

SHORT SELLING: AN EXTENSION AND A DEADLINE**An Extension: Regulation SHO Pilot Program**

On April 21, 2006, the Securities and Exchange Commission (the “SEC”) announced that it is extending the Regulation SHO Pilot Program (“Pilot Program”) period to August 6, 2007.¹ The Pilot Program, established by the SEC as part of its review of short selling regulation, excludes certain equity securities from the SEC’s “tick” test set out in Rule 10a-1(a) of the Securities Exchange Act of 1934 (“Exchange Act”), and any self-regulatory organization (“SRO”) short sale price test.² The Pilot Program began on May 2, 2005, and was scheduled to end on April 28, 2006.

The order states that, although the period that will be analyzed by the SEC will extend to April 28, 2006, it is in the interest of the markets and investors to maintain the price test scheme of the Pilot Program until any rulemaking resulting from the data analysis is complete. It also notes that the staff has found no evidence of market disruption during the Pilot Program thus far.

The SEC implemented the Pilot Program as a means of collecting data on short selling and studying the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity. Under the terms of the Pilot Program, the SEC suspended the provisions of Rule 10a-1(a) under the Exchange Act and any short sale price test of any exchange or national securities association for:

- (i) short sales in the stocks contained in a subset of stocks selected by the SEC from the Russell 3000 index³;
- (ii) short sales in any security included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the consolidated tape⁴ on the following day; and
- (iii) short sales in all other exchange listed securities effected in the period between the close of the consolidated tape and the open of the consolidated tape the following day.

1 Securities Exchange Act Release No. 53684 (April 20, 2006).

2 *See* Rule 202(T) of Regulation SHO, 17 CFR 242.202(T); Securities Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004), and Securities Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004); the Pilot Orders are available at <http://www.sec.gov/rules/other/34-50104.htm> and <http://www.sec.gov/rules/other/34-50747.htm>.

3 A full list of the securities covered by the Pilot Program are available on the SEC’s website at <http://www.sec.gov/rules/other/34-50104.htm>; securities that at the time the Pilot Program commenced were included in the Russell 3000 index will remain in the Pilot Program even if during the term of the Pilot Program they cease being included in the Russell 3000 index.

4 The term “consolidated tape” refers to the effective transaction reporting plan of the Consolidated Tape Association.

At the time the Pilot Program was established, the SEC explained “[t]he Pilot includes securities with varying levels of liquidity, which will enable ... [the SEC] ... to examine whether the absence of a short sale price test affects less liquid and more liquid securities differently.” The SEC further noted that the securities selected “have significant market depth, and are traded on exchanges or other organized markets with high levels of transparency and surveillance, which will enhance the ability of the Commission and self-regulatory organizations (“SROs”) to monitor trading behavior during the Pilot and surveil for manipulative short selling.”

A Deadline: NASD Rule 3360

The NASD has set July 3, 2006, as the effective date for the amendment to Rule 3360 that expands short interest reporting to over-the-counter (OTC) stocks.⁵ With this amendment, Rule 3360 now requires NASD members to maintain a record of, and report on a monthly basis, total short positions in all customer and proprietary firm accounts in Nasdaq securities, listed securities if not reported to another self-regulatory organization, and OTC equity securities. For purposes of Rule 3360, OTC equity securities are defined as any equity security that is not listed on the Nasdaq Stock Market or a national securities exchange. The term does not include OTC options or non-standard equity derivative products (such as equity swaps and contracts for differences). Rule 3360(b) identifies short positions required to be reported as those resulting from short sales as defined in Rule 200 of SEC Regulation SHO, with limited exceptions.⁶

The rule amendment was approved by the SEC on February 3, 2006, but the effective date was delayed in recognition of the technological and systems changes the new requirement may require firms to make.⁷

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If you have any questions concerning the foregoing or would like additional information, please contact Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Michael S. Didiuk (202-303-1280, mdidiuk@willkie.com) or the attorney with whom you regularly work.

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5 See NASD Notice to Members 06-14 (April 2006).

6 Rule 200(a) of Regulation SHO defines “short sale” as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”

7 Securities Exchange Act Release No. 53224 (February 3, 2006), 71 FR 7101.