

SEC Issues Emergency Order to Deter Uncovered Short Sales in Certain Financial Institutions

July 17, 2008

What This Means

The SEC has issued an emergency order to deter naked short selling in the publicly traded securities of 19 specific financial services firms, including Fannie Mae and Freddie Mac (a list of the issuers is set forth below). Under the order, prior to effecting a short sale in any of the affected securities, a person must have borrowed or arranged to borrow the security, or otherwise have the security available to borrow in its inventory, and must deliver the security on the settlement date of the transaction. As such, the order extends the borrowing requirements beyond the usual "locate" requirement and requires short sellers to earmark shares for delivery under their short sales.

The order takes effect at 12:01 a.m. Eastern Time on Monday, July 21, 2008, and terminates at 11:59 p.m. Eastern Time on Tuesday, July 29, 2008, unless further extended by the SEC. The SEC's order will create additional compliance obligations for both sell-side and buy-side firms. Additional clarification of the order from the SEC and its staff is anticipated over the coming days.

Discussion and Analysis

Stricter Borrowing Requirements for Affected Securities

- Under normal circumstances, a person may effect a short sale in a security if the person has "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due." This requirement is known as the "locate" requirement.
- Under the SEC order, prior to effecting a short sale in an affected security, either the short seller or its agent will be required (1) to borrow or arrange to borrow the security, or (2) to otherwise have the security available to borrow in its inventory. As a result, prospective buy-side short sellers of one of the affected securities will have to have a "guaranteed" locate or preborrow in place and will not be able to rely on "easy to borrow" lists as they can with most other securities.
- In addition, the SEC's order requires that short sellers of the affected securities, or their agents, actually deliver the securities that are subject to the "guaranteed" locate or preborrow. This requirement may impose an obligation on lending firms to ensure that preborrows and guaranteed locates are in fact delivered out.

Practical Implications of the SEC Order

- The SEC order applies to all "publicly traded securities" of the identified financial services firms. While the order is not specific on this point, SEC staff members have advised informally that the stricter borrowing requirements apply only to the ticker symbols listed in the order and not to any publicly traded preferred stock or debt issued by the firms.

- Both short sellers (and their brokers) and stock lenders should document their “guaranteed” locates and preborrows for short sales in the affected securities.
- Broker-dealers should be cautious about accepting long sales in the affected securities where the short seller custodies the securities with another firm. If the short seller is unable to deliver the securities, the broker-dealer could be responsible for effecting a short sale in violation of the SEC order.
- SEC staff has advised informally that executing firms may rely on a representation from the customer that a short sale in an affected security is supported by a preborrow.
- Securities lending firms should document and keep track of the “guaranteed” locates or preborrows they have given so that they are able to fulfill all of their commitments to lend the affected securities. In addition, a lending firm may need to evaluate the bona fides of a locate request, particularly if a borrower gives multiple requests for “guaranteed” locates or preborrows but does not deliver out the shares or release the request.
- Perhaps most important, the SEC order creates potential enforcement liability in connection with settlement failures on short sales. Complicating compliance with the settlement delivery obligations under the emergency order is the fact that, under the continuous net settlement system in effect in the United States, a broker-dealer that effects a short sale (for itself or for a customer) may not have a specific delivery obligation in connection with that short sale if the broker-dealer has a net purchase amount for that day’s trading in the security.

Affected Securities

The SEC’s order affects short selling in the following securities:

| Financial Services Firm | Ticker Symbol |
|--------------------------------|----------------------|
| BNP Paribas Securities Corp. | BNPQF or BNPNY |
| 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 HSI |
| 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 |

To view the SEC’s order, please visit <http://www.sec.gov/rules/other/2008/34-58166.pdf>.

How Morgan Lewis Can Help

Morgan Lewis’s Broker-Dealer and Capital Markets Regulation Practices regularly advise clients on the application of Regulation SHO and are actively assisting clients with the implications of the SEC’s order. If you have any questions concerning these important legal developments, please contact any of the following Morgan Lewis attorneys:

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