

**SEC ISSUES AMENDMENT TO EMERGENCY ORDER
AND PUBLISHES STAFF GUIDANCE**

On July 18, 2008, the Securities and Exchange Commission (“SEC”) published an amendment to the emergency order issued on July 15, 2008¹ that is intended to prevent “naked short selling” in the securities of 19 large financial firms.² The Order, as amended, is effective from July 21 to July 29, 2008. Also on July 18, the SEC’s Division of Trading and Markets published guidance on the operation of the Order in the form of answers to “frequently asked questions” (“FAQs”).³ The Amendment and the FAQs provide accommodations and interpretations that resulted from a series of discussions with industry participants after the Order was issued. We discuss the principal changes below.

Securities Covered. FAQ 1 confirms that the Order applies only to the securities whose tickers appear in Appendix A to the Amendment (“Appendix A Securities”).⁴

Bona Fide Market Making. The Amendment permits registered market makers, block positioners, and “other market makers obligated to quote in the over-the-counter market” to sell short without preborrowing securities, if short sales are part of bona fide market making and hedging activities related directly to bona fide market making in: (a) Appendix A Securities; (b) derivative securities based on Appendix A Securities, including standardized options; and (c) exchange-traded funds of which Appendix A Securities are a component.⁵ Although market makers are excused from the preborrow requirement of the Order, they are not excused from the obligation to deliver securities upon the settlement date of their short sales. The Amendment does not define or describe what activities constitute “bona fide” market making and hedging activities, nor does it define the market makers that are “obligated” to quote in the over-the-counter market.

¹ Securities Exchange Act Release No. 58166 (July 15, 2008) (“Order”). See *SEC Emergency Order on “Naked” Short Selling*, Willkie Farr & Gallagher LLP Client Memorandum (July 18, 2008), available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2668/SEC_Emergency_Order_On_Naked_Short_Selling.pdf (“Willkie Client Memorandum”).

² Securities Exchange Act Release No. 58190 (July 18, 2008) (“Amendment”).

³ SEC Division of Trading and Markets, *Guidance Regarding the Commission’s Emergency Order Concerning Short Selling* (July 18, 2008), available at <http://sec.gov/divisions/marketreg/emordershortsalesfaq.htm>.

⁴ Appendix A to the Amendment corrects two items in the original Appendix A: the ticker HSI was deleted from the list, and the reference to BNP Paribas Securities Corp. was changed to BNP Paribas.

⁵ Amendment, Paragraph A.

Preborrowing Procedures. Brokers and dealers may satisfy the Order's preborrow requirement by using the processes and procedures that they have established to perform and document "locates" to comply with Rule 203(b)(1) of Regulation SHO.⁶ This includes the ability to rely on a customer's representation that the customer has arranged a preborrow of the securities where such reliance is reasonable under the circumstances.⁷ We believe that broker-dealers and, where relevant, their customers, should clearly document with the lenders of securities that requests made through their "locate" systems for Appendix A Securities are in fact preborrow requests rather than simply requests for locates. Importantly, the SEC Staff has said that "an arrangement to borrow requires more than a [sic] reasonable grounds to believe that the security can be borrowed." There must be a bona fide agreement to borrow such that the security is "set aside at the time of the arrangement solely for the person requesting the security."⁸

"Re-applied" Preborrows. FAQ 5 permits "re-applying" preborrows in the same manner as re-applying locates under Regulation SHO.⁹

Rule 144 Sales. As discussed in our recent Client Memorandum, sales of restricted securities pursuant to Rule 144 under the Securities Act of 1933 invariably will constitute short sales as defined in Regulation SHO and also for purposes of the Order. The Amendment excludes from the Order short sales of Appendix A Securities effected pursuant to Rule 144. Such short sales, however, remain subject to the requirements of Regulation SHO.¹⁰

Options Exercises. FAQ 4 clarifies that, in addition to voluntary exercises, automatic exercises of put options are subject to the Order. This means that a person who has a put option position in one of the Appendix A Securities must preborrow before the automatic exercise occurs or have the securities in inventory. As a practical matter, this may not be a problem, because most automatic exercises in listed options occurred on July 18, and the Order is effective only from July 21 to July 29, 2008. Unless the Order is extended to cover another options expiration date, put option holders will not be affected unless they elect to exercise their puts before expiration. An assignment of an exercise of a call option is not subject to the preborrow requirement, but it is subject to the timely delivery requirement. Options market makers have an exemption from the preborrow requirement when they exercise puts in connection with hedging activity associated with bona fide market making. The market makers, however, are not excused from the requirement to deliver the security related to the exercise on settlement date.

⁶ Amendment, Paragraph B.

⁷ FAQ 3.

⁸ FAQ 2.

⁹ See *Responses to Frequently Asked Questions Concerning Regulation SHO* ("SHO FAQs"), available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>, SHO FAQ 4.4. See also Willkie Client Memorandum.

¹⁰ Amendment, Paragraph C.

Syndicate Short Sales. Short sales by underwriters and members of a syndicate or group participating in distributions of Appendix A Securities are excluded from the Order when made in connection with over-allotments of securities, or lay-off sales in connection with a distribution of Appendix A Securities through a rights offering or a standby underwriting commitment.¹¹

Extraterritorial Application. The SEC Staff has taken an expansive view of the extraterritorial reach of the Order. FAQ 6 states that the Order applies to short sales of Appendix A Securities agreed to in the United States, even if the trade is booked abroad. It also applies to a short sale involving a customer located in the U.S., and to any broker-dealer, whether registered or not (such as a Rule 15a-6 foreign broker-dealer) using the U.S. jurisdictional means to effect the short sale.

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If you have any questions regarding this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), or the attorney with whom you regularly work.

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July 21, 2008

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¹¹ Amendment, Paragraph D. The Amendment also excludes from the Order a net syndicate short position created in connection with a distribution of an Appendix A Security that is part of a fail-to-deliver position at a registered clearing agency in the Appendix A Security if action is taken to close out the net syndicate short position no later than the 30th day after commencement of sales in the distribution. This provision is similar to the position taken by the SEC Staff providing limited relief from the "close-out" provision in Rule 203(b)(3) of Regulation SHO for net syndicate short positions. See SHO FAQ 1.5. However, it is not clear why this exclusion from the Order is necessary, because the Order applies only to short sales, and has no close-out requirements for aged fail-to-deliver positions. Presumably, aged syndicate short positions remain subject to Regulation SHO and can take advantage of the SEC Staff's position in the SHO FAQ 1.5. The net effect appears to be that syndicate short sales are excepted from the Order but failures to deliver arising from such short sales are subject to a 30-day close-out requirement.