Date: April 16, 2009

To: Interested Persons

Re: SEC Proposed Short Sale Restrictions: Implications for Equity Derivatives and Equity-Linked Securities

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On April 10, 2009, the Securities and Exchange Commission (the "SEC") published proposed amendments to Regulation SHO that would impose new restrictions on short sales. As proposed, the amended rules do not provide clear exemptions for important aspects of the equity derivatives and equity-linked business as currently conducted.

In its release proposing the amendments (the "Release"), the SEC seeks comments on whether short sale price restrictions or circuit breaker restrictions should be imposed and whether such measures would help promote market stability and restore investor confidence. The SEC has proposed several alternative approaches:

(a) a modified uptick rule (i.e., a market-wide short sale price test based on the "national best bid");

(b) an uptick rule (i.e., a market-wide short sale price test based on the last sale price or tick) similar to former Rule 10a-1, the pre-2007 uptick rule; and

(c) a circuit breaker that would either (i) ban short selling in a particular security for the remainder of the day if there is a severe decline in the price of that security (a proposed "circuit breaker halt rule") or (ii) impose a short sale price test of the type described in (a) or (b) above in a particular security for the remainder of the day if there is a severe decline in price in that security.

This memorandum puts the Release in the context of other SEC initiatives regarding short selling, then focuses on the most significant aspects of the proposals that may have a major impact on the ability of equity derivatives and equity-linked market participants to hedge their exposures to equity derivatives and equity-linked securities through short sales.

What led to this proposal?

In June 2007, the SEC repealed the almost seventy-year-old "uptick" rule. That decision followed an eight-year review by the SEC, including the completion of a one-year pilot study by the Office of Economic Analysis, which concluded

that the removal of the price tests would reduce market distortions without an increase in market manipulation. This conclusion was consistent with other academic and expert analyses undertaken between 1963 and 2004, including studies that evaluated short sale price tests during severe market declines that occurred in that period.

However, the SEC's approach began to change in the late summer of 2008. In the midst of the financial crisis and in response to outcries that short sales were responsible for a rapid decline in financial stocks and political pressure from the administration, on September 17, 2008, the SEC issued a temporary emergency short sale ban and imposed enhanced delivery requirements on sales of equity securities. Concerned that manipulative "naked" short selling was in part responsible for the deterioration of certain stocks, the SEC subsequently adopted a "naked" short selling antifraud rule, Rule 10b-21, which had been proposed prior to the fall crisis.

Political and public pressure to permanently re-regulate short selling continued to be exerted on the SEC, notwithstanding experts' inability to find empirical evidence that short selling distorted or corrupted financial markets.[1] Notably, on April 1, 2009, six U.S. Senators[2] sent a letter to Mary Schapiro, Chairman of the SEC, expressing their concern that the SEC needed to promulgate and enforce regulations to end naked or abusive short selling.[3] The letter stated flatly that "at a minimum, those regulations should address the need for an uptick rule, as well as a pre-borrow requirement to prevent naked short sellers from artificially depressing or diluting stock values." The letter threatened that if the SEC failed to send a "strong message," the Congress will consider legislation to direct the SEC to do so.[4]

How strongly does the SEC support these proposals?

In their prepared comments at the public hearing to vote on proposing the rules, held on April 8, 2009, certain SEC Commissioners expressed significant skepticism about the need for and potential benefits of reinstating a short sale price regulation. Commissioner Casey, for example, questioned, among other things, whether the SEC was engaging in merely a political exercise, whether an

[1] Commissioner Kathleen L. Casey, Statement Before the Commission Open Meeting on April 8, 2009.

[2] Edward E. Kaufman, Jon Tester, Carl M. Levin, Johnny Isakson, Saxby B. Chambliss and Arlen Specter.

[3] The letter refers to a report of David Kotz, the SEC's Inspector General, that while the SEC's Enforcement Complaint Center received about 5,000 complaints about naked short selling from January 2007 to June 2008, none led to enforcement actions.

[4] On March 16, 2009, Senators Kaufman, Isakson and Tester introduced S. 605, which directs the SEC to write regulations within sixty days that end abusive short selling.

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uptick rule reinstituted without credible evidence that its elimination drove down security prices would survive judicial review, whether an uptick rule could have unintended negative consequences such as interfering with shorting in a rising market and whether the benefits of the regulation would outweigh the costs. Instead, the Commissioners acknowledged that a leading rationale offered for a short sale price test is to "bolster investor confidence." Commissioner Paredes warned that "the failure of a short sale restriction to serve its intended goals . . . actually might erode investor confidence over the longer term, whatever the immediate positive impact might be."[5]

The SEC Commissioners acknowledged that the Release was "very much a response to the vocal calls for the Commission to consider short sale restrictions. . . ."[6] They explicitly called for the public to comment and seemed to openly invite challenges to the proposals based on empirical and factual evidence. Chairman Schapiro memorably said, "I urge all those within the sound of my voice to actively participate in the rulemaking process."[7]

Is it worthwhile commenting on the proposals?

Notwithstanding the skepticism of certain of the Commissioners, the Release itself is not markedly negative about short sale restrictions. Therefore, it may not be politically feasible to prevent the adoption of some form of renewed short sale price regulation, but there may be significant potential benefits to providing the SEC with reliable information regarding the expected costs to the financial system of such regulations. In addition, the comment process may provide an important opportunity to suggest technical changes to eliminate or minimize problems caused by the proposed rules for hedging activities of equity derivatives and equity-linked market participants.

Will the proposed rules impede convertible arbitrage strategies?

Modified Uptick and Uptick Rules Provide a Possible Exception, But It Is Inadequate. Both the Modified Uptick Rule and the Uptick Rule provide exemptions for certain "bona fide arbitrage," [8] explicitly including convertible

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[5] Commissioner Troy A. Paredes, Statement Before the Commission Open Meeting on April 8, 2009.

[6] Commissioner Luis Aguilar, Statement Before the Commission Open Meeting on April 8, 2009.

[7] Chairman Mary L. Schapiro, Statement Before the Commission Open Meeting on April 8, 2009.

[8] The exception for bona fide arbitrage reads as follows: "The short sale order of a covered security is for a good faith account by a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the

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arbitrage.[9] This exception, which largely tracks the old arbitrage exemption in the repealed Uptick Rule, would appear to be aimed at simple price arbitrage and seems inadequate for hedging of the various types of convertibles that are now typically in the market. Examples of the limitations of this exception include:

- it does not cover "cash settled" or "net share settled" convertibles;
- it requires immediate convertibility (i.e., contingent or European-style convertibles not covered);
- it is unclear whether it covers "delta-one" structures (i.e., delta-one mandatory convertibles) which, it may be argued, are not hedged for the purpose of arbitraging two disparate securities prices;
- it is unclear whether it covers hedging of swaps; [10]
- it is unclear whether it covers typical registered short sales in the case of stock loan facilities entered into in connection with convertibles (because such short sales are often executed against swaps entered into by stock loan providers with buyers of the convertibles);
- it is unclear whether delta hedging is permissible (because of the requirement that the right to acquire be of an "equivalent number" of securities as the number of securities sold short);
- it probably does not permit short sales of ADRs if the securities held are convertible only into ordinary shares; and
- it requires the short sale to be executed out of a "good faith account" of the customer.

No Exception under the Circuit Breaker Halt Rule. The proposed circuit breaker halt rule does not provide an exception for hedging of convertible securities or for convertible arbitrage by persons who are not market makers engaged in bona fide market making at the time of the short sale. The SEC's general rationale is that it might restore investor confidence in the markets if there is a complete but temporary "pause" in all short selling when prices decline dramatically. The SEC recognizes that this "could restrict otherwise legitimate short selling activity during periods of extreme volatility." Interestingly, a non-market maker arbitrageur theoretically could achieve the economics of such a short position by entering into a derivative with a market maker who could, in

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security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities of the issuer."

[9] The release cites as an example of bona fide domestic arbitrage that "a person may sell short securities to profit from a current price differential based upon a convertible security that entitles him to acquire an equivalent number of securities of the securities sold short." Release at 53.

[10] The bona fide arbitrage exception only allows hedging of "securities." Under the Gramm-Leach-Bliley Act, swaps are excluded from the definition of "securities" under the Securities Act of 1933.

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turn, short under the market maker exception (discussed below). However, given the expected short duration of any halt, the SEC appears to consider this risk to be minimal.

Are there any proposed exceptions for hedging by derivatives dealers?

No explicit exceptions under the Modified Uptick and Uptick Rules. Neither the Modified Uptick Rule nor the Uptick Rule contains explicit exceptions for hedging short sales by derivatives dealers. However, two other exceptions may be relevant:

- Bona fide arbitrage. Hedging of physically settled American-style over-the-counter options may fit within the bona fide arbitrage exception described above. However, as discussed above in the context of convertible arbitrage, that exception has significant limitations.

- After-hours trading. Neither the Modified Uptick Rule nor the Uptick Rule would apply after hours. This would make possible a limited amount of shorting executed after regular trading hours.

There is a limited exception under the Circuit Breaker Halt Rule. There is an exception for hedging activity in a "covered security" related directly to bona fide market making in derivative securities based on that covered security.[11] However, the exception has significant limitations. It is only being proposed in connection with the circuit breaker halt rule, not any of the price tests. In addition, there is ambiguity as to the meaning of "bona fide market making in derivative securities." Is the writer of an individually negotiated, bilateral, nontransferable over-the-counter derivative such a market maker? Is the issuer of a structured product (or its affiliate) such a market maker, particularly if it is not at the time actively making a market in those notes but instead hedging its exposure? Finally, are swaps "derivative securities"? As noted above in footnote 10, swaps are excluded from the definition of "securities" under the Securities Act of 1933. However, for purposes of Section 16 under the Securities Exchange Act of 1934, the term "derivative securities" has been generally understood to include "security-based swap agreements."

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[11] The proposed exception reads as follows: "Any sale of a covered security by any person that is a market maker, including an over-the-counter market maker, if the sale is part of a bona fide market making and hedging activity related directly to bona fide market making in: (i) derivative securities based on that covered security; or (ii) exchange traded funds and exchange traded notes of which that covered security is a component." Unlike the temporary emergency short sale ban of September 2008, this exception does not prevent a market maker from effecting a short sale if the market maker knew it would result in an economic net short position.

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There is no general exception for delta hedging. In its list of questions regarding the proposed circuit breaker halt rule, the SEC asks whether there should be an exception for delta neutral hedging.[12] In fact, certain commentators have previously suggested a general delta hedging exception - even in the case of uptick or modified uptick rules - as a preferred approach to short sale regulation.[13] Any uptick rule or circuit breaker could contain a general exception for bona fide delta hedging by any holder of a corresponding “long” position, either in the form of the underlying security or in the form of a derivative contract on the underlying security, provided that in the latter case, the person relying on the exception has obtained a representation from its counterparty to the derivative contract that such counterparty either owns such a long position or is the issuer of the underlying security (and, if such counterparty’s long position is itself in the form of a derivative contract, a chain of such representations can ultimately be traced back to a holder of a long position in the underlying security or the issuer of the underlying security). This would prevent “net” shorting by market participants in a chain of transactions in which there is no “long” holder of the underlying security.

There is no general exception for issuer transactions. Neither the uptick nor circuit breaker proposals contains a general exception for hedging privately negotiated transactions with the issuer of the stock, such as the types of capital raising transactions that may be effected under the 2003 Goldman no-action letter. Because a primary purpose of proposed short sale regulation is to protect issuers from abusive short sellers, an exception for anticipated hedging of transactions to which the issuer is a party seems fair. Such an exception could be stated narrowly or could be part of a broader exception for convertible arbitrage.

If you have any questions regarding the matters covered in this memorandum, please contact any of the lawyers listed below or your regular Davis Polk contact.

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[12] Release at 153.

[13] See, e.g., letter to the SEC from Dan Mathisson, Managing Director, Credit Suisse Securities USA, LLC, dated March 30, 2009 at 8. *See also* letter to the SEC from the Derivative Products Committee of the Securities Industry Association dated as of February 19, 2004.

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