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SEC Holds Roundtable on Securities Lending/Short Selling

Introduction and Executive Summary

On September 29 and 30, 2009, the Securities and Exchange Commission ("SEC") held a roundtable on various issues relating to securities lending, as well as short selling, including possible requirements to pre-borrow securities prior to short sales, and additional short sale disclosures. Roundtable participants included representatives from broker-dealers, corporate issuers, beneficial owner lenders, lending agents, borrowers of securities, self-regulatory organizations, international regulators and the academic community. Chairman Schapiro opened the roundtable by noting that securities lending is a long-standing practice that increased in the 1970s, and that demand for securities lending grew in the 1990s and 2000s, especially due to strategies that increasingly used short selling. Chairman Schapiro noted that, while securities lending was generally thought to involve low-risk activities, the events of the recent past have shown that there is indeed risk, especially with cash collateral reinvestment programs. As a result, many questions have arisen with respect to the securities lending market and whether it may be improved. This Update provides summaries of the key points raised during the various panels, with a particular focus on comments made by the regulators and responses thereto.

Panel 1 - Overview of Securities Lending: Participants; Process; Benefits and Pitfalls

Panelists:

Jerry Davis, New Orleans Municipal Employees' Retirement System

David Downey, OneChicago

Irving Klubeck, Pershing LLC

William Pridmore, William F. Pridmore, Ltd.

Professor Adam Reed, University of North Carolina

Irv Klubeck provided an overview of securities lending from a broker-dealer's perspective, commenting that securities lending commenced in earnest in the late 1960s/early 70s, stemming from the paper crunch and the desire to timely settle securities transactions and eliminate settlement risk. Broker-dealers reduced risk by making delivery through borrowing, thereby replacing settlement risk with a transaction involving a lender, and daily mark to market payments. The desire for securities lending was further enhanced with the dematerialization of securities and automated settlement through registered clearing agencies, such as the National Securities Clearing Corporation ("NSCC"). Mr. Klubeck commented that in the

current environment most securities lending transactions occur in an automated fashion, with broker-dealers typically using securities lending to reduce settlement exposure, or as an alternative means of financing, including to offset cash loaned to customers effecting margin transactions through the broker-dealer.

In response to a question from Chairman Schapiro regarding the compensation structure for securities lending transactions, Mr. Klubeck commented that many pension funds lend securities and, in turn, derive varying profits. It was explained that the majority of the profit goes to the beneficial owner who is lending the securities, while other parties include the lending agent and the broker-dealer who may be borrowing the securities and providing to a short seller to settle transactions. Mr. Klubeck noted that the securities lending market is based on supply and demand — there would be reduced spreads with respect to securities that are easy-to-borrow, as opposed to other securities that are not easy-to-borrow and where there may be large desire to engage in short sales.

Chairman Schapiro next inquired to what extent the goal of growing lending income has driven investment decisions, *i.e.*, whether funds may make investment decisions in hard-to-borrow securities to lend rather than for true investment purposes. Mr. Pridmore, who indicated that his company works for beneficial owners, indicated a belief that securities lending incentivized beneficial owners to take on more risk with respect to cash collateral. Mr. Downey also commented that there can be real money in connection with lending securities in size, noting that Calpers earned about \$150 million in 2007 with respect to its securities lending program.

In response to a question from Commissioner Paredes concerning whether beneficial owners have developed checklists for diligence, including making market-based adjustments as necessary, Mr. Davis noted his belief that historically banks were very careful in marking to market loans, but that there were not similar diligent efforts with respect to collateral. He indicated that his organization was looking for checklists to come from banks concerning the type of collateral for securities loans, how to monitor value, and when to adjust collateral.

Commissioner Walter inquired on whether there was any guidance obtained from funds with respect to their securities lending programs, including any insight into why funds may be more conservative. Mr. Pridmore indicated in response that, in his estimation, mutual funds were sometimes skeptical about securities lending and concerned about risk. He noted one example where he helped put in place a program with a third-party lender in the third quarter of 2008, which the lender operated for about one month before recalling the securities loaned and instructing the liquidation of cash collateral. It was noted that the lender saw the cash collateral as the key risk. In response to a question from Chairman Schapiro on whether any cash reinvestment programs had experienced inabilities with respect to redemption, including liquidity difficulties, Mr. Pridmore commented that he believed most institutions investing in paper did experience liquidity problems.

Jamie Brigagliano, Acting Co-Director of the Division of Trading and Markets, inquired about whether beneficial owners had concerns about the master securities lending agreement (“MSLA”), including whether there should have been enhanced disclosure of potential risks. In response, Mr. Davis indicated his belief that there should have been more disclosure, commenting that, in his view, there was nothing about issues such as the rating of instruments, or monitoring by the bank. Mr. Davis commented that he believed the MSLA was skewed in favor of the lending agent.

Chairman Schapiro followed on this point to ask the panelists their views on the best improvements that may be made to securities lending, including increased transparency and disclosure. In response, Mr. Downey offered the following: (i) there should be increased transparency; (ii) Section 31 fees should be applied to securities lending transactions; (iii) there should be a clearing organization acting as a central counterparty, an idea which should be promoted by the SEC; and (iv) portfolio margining has been hampered because it does not include index futures. Mr. Klubeck commented that he believes the securities lending market is currently fairly efficient, and applies the rules of supply and demand. He noted that a number of regulatory changes, including Rule 204 of Regulation SHO, have enhanced the usefulness of securities lending transactions and drastically reduced fails to deliver, and

recommended that Regulation SHO be expanded beyond equities to the fixed income market. Mr. Pridmore noted that the basic fundamentals of securities lending have worked well, even during the crisis, however commented that investment of cash collateral has been a problem and recommended that it be a focus in the future. Professor Reed recommended that securities lending be enhanced to allow for greater short selling, which would in turn improve the efficiency of the markets.

Mr. Brigagliano closed by inquiring on how a borrower in a securities lending transaction knows that they are getting a good price. In response, Mr. Klubeck commented that broker-dealers will generally contact many different counterparties to ascertain the best rate (*i.e.*, the highest rebate available to the broker-dealer and its customers).

Panel 2 - Securities Lending and Investor Protection Concerns: Cash Collateral Reinvestment; Default; Lending Agent Compensation and Fee Splits; Proxy Voting

Panelists:

Patrick Avitabile, Citigroup

Ed Blount, Center for the Study of Financial Market Evolution

Karen Dunn Kelley, Invesco

Bruce Leto, Stradley Ronon Stevens and Young, LLP

Kathy Rulong, Bank of New York Mellon Corporation

Julia Short, RidgeWorth Investments

Christianna Wood, Internat'l Corporate Governance Network

Chairman Schapiro inquired with the panel on the discretion the lender has with respect to the lending program, asking whether that it a true statement across the board, or only with certain firms. In response, Mr. Avitable indicated affirmatively with respect to his firm, while Ms. Wood indicated her belief that, with respect to even the largest and best-staffed pension plans, transparency doesn't go very deep and those monitoring risk don't take into account their securities lending portfolio, which she believes is a major flaw.

Commissioner Walter inquired on the causes of losses in cash reinvestment for some funds versus others. In response,

Ms. Short noted that, from a mutual fund perspective, more conservative approaches were being taken with respect to collateral reinvestment, including disclosures of the underlying asset manager. Following-up on a question of whether there was an inherent tension between using a dollar per share price model, Ms. Short indicated that she believed there was, and that tension is why many of the products don't exist today — she noted her belief that the SEC can be useful in avoiding those types of problem. Mr. Blount added that the recent past reflects an unusual time where the securities lending market reflected the overall trouble in the market, noting that instruments put in pools were under stress, and that pools were being sold to pay cash collateral.

Chairman Schapiro inquired whether the experiences in Europe were different, asking about any relative benefits of accepting securities versus cash. In response, Ms. Rulong noted that, as in the European markets, she believed that there was an increased desire of clients in the US to do non-cash lending and borrowing. She indicated her belief that, with the market events over the last year, beneficial owners and agents have re-examined their practices, and that, with respect to non-cash collateral, there was a focus on making sure there was sufficient diversity and better valuation in securities, to guard against potential borrower default. Mr. Avitable confirmed this belief concerning diversification, and noted that one of oldest models in the UK involved securities being lent for cash which is then converted to a basket of equities. He commented on the fact that this had been a successful model.

Commissioner Paredes asked a question concerning the potential spotting of risk concerns, and the extent to which the lenders have leverage with respect to the reinvestment of cash collateral. In response, Ms. Kelley indicated her belief that many mutual funds view securities lending as investment activity, versus a merely back office activity. She noted her personal experiences that, in discussions between a firm and the lending agent, decisions can be made on who the lending agent will be and the appropriateness of the product. She also noted that correct reporting can be created and enhanced to mitigate risk.

Chairman Schapiro inquired on whether there were sufficient protections in place concerning default risk, or whether there

should be enhancements. Mr. Avitable commented on different types of default, namely default resulting from a bankruptcy (e.g., Lehman), and other events of default outlined in a client's agreement, such as a failure by the broker-dealer to return securities, or a failure to mark to market. He commented that there were levels of protection in securities lending programs — counterparty can be chosen that is approved by the lending agent; client can choose to set own credit limits with respect to counterparties, and attention could be paid to looking at collateral and marking to market. He also noted that most lending agents provide indemnity against borrower default.

Commissioner Aguilar inquired on the process and safeguards that exist, asking in particular whether they are widespread throughout industry, and limited to only 40 Act registered institutions. In response, Ms. Wood commented that, in her view, many pension plans are thinly-staffed and have lower levels of expertise, including in negotiating contracts. She noted that, in the past year, certain pension plans suffered their fair share of losses, and were surprised that the cash collateral had been reinvested in a riskier manner than they had believed. Mr. Blount added his belief that funds registered under the 40 Act have a lower participation in securities lending programs, relative to their entire portfolio. He noted that pension funds are far more active in securities lending, commenting that approximately 80-90% of plans were so involved. Ms. Rulong added that any risk mitigants (daily mark to market, reporting to clients, etc.) were equal across entire securities lending programs — the type of client did not matter.

In response to a question from Division Director Donohue concerning the types of agent lending compensation, Mr. Blount noted that the agent will take a portion of the cash pool, with the return being determined through the relationship between the bank and the institution providing the long position. Ms. Wood noted that she did not agree with a statement made in the prior panel that 70-80% of profit went to beneficial owners, commenting that she believes the prime broker makes significantly larger profits than the beneficial owner, and believes that there should be greater transparency on where profits are being made.

Dr. Henry Hu raised the issue concerning proxy voting, noting his belief that the current structure of securities lending

arrangements, where the lender does not retain the voting rights, results in a decoupling of economic interests from voting rights, and could result in “empty voting,” (i.e., borrowing securities for the sole purpose of voting those securities). Dr. Hu inquired on any difficulties that might arise with the lender keeping voting rights. Ms. Wood added her belief that, while the SEC has significant rules on how majority owners can behave, in situations where shares are lent owners have no control over the borrower's actions. She indicated her belief that this is an issue of primary concern to investors. Commissioner Walter followed up on this point and inquired on whether, in situations where securities are recalled, borrowers may try to find out reasons for the recall. In response, Mr. Avitable commented that, under the present mechanism, lenders of securities give up the right to vote. He noted that this is necessary, as the securities are often lent to short sellers, who need to deliver beneficial ownership, including voting rights, to the purchaser of securities. However, he indicated his belief that there should be a process in place to allow the lender to take in feeds regarding announcement of proxies in securities out on loan, so that action can be taken as necessary to recall the securities or reallocate the loan. Ms. Kelley added her view that her firm looks at proxies very closely, and has never experienced a situation where a lender wanted to vote securities, but couldn't get them back.

Further to this point, Mr. Blount pointed out how difficult it was to prove the allegations offered by Dr. Hu that hedge funds and other market participants were borrowing securities for the sole purpose of voting. He noted, in particular, that it would be insufficient to merely track an increase in securities lending activity across a record date, in that there would be perfectly legitimate reasons for an increase in securities lending activity, such as broker-dealers borrowing shares to allow margin long holders the right to vote. Mr. Blount indicated that, rather than altering the current process in response to allegations that may not be based on reality, there could be identification by the regulators of any suspicious situations, for further investigation.

**Panel 3 - Improving Securities Lending for the Benefit of Investors:
Transparency; Electronic Platforms; Central Counterparties;
Accountability**

Panelists:

Gregory DePetris, Quadriserv, Inc.
Christine Donovan, Brown Brothers Harriman
Aaron Gerdeman, Sungard
Chris Jaynes, eSecLending
Mike McAuley, State Street Corporation
Jeff Petro, Federated
Shawn Sullivan, Credit Suisse

Ms. Donovan opened the panel by noting her belief that, different from a securities transaction, a securities loan involves a continuing obligation that is governed by a bilateral arrangement between a borrower and lender. She urged the Commission to proceed with caution before changing the fundamental securities lending model, noting that there could instead be further education and disclosure concerning the risks of lending. Mr. Jaynes confirmed this view, indicating that securities lending is an investment function and needs to be treated as such. Furthermore, Mr. McAuley indicated that the majority of loans occur through an automated process, which serves the industry well, and that any focus on further automation should be with respect to post-trade activities, rather than at the time of trade. This being the case, Mr. McAuley indicated his belief that, with respect to the involvement of a central counterparty, there should be a support for changes to allow agent lenders to use the current OCC process for securities lending as another alternative, as long as this did not result in increased costs or liability. Mr. Sullivan largely echoed these thoughts and further commented on the successes of Reg SHO in reducing fails, and that there was no need to impose a pre-borrow requirement on short sales, especially because he estimated that 90% of securities are easy-to-borrow securities for which there is adequate supply.

Chairman Schapiro commented to the panel that she had reviewed and was impressed with AQS's written submission

and was interested in obtaining the panel's ideas regarding the use of a central counterparty with respect to securities lending. In response, Ms. Donovan commented that, in her view, lenders want the ability to manage risk themselves rather than outsource that function to another party. She noted her belief that a central counterparty would limit the ability to manage risks, and, in her view, would be a solution for a problem that doesn't exist, commenting that experience shows that there are no systemic risks derived from the unwinding of securities lending transactions. Mr. McAuley agreed with these points, highlighting in addition that any problems in securities lending arise with cash reinvestment, not the securities lending process. In his view, a central counterparty adds another intermediary, thus increasing costs which he did not believe were warranted. In contrast, Mr. Depetris cited his views on the benefits of a central counterparty in securities lending transactions, namely guaranteeing payment, and leading to the growth of potential bidders in an auction market, thus ensuring the best price discovery. Mr. Depetris stated his belief that the use of a central counterparty could complement the existing securities lending framework, rather than being the only model.

Chairman Schapiro then inquired on what process in securities lending might most need automation. Mr. McAuley commented that the biggest risks occur with respect to corporate actions, noting that there could possibly be efforts made to automate the recall process to reduce risk. In contrast, he noted that trade and settlement in securities lending works well and is not in need of further automation.

Chairman Schapiro went on to note that she has a "gnawing concern" about securities lending, and was looking for input from the panelists as to reasons why the Commission shouldn't be worried just because there have not been prior problems experienced with securities lending. In response, Mr. Jaynes commented that the industry has built checks and balances; however he noted a belief that big pockets of the market don't view securities lending as an investment function, and that it should be treated as such and participants should be aware of risks. Ms. Donovan noted attention should be paid to collateral

and reinvestment, noting in particular that the stability of collateral is important.

Panel 4 - The Future of Securities Lending and Potential Regulatory Solutions: Market Evolution; SEC's Role; Assessing any Regulatory Gaps

Panelists:

Mark Faulkner, Data Explorers

Richard Ketchum, FINRA

John Nagel, Citadel Investment Group, L.L.C.

Leslie Nelson, Goldman Sachs

Les Nelson opened the panel by commenting, among other things, that there had never been as much urgency in securities lending as today, due to the close-out requirements of Rule 204. Mr. Nelson further noted that the securities lending market is highly regulated, including through requirements imposed by Regulation T, 15c3-3, 15c3-1, Regulation SHO, and ERISA guidelines. Mr. Nelson further commented on the fact that the revised Prime Broker Letter, which has been pending with the SEC, would be a further positive step.

Rick Ketchum commented that FINRA needs to know and understand the securities lending market, noting the prior issues concerning stock loan “finders”, based on the skimming of profits due to payments to finders. Mr. Ketchum commented that FINRA has seen a significant reduction in securities available for loan, commenting that pressure had been produced on firms due to action required under Regulation SHO. Mr. Ketchum further commented that FINRA had seen some retailization of the securities lending market, with firms increasingly borrowing from retail customers. Mr. Ketchum notes that, since he believed the customer protection rules never focused on this situation, potential issues were raised, including lack of SIPC protection, conflicts of interest, notice to clients regarding payments in lieu of dividends, and loss of voting rights. Mr. Ketchum noted that firms had been generally responsive to FINRA’s concerns, and that FINRA was “looking hard” at potential additional rulemaking to make sure there was sufficient disclosure to retail clients concerning

securities lending programs. In addition, Mr. Ketchum noted that FINRA was considering the extent to which there should be increased transparency in the securities lending market.

Chairman Schapiro inquired on the type of collateral posted, including whether there was any trend toward the European model of non-cash collateral. In response, Mr. Faulkner noted his belief that such a change would be welcomed by the market, and could be supported on a global basis. Mr. Nelson commented further that, from his perspective, he has not seen a move toward using non-cash collateral, but that providing equities as collateral would generally be welcomed by the broker-dealer community. Mr. Ketchum further commented on this point that, when firms move from cash collateral to equity, firms need to look at their processes and procedures.

Chairman Schapiro inquired on the use of a central counterparty, asking whether that could be an additional investor protection or systemic protection measure. In response, John Nagel commented that, until recently, no centralized market existed. He noted that Citadel applauds efforts to increase transparency of OTC derivatives, and believes that the use of a central counterparty could be helpful with respect to securities lending, as could automated matching platforms. Mr. Ketchum further stated he was a believer in a central counterparty and, from a transparency and systemic risk standpoint, believes that a central counterparty could have real benefit.

Chairman Schapiro further inquired on how often the panelists believed that securities loans may have been recalled for voting purposes. In response, Mr. Nelson indicated that it is difficult to determine the reason why recalls may be occurring. Furthermore, responding to allegations of securities being borrowed for the purpose of voting, Mr. Nelson pointed out that broker-dealers are restricted by the parameters of Regulation T, which indicates that shares may only be borrowed for permitted purposes, including for delivery on short sales. Mr. Nelson furthermore noted that increased activity around record date could be explained by the fact that firms will seek to borrow shares to allow customers to vote, in

that they have loaned out rehypothecated securities. He believed that this has been misconstrued to mean that borrowing may be occurring for the purpose of voting securities.

Day 2 of Roundtable

Chairman Schapiro kept her opening remarks fairly brief, thanking all the panelists for participating and outlining the upcoming panels discussing naked short selling and short sale disclosure. Chairman Schapiro highlighted the fact the issues being presented have been at the forefront of her tenure at the SEC and that short selling issues evoke strong opinions both from supporters and detractors. Chairman Schapiro highlighted the concerns about abusive short selling and their effect on the markets and the need to look at various alternatives to address these issues.

Panel 1: Controls on “Naked” Short Selling: Examination of Pre-Borrow and Hard Locate Requirements:

Panelists:

William Conley, Goldman Sachs
Peter Driscoll, Security Traders Association
Dr. Frank Hatheway, NASDAQ OMX Group
William Hodash, The Depository Trust & Clearing Corporation
Paul Lynch, State Street Corporation
Michal Mendelson, AQR Capital Management
Dennis Nixon, International Bancshares Corporation
William O’Brien, Direct Edge
Thomas Perna, Quadriserv, Inc.

Mr. Conley opened by noting that the topics under discussion have an impact on market structure and liquidity. Referring to the recent GAO report on Regulation SHO, Mr. Conley noted that the available evidence does not support the need for a pre-borrow requirement, and that Rule 204 has been an effective way to address the issues of fails. The evidence suggests that fail rates have declined by 80% since implementation of the rule,

and he noted that pre-borrow or hard locate rules would result in significant expenses to market participants, for example, as a result of the need to fund the pre-borrow from a firm’s own capital. Mr. Conley noted that less than 5% of locates require a borrow, and that costs related to short selling would rise as a result of a pre-borrow/hard locate. Further, Mr. Conley pointed out his belief that a pre-borrow/hard locate would likely have minimal effect on abusive practices, and recommended the adoption of the revised SIFMA Prime Brokerage Letter.

Mr. Driscoll, speaking on behalf of the STA, noted that the SEC should be applauded for its efforts and implementation of Regulation SHO, and believes that with minor adjustments, current regulation can address naked short selling and related abuses. Mr. Driscoll noted that he is unaware of evidence that indicates restricting short selling would address naked short selling and related abuses, and noted that Rule 204T was very effective in reducing fails from around 500 to 63 stocks. Mr. Driscoll recommended that the SEC take a look and review the “locate” requirement of Rule 203, which could lead to improvements in addressing naked short selling. Mr. Driscoll also highlighted the Circuit Breaker Pre-borrow alternative suggested by the STA in May and urged the SEC to review this proposal. Mr. Driscoll also pointed out that the cost/benefit analysis is highly important in implementing any market-wide pre-borrow rule/arrangement, but noted that a permanent market-wide pre-borrow solution would be inappropriate.

Dr. Hatheway noted that the SEC has been successful in their efforts to reduce fails to deliver and should continue using a careful approach and incremental regulatory practices to address short selling abuses and related issues. Dr. Hatheway recommended one course of action the SEC might wish to undertake is to monitor loopholes in existing regulations to determine if abusive practices are resulting from such gaps, and noted that there may be such gaps in the current locate practices. Dr. Hatheway stated his belief that hard locate rules could be used to address abusive/naked short selling issues, and

that the SEC/Commission should consider differential requirements for market participants. Depending on whether empirical evidence warrants such measures, Dr. Hatheway/NASDAQ believes that a hard locate could be effective to address issues.

Mr. Hodash noted that fails to deliver are cited as an indicator of naked short selling activity, and pointed out that recent trends in fails suggest how the market is acting. Looking at fail rates before/after the implementation of Rule 204(T) is an important factor in determining whether the regulations are working. Mr. Hodash noted that statistics suggest regulation has had a significant impact and the low fail rate combined with Rule 204 have placed appropriate measures on preventing fails to deliver. Such decrease in fails calls for additional time to identify whether abusive practices are still ongoing, and if it is determined that there are additional on-going issues, then an enhanced (phased) approach to regulation should be considered.

Mr. Lynch stated his opposition to proposals for a pre-borrow or hard locate, and stated his support for Rule 204 of Regulation SHO and noted that the implementation of this rule has had a positive impact. Mr. Lynch, noted that a pre-borrow/hard locate would be unnecessary and will add additional costs; any pre-borrow would incur certain fees and would be an unnecessary use of inventory.

Mr. Mendelson noted that short selling is an important activity with market benefits and the regulation should serve to maximize such benefits. Mr. Mendelson noted that Rule 204 is well targeted to address issues, whereas a pre-borrow/hard locate is unguided and will result in excessively expensive requirements, and will not serve to deter naked short selling nor prevent fails to deliver. Instead such measures (pre-borrow/hard locate) will impair liquidity providers and will lead to herding and further potential abuses.

Mr. Nixon stated his belief in a pre-borrow requirement and that there should be a parallel disclosure regime to that for long

traders. Mr. Nixon noted that IBC (Mr. Nixon's Firm) submitted a comment letter calling for the SEC to enforce short selling rules and institute a pre-borrow and to investigate/review the market maker exemption. IBC urges the SEC to promulgate rules to address disclosure and transparency of short selling. Mr. Nixon noted his belief that short sellers severely caused detachment of IBC's stock price from true value, and drove the price downward, and noted his belief that short sellers don't add very much to markets.

Mr. O'Brien noted that the SEC's target of naked short selling via Rule 204 and locate requirements has had a significant positive effect. Mr. O'Brien believes that a pre-borrow requirement would be an inefficient use of capital. However, cost-effective review of locate issues would be useful. Mr. O'Brien noted that greater transparency with respect to borrowing would offer the potential for enhanced reliability in the markets, and that any mandates should consider the costs involved. Further, any consideration for more regulation should take into consideration current inefficiencies in the marketplace. Further, efforts to minimize the need to locate more securities than are really necessary should be examined.

Mr. Perna stated his view on the need for continued transparency and the need to make settlement more efficient. Mr. Perna noted that a mandatory pre-borrow would be balance sheet intensive and will raise the net costs of borrowing stocks, with such costs outweighing any potential benefits. Mr. Perna believes that a middle ground could be developed that considers the efficient interaction of supply and demand. Further, Mr. Perna noted his awareness of the complex challenges associated with hard locate requirements, but was confident in the industry's ability to arrive at a compromise.

Question Session and Discussion:

Question 1: Chairman Schapiro asked the panel for ways to improve existing locate rules and whether any tweaks could be made to improve the existing rule, and what might the differences in costs be between the current locate requirement and a hard locate.

Peter Driscoll: stated that the issue of the ‘reasonable standard’ in Rule 203 needs to be tightened up.

Michael Mendelson: noted that costs associated with a hard locate proposal would be pretty high, and that the many steps in communication between various parties before and after a trade would be very onerous.

Question 2: Chairman Schapiro followed up on the locate issue, inquiring whether the costs would be ‘technology’ related or simply just by having the hard locate.

Michael Mendelson: believes that the costs related to a hard locate are mainly economical (not technology related) but would also entail costs to investors engaging in short selling that would result in a decline in market making activity.

Paul Lynch: noted that there will be technological costs (setting up various IT systems) but there will also be associated costs resulting from encumbering the shares needed under a hard locate.

Question 3: Comm. Walter noted her surprise that the industry has not come up with a solution that realigns markets and imposes costs on locate requirements. Comm. Walter noted her belief in the rationalization between shares available and shares located, and inquired as to how the Commission should structure the locate requirement, using either a fail list or some other method.

Peter Driscoll: noted that a circuit breaker with a hard locate would be effective.

William Conley: noted that a hard locate is not a guarantee of delivery. The fundamental tenet with respect to encumbering or restricting shares is that you would make shares unavailable to investors because they are being used for the hard locate.

Question 4: Comm. Walter inquired as whether behavior would change if costs were imposed on the locate process.

Michael Mendelson: noted that firms over-allocate because they do not know exactly what will be shorted that day and

firms will likely not short sell the maximum allotment that exists. The system works on a statistical basis but there is a small probability that locates won’t result in delivery. If costs are imposed, then firms would locate less, and the result of imposing costs would be to widen bid/ask spreads.

Frank Hatheway: we do not know who marginal users of locates are, so unless we can determine who should pay, imposing a constant fixed price will be difficult and will create advantages for large firms who can function under economies of scale.

William Hodash: noted there is no single hard locate proposal that provides transparency with respect to who is over-locating. There are attendant issues of transparency and technical issues involved with the hard locate.

William Conley: the way to reduce fails is to link the client, prime broker and executing broker and solution is to close the circle and provide visibility as to who is circumventing locate rules.

Dennis Nixon: it is mainstream America that is being abused through predatory short sellers. The SEC should consider “mom ‘n’ pop” as opposed to Wall Street powerhouses making money through short selling.

Frank Hatheway: recommended looking at transparency solution with enhanced enforcement.

Question 5: Comm. Walter suggested hardening the edges or objectiveness with respect to the reasonable belief/grounds standard. J. Brigagliano also brought up issue of away locates, whereby currently brokers have requirement to locate but can rely on assurances of customers who may not be a regulated entity, and inquired about possibility of doing away with the ability for brokers to rely on customer assurances.

William Conley: brought up the policing nature of Rule 204 and the fact that, even if a locate does not result in delivery, trades will still be closed out (which is painful for the investor), so the rule protects against abusive behavior. Firms are very

aware of the reliability of locates because of these forced close-outs. Mr. Conley promoted the Prime Brokerage letter which could positively affect such issues.

Question 6: Comm. Paredes inquired about the potential causes of fails and what other reasons might exist beyond abuse/manipulation for fails?

William Conley: noted that the focus is on manipulation and not looking at the issue broadly. Also noted that 50% of fails are ETFs and this is a latency issue relating to creation/redemption of ETFs. One thing to understand and publicize are what issues are causing fails and believes that they are related to ETFs and penny stocks.

Peter Driscoll: noted that 58 of 63 stocks on the fail list were ETFs.

Question 7: Comm. Walter inquired as to whether we need a targeted approach to ETFs and Chairman Schapiro inquired whether we need other requirements for penny stocks.

Frank Hatheway: noted that he has heard it is difficult to bring enforcement actions around short selling, locates and 204. SEC should improve audit/paper trail around short selling to enhance documentation to understand what leads to fails.

Paul Lynch: volatility and supply are greatly affected because of the nature of penny stocks and ETFs.

William Hodash: noted it may be necessary to look at creation/redemption process for ETFs and look at the process to determine the effects of ETFs on fails.

Michael Mendelson: noted the need to dissect the source of fails and better understand the source of fails through gathering data from executing/prime brokers and through statistical evidence.

William Conley: the overriding factor on fails is mostly availability and not customer activity.

Dennis Nixon: questions why the long side of the market has so many restrictions but not so on the short side. Wants the

SEC to look at why there is an unequal playing field on the short side with short sellers having a strategic advantage.

Peter Driscoll: legitimate short sellers are not creating phantom stocks but are going out and getting locates.

Paul Lynch: highlighted that legitimate short selling is very important for efficient markets.

Panel 2: Making Short Sale Disclosure More Meaningful: Public versus Non-public Reporting; Consolidated Tape Disclosure; Timeliness of Information

Panelists:

Professor James Angel, Georgetown University

David Carruthers, Data Explorers

Richard Gates, TFS Capital LLC

Michael Gitlin, T. Rowe Price

Jesse Greene, IBM

Joseph Mecane, NYSE Euronext

Michael Treip, UK Financial Services Authority

Opening Statements:

Prof. Angel noted that we must not forget the compliance burdens that come with transparency and that disclosing information is confiscating intellectual property. We must be sure in looking at disclosure/transparency that there is a compelling public policy that meets the burdens such a regime would impose. We must also be aware of market efficiencies and the fact that investors want to know what everyone else is doing but at the same time do not want to give up their own information. Prof. Angel noted his support and mandate for disclosure and supports better transparency with respect to short selling, short interest and stock lending.

David Carruthers stated that any discussion on disclosure needs to clarify the reasons and purpose for disclosure. We must look at who disclosure is aimed at helping and to what it serves to prevent. Mr. Carruthers noted that short selling is used to hedge, by market makers and arbitrageurs and that the concern of short selling is not just naked short selling but also directional

short selling. With respect to transparency, anonymous disclosure will not necessarily harm markets. Mr. Carruthers stated his strong support for both a public and private partnership in disclosure and transparency requirements.

Mr. Gates pointed out that academic literature suggests short selling is positive and does not think short selling resulted in manipulation of prices and abuse of markets during recent times. Mr. Gates noted that good disclosure should have two criteria: (i) each disclosure requirement should stand on its own two feet and provide value to markets, and (ii) short sellers should not be subject to more onerous requirement than long traders. In general, short sale disclosure should be the same as required on the long side such as under 13F/13D. With respect to fails to deliver, which no one wants, he believes that we should have as much disclosure as the Commission feels is necessary to eliminate fails. Further, Mr. Gates believes that the aggregated short sale data that is reported bi-monthly underestimates the positions which have been sold short and does not include shares sold short overseas. Mr. Gates suggests a careful analysis and encourages the SEC proposal to require hedge funds to register as this will lead to more access to available information.

Mr. Gitlin urges the Commission to work with foreign regulators and encourages symmetry, and believes the benefits of public disclosure outweigh the drawbacks, by putting all market participants on a level playing field. Mr. Gitlin believes in a common approach whereby short selling disclosure is no less onerous than long position disclosure, believing that the markets would benefit from such disclosure. Mr. Gitlin supports two levels of reporting and timing similar to the quarterly filing required under 13F and requirement to file positions within 10 days depending on level of short positions [akin to 13D/G]. Mr. Gitlin urges the SEC to examine relevant data/statistics to determine an appropriate reporting threshold. Mr. Gitlin also supports real-time tagging of short sales and marking of short sales on the consolidated tapes, and is in favor of short sale reporting mirroring long sale disclosure.

Mr. Greene pointed to IBM's comment letter noting that how a stock trades is an indicator of the health of the issuer and provides feedback from and with those who own the stocks. Mr. Greene noted that we currently know very little about who short sellers are due to the lack of disclosure, and the SEC must restore confidence by prohibiting manipulative tactics. Mr. Greene noted that the SEC rules implemented had the effect of tightening controls and reducing abuses and the SEC should increase transparency through a comprehensive disclosure framework. Mr. Greene suggested equal short disclosure to that under 13F and that transparency in financial markets is critical. Managers should not have the ability to disclose certain positions and not be required to disclose other positions. Mr. Greene believes that parity in disclosures between short and long positions is a significant step.

Mr. Mecane stated his belief that some information of short sales is useful for market participants and pointed out the current types of public disclosure and data being provided by the NYSE on various timelines (monthly/bi-monthly), and the fact that audit trail information is available resulting from marking short sale trades. Mr. Mecane pointed out that the question is whether any change in disclosure would enhance the market without encroaching on the need for confidentiality, and whether a short sale indicator should be added to the consolidated tape. Mr. Mecane noted that increased short reporting may be of some benefit and a reasonable place to start would be similar to 13F/13D regime. Mr. Mecane questioned whether disclosure would enhance the ability for regulators to detect fraud and abuses, and on this point noted that it may be useful to enhance confidential disclosure while the discussion of public disclosure continues.

Mr. Treip stated his strong belief that convergence between different jurisdictions is critical. Mr. Treip discussed the FSA implementation (since 9/08) of individual public disclosure but noted that the FSA does not support or favor a ban or restraint. Mr. Treip noted the FSA measures that in terms of a threshold for disclosure, holders of 0.5% of stocks should disclose to the

markets by the end of the trading day on which the positions is reached. Mr. Treip noted some key issues such as the beneficial impact of transparency on market efficiency, and belief in the enhanced transparency of investor short interest regardless of how the short position is achieved. Mr. Treip noted that the costs for enhanced transparency in Europe would be great. With respect to public disclosure, Mr. Treip believes that you want do identify the position holder because you want to create a degree of deterrence against aggressive short sellers and cause such sellers to re-evaluate their strategies as they approach disclosure thresholds. Mr. Treip did not advocate aggregation because anonymization will not prevent continuing behavior by participants, but believes that disclosure should be timely.

Question Session and Discussion:

Question 1: Chairman Schapiro noted that the FSA has had one year of experience with their disclosure regime and have dealt with potential consequences and inquired as to whether FSA had experienced a negative/positive impact with their disclosure regime?

Michael Treip: pointed out the need to be cautious with a broad scoped regime and noted that for the first three to four months of the disclosure regime there also existed a ban on the creation of additional short positions in financial stocks, and this factor needs to be discounted. The FSA has seen little impact on levels of short selling as a result of the disclosure regime based on limited data, but noted they have not seen an enormous negative impact. However, the ban did widen bid/ask spreads.

Question 2: Comm. Paredes inquired as to what were the limitations on the studies?

Michael Treip: noted the FSA struggled to find meaningful behavior of herding or squeezing practices, and noted that stock lending data is also a proxy on short selling.

David Carruthers: worked with FSA and market abuse committee and noted a considerable overlap between stock lending data and disclosure of covered short selling. With

respect to herding, it is possible to identify what the market is doing through disclosures, but noted that naked short selling is very difficult to contain.

Question 3: Comm. Paredes inquired whether any academic data is available that offers insight into the expected results from different disclosure measures?

James Angel: was not aware of studies that looked at the transparency regimes currently being discussed but noted that with respect to bonds, disclosure did provide better efficiency. Prof. Angel suggested phasing in disclosure regimes or utilizing pilots as this would provide and allow for better analysis.

Question 4: Chairman Schapiro noted that anonymous disclosure (according to Carruthers) is unlikely to harm the market but inquired as to whether the same would be true for public disclosure?

David Carruthers: noted that there would be timing issues that would arise with respect to such transparency.

Michael Gitlin: noted that as to herding, there appear to be the same risks with respect to short and long herding, and we have to consider a level playing field and timelines.

Question 5: Comm. Walter noted the exemption for bona-fide market making in the FSA regime and questioned how we should go about defining exemptions?

Michael Treip: stated that he recognized the role short selling market makers have in efficient markets and overly burdensome disclosure could harm liquidity providers and market makers. There is a consensus of holding the line on the concept of market making, and the FSA has proposed an appropriate definition of market maker but there is also a need to avoid the proliferation of various definitions.

Question 6: Comm. Walter inquired into whether there were any other rationale for exemptions for market makers, as liquidity providers.

Michael Treip: noted the suggestion has been made that positions in ETFs and similar products should be exempt, but FSA does not agree with exemption from disclosure for such products.

Joseph Mecane: suggested that we must look at activity versus positions with respect to different types of disclosures. With positions you likely would not need exemptions, but with respect to activity there is a potential for confusion, which makes it difficult to determine the benefit you get from disclosure of activity. There is a valid case to be made to exempt market making activity from real-time disclosure and whether it would enhance such disclosure of this type of activity.

Question 7: Chairman Schapiro inquired as to any view with regard to putting short sale indicator on the consolidated tape?

Michael Gitlin: you would end up with good information to know that a lot of the activity was market making and not fundamental trading activity.

James Angel: instantaneous real-time marking would assure investors that there is legitimate short selling and not everyone is a predator. Transparency on a trade by trade basis is relatively easy to do, will have low costs and should be done.

Joseph Mecane: agrees that it should be done but issue is with time lags and differences in discerning real trading activity against market making/position making.

David Carruthers: it is difficult to turn daily data into meaningful information and the collection of aggregates on net positions can lead to issues. Collecting any raw data is not trivial.

Jesse Greene: information on short selling coming across the tape is valuable information from the issuer perspective as it would indicate something is occurring in the market and allow the issuer to investigate.

James Angel: we should start simply, identifying trades long/short and it would be easy to release the data publicly, but to require additional data would be significant.

Question 8: SEC staff inquired about a comparable short selling disclosure regime to long disclosures and any reasons why we should not have the same timing and thresholds.

James Angel: Asymmetric treatment for short selling against long activity is required because purchasers and short sellers have different motivations.

Joseph Mecane: there could be different levels of private disclosure to regulators who are looking at abuses and manipulation versus different thresholds for public disclosure is provided to investors who are looking for assurances and confidence in markets.

Michael Treip: we need to look at policy reasons for disclosure thresholds and what kind of activity you are trying to look at. It is a difficult concept/area to have one-stop shopping in terms of disclosure. The UK looked at daily volume that was or had a meaningful proportion or percentage that could indicate and provide useful data. Once the disclosure regime is in place for a while it would be necessary to revisit and see if the data is meaningful and re-assess the burdens.

Richard Gates: short sellers are there in the market because they help reflect the true value of the security. Mr. Gates believes long buyers are more out of control than shorts and notes it is easier to punish the over-zealous short seller than it is to punish the over-zealous purchaser.

Jesse Greene: no reason why disclosure for shorts should be any more lax than it is for long positions.

Michael Gitlin: having a globally aligned threshold trigger for disclosure would be beneficial and there should be symmetry in different regulatory regimes.

James Angel: there could be a de minimis exemption which could deal with not revealing a trading strategy and the SEC could determine if a particular or specific disclosure should remain confidential for a period of time.

Jesse Greene: issuers want to know who short sellers are because they want to be able to take action, talk to short sellers

and find out if the issuer is doing anything wrong or should be doing something.

Michael Gitlin: suggests that the SEC should do more work in looking at disclosure of short sellers.

Michael Treip: the FSA has seen that having to disclose short sellers cuts the lines of communication between the issuer and sellers and hinders progress and efficiency.

Closing Remarks: Chairman Schapiro

Thanked all panelists and noted the SEC's decision to hold the roundtable reflects deep commitment to the protection of investors. The discussion of these issues will be of enormous value in determining future steps.

If you would like more information concerning any of the matters mentioned in this SEC Update, please call or email your primary Sidley Austin LLP contact.

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