CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-1777

Hedge Fund Enforcement & Regulatory Developments 2009

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FINANCIAL REGULATORY REFORM—HOW WILL IT AFFECT HEDGE FUNDS?

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RECENT SEC RULEMAKINGS AND INTERPRETATIONS AFFECTING HEDGE FUNDS AND THEIR MANAGERS

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The author thanks Jonathan P. Goodman and Eva Gutierrez of Gibson, Dunn & Crutcher LLP for their assistance in preparing materials used in this outline.

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I. COMPLIANCE ISSUES UNDER THE INVESTMENT ADVISERS ACT OF 1940 (THE "ADVISERS ACT")

A. Advisers Act Rule 204-2 - Outsourcing Trade Confirmation Retention

On August 14, 2009, the Securities and Exchange Commission's (the "SEC's") Division of Investment Management issued a no-action letter to Omgeo LLC ("Omgeo"),[2] stating that it would not recommend enforcement action under Advisers Act Rule 204-2 against investment advisers ("Adviser Participants") that outsource the maintenance and preservation of trade confirmations to Omgeo, a third-party service provider of post-trade applications through its TradeSuite and Central Trade Manager services.[3] Absent such relief, Rule 204-2 generally requires that investment advisers make and keep originals of all trade confirmations.

The SEC staff conditioned its no-action relief as follows:

a. Omgeo will store at least two electronic copies of all confirmations sent to Adviser Participants for not less than five years from the end of the fiscal year during which the last entry was made on the confirmation;

b. At least one copy of each document will be stored in a secure facility separate from the facility used to store the other copies;

c. During the retention periods specified in the Advisers Act recordkeeping rules, Adviser Participants will be able, at any time, to access confirmations sent by Omgeo and available through computers located at the Adviser Participant's office, but are not required to download and print the confirmations in order to comply with Advisers Act Rules 204-2(a)(7) and 204-2(b)(3);

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2. Letter *to Omgeo LLC,* SEC Staff No-Action Letter (Aug. 14, 2009), available at http://www.sec.gov/divisions/investment/noaction/2009/omgeo081409.htm.

3. Pursuant to prior no-action letters, investment advisers may treat confirmations available through Omgeo as original communications for purposes of Advisers Act Rules 204-2(a)(7) and to satisfy the requirements of Advisers Act Rule 204-2(b)(3), which requires investment advisers to make and keep copies of confirmations of all transactions effected by or for the account of a client. See *Letters to The Depository Trust Company*, SEC Staff No-Action Letters (Sept. 4, 1992) and (Apr. 17, 2001).

d. For at least five years from the end of the fiscal year during which the last entry was made on a confirmation, Omgeo will provide former Adviser Participants with requested documents within 24 hours of the time of a written request;

e. In the event that an Adviser Participant ceases operations without making adequate provision for its continued compliance with its recordkeeping obligations under Rule 204-2(f), Omgeo will provide the SEC within 24 hours of the time of the request, without charge to the SEC, an electronic copy of any record that the Adviser Participant received through Omgeo for not less than five years after the end of the fiscal year during which the last entry was made on the confirmation;

f. In the event that Omgeo ceases operations, it will make arrangements reasonably acceptable to the SEC or its staff to ensure the continued availability of documents for regulatory purposes during the remainder of the applicable recordkeeping period; and

g. Omgeo's internal systems for making and keeping confirmations on behalf of Adviser Participants are required to meet all of the requirements of Rule 204-2(g) under the Advisers Act.

B. Advisers Act Rule 206(4)-2 - Custody of Client Assets

On May 20, 2009, the SEC published for comment proposed amendments to Advisers Act Rule 206(4)-2.[4] The comment period for the proposal expired July 28, 2009.

1. Application to Unregistered Advisers

The proposed amendments would not change the application of current Rule 206(4)-2. Accordingly, investment advisers who are not registered (or required to be registered) under the Advisers Act are not proposed to be affected by the proposed amendments.

4. *See* Advisers Act Release No. 2876 (May 20, 2009), available at http://www.sec.gov/rules/proposed/2009/ia-2876.pdf.

2. *Proposed Requirements*

The proposed amendments would expand the definition of "custody" under rule 206(4)-2 to capture any registered investment adviser who has the ability to deduct fees directly from its clients' accounts. As proposed, Rule 206(4)-2 would require that an investment adviser who has custody of its clients' funds and securities obtain a surprise examination by an independent public accountant on an annual basis. The proposed amendments would also require that:

a. privately placed and uncertificated securities be included in the audit;

b. covered investment advisers include in reports filed with the SEC, the name of the independent accountant conducting the audit, and amend such report any time the adviser changes the accountant providing the audit;

c. accountants inform the SEC within one business day if any "material discrepancies" are discovered in an adviser's audited accounts. A report must also be filed if the accountant or investment adviser terminates the engagement, and include the reasons for any such termination; and

d. the custodian and the investment adviser send clients copies of their statements and notify them when an account has been opened in their name, or money from their account has been moved. Under the current rule, if the custodian delivers account statements, the investment adviser is not required to deliver them.

3. *Affiliated Custodians*

Under current law, the funds or securities of an investment adviser's client may be maintained by a custodian who is an affiliate of the adviser. Where such a relationship exists, the proposed rule would require that an accountant perform an annual custody control examination and that the accountant be registered with, and subject to inspection by, the Public Company Accounting Oversight Board. The SEC intends for this proposed requirement to accomplish two goals: (a) the exam will help ensure that an investment adviser with an affiliated custodian has proper custody control protections, and (b) the administrative and

financial burden of the annual examination will encourage investment advisers to retain independent custodians for their clients' accounts.

C. Advisers Act Proposed Rule 206(4)-5 - Pay-to-Play Arrangements

On August 3, 2009, the SEC published for comment new Advisers Act Rule 206(4)-5 to prohibit "pay to play" arrangements by most investment advisers.5 The SEC uses the phrase "pay to play" to refer to arrangements whereby investment advisers make political contributions or related payments to governmental officials in order to be rewarded with, or afforded the opportunity to compete for, contracts to manage the assets of public pension plans and other government accounts. Comments on the proposed rule are due on or before October 6, 2009.

1. Overview of the Proposed Rule

As proposed, a covered investment adviser would be:

a. banned from providing advisory services to a state or local government entity for two years if it or its "covered associates" make a political contribution of more than $250 to an official of the government entity who is in a position to influence the selection of the adviser,

b. prohibited from paying unrelated third parties, such as placement agents, to solicit government clients, and

c. prohibited from soliciting or coordinating certain political contributions to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or a political party of a state or locality where the government entity is located.

These prohibitions would supplement the current restrictions on cash payments for client solicitations under Advisers Act Rule 206(4)-3.

5. *See* Advisers Act Release No. 2910 (Aug. 3, 2009), available at http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

2. *Key Definitions*

a. Covered Investment Advisers

The substantive provisions of the proposed rule would generally apply to advisers registered (or required to be registered) under the Advisers Act as well as to advisers exempt from registration under Advisers Act Section 203(b)(3), which generally exempts from registration those advisers that have fewer than 15 clients. Accordingly, most hedge funds managers would be subject to the proposed rule. As discussed below, however, additional record keeping requirements under proposed Advisers Act Rule 204-2(a)(18) would not extend to advisers who are exempt from registration under Section 203(b)(3).

b. Covered Associates

According to the proposing release, the SEC designed the proposed rule so that its prohibitions are triggered by political contributions by persons who the SEC believes, based on its experience in recent enforcement actions, are likely to have an economic incentive to make contributions to influence the adviser's selection. Thus, the provisions of the proposed rule would extend to the activities of an adviser's "covered associates," which would include any (i) general partner, managing member or executive officer of the adviser, or any other individual with a similar status or function; (ii) employee who solicits a government entity for the adviser; and (iii) political action committee controlled by the adviser or by any person in clause (i) or (ii) above. An adviser's "related persons" (*i.e.*, any person directly or indirectly controlling or controlled by the adviser, and any person that is under common control with the adviser) and the employees of such related persons are not proposed to be considered "covered associates."

Under paragraph (f)(5) of the proposed rule, "executive officers" of an adviser would be the president, any vice president in charge of a principal business unit, division or function, or any other executive officer of the adviser who, in connection with his or her regular duties,: (i) performs, or supervises any person who performs, investment advisory

services for the adviser; (ii) solicits, or supervises any person who solicits, for the adviser; or (iii) supervises, directly or indirectly, any person described in clauses (i) or (ii) above. According to the proposing release, an adviser's other executives, such as the comptroller, the head of human resources, or the director of information services would not be "executive officers" for purposes of the proposed rule because the compensation of these individuals is less likely to be tied directly to obtaining or retaining clients.

c. Covered Government Entities

The government entities covered by the proposed rule would be any state or political subdivision of a state, including (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) any investment program, pool of assets, or plan sponsored or established by the state; or (iii) any political subdivision thereof, including a public pension plan, 529 college savings plan, 403(b) and 457 retirement plan, and any similar program or plan.[6] An adviser to a "covered investment pool" in which a government entity invests will be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.

d. Covered Investment Pools

A "covered investment pool" generally is proposed to be defined as any investment company, as defined in the Investment Company Act of 1940 (the "Investment Company Act"), or any company that would otherwise be an investment company, but for the exclusions provided under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act Accordingly, most U.S. hedge funds would be "covered investment pools."

6. A "government entity" would also include the officers, agents and employees of the state or political subdivision, or any agency, authority or instrumentality thereof, acting in their official capacity.

3. Ban on Political Contributions

Pursuant to proposed Rule 206(4)-5(a)(1), an adviser would be prohibited from providing investment advisory services for compensation to any government entity within two years after the adviser or any covered associate, as defined above, makes a "contribution" to any person who was at the time of the contribution an incumbent or candidate for elective office, if such office (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser by such government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser by such government entity.[7]

The two-year ban would continue even after the departure of the applicable covered associate, and the contributions of the covered associate would be attributed to any other adviser that employs or engages such covered associate during the two years after the relevant contribution. According to the proposing release, the purpose of this extension of the ban is to prevent advisers from circumventing the rule by channeling contributions through departing employees or by influencing the selection process by hiring persons who made political contributions. The SEC did not propose to restrict the contributions of "related persons" and their employees, but seeks comment on whether they should also be covered.

If the two- year time out is triggered with respect to a covered investment pool, the adviser would be required to forego management fees, profits, interests (including traditional carried interest and incentive fees) and recouping of costs related to the assets invested or committed by the applicable government entity. Accordingly, advisers would be required to waive or rebate any such compensation or, alternatively, to terminate the relationship with the applicable government entity. Alternatively, the adviser could seek to cause the covered investment pool to redeem the government entity's investment; however, for many private funds,

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7. "Contribution" is proposed to be defined as any gift, subscription, loan, advance or deposit of money or anything of value for: (i) the purpose of influencing any election for federal, state or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of the successful candidate for state or local office.

contractual restrictions on withdrawals could preclude a government entity from withdrawing its capital or canceling its commitment. Even if possible, such action could harm the fund's other investors, accordingly, the SEC has solicited comment on how to protect other investors in this context.

The SEC stated in the proposing release that if an adviser seeks to cease providing investment advisory services to a government entity as a result of the ban, the adviser's fiduciary duties may require it to continue providing such services, at no fee, for a reasonable period of time.

4. Third Party Solicitors

Pursuant to proposed Rule 206(4)-5(a)(2)(i), an adviser and its covered associates would be prohibited from providing payment to any person to solicit a government entity for investment advisory services on behalf of such adviser. This prohibition would not apply to the solicitation activities of an adviser's related persons, employees of a related person, or its executive officers, general partners, managing members or employees. The proposed rule would not prohibit government entities from retaining third parties, such as pension consultants, and paying them to recommend particular investment advisers for the management of public funds.

The strict prohibition on the use of third party solicitors, such as placement agents, would likely have a number of consequences. For example, investment advisers and their related persons may seek to bolster the ranks of their investor relations staff in order to perform placement and solicitation activities in-house. The SEC will need to address the catch-22 for advisers who will be prohibited by the proposed rule from paying placement agents to solicit investors and who may be prohibited by Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") from soliciting investors if they are not also registered as broker-dealers. Government entities with limited staffs would likely not be able to conduct a thorough adviser selection process without engaging a third party consultant.

5. *Solicitation of Contributions*

Proposed Rule 206(4)-5(a)(2)(ii) would prohibit an adviser and its covered associates from coordinating or soliciting any person or political action committee to make a contribution to any incumbent or candidate for elective office, if such office: (a) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser by such government entity; or (b) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser by such government entity. The adviser and its covered associates would also be prohibited from making payment to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.

6. *Indirect Contributions and Solicitations*

Pursuant to proposed Rule 206(4)-5(d), an adviser and its covered associates would be prohibited from doing anything indirectly that, if done directly, would result in a violation of the proposed rule, such as directing or funding contributions through third parties such as spouses, lawyers, or companies affiliated with the adviser.

7. *Exceptions and Exemption to Proposed Rule on Political Contributions*

The SEC proposes two limited exceptions from the general ban on prohibited contributions. First, a *de minimis* exception would be provided to allow a covered associate who is a natural person to contribute up to $250, per election, to an otherwise prohibited official or candidate if the covered associate is entitled to vote in the election. Primary and general elections would count as separate elections. The adviser would be required to make and keep records of contributions that satisfy the *de minimis* exception.

If this provision is adopted, advisers will want to include in their compliance procedures a methodology for documenting and approving these contributions, with particular care to make sure that the $250 limit is not exceeded, because, as discussed below, the SEC proposes to limit advisers' ability to cure noncompliance with this exception.

Second, an adviser will not be subject to the two-year time out if (a) within four months of the date of a contribution by a covered

associate the adviser discovers the contribution would have triggered the ban; (b) such contribution was equal to or less than $250; and (c) the contributor obtains a return of the contribution within 60 calendar days of the date of discovery of such contribution by the adviser. The SEC proposes to limit reliance on this exception to no more than two times in any 12-month period, but not more than once with respect to contributions made by the same covered associate.

In addition to the two exceptions discussed above, the proposed rule provides that the SEC may, upon application, grant an adviser conditional or unconditional exemptions with respect to the application of Rule 206(4)-5(a)(1) as a result of any prohibited contribution. In addition to the standard general exemptive authority granted to the SEC, the proposed rule also outlines the conditions for an "inadvertent violation" exemption based on an adviser's procedures to prevent violations, and its actions to prevent any of the abuses that the proposed rule is intended to address. Among the specific steps that an adviser could take in hopes of qualifying for this essentially retroactive exemption would be placing advisory fees earned between the date of the prohibited contribution and the date on which the SEC's determines whether to grant an exemption in an escrow account that would be payable to the adviser only if the SEC grants the exemption. If the SEC does not grant the exemption, the fees contained in the account would have to be returned to the government entity.

8. Recordkeeping and Compliance

Under the proposed rule, registered advisers (and those required to be registered) would be required to maintain additional records documenting the contributions and payments of the adviser and its covered associates, which would be available to the SEC in its examination process. Advisers who are exempt from registration as investment advisers pursuant to Section 203(b)(3) would not be subject to these record keeping requirements.

Non-exempt advisers would be required to maintain the following records:

a. the names, titles and business and residence addresses of covered associates, including those that are political action committees;

b. records of government entities to which the adviser or any covered associate is providing or seeking to provide advisory services, or that invest or are solicited to invest in covered investment pools to which the adviser provides advisory services;

c. records, going back five years (but not prior to the effective date of the rule), of government entities to which the adviser provided advisory services and the covered investment pools that the adviser provided advisory services to and in which a government entity invested; and

d. records, in chronological order, of direct or indirect contributions or payments made by the adviser or any covered associate to an official or a political party of a state or political subdivision thereof, or a political action committee (including the name and title of each contributor and recipient, the amount involved and whether it was returned under the exception described above).

II. EXCHANGE ACT COMPLIANCE ISSUES

A. Short Selling

1. September 2009 Roundtable on Short Sale Transparency

On September 29 and 30, 2009, the SEC will hold a roundtable on securities lending and short sales.[8] The first day of the roundtable will focus on a securities lending , including compensation arrangements, disclosure practices, proxy voting, and methods of collateral and cash-reinvestment. The second day of the roundtable will examine controls on "naked" short selling, particularly pre-borrow and hard locate requirements, and proposals to make short sale disclosure more meaningful.

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8. *See* Exchange Act Release No. 60643 (Sept. 10, 2009), available at http://www.sec.gov/rules/other/2009/34-60643.pdf.

2. *Price Test*

In April 2009, the SEC published amendments to Regulation SHO to adopt one of five alternatives for restricting short selling, including two variations of a price test, and three variations of circuit breaker restrictions (collectively referred to as the "April Proposals").[9]

a. Price Tests

The SEC proposed two versions of a market-wide, permanent price restriction on short sales: (i) the proposed Modified Uptick Rule, which would restrict the display or execution of short sales on a down-bid price, as determined by the national best bid; and (ii) the proposed Uptick Rule, a modified version of former Exchange Act Rule 10a-1, which would prohibit short sales except at a plus tick or a zero plus tick.

b. Circuit Breaker Alternatives

The SEC also proposed three variations of circuit breakers, which are security-specific, temporary restrictions designed to target only those securities that experience rapid severe intraday declines so as to prevent short selling from being used to accelerate the decline in the price of those securities. The proposed Circuit Breaker Halt Rule would ban short selling in a particular security for the remainder of the day if there is a severe decline in price in that security. The proposed Circuit Breaker Modified Uptick Rule would impose a short sale price test based on the national best bid in a particular security for the remainder of the day if there is a severe decline in price in that security. The proposed Circuit Breaker Uptick Rule would impose a short sale price test based on the last sale price in a particular security for the remainder of the day if there is a severe decline in price in that security. Each of the three proposed circuit breakers would be triggered if the price of a security declines by at

9. *See* Exchange Act Release No. 59748 (Apr. 10, 2009), available at http://www.sec.gov/rules/proposed/2009/34-59748.pdf.

least 10% from the prior day's close price for that security, although the SEC requested comment on whether 10% is the correct threshold.

c. Expiration of Comment Period and Re-Proposal

By the expiration of the June 19, 2009 comment period on the Commission had received approximately 5000 comment letters as well as a petition containing in excess of 5500 signatures.

On August 17, 2009, the SEC published a release re-opening the comment period on the April Proposals, and also soliciting comment on an alternative, which could be used either as a stand-alone price test or combined with a circuit breaker, that would allow short selling only at a price above the current national best bid.[10] The comment period for this proposal expires September 21, 2009.

3. Regulation SHO Interpretations Relating to Marking Requirements

On August 28, 2009, the staff of the SEC's Division of Trading and Markets posted updates to its Responses to Frequently Asked Questions ("FAQs") for Regulation SHO, which provided guidance on how a broker-dealer should mark (a) an order where the seller is net long for only part of the order (Question 2.4), and (b) multiple orders "in flight" (Question 2.5).[11]

In the case of an order from a customer who has a net long position, but may wish to sell additional shares, the SEC staff advised that the broker-dealer is required to mark part of the customer's sell order as "long", and treat (and mark) the additional amount as a separate short sale order.

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10. *See* Exchange Act Release No. 60509 (Aug. 17, 2009), available at http://www.sec.gov/rules/proposed/2009/34-60509.pdf.
11. The staff also provided guidance that broker-dealers must treat non-U.S. registered broker-dealers the same as non-broker-dealer customers when obtaining assurances regarding the availability of securities for delivery on settlement date, and may not rely on the broker-to-broker exception provided in Rule 203(b)(2)(i) of Regulation SHO. (Question 4.6). The Regulation SHO FAQs are available at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

In the case of customers, such as high frequency traders, who simultaneously enter the same order for the same security multiple times (*e.g.*, a customer who is long 1000 shares of stock XYZ and enters multiple orders of the same stock for 1000 shares), only the first order that is entered can be marked "long". According to the staff, "after the [initial] long sale order is entered to sell the 1,000 shares, it is no longer reasonable to expect that delivery can be made by settlement date on additional orders to sell the same shares. In addition, under Rule 200(g)(1) of Regulation SHO, a broker-dealer must mark only one order as "long" and any additional orders as "short."

4. Disclosure

In October 2008, the SEC adopted interim final temporary Rule 10a-3T under the Exchange Act, which required certain institutional investment managers to make disclosures on temporary Form SH concerning their short sales of and short positions in Exchange Act 13(f) securities (other than options).[12] The SEC allowed Rule 10a-3T to expire on July 31, 2009.[13]

The SEC and relevant SROs have begun publishing on their websites additional information relating to short sales:

- Daily aggregate short selling volume in each individual equity security is available for that day on the relevant SRO's Web site;
- Individual short sale transactions in all exchange-listed equity securities are published on a one-month delayed basis by the relevant SRO on its Web sites; and
- Information about fails to deliver for all equity securities, regardless of the amount of fails, is published twice monthly on the SEC's Web site.

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12. *See* Exchange Act Release No. 58785 (Oct. 15, 2008), available at http://www.sec.gov/rules/final/2008/34-58785.pdf.
13. *See* SEC Press Release, *SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency*, July, 27, 2009, available at http://www.sec.gov/news/press/2009/2009-172.htm.

5. Close-out Requirements

The SEC initially adopted Exchange Rule 204 on a temporary basis, but made the rule permanent, effective July 31, 2009.[14] Rule 204 requires broker-dealers that clear and settle trades to deliver securities for clearance and settlement on long and short sale transactions in any equity security by settlement date (trade date, plus three days).

Failure to deliver by settlement date triggers requirement to immediately close out the fail position by borrowing or purchasing securities by no later than the beginning of regular trading hours on the next business day. The penalty for non-compliance is pre-borrow or arrangement to borrow requirements until the fail position is closed out.

When the SEC adopted final Rule 204, it made the following slight modifications:

a. Permitting borrows as well as purchases to be used to close out a fail to deliver position; provided that (i) the borrow or purchase is bona fide; (ii) the borrow or purchase is executed after trade date, by no later than the end of regular trading hours on the transaction's settlement date (*i.e.*, no later than T+3); (iii) the borrow or purchase is of a sufficient quantity to cover the entire amount of the open short position in that security; and (iv) the broker-dealer is net flat or net long in that security on its books and records on the day of the purchase and can demonstrate its compliance with this requirement;

b. Extending the exemption for fails to deliver relating to processing delays in connection with sales of Rule 144 securities to fails to deliver resulting from the sale of any equity security that a person is deemed to own pursuant to Rule 200 of Regulation SHO, and that such person intends to deliver as soon as all restrictions on deliver have been removed. Accordingly, in addition to Rule 144 securities, the exemption applies to convertible securities, options, and

14. *See* Exchange Act Release No. 58733 (Oct. 14, 2008), available at http://www.sec.gov/rules/final/2009/34-60388.pdf (adopting Rule 204T); and Release No. 34-60388 (July 27, 2009), available at http://www.sec.gov/rules/final/2009/34-60388.pdf (adopting Rule 204 on a permanent basis).

warrants that have been tendered for conversion or exchange, but for which the underlying security is not reasonably expected to be received by settlement date. The close-out period for these securities will be 35 calendar days following the transaction's trade date; and

c. Granting the Director of the SEC Division of Trading and Markets delegated authority to grant conditional and unconditional exemptions from Rule 204.

The SEC declined to exempt securities other than debt securities, but said it will consider on a case-by-case basis whether the provisions of Rule 204 and Regulation SHO more generally, should apply to particular securities, including various structured products.

B. High Frequency Trading

On September 17, 2009, the SEC will meet to consider possible amendments to Rule 602 of Regulation NMS to eliminate an exception for the use of flash orders, and other issues relating to high frequency trading and dark pools of liquidity.[15]

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15. *See*, SEC, Open Meeting Agenda Thursday, September 17, 2009, available at http://www.sec.gov/news/openmeetings/2009/agenda091709.htm.