

**THE SECURITIES AND EXCHANGE COMMISSION APPROVES PROPOSALS TO
REPEAL PRICE TESTS ON SHORT SALES AND AMEND PROHIBITIONS ON
SHORT SELLING IN CONNECTION WITH A PUBLIC OFFERING**

On December 4, 2006, the Securities and Exchange Commission (the “SEC” or the “Commission”) unanimously voted to publish proposals to amend two major rules under the Securities Exchange Act of 1934 (the “Exchange Act”) regulating short sales of securities. The proposed amendments involve the following:

- (a) repealing all price restrictions on short sales under Rule 10a-1 and requiring conformity of self-regulatory organization (“SRO”) rules with such repeal, and
- (b) establishing a bright line prohibition on short selling in connection with public offerings under Rule 105 of Regulation M.

This proposed bright line rule eliminates the “covering” of short sales requirement in current Rule 105, and simply prohibits persons from purchasing securities in a firm commitment public offering, if they have sold the security short during the five trading days before such offering is priced.

The SEC’s release containing the proposed amendments will be available on the SEC’s website at www.SEC.gov. The proposing release will contain numerous questions about the application, effectiveness and market impact of the two proposed amendments, and interested persons will be invited to submit comments for 60 days after publication of the release in the Federal Register.

The SEC has other short sale rule proposals pending, principally proposed amendments to the “grandfather” and options market maker provisions of Regulation SHO.¹ The SEC staff stated that they anticipated presenting their recommendations on their proposals in the first quarter of 2007. It can be expected that recommendations regarding yesterday’s proposals will also be a part of that package.

BACKGROUND

Rule 105 of Regulation M

In 2004, the SEC promulgated Rule 105 of Regulation M to address abusive and manipulative conduct before the pricing of stock in a public offering. (Rule 105 is the successor to former Rule 10b-21 which was originally adopted in the 1980s.) Rule 105 is intended to

¹ See Willkie Farr & Gallagher LLP Client Memorandum, “SEC Proposes Amendments to Regulation SHO” (July 18, 2006), available at <http://www.willkie.com/firm/pubs.aspx>.

reduce distortions in order to allow the offering price to reflect supply and demand in the market. To fulfill this purpose, Rule 105 currently prohibits short sellers from covering a short sale with offered securities purchased from an underwriter or a broker or dealer participating in a firm commitment offering, if such short sale occurred during the shorter of: (1) the period beginning five business days before the pricing of the offered securities and ending with such pricing, or (2) the period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing.

Since Rule 105 became effective, the SEC has faced challenges in enforcing compliance with the Rule because some traders were alleged to have engaged in transactions to conceal covering purchases made with offering securities.² Consequently, the SEC staff proposed to the Commission the bright line rule that would allow the SEC to more effectively carry out the purpose of Rule 105. This proposed bright line rule eliminates the “covering” of short sales requirement in current Rule 105, and simply prohibits persons from purchasing securities in a firm commitment public offering, if they have sold the security short during the five trading days before such offering is priced.

The Director of the Division of Market Regulation suggested that there would be no exceptions to the purchase prohibition. The SEC will invite comments on, for example, specific issues related to the restricted period of time in the Rule and the effects on the underwriting process, derivative transactions and private investment in public equity (“PIPE”) transactions.

“Tick Test” of Rule 10a-1

Rule 10a-1 under the Exchange Act regulates the pricing activities of short sales through a “tick test,” which places price restrictions on when a short sale can be executed. In order to collect data on short selling and study the market impact of short selling in the absence of price regulation, the Commission conducted a pilot program from May 2, 2005 to August 28, 2006 to suspend all price tests for an identified group of securities. The empirical evidence from this study showed that relatively unrestricted short selling had minimal effects on market volatility, price efficiency and liquidity.

As a result, the SEC staff set forth a proposal to eliminate all price restrictions under Rule 10a-1 and prohibit SROs from applying their respective price tests and from adopting new ones related to short sales for any security.

² See, e.g., *SEC v. Graycort Financial, LLC*, No. 06-6033 (N.D. Cal. filed Sept. 28, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19851.htm>.

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