

SEC EMERGENCY ORDER ON “NAKED” SHORT SELLING

On July 15, 2008, the Securities and Exchange Commission (“SEC”) issued an extraordinary and unprecedented emergency order relating to short sales of the securities of 19 financial services companies (the “Order”).¹ The Order becomes effective at 12:01 a.m. on July 21, 2008 and expires at 11:59 p.m. on July 29, 2008, but may be extended for no more than 30 calendar days in total duration. Market participants were taken by surprise by this action, and have raised a number of questions that we discuss below.

The Order prohibits any person from effecting a short sale² in the publicly traded securities of the financial firms listed in Appendix A to the Order unless the person or its agent has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting the short sale (“preborrow requirement”), and delivers the security on the settlement date.³

Notable features of the Order include the following:⁴

1. The Order applies to all “persons.” This is different from Regulation SHO, which directly applies only to broker-dealers that effect short sales for themselves or for others.⁵ This means that non-broker-dealer short sellers that fail to preborrow can be found to directly violate the Order.
2. The Order applies to the “publicly traded securities” of the issuers listed in Appendix A.⁶ While the Order may be ambiguous as to whether it is intended to be broader than the scope of

¹ Securities Exchange Act Release No. 58166 (July 15, 2008). Appendix A of the Order lists the 19 companies, which notably include Freddie Mac and Fannie Mae: BNP Paribas Securities Corp. (BNPQF or BNPQY); Bank of America Corporation (BAC); Barclays PLC (BCS); Citigroup Inc. (C); Credit Suisse Group (CS); Daiwa Securities Group Inc. (DSECY); Deutsche Bank Group AG (DB); Allianz SE (AZ); Goldman, Sachs Group Inc. (GS); Royal Bank ADS (RBS); HSBC Holdings PLC ADS (HBC and HIS); J.P. Morgan Chase & Co. (JPM); Lehman Brothers Holdings Inc. (LEH); Merrill Lynch & Co., Inc. (MER); Mizuho Financial Group, Inc. (MFG); Morgan Stanley (MS); UBS AG (UBS); Freddie Mac (FRE); and Fannie Mae (FNM). Although the Order refers to “substantial financial firms” and does not otherwise indicate the criteria that were used to select the companies on the list, the SEC’s press release accompanying the Order refers to the broker-dealers as “primary dealers at commercial and investment banks.” SEC Press Release No. 2008-143.

² The Order incorporates the definition of “short sale” in Rule 200(a) of Regulation SHO. Order, n.2.

³ The Order is an outgrowth of the SEC’s intense concern about rumor mongering that can lead to a loss of confidence in the United States securities markets. See SEC Press Release No. 2008-140 (July 13, 2008). The SEC also believes that loss of confidence could result in panic selling of securities, which can be exacerbated by naked short selling. Order at 1. Naked short sales are short sales that are effected without any determination that securities will be available for delivery on the settlement date.

⁴ The SEC staff may provide additional guidance on the Order.

⁵ Regulation SHO, which became fully effective in 2005, is largely concerned with preventing failures to deliver securities at the time of trade settlement. The regulation includes various measures to avoid failures to deliver and corrective steps if failures to deliver in certain securities (called “threshold securities”) are relatively large and persistent.

⁶ The SEC press release also refers to the “securities identified in the Commission’s order,” with the associated ticker symbols.

Regulation SHO's "locate" requirement,⁷ which is limited to equity securities, only the securities represented by the ticker symbols in Appendix A are covered.

3. The short seller or its agent must preborrow the security before the short sale is effected. Whereas Regulation SHO permits a broker-dealer to perform a locate and have a "reasonable basis to believe" that the security will be available at settlement, that option is not available under the Order. This also means that reliance on an "easy to borrow" list would be insufficient.

4. The SEC staff has indicated that a broker-dealer may accept a customer's assurance that a preborrow has been arranged, and should document that assurance as it would under Regulation SHO. Given that a failure to deliver will constitute a violation of the Order, careful documentation of the preborrow will be essential, especially as it relates to the source of the preborrowed stock.

5. The preborrow requirement can be expected to have an adverse impact on active traders, and is likely to increase their costs. However, an active trader should be able to "recycle" a preborrow where the lender clearly indicates that the securities have been allocated to the trader for the entire trading day, the security is not a "hard to borrow" security or a "threshold security," and the net amount of the short sales does not exceed the preborrow amount.⁸

6. The Order does not contain an exception for market makers. Therefore, the impact on dealer markets, such as the Nasdaq Stock Market and options markets, is uncertain. The SEC staff is aware of the problem and there are indications that it will issue guidance in the immediate future.⁹

7. The Order states, apparently for the first time, that the exercise of a put option can result in a short sale (presumably only if it is settled by physical and not cash delivery).¹⁰ The Order contains no "grandfather" provision for options positions extant at the time that the order becomes effective. This means that persons obligated to deliver on the exercise of a put option must preborrow the securities to cover the exercise. Mandatory assignments of options are exempt from the Order. Although it is not entirely clear, it appears that automatic exercises of options also are exempt; voluntary exercises are not. In a similar vein, short sales used to hedge are also subject to the terms of the Order.¹¹ Short swaps and shorting of exchange-traded funds are not covered by the Order.

8. The Order requires a preborrow *and* delivery of the security on the settlement date. Accordingly, it appears that a failure to deliver will result in a violation of the Order, even when a bona fide preborrow has been made. The SEC staff has indicated that a fail randomly assigned by the National Securities Clearing Corporation will not result in a violation of the Order.

⁷ Rule 203(b)(1) of Regulation SHO requires a broker-dealer, prior to executing a short sale, to (1) borrow the security or enter into a bona-fide arrangement to borrow the security; or (2) have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the settlement date of the trade; and document compliance with (1) or (2).

⁸ See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, Answer to Question 4.4 (permitting an executing broker-dealer to "re-apply" a locate for intra-day buy-to-cover trades), available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

⁹ See Judith Burns, *SEC Order May Exclude Market Makers*, The Wall Street Journal, July 18, 2008, at C6.

¹⁰ Order, n.3.

¹¹ *Id.*

9. The Order may disrupt sales of restricted securities effected pursuant to Rule 144 under the Securities Act of 1933. Restricted securities often must be submitted to the issuer or its transfer agent for processing, and therefore may not be available in time for settlement of a sale. The sale in such circumstances is a short sale under Rule 200(a) of Regulation SHO. However, Rule 203(b)(2) of Regulation SHO provides a limited exemption from the locate requirement to provide time for the securities to be processed and received by the seller. The Order contains no similar exemption. Therefore, even where a seller is deemed to own a restricted security of an Appendix A issuer, short sales of such securities under Rule 144 invariably will be subject to the preborrow requirement. The staff is aware of the Order's potential to disrupt sales of restricted securities under Rule 144, but has not indicated what, if any, steps it may take to address those disruptions.

10. An independent trading aggregation unit, as that term is used under Regulation SHO, may not transfer all or a portion of a net long position in a security it holds to another aggregation unit with a net short position for purposes of allowing the aggregation unit with the net short position to comply with the Order. The SEC staff takes the position that such transfers would call into question the independence of the aggregation units. The aggregation unit with a net long position in a security presumably could loan shares of the security to another aggregation unit to permit that aggregation unit to comply with its obligations under the Order.

The SEC press release that accompanied the Order states that the SEC will undertake a rulemaking to address the issues identified in the Order "across the entire market."¹² Therefore, the SEC may propose a rule to require preborrowing on a wider group of securities. This seems to be an acknowledgement that, in the SEC's view, Regulation SHO has been ineffective in halting abusive "naked short selling."

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¹² SEC Press Release No. 2008-143 (July 15, 2008).