

**THE SECURITIES AND EXCHANGE COMMISSION PUBLISHES PROPOSALS TO
TIGHTEN PROHIBITIONS ON SHORT SELLING IN CONNECTION WITH A
PUBLIC OFFERING AND TO ELIMINATE THE “TICK TEST”**

On December 6 and 7, 2006, the Securities and Exchange Commission (the “SEC”) published the following proposals to amend two major rules under the Securities Exchange Act of 1934 (the “Exchange Act”) regulating short sales of securities. The proposed amendments would

- (a) eliminate the language in Rule 105 that makes the rule apply only to “covering” short sales with offered securities, and instead impose a broader prohibition against the purchasing of securities in a firm commitment public offering by persons who have sold the security short during the five business days before such offering is priced,¹ and
- (b) repeal all price restrictions on short sales under Rule 10a-1 (*i.e.*, the “tick” test) and require self-regulatory organizations to conform their rules with such repeal.²

The Releases discussing the proposed amendments contain numerous questions about the application, effectiveness and market impact of the two proposed amendments, and allow interested persons until February 12, 2007 to submit comments on either proposal.

Modification of 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 replaced the earlier Exchange Act Rule 10b-21 and 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.

Citing concerns that some market participants were engaging in transactions or “schemes” to conceal covering purchases made with offering securities,³ the SEC proposes to eliminate the language that makes Rule 105 apply only to “covering” short sales with offered securities, and

¹ Release No. 34-54888, File No. 57-20-06, 71 Fed. Reg. 75002 (December 13, 2006) <http://www.sec.gov/rules/proposed.shtml>

² Release No. 34-54891, File No. 57-21-06, 71 Fed. Reg. 75068 (December 13, 2006) <http://www.sec.gov/rules/proposed.shtml>

³ 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>.

replace it with language that would instead prohibit persons from purchasing securities in a firm commitment public offering if they have sold the security short during the five business days before such offering is priced.⁴

In the Release, the SEC seeks comment on a number of issues, including the situation where a short position is taken but then covered in an open-market purchase during the five-business-day period before pricing. The proposed revision to Rule 105 would make a subsequent purchase in the offering illegal, even though it might be thought, for example, that the subsequent purchase “cleansed” the market effect of the earlier short sale. The SEC asks for alternative solutions to deal with such “covering,” such as establishing a shorter two-day period prior to pricing before which a short position could be closed out in the open market.

The Rule amendment would flatly prohibit purchasing in an offering if the purchaser has shorted the stock within the five-business-day window, but does not address establishing an economic short via swaps during that period. The SEC also seeks comment on that issue. The Rule amendment also does not address the situation where an issuer sells securities off a shelf with very little notice to the market, possibly only a single day’s notice. In such a case, if the SEC adopts the Rule amendment in the form proposed, prospective buyers who had made short sales during the five-business-day period, even if before the offering announcement, would be precluded from buying the offered securities.

The issue as to when securities positions of affiliated traders should be aggregated for purposes of determining a short position is not addressed in the proposed amendments to the Rule, but the SEC seeks comment on whether the aggregation principles which have been established for broker-dealers should be expanded to cover registered investment advisers.

The SEC also asks whether the Rule should apply to offerings that are not “firm commitments” or should address shorting common shares during the five-business-day period and purchasing a security convertible into the common shares, and whether shorting an ADR or GDR should prohibit a person from buying the ordinary shares, whether the Rule should be applied to issuances of rights to existing security holders and, notably, whether the Rule also should prohibit purchases in an offering by persons who have sold a “long” position during the five-business-day period.

⁴ For this purpose, a “short sale” is a sale of securities that either (a) the seller does not own, or (b) is settled by the delivery of securities borrowed from a third party for the account of the seller. The resulting short position rises in value if the value of the security declines and declines in value if the value of the security rises. If a short seller realizes net proceeds of a short sale that exceed the all-in costs of buying identical securities in an offering, he or she profits from the transaction.

The SEC also asks whether the Rule should address (1) short sales effected during the period following the entering into a “Private Investment in Public Equity” (“PIPE”) transaction and before a registration statement for resale of the restricted securities acquired in the PIPE transaction is declared effective, or (2) short sales that are effected at any time in connection with the PIPE transaction.

Rule 105’s antecedent, Exchange Act Rule 10b-21, was adopted to prohibit hedge funds and others from causing market “downdrafts” by selling short during the time immediately before an offering when other regulations substantially restricted the ability of distribution participants to bid for or purchase securities of the same class and series as the underwritten stock.⁵ The SEC has substantially relieved those restrictions on underwriters in the last several years by, among other things, excluding from the prohibition securities that have an average daily trading volume of \$1 million or more and a public float value of \$150 million or more. The SEC did not mention that history or ask whether parallel relief should now be provided under Rule 105.

Elimination of the “Tick Test” of Rule 10a-1

Exchange Act Rule 10a-1 regulates the pricing activities of short sales through a “tick test,” that prohibits most short sales on a “down tick”, that is, a price lower than the last preceding different sale price. Particularly given the advent of decimalized pricing, in which there are now 100 price points to the dollar in place of the previous eight or sixteen, the SEC and others began to question whether a tick test, measured by a penny up or a penny down, continued to be useful. To collect data on short selling and to study the market impact of short selling in the absence of price regulation, the SEC has conducted a pilot program in which it has suspended 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 proposes to eliminate all price restrictions under Rule 10a-1, and to prohibit SROs from applying their respective price tests or adopting new ones related to short sales for any security. The proposed restriction on SRO rules would not apply to SRO rules that impose price restrictions in other contexts, such as NYSE Rule 80A.

⁵ See Rule 101 of Regulation M, which superseded the previous Exchange Act Rule 10b-6.

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If you have any questions regarding this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C., 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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