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A legal update from Dechert's Financial Services and White Collar and Securities Litigation Groups

SEC Issues Subpoenas, Emergency Orders to Curb Short Selling

Recent Developments

The Securities and Exchange Commission ("SEC") has recently acted to curb "naked" short selling and the intentional spreading of misinformation, practices believed by some to have contributed to the financial and market difficulties experienced by certain financial institutions.

On July 13, 2008, the SEC announced plans to cooperate with the Financial Industry Regulatory Authority and New York Stock Exchange Regulation, Inc. to determine whether broker-dealers and investment advisers have controls to prevent the intentional spreading of misinformation. The announcement followed the SEC's widely reported effort last week to serve subpoenas on a number of broker-dealers and hedge fund managers seeking information on short selling in the securities of certain financial services companies. These subpoenas may indicate the beginning of significant enforcement activity. SEC Chairman Christopher Cox told the Senate Banking Committee on July 15, 2008, that the agency is investigating whether illegal trading contributed to the increased market volatility experienced recently.

On July 15, 2008, the SEC issued an Emergency Order ("the Order") restricting naked short selling of the securities of certain financial institutions ("listed securities"), and on July 18, 2008, amended the Order to exempt short selling in connection with market making, underwriting and restricted securities. The Emergency Order precludes naked short selling in the securities of Fannie Mae, Freddie Mac, and several other large financial institutions engaged in commercial banking, investment banking, and capital markets activities.

Taken together, these developments suggest the beginning of a period of significant enforcement, regulatory, and civil litigation activity targeting illegal activity by market participants and attempting to restore greater market stability.

Short Sale Regulation and the Order

Regulation SHO, which first went into effect in January 2005, requires short sellers in all equity securities to locate securities to borrow before selling and also imposes additional delivery requirements on broker-dealers with respect to securities in which a substantial number of failures to deliver have occurred.[1]

[1] Regulation SHO was implemented in stages, with certain portions not becoming effective until October 2007. It requires broker-dealers to mark sales in all equity securities "long" or "short," defines ownership of securities, and specifies netting of broker-dealer long and short positions for certain purposes. Regulation SHO was further amended in 2007. Amendments to Regulation SHO were adopted in August 2007, with an October 15, 2007, effective date. The amendments eliminated the grandfather provision of Regulation SHO in an attempt to further reduce the number of persistent fails to deliver certain equity securities and amended the close-out requirement of Regulation SHO for certain securities that a seller is "deemed to own." The amendments also updated the market decline limitation referenced in Regulation SHO.

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Regulation SHO, like its predecessors, is intended to limit or prevent fails to deliver and the settlement risk and market disruption that results.

A short sale is generally defined as the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Rule 203(b) of Regulation SHO imposes requirements on broker-dealers stating that:

> "A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has:
>
> (i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or
>
> (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due . . ."

The SEC's Order has temporarily repealed paragraph (ii) above with respect to the 19 securities listed in the Order by stating that "no person may effect a short sale in these securities . . . unless such person or its 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." Reasonable grounds to believe that the security can be borrowed for delivery are insufficient under the Order.

The amendments to the Order issued on July 18, 2008 and the SEC guidance contained in a Q&A release of the same date addressed the following topics:

- *Market Maker Exemption.* Bona-fide market makers, including "block positioners" in the listed security (and market makers in derivatives of the listed security and ETFs where a component of the ETF is the listed security) are exempted from the Order's arrange-to-borrow requirements.[2] For example, shorting a derivative, such as an option, of a listed security is not covered by the Order, but a person who holds such an option position is otherwise prohibited by the Order from offsetting or hedging that position by shorting the listed security. The exemption for market makers permits them to short the listed securities as long as they are doing so in connection with their market-making activities.

- *Locate Procedures.* Broker-dealers do not need to change their processes and procedures used to document compliance with Rule 203(b)(1)(i)—the "locate" requirement, and for purposes of documenting any reliance on customer assurances that such customer has obtained or arranged a pre-borrow from another source (discussed further below), broker-dealers can employ the same methodology used currently to document locates.

- *Arrangements to Borrow.* An "arrangement to borrow" means a bona fide agreement to borrow the security whereby the security being borrowed is set aside at the time of the arrangement solely for the person requesting the listed security. For example, a valid arrangement to borrow is a contractual commitment (or a return demand under a stock loan agreement) to borrow the security. It is not sufficient to have "reasonable grounds to believe" the security can be borrowed for delivery.

- *Reliance on Customer Assurance.* A broker-dealer effecting a short sale for a customer with regard to a listed security may rely upon an assurance from the customer that the customer has borrowed or arranged to borrow the security from another identified source, provided the broker-dealer documents its reliance on the customer's assurance and that the broker-dealer has reasonable grounds to believe that the customer has borrowed or arranged to borrow the security.

- *Customers are Subject to the Order.* All market participants, including customers, are subject to the Order. Investment advisors are subject to the Order and may not enter a short sale trade unless they have made arrangements to borrow. While SEC guidance has not said so expressly, this should mean that a customer need not deliver the securities to the executing, clearing, or prime broker prior to entering a short sale, thereby preserving customary institutional receipt-versus-payment and delivery-versus-payment practices, but the customer must have made an "arrangement to borrow" and communicated sufficient information about that arrangement to permit the broker to document the arrangement.

- *Offshore Trades.* The Order applies to any short sale transaction in the listed securities if the short sale is agreed to in the United States, even if the trade is booked overseas. The Order also applies to any short sale of a listed security involving a

[2] Bona fide market makers include market makers in the listed securities, derivative securities of the listed securities, including standardized options, and ETFs of which any of the listed securities are a component.

customer located in the United States as well as any broker-dealer who uses any means or instrumentalities of interstate commerce in the U.S. to effect short sales of one of the listed securities. Therefore, customers, portfolio managers and others located in the U.S. may not agree to or enter short sales in violation of the Order on a foreign market. The SEC so far has not provided guidance on whether a short sale in the same security traded on a foreign market under a different ticker symbol than the listed ticker symbols is prohibited by the Order. The SEC has indicated that further guidance is forthcoming.

- *Underwritten Offerings and Restricted Securities.* The Order does not apply to short sales of the listed securities effected pursuant to Rule 144 or underwriters or members of a syndicate or group participating in distributions of the relevant securities in connection with an over-allotment of securities, or any lay-off sale through a rights or a standby underwriting commitment.

- *Reallocating Borrowed Securities.* If a person has borrowed or arranged to borrow a listed security prior to effecting a short sale in that security, the borrow or arrangement-to-borrow may be reapplied by that person's broker-dealer to short sales following a buy-to-cover trade in that same security on the same trading day. In other words, securities either bought or borrowed need not be applied to the particular short sale originally contemplated to be covered by either borrowed or long stock.[3]

Effects of the Order on Stock Lending

If a security identified in the Order is out on loan when a portfolio manager enters a sell order and the securities lending agent is not notified either prior to or at the time the sell order is placed, it appears that such a circumstance may be inconsistent with the requirements of the Order because the securities that are the subject of the sell order are neither long nor subject to an arrange-to-borrow. In a securities lending arrangement, title to the security passes to the borrower and portfolio managers are often unaware of which portfolio securities are out on loan.[4] Therefore, a sale order for a listed security that is out on loan would likely be deemed a short sale. While the SEC has not specifically commented on securities lending in the context of the Order, fund complexes with securities lending arrangements may wish to consider these implications and implement procedures to ensure that a lending agent is notified to recall a loaned security (if the security is listed in the Order) prior to or simultaneously with a portfolio manager's sale order to avoid running afoul of the SEC Order.

Expiring In-the-Money Options

Another effect of the Order on broker-dealer operations is the effect of the pre-borrowing requirement on listed options expiring in the money, which will next occur in mid-August. For example, with an expiring in-the-money put option in one of the listed securities, under the SEC guidance broker-dealers are required to pre-borrow the underlying security in order to ensure its availability for delivery in anticipation of exercise on expiration. A broker-dealer that does not pre-borrow (or otherwise fails to identify and segregate pre-borrowed shares to comply with the SEC's advice on compliance with 15c3-3 possession and control requirements—see Footnote 3 above), and delivery to settle the exercise fails, may have violated the Order.

Manipulation and Rumors

The SEC investigates and prosecutes market manipulation under several statutes, including the general antifraud provisions of Section 10(b) of the Securities and Exchange Act of 1934. Most of these statutes require the SEC to prove that the defendants acted with *scienter*, which is an intent to engage in illegal conduct or a conscious disregard of the legality of the conduct. Criminal prosecutors must meet an even higher

[3] FINRA published Notice to Members 08-38 July 23, 2008, clarifying the effect of the pre-borrow requirements of the Order in connection with the possession or control requirements of Rule 15c3-3. FINRA said that it had been advised by the SEC staff that a broker-dealer may use pre-borrowed shares to meet its delivery obligation under the Order, without regard to the whether a possession and control deficit exists at the time of delivery by: (1) identifying in its books and records that the securities to be delivered have been borrowed to complete the short sales; and (2) the borrowed shares may not be commingled with other customer or proprietary positions and must be distinguished from other securities lending transactions. These conditions are two of six conditions imposed by the SEC on conduit business in a 1991 no-action letter.

[4] Additionally, it should be noted that the SEC Staff has taken the position that the loan of a security in a securities lending transaction is treated as a "sale" under Section 17(e) of the 1940 Act. *See, United Services Funds* (pub. avail. Apr. 23, 1993); and *Norwest Bank, N.A. Society National Bank* (pub. avail. May 25, 1995).

standard and must prove that the defendants had a specific intent to violate the law.

It is very difficult for the SEC and other securities regulators to meet these standards in the context of an alleged market manipulation, especially where the market for a company's stock is relatively liquid and the company has substantial capitalization. (After all, it is hard to prove that someone intended to manipulate a stock when, from an economic perspective, it is highly unlikely that they would have success.) As a result, the SEC and criminal prosecutors have brought relatively few securities manipulation cases.[5] Where they have, most successful prosecutions have involved situations where the dissemination of false rumors about a company accompanied overt manipulative acts, such as "wash-trades" (non-arms-length transactions designed to create an appearance of market activity) or "marking the close" or "painting the tape" (end-of-the-day trades at incrementally higher or lower prices, designed to gradually create an appearance of heightened or decreased demand).

This is not to say that it is unheard of for the SEC to institute successful enforcement actions alleging market manipulation of the stock of a well capitalized company solely through the dissemination of false rumors. In April 2008, a former Schottenfeld Group LLC trader settled claims that he spread rumors in November 2007 that Blackstone Group LP was lowering a takeover bid for Alliance Data Systems Corp.[6] But even in that case, the defendant's conduct was not very sophisticated: he allegedly disseminated the rumor through a large number of instant messages at the same time that he was personally short-selling the target company's stock. Nevertheless, "more of these cases have to be brought," Chairman Cox said in his recent Congressional testimony. He added that, historically, "it has been difficult to parse where rumors start and where they are being spread." Now, technology is "permitting us to trace back through e-mails and instant messages to the very individuals who have manufactured intentionally false information," he said.

There are also a variety of potential private claims arising out of alleged securities manipulation by short sellers. Section 10(b) of the Securities Exchange Act prohibits the use of any "manipulative or deceptive device" in connection with the purchase or sale of a security and market manipulation claims are derived from this prohibition. Manipulation is a term of art that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[7] The legal standard for market manipulation varies based on jurisdiction.[8] In addition, there have been several lawsuits brought in state courts against hedge funds and analysts which have asserted claims under state RICO and unfair competition statutes, as well as for intentional torts such as tortious interference and commercial disparagement.

Conclusion

The recent burst of activity by regulators in response to the credit crisis and upheavals in the financial sector is not likely to abate any time soon. Indeed, it may prove to be the catalyst for fundamental reforms to U.S. and worldwide financial markets embodied in recent proposals to modify regulatory structures and improve risk management while simultaneously reducing barriers to globalized financial markets.

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5 *See* Steve Thel, *$850,000 in Six Minutes – The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219, 291 (January, 1994); William R. McLucas & Alma M. Angotti, *Market Manipulation*, 22 Rev. Sec. & Commodities Reg. 103, 111, 633 n. 1 (1989).

6 *SEC v. Paul S. Berliner*, Civil Action No. 08-CV-3859 (JES)(SDNY)(April 24, 2008).

7 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

8 *Compare Schnell v. Conseco, Inc.,* 43 F. Supp 2d 438, 448 (S.D.N.Y. 1999) *and Global Intellicom v. Thomas Kernaghan & Co.*, 1999 WL 544708, 7 (S.D.N.Y. July 27, 1999) *with GFL Advantage Fund Ltd. V. Colkitt*, 272 F.3d 189 (3d Cir. 2001)

Practice group contacts

For more information, please contact one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices or www.dechert.com/securities.

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

William K. Dodds
New York
+1 212 698 3557
william.dodds@dechert.com

Paul Huey-Burns
Washington
202 261 3433
paul.huey-burns@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

David A. Kotler
Princeton
+1 609 955 3226
david.kotler@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Gary J. Mennitt
New York
+1 212 698 3831
gary.mennitt@dechert.com

Alison Ryan
Newport Beach
+1 949 442 6006
alison.ryan@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Dechert LLP

www.dechert.com

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