

July 16, 2008 (UPDATED July 18, 2008)

## SEC Places Limitations on Short Selling of Securities of Financial Institutions and Announces Renewed Enforcement Focus on Spreading of Market Rumors

For the past several months, there has been significant volatility in the capital markets, particularly in the securities of large financial institutions and others affected by credit market-related volatility. Responding to concerns that some of the volatility may be due to manipulative activity, particularly the spreading of false rumors, the SEC has taken several unprecedented steps intended to preserve market integrity.

### Increased Focus by Regulatory Authorities

On July 13, 2008, the SEC announced that it and other securities regulators would undertake examinations aimed at preventing the intentional spreading of false information intended to manipulate the prices of traded securities. These examinations are to be conducted by the SEC, as well as FINRA and NYSE Regulation.<sup>1</sup> The SEC action follows a March 31 notice by FINRA, NYSE Regulation and participants of the Options Regulatory Surveillance Authority reminding industry participants of the prohibition against the circulation of rumors that might reasonably be expected to affect market conditions and advising such participants to review internal controls and procedures in respect of such activity.

### Emergency Action in Respect of Short Selling

On July 15, 2008, facing what it characterized as a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets, the SEC exercised its emergency powers to issue an order. The order provides that no person may effect a short sale in certain specified securities (see list of issuers in Appendix A) unless such person or its agent has borrowed or arranged to borrow the security or otherwise has the security available to borrow in inventory prior to effecting such short sale and delivers the security on the settlement date.<sup>2</sup> The emergency order takes effect July 21, and will be effective at least through July 29. The period could be extended for up to 30 days in total.

<sup>1</sup> See <http://www.sec.gov/news/press/2008/2008-140.htm>.

<sup>2</sup> See <http://www.sec.gov/rules/other/2008/34-58166.pdf>.

---

1285 Avenue of the Americas  
New York, New York 10019-6064  
(212) 373-3000

Fukoku Seimei Building 2nd Floor  
2-2, Uchisawaicho 2-chome  
Chiyoda-ku, Tokyo 100-001, Japan  
(81-3) 3597-8101

1615 L Street, NW  
Washington, DC 20036-5694  
(202) 223-7300

Unit 3601, Fortune Plaza Office Tower A  
No. 7 Dong Sanhuan Zhonglu  
Chao Yang District, Beijing 100020  
People's Republic of China  
(86-10) 5828-6300

Alder Castle, 10 Noble Street  
London EC2V 7JU England  
(44-20) 7367 1600

12th Fl., Hong Kong Club Building  
3A Chater Road, Central  
Hong Kong  
(852) 2536-9933

Regulation SHO, the SEC's rule on short selling, provides that a broker dealer may not accept a short sale order for an equity security from another person or effect a short sale in an equity security for its own account unless the broker dealer (i) has borrowed the security or entered into a bona fide arrangement to borrow the security (i.e. "borrow" the security) or (ii) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due (i.e. "locate" the security).

Currently, Regulation SHO exempts from the "borrow or locate" requirement short sales effected by a market maker in connection with bona-fide market making activities. As a result, market makers have not had to comply with this requirement in connection with their market making activities. While the emergency order is in effect, market participants, sellers and market makers will be required to "borrow" and not just "locate" shares prior to entering a short sale order. As a result, the order will effectively make it more difficult to sell short shares of the subject companies.<sup>3</sup>

The companies identified in the SEC's emergency order are Fannie Mae and Freddie Mac, two major mortgage intermediaries, and the "primary dealers" (those firms that are authorized to trade directly with the Federal Reserve). Primary dealers play an active role in the market for U.S. Treasury securities and in response to the subprime mortgage crisis were permitted to borrow at the Federal Reserve's discount window. In promulgating the emergency order, the SEC expressed its concern that selling pressure on these financial institutions had the potential to significantly disrupt the U.S. capital markets.

### **Enforcement Action**

The SEC can be expected to be particularly vigilant over the coming months, in respect of current as well as past manipulative activity, with violations triggering enforcement action. In April, the SEC charged a trader with securities fraud and market manipulation for intentionally disseminating a false rumor concerning The Blackstone Group's acquisition of Alliance Data Systems Corp ("ADS"). The SEC alleged that this false rumor (to the effect that the ADS board was to meet to consider a revised lower offer price for the acquisition), which was disseminated through instant messages to traders at brokerage firms and hedge funds, caused the price of ADS stock to plummet, and that the trader profited by short selling ADS stock and covering those sales as the price of ADS stock fell.<sup>4</sup> The rumor netted the trader a profit of only \$25,000, while the impact on the market was a 17% drop in stock price and an increase in trading volume of over 20

---

<sup>3</sup> On July 18, 2008, the SEC amended the order to provide that the borrow or arrange-to-borrow requirement of the order does not apply to certain *bona fide* market makers. The exception provided by the amendment applies to registered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, that are selling short as 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. The settlement date delivery requirement of the order will continue to apply to these market makers. The amendment also included exceptions for sales under Rule 144 and short sales by underwriters and syndicate members in connection with over-allotments and other underwriting activity.

<sup>4</sup> See <http://www.sec.gov/litigation/litreleases/2008/lr20537.htm>.

times the prior day's level, followed by a temporary trading halt. The trader was subject to a fine and other penalties and banned from the industry for life.

### **Next Steps**

Additional regulatory action may follow.

In response to the foregoing, in addition to advising traders of the existence and effect of the emergency order, compliance personnel at financial service firms and at hedge funds would be well-advised to review their applicable internal controls and procedures and to remind their trading desks of the level of concern on the part of regulators with respect to the spreading of false rumors and other manipulative activity generally and, particularly, affecting issuers that are subject to credit-market related volatility.

\* \* \*

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul, Weiss Securities Group including: Mark S. Bergman 44-20-7367-1601 and Raphael M. Russo 212-373-3309.

**Appendix A**

<b>Company</b>	<b>Ticker Symbol(s)</b>
BNP Paribas	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
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
Fannie Mae	FNM