



SEC Issues Emergency Order Restricting Short Sales of GSEs and Primary Dealers

On July 15, the Securities and Exchange Commission (“SEC”), in a further response to reports that certain financial services firms, including government-sponsored enterprises Fannie Mae and Freddie Mac and the parent companies of several primary dealers, have been the victims of rumors designed to drive down their stock prices and resulting large scale short-selling, issued an emergency order (the “Order”) to increase protections against such activities. According to the Order, false rumors can result in panic selling, which can be aggravated by “naked” short selling, and price declines to levels well below that which would result from normal price discovery. Where significant financial institutions are involved, this creates a risk of disrupting the markets.

Emphasizing recent false rumors that certain financial institutions are facing liquidity problems, and the threat of sudden and excessive fluctuations of securities prices that could threaten fair and orderly markets, the SEC exercised its powers under Section 12(k)(2) of the Securities Exchange Act of 1934, as amended,¹ and issued the Order. The Order states that no person may effect a short sale in any of the following securities (“designated securities”) unless the person or the person’s agent “has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting such short sale and delivers the security on settlement date” (a “pre-borrow”).

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Company	Ticker Symbol(s)
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
J. P. Morgan Chase & Co.	JPM
Lehman Brothers Holdings Inc.	LEH

1. Under Section 12(k)(2), the SEC, in an emergency, may issue an order summarily altering, supplementing, suspending, or imposing requirements or restrictions with respect to any matter or action subject to its regulation as the SEC determines necessary in the public interest and for the protection of investors.

Company	Ticker Symbol(s)
Merrill Lynch & Co., Inc.	MER
Mizuho Financial Group, Inc.	MFG
Morgan Stanley	MS
UBS AG	UBS
Freddie Mac	FRE
Fannie Mae	FNM

This is a stricter requirement than the current “locate” requirement found in Rule 203(b)(1) of SEC Regulation SHO, which permits a broker or dealer to sell short an equity security for its own account or the account of a customer provided that it has “reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.”

Because of the brevity of the Order, which simply states no person may effect a short sale in a designated security unless the person or the person’s agent has pre-borrowed the shares, a number of questions have been raised by the industry in the days since the Order was published. On July 18, the SEC issued an amendment to the Order, which clarified that:

The pre-borrow requirement does not apply 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) designated securities;
- (b) derivative securities based on designated securities, including standardized options; and
- (c) exchange traded funds of which designated securities are a component.

Broker-dealers must document compliance with the pre-borrow requirement and may use the same processes and procedures currently used to document compliance with the locate rule.

The Order does not apply to any sale by an underwriter, or any member of a syndicate or group participating in the distribution of a designated security, in connection with an over-allotment of securities, or any lay-off sale by such person in connection with a distribution of designated securities through a rights or a standby underwriting commitment.

The Order does not apply with respect to a net syndicate short position created in connection with a distribution of a designated security that is part of a fail to deliver position at a registered clearing agency 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.

The Staff of the SEC Division of Trading and Markets (the “Staff”) has indicated that it may issue an interpretive release addressing certain other questions and providing guidance with respect to compliance with the Order, which would be posted on the SEC’s website (<http://www.sec.gov>) and which may be available by the afternoon of Friday, July 18. Among the issues awaiting resolution are:

Securities Covered. Whether other securities of the issuer of a designated security (*e.g.*, a convertible preferred security) are covered.

Responsibility for Pre-Borrow. Whether an executing broker-dealer will be permitted to rely on a customer representation that a pre-borrow has been arranged, in a manner equivalent to the current treatment of such representations under the locate requirement. Also under consideration is whether, where a broker-dealer is executing a short sale in a designated security for another broker-dealer, that executing broker will be exempt from compliance

with the pre-borrow requirement based on the other broker-dealer's obligation to satisfy the pre-borrow requirement. (Equivalent to the current exemption from the locate requirement found in Rule 203(b)(2)(i).)

Arrangements to Borrow. What kind of arrangements will constitute satisfactory pre-borrow arrangements, for example, pay-to-hold or similar arrangements, reliance on securities in inventory (including pending settlements), etc.

Recycling. Whether a customer may "re-use" pre-borrowed securities if it closes a previous short position and reestablishes a new one. For example, if there is an arrangement to borrow 100 shares, a customer shorts 100 shares and the customer then buys 100 shares (eliminating the need for the pre-borrowed shares), may the customer then short another 100 shares in reliance on the original pre-borrow?

Options. The Order states that short sales effected as a result of the exercise of a put option, and short sales used to hedge option positions, are subject to the Order. An issue remains whether short positions created by "involuntary" assignments (*e.g.*, the random allocation of an exercise notice against a short call position) will be exempt from the pre-borrow requirement.

Other Issues. Other issues also may be clarified in the interpretive release including how the Order applies to transactions executed on a "riskless principal basis" and the effect of the Order and pre-borrow requirements on the segregation requirements of SEC Rule 15c3-3.

Finally, it also is important to note that, while testifying before the U.S. Senate Committee on Banking, Housing and Urban Affairs on July 15, SEC Chairman Christopher Cox announced not only that the Order was about to be issued, but also that the SEC will undertake rulemaking to address these same issues across the entire market.

The Order will take effect at 12:01 a.m. EDT on Monday, July 21, 2008, and will terminate at 11:59 p.m. EDT on Tuesday, July 29, 2008, unless further extended by the SEC.

The SEC's announcement can be found at <http://www.sec.gov/news/press/2008/2008-143.htm>

The Order can be found at <http://www.sec.gov/rules/other/2008/34-58166.pdf>

The amendment to the Order can be found at <http://www.sec.gov/rules/other/2008/34-58190.pdf>

Chairman Cox's testimony can be found at <http://sec.gov/news/testimony/2008/ts071508cc.htm>

The Financial Services Practice Group of Winston & Strawn represents a broad range of financial institutions on all regulatory matters. If you have any questions regarding the matters discussed in this Client Briefing, or if you need assistance in developing and/or reviewing systems, controls and/or procedures relating to the matters covered by the Order, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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