

September 19, 2008

SEC Takes Further Steps to Protect the U.S. Markets against Short Selling Abuses

Early this morning, the SEC took further emergency action to address heightened concerns over market manipulation in light of the unprecedented turmoil in the financial markets. This follows action yesterday, as reported in our memorandum dated September 18, 2008.

Today, the SEC has, on a temporary basis:

- imposed a ban on short sales “by all persons” of publicly traded securities of 799 financial institutions;
- adopted short sale reporting requirements for institutional investment managers that have Form 13F filing obligations (*i.e.*, those that exercise investment discretion with respect to accounts holding Section 13(f) securities having an aggregate fair market value of at least \$100 million) – this action had been announced yesterday, but the rules were only approved by the SEC today; and
- eased conditions to take advantage of the Rule 10b-18 issuer safe harbor to facilitate issuer repurchases of their securities.

These actions supplement the following developments taken yesterday:

- The SEC issued an emergency order adopting new short selling rules aimed at strengthening investor protections against “naked” short selling. The rules adopted yesterday apply to the securities of *all public companies*, including all companies in the financial sector. The SEC’s actions were effective as of 12:01 a.m. EDT on Thursday, September 18, 2008.
- Later in the day, SEC Chairman Cox and SEC Enforcement Division Director Thomsen issued a statement regarding immediate SEC action to combat market manipulation.
- Chairman Cox and Enforcement Director Thomsen also announced an expanded enforcement effort against market manipulation.

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September 19th Temporary Ban

The SEC has imposed a temporary ban on short selling of the publicly traded securities of 799 banks, insurance companies, securities firms and their holding companies. The ban is immediately effective and will terminate at 11:59 p.m. EDT on October 2, 2008. The SEC may, however, extend the order beyond that time if necessary to protect investors, but not for more than 30 calendar days in total.

All persons are prohibited from selling short any publicly traded securities of any firm included on the list of 799 financial institutions appended to the emergency order. Registered market makers, block positioners and other market makers obligated to quote in the OTC market are exempt from the ban if they are selling short as part of bona fide market making in the applicable security.

The ban does not apply to short sales as a result of automatic exercise or assignment of an equity option held prior to the effectiveness of the ban due to expiration of the option. Option market makers have a grace period until 11:59 p.m. today (September 19th) when selling short as part of bona fide market making and hedging activities related directly to bona fide market making in derivatives.

The short sale ban only addresses effecting a short sale and does not have a “close out” requirement. Note, however, that the September 18th emergency order (see below) applies to “fail to deliver positions” resulting from trades that occur on or after September 18th, and the general provisions of Regulation SHO, including the “close out” requirements of Rule 203(b)(3), continue to apply as well.

September 19th Temporary Disclosure Requirement

The SEC has imposed temporary disclosure requirements on institutional investment managers that have filed, or were required to file, a Form 13F for the calendar quarter ended June 30, 2008. These investment managers are required to report their new short sales of publicly traded securities on new Form SH. New Form SH is available on the SEC web site. This requirement is effective at 12:01 a.m. EDT on September 22nd and terminates at 11:59 p.m. on October 2nd, unless extended. The first Form SH is to be filed on September 29th.

Form SH must be filed with the SEC on the first business day of each week immediately following a week in which an investment manager has effected a short sale of a security subject to Section 13(f) that is not an option. Form SH is to include disclosure of the number and value of securities sold short during the day, as well as the opening short position, closing short position, largest intraday short position and the time of such largest intraday short position. No filing will be needed if no short sales of a Section 13(f) security had been effected since the filing of the last form.

An institutional investment manager need not report otherwise reportable short positions if the short position is less than one-quarter of 1% of the issued and outstanding securities of that class and the fair market value of the short position is less than \$1 million.

September 19th Temporary Rule 10b-18 Relief

The SEC has modified the Rule 10b-18 safe harbor. In connection with a purchase or a bid subject of Rule 10b-18, the relief suspends the time of purchase condition (*i.e.*, the restriction on opening purchases and purchases made during the 10 minutes/30 minutes prior to close), and modifies the volume condition such that the amount of Rule 10b-18 purchases does not exceed 100% of ADTV (in lieu of the 25% condition). The manner and price of purchase conditions have not been modified.

The relief is effective at 12:01 a.m. EDT September 19th and terminates at 11:59 p.m. on October 2nd, unless extended.

September 18th Emergency Order

The actions under the emergency order of September 18th are the result of formal SEC rulemaking and go beyond the temporary short selling order issued last July, which applied only to the securities of a narrow list of financial institutions (the primary dealers) and expired on August 12, 2008.

Hard T+3 Close Out Requirement; Penalties for Violation Include Mandatory Pre-Borrow

The new rules require that short sellers and their broker-dealers deliver equity securities for clearance and settlement of long and short sales and, if there is a failure to deliver the equity security, close out the short sale transaction no later than the close of business on the settlement date (three days after the transaction date, or T+3). These new rules effectively ban “naked” short selling.

If a broker-dealer violates this “close out” requirement, it will be prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. This prohibition will apply to all short sales in the same security effected by the broker-dealer, not just future sales for the particular “naked” short seller.

The new “close out” requirement was adopted on an interim final basis, which means that the rules will be effective immediately and the SEC will seek public comments before adopting final rules.

Repeal of Exception for Market Makers from Short Selling Close Out Provisions

The SEC also approved a final rule to eliminate the options market maker exception from the “close out” requirement of Rule 203(b)(3) in Regulation SHO. As a result, options market makers will be treated in the same way as all other market participants, and required to abide by the hard T+3 “close out” requirements. This rule change will become effective five days after publication in the *Federal Register*.

Short Selling Anti-Fraud Rule

In addition, the SEC adopted a new anti-fraud rule that expressly targets short selling transactions. New Rule 10b-21 will prohibit short sellers from deceiving their broker-dealers or other market participants about their intention or ability to deliver securities in time for settlement. The new rule is effective immediately.

Further Enforcement Measures Announced September 18th

The Division of Enforcement will expand its ongoing investigations by undertaking additional enforcement measures against market manipulation. As stated by Chairman Cox, the Division of Enforcement “will obtain disclosure from significant hedge funds and other institutional traders of their past trading positions in specific securities” and such institutions “will also be required immediately to secure all of their communication records in anticipation of subpoenas for these records.”

Possible Enforcement Action

Enforcement action may also follow. The tools to combat market abuse have been in place and remain unchanged as the U.S. regulators have a range of bases on which to pursue market manipulation. The key will be access to information by regulators through greater transparency.

The SEC announced in July that it and other securities regulators would undertake examinations aimed at preventing the intentional spreading of false information to manipulate the prices of traded securities. That followed 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. An enforcement action in April was brought against a trader for securities fraud and market manipulation for intentionally disseminating false rumors. The SEC had, the previous month, reminded investment professionals, through a Section 21(a) report of investigation of an unregulated money manager, of their responsibilities under the federal securities laws and highlighted the risks of operating without an effective compliance program.

The Office of the New York Attorney General announced yesterday an investigation of short selling practices focused on short sales combined with the spreading of false rumors.

A Global Response

In its announcement today, the SEC noted that it was acting in concert with the UK Financial Services Authority (“FSA”), which took similar action. The FSA banned short sales of securities (shares, as well as investments in derivative instruments such as contracts for differences, options and depository receipts) of 29 UK financial services companies and imposed disclosure requirements of net short positions effective today through January 16, 2009.

The Swiss Federal Banking Commission also banned “naked” short sales and reminded market participants that the spreading of misleading rumors and incorrect information to the market constitutes market abuse. In a separate release later this morning, SWX Europe (a trading

platform for Swiss companies, which is located in the United Kingdom) announced that the creation of net short positions in stocks of specified financial institutions (including the institutions on the FSA's list plus Swiss financial institutions) would be considered to be covered by its rule on market integrity.

Other jurisdictions are taking action as well.

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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 the initiatives addressed in this memorandum can be directed to:

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