

## Recent Short Selling Developments

In response to a financial crisis of historic proportions, regulators around the world adopted short-term emergency measures in 2008, frequently involving restrictions on short selling of securities, to stabilize financial markets and restore investor confidence. Since that time, legislators and regulators have continued to adopt initiatives intended to strengthen global financial markets.

A number of approaches to short selling reform have been variously undertaken, including: imposition of limitations upon short sales, addressing clearance and settlement issues, and requiring enhanced disclosure to provide transparency. This *DechertOnPoint* discusses recent short sale developments in several jurisdictions.

### U.S. SEC Approves New Short Selling Restrictions

The Securities and Exchange Commission (the "SEC" or the "Commission") on February 24, 2010 adopted amendments to Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act") to restrict short selling when a stock is experiencing significant downward price pressure.<sup>1</sup> New Rule 201 of Regulation SHO ("Rule 201" or "Rule") imposes limits on the ability of trading centers to effect short sales in a particular security if the price of that security has declined by 10% or more from the prior day's close. Trading centers will have until November 10, 2010 to develop systems and procedures to comply with the Rule's requirements.

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<sup>1</sup> Amendments to Regulation SHO, Rel. No. 34-61595 (Feb. 26, 2010) available at [www.sec.gov/rules/final/2007/34-56212.pdf](http://www.sec.gov/rules/final/2007/34-56212.pdf) (hereinafter the "Adopting Release").

### Background

The volatility of the global markets in 2007 and 2008 prompted the Commission to impose a host of new requirements on short sellers and reconsider the merits of short sale limitations. In addition to a number of temporary and emergency orders implemented during 2008 and 2009, the Commission has adopted new regulations requiring increased disclosure of short positions and adopting specific antifraud rules relating to short sellers. Moreover, last year, the Commission adopted Rule 204, intended to improve settlement and reduce "fails to deliver" by naked short sellers.

In 2009, the Commission proposed for comment Rule 201, which contained several alternative strategies to address potential short selling issues, and the Commission initiated a series of academic studies and industry roundtables. The Commission received over 4,700 unique comments on the rule proposal. Rule 201, as adopted by a divided Commission, is the least disruptive of the alternatives it considered.

## Significant Provisions of the New Rule

### *Scope of Rule*

As adopted, the Rule imposes short sale restrictions on a security-by-security basis that are triggered when the price decline of a security exceeds a “circuit breaker”. Specifically, if the price of a “covered security” decreases by 10% or more from its closing price at the end of regular trading hours on the prior day, then Rule 201 requires that a “trading center”<sup>2</sup> enforce written policies and procedures “reasonably designed” to prevent the “execution or display” of a short sale order at a price that is less than or equal to the current national best bid. The Rule places the limitation on trading in the security for the remainder of the day in which the circuit breaker is triggered, and for the following day.

One of the significant exemptions from the Rule’s restrictions, noted below, will permit brokers to measure compliance with the bid test at the time that the order is routed to a trading center, rather than at the time of execution. Thus, while the Rule nominally targets trading centers, a significant compliance burden is likely to be borne by brokers who will need to pre-filter short transactions before they are submitted to a trading center for execution, and mark short transactions as “short exempt” in order to assure their execution. While pre-filtering is not required, for competitive reasons many brokers may be forced to implement short sale compliance systems to assure execution for their customers’ orders.

### *Securities Covered*

A “covered security” for Rule 201 purposes is a security that is considered to be a “national market system” security and subject to Regulation NMS. As a result, Rule 201 will cover all securities, except options, listed on a national securities exchange whether such securities are traded on an exchange or in the over-the-

<sup>2</sup> The Rule references the definition of a trading center found in Regulation NMS. Specifically, a “trading center” means: a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

counter market. The Commission specifically chose not to place restrictions on “synthetic shorts” that may be implemented through derivatives. Consequently, despite the Rule, a customer may obtain an economically equivalent short position in a down market by using alternative vehicles.

### *Determining When Circuit Breakers Have Been Triggered*

Under the Rule, determinations regarding whether or not a circuit breaker has been triggered are left to the listing market for that security, which will then communicate the restrictions to the broader market. Once the circuit breaker is triggered, the short sale price test will remain in place for the remainder of that day, regardless of the time at which it is triggered. Although commenters expressed concern that a “magnet effect” could cause short sellers to stampede in order to effect short sales prior to the time a circuit breaker is triggered, particularly at the end of regular trading hours, the Commission did not offer any exceptions to address this potential issue.

### *Bid Test*

Rule 203(b) requires trading centers to prevent the “execution or display” of a short sale order of a covered security at a price that is less than or equal to the current national best bid once a circuit breaker has been triggered. No minimum bid increment was specified by the Commission in the Rule, suggesting that, in some cases, sub-penny increments may be permitted if they comply with Regulation NMS. Short sellers that want to place limit orders above the best bid, without displaying their interest, also may use dark pools or route their orders to brokers that internalize transactions.

### *Compliance*

Both for trading centers, and for brokers routing short exempt transactions, compliance will be based on a “policies and procedures” approach, rather than a strict compliance result. This approach echoes that taken by the Commission under Regulation NMS, and also is designed to give firms greater flexibility to work with their customers to resolve order flow that is not immediately executable or displayable. Among other things, this would permit a trading center to re-price and re-display short sales to comply with the bid test. A trading

center, or a broker relying on the brokers' exemption, will be expected to enforce compliance with its policies and procedures, potentially generate exception reports, and otherwise conduct its own "regular and periodic" surveillance of the effectiveness of its compliance program. Executions that do not comply with the Rule must be monitored by the trading center or broker and may present problems if they occur with any regularity.

## "Short Exempt" Provisions

### *Brokers' Exemption*

After the 10% circuit breaker is triggered for a covered security, Rule 201 permits a broker-dealer who submits a short sale order to a trading center to mark the order "short exempt" under certain conditions. As noted above, the most significant of the exemptions is likely to be the exemption for brokers who pre-filter customer short transactions to assure compliance with the bid test under the Rule at the time of transmission to a trading center. Commenters noted that for competitive reasons, brokers would need to assure their customers that the brokers had appropriate systems in place to rely upon this exemption. In fact, while referred to as an "exemption" this provision will effectively shift the compliance burden for many short transactions to brokers, from the trading centers.<sup>3</sup>

### *Other Exemptions*

Other short exempt transactions that, with notable exceptions, are generally patterned after the exemptions in former Rule 10a-1 under the Exchange Act, include:

- *Sellers' Delay in Delivery.* Long-sale transactions are not subject to the Rule. Normally, a sale may only be marked "long" if the broker-dealer has a reasonable basis to believe the sale order is by a

<sup>3</sup> In heavily traded markets, price quotes often "flicker"—moving up and down in subsecond intervals. Without the brokers' exemption, a transaction that complied with Rule 201 at the time it was electronically transmitted to the trading center by the broker, could be rejected when it is received by the trading center, because the quote had changed in the interim. The Commission suggested that because of "flickering quotes", brokers seeking to rely on the brokers' exemption should take a "snapshot" of the market at the time an order is routed to a trading center, in order to determine whether they are complying with the exemption.

person that is "deemed to own" the covered security pursuant to Rule 200 of Regulation SHO by virtue of the fact that the security is in the physical control and possession of the broker, or it is reasonably expected to be in the broker's physical control and possession by settlement. In instances in which delivery may be delayed due to circumstances outside control of the seller, for example due to exercise requirements, this exemption permits the broker to mark the transaction as "exempt";

- *Odd-Lot Transactions.* An odd-lot exemption is available if the broker-dealer has a reasonable basis to believe that the short sale order is by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading;
- *Domestic Arbitrage.* As with the former short sale rules, short sale orders associated with certain bona fide domestic arbitrage transactions are exempt. This exemption will apply to strategies that seek to profit from arbitrage between convertible or exchangeable securities, held in a good faith account, and the shares that are traded on a trading center;
- *International Arbitrage.* Short sale orders associated with certain international arbitrage transactions also are exempt;
- *Over-Allotments and Lay-offs.* Short sale orders by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any short sale orders for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment, are exempt under the Rule;
- *Riskless Principal Transactions.* Short sale orders by broker-dealers facilitating customer buy orders are exempt if the customer is net long and the broker-dealer is net short, but is effecting the sale as riskless principal; and
- *VWAP Transactions.* Short sale orders executed on a volume-weighted average price basis meeting detailed requirements are exempt.

Pursuant to Rule 201(f), the Commission also has indicated that it will consider and act upon requests for relief from the provisions of Rule 201.

## Offshore Transactions and After-Hours Transactions

At the time that it adopted the Rule, the Commission clarified its view of the extraterritorial application of the Rule's provisions. The Rule will apply to any transaction executed on a trading center in the United States. As with the former Rule 10a-1, the Commission also stated that once a transaction has been "agreed upon" between the U.S. broker and its customer, the U.S. broker may not send the transaction offshore to the broker's foreign trading desk for execution in order to avoid the limitations of the Rule.

Circuit breakers will be triggered only by price declines that occur during regular trading hours from 9:30 AM until 4:00 PM Eastern Time. However, once the circuit breaker is triggered, it would apply only to transactions that occur during a period in which the national best bid is provided to the market. Thus, in some cases, the limits might extend beyond 4:00 PM. However, the Commission specifically chose not to address overnight transactions, allowing short sellers to execute transactions following the close.

## Implementation

The Rule will become effective on May 10, 2010. From that point, brokers and trading centers will have an additional six months to develop systems and procedures to comply with the Rule. Because the Rule also will force brokers to "mark" their customers' orders "short exempt", many different system interfaces will need to be revised, including for transaction reporting purposes. In the meantime, buy-side firms will need to evaluate the effect that the new Rule will have on their trading strategies.

## Conclusion

Economic studies reviewed by the Commission suggest that circuit breakers are not likely to be triggered on a regular basis. Once circuit breakers are triggered, however, there appears to be significant latitude under the Rule to allow many types of short sellers to continue to execute their strategies without significant disruption. Among other things, there are no express minimum bid increments under the Rule, orders may be internalized or placed in dark pools where they are not displayed, and the Rule does not apply to derivative transactions that may be used as an alternative to shorting. Ulti-

mately, however, the effect on short selling will not be fully understood until the Rule has been implemented.

## CESR Publishes Technical Advice on Short Selling Disclosure

On March 2, 2010, the Committee of European Securities Regulators ("CESR") published a report on a Model for a Pan-European Short Selling Disclosure Regime (Ref. CESR/10-088) advocating the introduction of harmonized, permanent short selling disclosure obligations. While accepting that legitimate short selling plays an important role in financial markets, for example in increasing market liquidity and facilitating hedging and other risk management activities, CESR has expressed concerns that abusive use of short selling may distort prices of financial instruments and adversely affect financial stability. It considers that aggressive, large-scale short selling would be deterred and constrained by enhanced public transparency, and that reporting of significant positions to regulators would better enable them to pursue inquiries with participating parties.

The proposed disclosure system is therefore a two-tier one, with separate thresholds for private disclosure of short positions to regulators (0.2% of a stock's issued share capital) and public disclosure of positions to the market (0.5%), along with incremental threshold bands requiring reporting of every 0.1% increase or decrease above the thresholds and any fall in positions to below a threshold.

Disclosures will be required to be made on the trading day following the day a disclosure obligation is triggered and will need to contain the identities of the short position holder and the issuer, the size of the position held and the date it was created or ceased to be held. Disclosure calculations and reports are to be on a net basis (subtracting any positions involving long economic exposure to a share from the short positions).

CESR proposes that the requirements apply to all short positions held that create an economic exposure to shares (e.g., derivative contracts, indices, baskets and exchange traded funds ("ETFs")) where those shares are admitted to trading on EEA regulated markets and/or EEA multilateral trading facilities, as long as the primary market is not outside the EEA. CESR views it as critical

that the regime should apply to positions held by both the regulated and the unregulated community (with exception being made for market-making activities).

While CESR recommends that the disclosure regime be one harmonized across Europe by means of European legislation, with consistent disclosure thresholds, it has also commented that it “respects the right of individual members to maintain their own particular measures”, such as existing prohibitions on naked short selling. CESR is also continuing to consider whether further measures beyond disclosure are required to regulate short selling, so more requirements may follow, such as Germany’s recent announcement of disclosure obligations in respect of certain specified financial institutions and further promised restrictions.

While industry bodies have welcomed a harmonized disclosure-based approach in preference to outright restriction, they have raised concerns about the potential compliance burdens caused by such low thresholds and questioned the need for public disclosure of individual positions.

In addition, while CESR is making this proposal to the European Institutions, those CESR members who already have powers to introduce a permanent disclosure regime will begin the process of implementing one (with others implementing on a best efforts basis). Again, although CESR’s stated intention is to move towards a harmonized system, this approach gives rise to a potentially increased compliance burden during the implementation period, during which it will be necessary to keep track of several disclosure regime variants.

## German Financial Regulator Introduces Disclosure Requirement for Net Short Positions

Shortly after CESR published its proposals for a pan-European transparency system for net short selling positions, the German Federal Financial Supervisory Authority (“BaFin”) on March 4, 2010 issued a General Decree (“Decree”), under which market participants must notify BaFin whenever the participant’s net short selling positions in certain financial stocks reach or exceed, or subsequently fall below, a threshold of 0.2% of the issuer’s outstanding shares, and publish net short

selling positions that reach or exceed, or subsequently fall below, a threshold of 0.5%.

BaFin stated that, although the situation in the financial markets has stabilized over the past months, to the point where a general prohibition of uncovered short selling transactions in the specified stocks would not be required, it is still necessary to enable the supervisory authority to take targeted action against short selling transactions that may pose risks to the orderly conduct of securities trading and the stability of the financial system.

### Financial Stocks Concerned

The Decree relates to all transactions that, in terms of the holder’s aggregate economic interest, result in a net short selling position at the designated thresholds, in shares of the following companies:

Aareal Bank AG  
Allianz SE  
Generali Deutschland Holding AG  
Commerzbank AG  
Deutsche Bank AG  
Deutsche Börse AG  
Deutsche Postbank AG  
Hannover Rückversicherung AG  
MLP AG  
Münchener Rückversicherungs-Gesellschaft AG

The Decree will enter into force on March 25, 2010, and initially will apply through January 31, 2011. The first notification and/or publication must be made on the first trading day after the Decree enters into force, for positions existing at that time.

### Net Short Positions

A net short selling position arises if the aggregate of the holder’s financial instruments results in a net exposure on the short side.<sup>4</sup> Such aggregate economic interest (economic exposure) is subject to a notification requirement and/or a notification and publication requirement when the Decree’s thresholds are met.

<sup>4</sup> The net short selling position percentage is calculated as: (Long position - short position) / aggregate number of shares outstanding.

## Financial Instruments Affected by the Disclosure Requirement

In addition to covered and uncovered short selling transactions in the shares concerned, the Decree applies to positions in financial instruments traded on the stock exchange or over-the-counter, that correspond to a short selling position in such shares (e.g., sale of futures, purchase of put options, contracts for difference, regardless of whether physical delivery or cash settlement takes place). All types of financial instruments are to be included in the calculation. Furthermore, this applies regardless of whether the underlying transaction is concluded in Germany or abroad, on a regulated market, a multilateral trading facility or OTC. It thus relates in particular to: covered and uncovered short selling transactions, option transactions, and swaps and financial instruments based on indices and baskets that at least partly include the specified stocks. Exceptions apply to market makers, to the extent the transaction is required for performance of their contractual obligations.

Index and basket products, as well as ETFs, are included without regard to any minimum percentage that the underlying specified financial stocks must represent in the respective product. The holder of these financial instruments is required to determine the extent to which they provide the holder with an exposure to the underlying financial stock and must include this exposure in the calculation of the threshold. The financial instruments on which the exposure is based must be considered with their delta value.<sup>5</sup> If the net short selling position reaches, exceeds or falls below the specified thresholds merely because of the change in the delta for the aggregate net short selling position, a notification and, if applicable, publication is nevertheless necessary.

<sup>5</sup> Under a nominal approach, an instrument is counted as the number of shares it is referenced to. Voting rights are calculated based on the number of shares. Under a delta adjusted approach, share equivalence is based on the delta. The delta of an equity derivative represents how the pay off from that instrument changes in relation to a change in the price of the underlying equity. A Contract for Difference for example would normally have a delta of 1 as it perfectly mirrors the change in the underlying share price. Options on the other hand have a delta that fluctuates. Furthermore, the delta of a cash-settled option will change as the time to expiry shortens.

## Disclosure and Publication

The Decree provides for a two-step transparency system:

### *Disclosure*

- Holders of net short selling positions that reach, exceed, or fall below 0.2% of the outstanding shares of one of the above-mentioned companies must notify BaFin of such positions,<sup>6</sup> by the end of the next trading day.<sup>7</sup>
- When the level of a net short selling position exceeds the thresholds by a further 0.1% (e.g., 0.3%, 0.4%, etc.) or reaches or falls below such incremental thresholds, the holder must submit a further notification to BaFin. If the holder reaches, exceeds, or falls below a threshold of 0.5% or more, the holder must make a publication, as discussed below.

### *Publication*

- Net short selling positions in the above-mentioned stocks that reach, exceed or fall below a threshold of 0.5% must be published by the holder in anonymous form. For this purpose, the holder must communicate the net short selling position to BaFin within one trading day.<sup>8</sup> BaFin will make available the net short selling positions communicated on its homepage in anonymous form within one further trading day. However, neither the name nor the domicile of the holder is stated in the publication.

The notification and publication periods begin when the holder learns or, in consideration of the circumstances, should have known, that the level of its net short selling position has reached, exceeded or fallen below the applicable thresholds.

<sup>6</sup> Such notification may be made only on the form provided for that purpose on the homepage of BaFin.

<sup>7</sup> According to section 30 (1) of the WpHG, trading days are calendar days other than Saturdays, Sundays and public holidays that are legally recognized in at least one Federal State. BaFin will make available a calendar of trading days.

<sup>8</sup> Such publication may be made only on the form provided for that purpose on the homepage of BaFin.

According to the Regulator, the rationale of the Decree is to help to address potential market abuse and disorderly markets through acting on particularly aggressive, large-scale short selling that might involve such risks. In addition, it can provide informational benefits to the market by improving transparency of short positions.

## Hong Kong: Increasing Short Position Transparency

### Background and the Current Reporting Regime

While many overseas markets (including Australia, the United States, the UK, and Japan) have, since September 2008, imposed emergency measures to regulate short selling and/or to enhance related disclosures, Hong Kong was one of the few markets that did not do so, even at the height of the global financial crisis. On the back of lessons learned from the 1997 Asian financial crisis, the existing Hong Kong short selling regime (that has by all accounts held up quite well during turbulent market conditions) generally prohibits uncovered or “naked” short selling with exceptions for market makers and liquidity providers and off-exchange short sales. Only certain liquid securities designated by the Stock Exchange of Hong Kong (“SEHK”) are eligible for short selling. The tick rule (no sale below the best current ask price) applies unless the sale is related to designated index arbitrage or made by market makers in their market making activities.

In terms of reporting requirements, all short orders must be marked. Short holdings of more than 1% where a long holding exceeds 5% must be disclosed to both the SEHK and the relevant issuer. Aggregated covered short selling turnover is published daily. However, no information is available on the outstanding short position in the market at present. On July 31, 2009, the Securities and Futures Commission (“SFC”) issued a consultation paper to gather public input on increasing short position transparency, which is one of the four principles recommended in the report entitled “Regulation of Short Selling” published by the International Organization of Securities Commissions’ (IOSCO) Technical Committee. The consultation conclusions were released on March 2, 2010.

### The New Position

After taking into account industry feedback and the domestic market situation, the SFC decided in the main that the existing transactional reporting requirement for all short orders to be marked will remain, but the use of close-out indicators will not be introduced. Instead, based on market feedback, the SFC will introduce a new short position reporting regime, key features of which are set out below.

#### *Scope of Reporting*

Reporting will be based on cash positions only; derivatives are currently to be excluded from the short position reporting regime.

#### *Scope of Coverage*

A risk-based approach will be adopted—at the outset, short position reporting requirements will only be applicable to constituent stocks of the Hang Seng Index, the H-shares Index and other financial stocks (which are not the constituent stocks of the two indices but are permitted by SEHK for short selling).

#### *Reporting Requirements*

A periodic reporting approach with a threshold level will be adopted by the SFC:

- The reporting requirement will be triggered if the gross short position amounts to or exceeds 0.02% of the issued share capital of the particular listed company, or the value of the short position amounts to, or exceeds, HK\$30 million, whichever is lower;
- Reporting will be done on a weekly basis, i.e., a snapshot of the short position as at the last trading day of the week is to be reported until the short position falls below 0.02% of the issued share capital of the particular listed company or HK\$30 million, as the case may be;
- The report is to be submitted to the SFC by the second business day of the following week; and
- The SFC may, in its discretion, change the reporting requirements in contingency situations.

***Parties Required to File a Report***

To enhance transparency without making it overly burdensome for market participants, the SFC has determined the following to be the most sensible approach:

- Short sellers will be required to report their short positions;
- Agents will be authorized to report on behalf of the short sellers;
- In the case of funds, the reporting obligation shall apply to each fund (the fund manager may report the positions on behalf of each fund it manages but will not be permitted to aggregate or net positions between different funds under its management); and
- The reporting obligation will be imposed on the individual legal entities within a group rather than requiring an aggregation of the short positions within the entire group.

***Information to be Reported***

The short positions are to be reported on a gross basis. In this connection, a template will be created to facilitate the short position reporting via the SFC website.

***Private Reporting vs. Public Disclosure***

The SFC will not publish the reported information in its original form. Instead, it will publish on its website the information on an aggregated basis (the short position on a per stock basis) one week later.

***Parties Exempted from the Reporting Requirements***

The SFC will impose the short position reporting regime across the board on all short sellers with no exception. There is market support for exemptions to be granted to market makers, as it was thought that this would be consistent with the SFC's current treatment of market makers in exempting them from other requirements pertaining to short selling (e.g., the uptick rule and prohibition against "naked short" selling). The SFC acknowledges the role of market makers, but does not view it appropriate to exempt them from reporting requirements that are essentially post-trade activities

without direct impact on their trading/market making activities.

***Legislation Required to Give Effect to the Reporting Requirements***

A new piece of subsidiary legislation will be introduced to give effect to the new short position reporting regime, in respect of which separate consultation will be undertaken. The SFC will consult separately in due course on the proposed subsidiary legislation.

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