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February 16, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Short Selling in Connection with a Public Offering (File No. S7-20-06)

Dear Ms. Morris:

We are submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission" or "SEC") for comments regarding the Commission's proposed amendments (the "Proposed Amendments") to Rule 105 of Regulation M.[1]

The Proposed Amendments would modify existing Rule 105 to provide that persons who sell securities short during a specified period prior to the pricing of an offering (the "Pre-Pricing Period")[2] would not be able to purchase securities in that offering. Current Rule 105 provides only that persons who sell short during the Pre-Pricing Period cannot use the offered securities to cover such short sales.

The Commission's stated purpose in suggesting the Proposed Amendments is to "further safeguard the integrity of the capital raising process and protect issuers from

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1 *See* SEC Release No. 34-54888 (Dec. 6, 2006), 71 Fed. Reg. 75002 (Dec. 13, 2006) (the "Proposing Release").

2 In particular, the Pre-Pricing Period for purposes of the Proposed Amendments is the shorter of "(1) [t]he period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) [t]he period beginning with the initial filing of [the] registration statement or notification on Form 1-A and ending with the pricing."

manipulative activity that can reduce issuers' offering proceeds and dilute security holder value."[3] By proposing the modifications, the Commission seeks to provide a "bright line test" for compliance with Rule 105 and address attempts to restructure transactions in an effort to evade the current Rule 105 covering prohibition.[4]

Although the blanket prohibition being proposed by the Commission may indeed serve to prevent certain manipulative conduct, it will likely also interfere with legitimate market activity. Moreover, in addition to being overbroad, we believe the Proposed Amendments are unnecessary to achieve the Commission's stated purpose. In particular, we note the conclusions in Commission enforcement proceedings that effecting a short sale while in possession of material nonpublic information is a violation of existing prohibitions against insider trading, including Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Exchange Act Rule 10b-5.[5] Further, using offered securities to cover a short sale that was entered into prior to the effectiveness of a registration statement with respect to such offered securities is already violation of Section 5 under the Securities Act of 1933.[6] Accordingly, we disagree with the statement in the Proposing Release that there are "no federal rules that duplicate, overlap or conflict with" the Proposed Amendments.[7]

We also find it at least potentially inconsistent that the Commission would propose amendments to Rule 105 that could have the effect of constraining legitimate market activity on the very day it proposed to modify other, longstanding regulation of short sale

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3 *See* Proposing Release at 75002.

4 *Id.*

5 *See, e.g.*, Securities and Exchange Commission v. Guillaume Pollet, SEC Litigation Release No. 19199 (Apr. 21, 2005) (in which the Commission charged Pollet, a former managing director of SG Cowen & Co., with insider trading and fraud in connection with certain private investment in public equity (or "PIPE") offerings by short selling the stock of the PIPE issuers prior to the closing date of the relevant offering); Securities and Exchange Commission v. Hilary L. Shane, SEC Litigation Release No. 19227 (May 18, 2005) (announcing a settlement with respect to allegations that Shane committed insider trading and registration violations by short selling securities of CompuDyne Corporation prior to the public announcement of a PIPE offering and prior to the effective date of the resale registration statement for the PIPE securities); Securities and Exchange Commission v. Friedman, Billings, Ramsey & Co., Inc. ["FBR"], Emanuel J. Friedman and Nicholas J. Nichols, SEC Litigation Release No. 19950 (Dec. 20, 2006) (announcing a settlement with respect to charges that FBR, in connection with a PIPE offering: (i) failed to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information; (ii) unlawfully traded while aware of material nonpublic information; and (iii) engaged in unregistered sales of securities).

6 *See, e.g.*, In the Matter of Spinner Asset Management, LLC & Spinner Global Technology Fund Ltd, SEC Release 33-8763 (Dec. 20, 2006) (noting that a person violates Section 5 of the Securities Act when it covers pre-effective date short sales with actual shares received in a PIPE offering because shares used to cover a short sale are deemed to have been sold at the time the short sale was made).

7 *See* Proposing Release at 75010.

activity – namely, Exchange Act Rule 10a-1 – to eliminate the provisions of that rule that similarly operate to artificially constrain legitimate market activity.[8]

Interestingly, the Commission notes in the Rule 10a-1 Release that:

> "today's markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of abusive or manipulative short selling going undetected if we were to remove price test restrictions, and permit regulators to monitor the types of activities that Rule 10a-1 and other price tests are designed to prevent. The general anti-fraud and anti-manipulation provisions of the federal securities laws would also continue to prohibit activity that improperly influences the price of a security."[9]

We believe the foregoing statement is equally applicable here, as is the statement in the Rule 10a-1 Release that "[s]hort selling provides the market with at least two important benefits: market liquidity and pricing efficiency."[10] The wide net cast by the Proposed Amendments could well inhibit legitimate and beneficial market activity. For example, as noted in the comment letter with respect to the Proposed Amendments submitted by SIFMA, short sales may be effected as part of, among other things, initial and dynamic hedging strategies, long/short strategies, convertible arbitrage, bona-fide market making or customer facilitation activities.[11] Preventing market participants that engage in these types of activities from purchasing the offered securities will serve only to harm issuers and reduce offering prices by barring issuers from being able to tap these previously available sources of ready capital.

More fundamentally, once a potential transaction has been publicly announced (see our comments below regarding the timing of operation of the rule) and is known to the market, what is wrong with an investor taking a view that the transaction is dilutive and executing a short sale? Does it become wrong if the investor changes that view and determines to buy in the offering? Shouldn't the offering price be a factor that an investor can take into account in determining its investment behavior? At least in liquid markets, shouldn't informed investors and informed issuers be able to make market-based decisions?

Should the Commission nonetheless determine that the potential benefits of the Proposed Amendments outweigh the potential costs, we believe certain changes should be made to narrow their scope and thereby lessen the likely adverse impact of the Proposed Amendments on the U.S. capital markets.

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8 *See* SEC Release No. 34-54891 (Dec. 6, 2006), 71 Fed. Reg. 75068 (Dec. 13, 2006) (the "Rule 10a-1 Release").

9 *See* Rule 10a-1 Release at 75069; s*ee also* accompanying footnote 16, which cites to existing federal antifraud provisions, including Securities Act 17(a), Exchange Act Sections 9(a), 10(b) and 15(c), Exchange Act Rule 10b-5, and Regulation M Rule 105.

10 Rule 10a-1 Release at 75069.

11 *See* SIFMA Comment Letter dated February 13, 2007.

First, we urge the Commission to clarify in the adopting release and in the final rule that the proposed modifications to Rule 105 are not intended to prohibit persons who sell short common stock from participating in a convertible securities offering with respect to which the shorted common stock is a "reference security" (as defined in Rule 100 of Regulation M). Were the final rule to prohibit such participation, we believe the likely result would be to drive prospective convertible issuers away from the U.S. public market and into the Rule 144A and Regulation S markets, because many of the investors that normally would purchase in registered offerings will be precluded from participating. This consequence would be directly contrary to other recent Commission efforts (in particular, Securities Offering Reform) that seek to encourage issuers to conduct U.S. public offerings by making the registration process easier, more streamlined and less costly.

Second, we believe the Pre-Pricing Period should commence no earlier than the date of the public announcement of the offering. There is simply no justification for prohibiting persons from participating in an offering simply because they happened to have engaged in short sales of the offered securities within a five day period prior to pricing, but prior to the public announcement of the offering, so long as they do not use the offered securities to cover those short sales.[12]

Third, the Proposed Amendments should include exceptions for those transactions and activities for which price manipulation is difficult or that are otherwise thought to be non-problematic and, thus, for which a blanket prohibition of the kind being proposed is unnecessary and potentially detrimental to the efficient operation of the U.S. capital markets. In particular, we urge the Commission to incorporate exceptions from the prohibitions of Rule 105 for (i) securities that are "actively-traded" (within the meaning of Rule 101(c)(1) of Regulation M), (ii) nonconvertible debt securities,[13] (iii) exchange-traded funds (or "ETFs") and similar products,[14] (iv) basket transactions of the kind currently excepted from Rule 101 of Regulation M,[15] and (iv) bona fide hedging activities conducted in accordance with pre-established trading strategies. We do not believe these types of transactions are generally susceptible to the kind of manipulative activity the Commission is seeking to prohibit and, by incorporating these exceptions, the

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[12] As noted above, investors engaging in short sales on the basis of material nonpublic information regarding an upcoming offering can be adequately dealt with under existing insider trading rules and regulations. An overbroad prohibition such as the one being proposed will simply reduce the pool of available investors and make the capital raising process less efficient and more costly for the very persons whose interests the Commission is seeking to protect.

[13] We note that Exchange Act Rule 10b-21, the predecessor to Rule 105, applied solely to equity securities.

[14] In this regard, we note that the Commission staff has on numerous occasions issued requested relief from Rules 101 and 102 of Regulation M (as well as from various other provisions of the securities laws) for these types of products, but Rule 105 relief was not previously needed because of the exemption in current Rule 105(b) for offerings not conducted on a firm commitment basis (*i.e.*, so-called "best efforts" offerings), which is the basis on which ETF (and ETF-like) offerings are typically conducted. Since the Commission is now proposing to eliminate this exception, Rule 105 relief will likewise be necessary for these offerings to proceed in the normal course. *See, e.g,* iPath Exchange-Traded Notes, SEC No-Action Letter (avail. July 27, 2006), and similar line of SEC no-action letters cited therein.

[15] *See* Rule 101(b)(6) of Regulation M.

Commission would better achieve its characterization of the Proposed Amendments as being "narrowly tailored to address short sales prior to pricing that can reduce issuers' offering proceeds without restricting other short sales before the offering."[16]

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We appreciate this opportunity to provide you with our thoughts on the Proposed Amendments. We would be pleased to respond to any inquires regarding this letter or our views on the Proposed Amendments more generally. Please contact Leslie N. Silverman or Dana G. Fleischman at 212-225-2000.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Annette Nazareth, Commissioner
The Hon. Kathleen Casey, Commissioner
Erik R. Sirri, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
James A. Brigagliano, Associate Director for Trading Practices and Processing, Division of Market Regulation
Brian Cartwright, General Counsel, Office of the General Counsel
Chester Spatt, Chief Economist, Office of Economic Analysis

[16] Proposing Release at 75002.