PROSKAUER ROSE LLP

Economic Crisis Response Group
Newsletter

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Economic Crisis Response Group

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SEC Adopts Permanent Rule on Naked Short Selling and is Working to Improve Short Sale Transparency

On July 27, the SEC made permanent Rule 204T, an interim final temporary rule intended to reduce "naked" short selling of securities; the temporary rule had been scheduled to expire on July 31. Naked short selling involves selling securities that are neither owned nor borrowed by the seller at the time of the sale. When the settlement date for the sale occurs, three days after the trade, such a seller will generally "fail to deliver" the security in question. By enabling a person to sell a security without actually owning or borrowing it, naked short selling creates the potential for more dramatic decreases in the price of a security than would otherwise occur. Even after the SEC required broker-dealers to locate the securities that were going to be borrowed in a short sale, or to rely on the seller to provide them, this practice persisted. The temporary rule, and the new permanent rule, Rule 204, require that the clearing broker-dealer in a short sale borrow or purchase securities in order to close out a "fail to deliver" on the fourth day after the trade or face penalties.

In an effort aimed at increasing the amount of publicly available data regarding short sales in the public securities markets, the SEC also announced that it is working with several self-regulatory organizations ("SROs") to make short sale volume and transaction data available through the SRO websites. The new data will be in lieu of disclosure required by Rule 10a-3T, a temporary rule that was not renewed when it expired on August 1. This rule, in effect since September 2008, had required all persons and entities that manage more than $100 million in securities listed on U.S. public markets to file a weekly confidential report with the SEC regarding their short sale activities during the prior week. The SRO-published data will include the aggregate short selling volume in each individual equity security for that day, individual short sale transactions in all exchange-listed equity securities (on a one-month delay), and information regarding "fails to deliver" twice per month for all equity securities.

The SEC is also continuing to consider the reinstatement of the "uptick" rule or similar rules that will seek to limit short sales of listed securities that are experiencing rapid price declines.

Proposed House Bill to Require Clearing of OTC Derivatives and Ban "Naked" CDS

A bill being drafted in the House of Representatives would require the clearing of OTC derivatives and would likely ban "naked" credit default swaps ("CDS"). Naked CDS are those where the party buying the protection against default does not own the underlying bond or loan. The House Financial Services Committee had been scheduled to begin drafting legislation in late July that would include regulation of derivatives. On July 30, Colin Peterson, Chairman of the House Agriculture Committee, and Barney Frank, Chairman of the House Financial Services Committee, issued an announcement that a bill in the Financial Services Committee and a bill approved by the Agriculture Committee in February of this year would be incorporated as a single bill that would require clearing of OTC derivatives and allow the CFTC to suspend trading of "naked" CDS.

According to the announcement, the reform bill will establish jurisdictional boundaries between the SEC and CFTC over OTC derivatives and create a coordinating council to resolve any disputes over which agency would regulate a particular type of derivative. The bill will also have mandatory clearing under which all contracts will go to central counterparties. If rejected by a clearinghouse as being too specialized, the SEC or CFTC would set the margin and collateral requirements for the contract.

SEC Approves ICE Clear Europe and Eurex Clearing AG

On July 23, the SEC approved temporary conditional exemptions from the Securities Exchange Act of 1934 to allow ICE Clear Europe and Eurex Clearing AG to operate as central counterparties to clear and settle certain CDS. These exemptions expire in nine months.

House Hearing on Derivatives

In a hearing before the House Financial Services Committee on July 22, the chairmen of the SEC and CFTC affirmed their commitment to working together to regulate OTC derivatives. SEC chairman Mary Schapiro and CFTC chairman Gary Gensler each testified about plans for a comprehensive framework for regulating OTC derivatives with four broad objectives: (1) the reduction of systemic risks; (2) promotion of efficiency and transparency of markets; (3) promotion of market integrity by preventing fraud, manipulation, and other market abuses; and (4) protection of the public from improper marketing practices.

Chairman Schapiro stressed the importance of prudential supervision and regulation of OTC derivatives dealers to reduce the occurrence of gaps in regulation. Chairman Gensler proposed two regulatory regimes – one focused on derivatives dealers and the other on the markets themselves. Gensler testified that all derivatives dealers should be subject to capital, margin, conduct, record-keeping, and reporting requirements, and advocated greater transparency in the derivatives markets through the use of central clearinghouses and regulated exchanges or electronic trading systems.

Federal Reserve Proposes Consumer-Friendly Changes to Mortgage Rules

On July 23, the Federal Reserve Board unanimously proposed new consumer-friendly disclosure rules for mortgages and home equity loans to address the roots of the current financial crisis and provide more information to borrowers about their mortgages and home equity loans. Under the Fed's proposal, lenders or other loan originators, such as mortgage brokers, would be required to provide borrowers with clear, one-page explanations of how adjustable-rate mortgages differ from fixed-rate products. In addition, lenders and other originators would have to provide greater disclosure of a borrower's true costs based on his or her particular mortgage or loan. For example, lenders would have to expand disclosure of the annual percentage rate to include the fees and settlement costs paid by consumers and set out the amount of increases of monthly payments for adjustable rate mortgages.

The proposed rules would require lenders to notify borrowers under adjustable rate mortgages of payment changes 60 days in advance, an increase from the 25-day notice period under the current rules. For home equity lines of credit, the notification period for changes in account terms would be increased to 45 days from 15. These expanded notice periods are intended to give borrowers more time to adjust to pending changes and, in the case of adjustable-rate loans, possibly to seek refinancing. Finally, the Fed's proposal includes a restriction on special compensation or bonuses given by lenders to mortgage brokers that obtain higher-priced loans for borrowers that qualified for lower rates.

The proposed rules also grant home-equity lenders greater power to reduce credit, as they would be allowed to suspend or reduce lines of credit when the values of the mortgaged properties decline by five percent and the borrowers have paid off no more than ten percent of the loans.

The proposed rules are subject to a four-month comment period before becoming final.

HUD Announces $360 Million in Recovery Act Grants to Support Community and Economic Development Nationwide

On July 16, Housing and Urban Development ("HUD") Secretary Shaun Donovan announced nearly 700 grants under the Community Development Block Grant Program ("CDB Grant Program") that will provide $360 million in funding under the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"). The grants awarded represent over half of the Recovery Act-funded grants available through the CDB Grant Program.

The CDB Grant Program primarily benefits low- to moderate-income families and provides financing that enables state and local governments to undertake a wide range of activities intended to create suitable living environments, provide affordable housing and create economic opportunities. Ultimately, a total of $1 billion will be awarded nationwide by HUD under the CDB Grant Program.

Proposed EU Regulation of Hedge Funds Imposes Strict New Requirements

The European Union is considering additional regulations on hedge funds and hedge fund managers that would place limits on leverage, impose borrowing restrictions and capital requirements, and require disclosure of investment strategies. These regulations would also apply to any alternative investment fund that is marketed to Europeans. The regulations, which were first proposed in April, will be discussed in Brussels by key EU parliamentary committees at the end of the summer.

The proposed EU rules are significantly more stringent than current proposals in other jurisdictions. In the United States, proposed regulation of hedge funds would require managers to register as investment advisors, but would not generally impose many operational limitations. There is some speculation that if the proposed EU rules are adopted, EU-based fund managers will move operations to jurisdictions with less stringent regulation.

Bernanke Presents Semi-Annual Monetary Policy Report to Congress; Outlines Exit Strategy from Lending Programs

In his remarks to the House Committee on Financial Services on July 21, Federal Reserve Chairman Benjamin Bernanke said that aggressive policy actions taken since September 2008 “may well have averted the collapse of the global financial system” and observed “notable improvements” in the economy over the past few months. Mr. Bernanke stated that the Federal Open Markets Committee (“FOMC”) expects unemployment to peak at the end of 2009 and a gradual recovery to follow in 2010, while inflation is expected to remain “subdued” over the next two years. Bernanke stated that the FOMC will maintain its “highly accommodative” monetary policy for an extended period.

Bernanke also discussed the importance of assuring the public and markets of the Federal Reserve’s exit strategy from its extraordinary policy measures to avoid the risk of future inflation, noting that the size of the Federal Reserve’s balance sheet will gradually shrink as its short-term lending facilities wind down. Mr. Bernanke outlined additional actions the Federal Reserve can take to tighten monetary policy, including (1) influencing interest rates in the broader market by paying interest on bank reserves and (2) reducing excess liquidity by (a) arranging reverse repos, (b) coordinating with Treasury to arrange the sale of Treasury bills, the proceeds of which would be deposited with the Federal Reserve, (c) paying interest on bank term deposits, and (d) selling some of its long-term securities in the open market.

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets; issues concerning investments in financial services companies; and complex financial instruments and transactions, including structured finance products; as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

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