedly tried to conceal that it had used the shares it purchased in the offerings to cover all or part of its Restricted Period short sales.

Contemporaneous trading. Another way Lion Gate allegedly attempted to hide its illegal flattening of boxed positions in violation of Rule 105 was hrough contemporaneous, post-pricing "sell" and "buy" orders, purportedly to sell the offering shares and to purchase shares to cover its short positions, respectively. The SEC charges that these contemporaneous, post-pricing transactions were shams because they involved minimal market risk, served no legitimate economic purpose and did not result in meaningful changes in ownership. The SEC claims that these transactions merely served to lock in nearly identical gains as would have been realized by immediately using the offering shares to cover the Restricted Period short position.

The case is pending before the U.S. District Court, Central District of California. As of November 3, 2008, an answer by the defendants to the complaint was not reflected in publicly available filings.

- **See a copy of the complaint**

If you have any questions regarding the matters covered in this Regulatory Update, please contact any of our Investment Management Group lawyers listed below or your regular Davis Polk contact:

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