
SECURITIES LAW UPDATE September 17, 2008

SEC MOVES DECISIVELY TO END NAKED SHORT SELLING

On September 17, 2008, the Securities and Exchange Commission (the "SEC") took important, decisive and long-sought action to stop "naked" short selling in the United States. The SEC's new rules apply to the securities of all public companies and, reflecting the urgency of the matter, are effective virtually immediately, beginning at 12:01 a.m. (Eastern time) on Thursday, September 18, 2008.

To clarify, in an ordinary short sale, the seller borrows stock and sells it in a financed transaction, with the understanding that the loan must be repaid by buying back the stock in the market (with the investor betting that the stock will be rebought in the future at a lower price, thereby making a profit on the short sale). However, in naked short selling, the seller doesn't actually borrow the stock and fails to deliver it to the buyer. As a result, naked shorting can allow manipulators to force stock prices down far lower than would be possible in legitimate short-selling conditions because there is no countervailing buy-side pressure to go into the marketplace and rebuy the already-sold stock based on prevailing market conditions.

The SEC's new interim final rule requires that short sellers and their broker-dealers deliver the actual shorted securities by the close of business on the settlement date (three days after the sale transaction date, commonly known as T+3) and imposes severe penalties for failing to do so. If a short sale violates this 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 unless the shares are not only located but also pre-borrowed.

The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales for any customer. It is this final provision where we think the teeth of the new rules are found. With the burden on the broker-dealer for across-the-board trading restrictions in the

event of a violation of the new close-out requirement on a short sale, the brokerage industry itself will rigorously enforce compliance by their brokerage customers. It is not uncommon for the SEC, through rule-making, to “deputize” the brokerage industry or other professionals to help enforce the anti-fraud provisions of the Federal securities laws.

On the trader’s side of the transaction, the SEC adopted new Rule 10b-21, which targets fraudulent activity by short sellers. This new rule applies to short sellers who deceive broker-dealers or any other market participants by providing that those who lie about their intention or ability to deliver securities in time for settlement are violating the antifraud provisions of the securities laws when they then fail to deliver the shorted security on or before the T+3 settlement date.

Although the new rules become effective almost immediately, the SEC is seeking public comment during a 30-day period on all aspects of the rules and expects to engage in further rulemaking at the expiration of the comment period.

We strongly welcome this action by the SEC.

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