

Client Alert

A report
for clients
and friends
of the Firm July 2008

SEC Takes Aggressive Action to Control Short Selling and the Spread of False Rumors

In rapid succession over a three-day period, the Securities and Exchange Commission ("SEC") has taken drastic measures to protect investors and stabilize U.S. markets by issuing an emergency order limiting "naked" short selling, by issuing 50 subpoenas to hedge funds to obtain documents concerning market manipulation through the spread of false rumors in Bear Stearns' and Lehman Brothers' securities, and by announcing that the SEC would immediately conduct industry "sweep" examinations of broker-dealers and investment advisors to determine whether they had adequate supervisory and compliance controls and training to prevent the spread of false information intended to cause market manipulation.

SEC Issues Emergency Order to Curtail Short Selling the Shares of Fannie Mae, Freddie Mac and 17 Other Financial Institutions

On Tuesday, July 15, 2008, the SEC, citing growing investor concerns, issued an emergency order to curtail short sales of securities of Fannie Mae, Freddie Mac and seventeen other major financial institutions.

Exercising its emergency powers under Section 12(k)(2) of the Securities Exchange Act of 1934, the SEC's emergency order limits the practice of "naked" short selling by requiring traders to "pre-borrow" shares to cover a short sale. In particular, the emergency order prohibits a person from effecting a short sale of shares of Fannie Mae and Freddie Mac, as well as the seventeen other entities, "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."

In contrast to permissible short selling which involves sales of securities that a trader either owns or arranges to borrow before a settlement date, "naked" short selling involves the sale of securities without having the shares in hand to cover the short position or otherwise intending to have such shares by settlement date.

Although "naked" short selling is illegal if there is no ability or intent to provide the requisite covering shares by the settlement date, it nonetheless is a pervasive trading practice that often goes undetected. The SEC hopes that its emergency order will curb manipulative, "naked" short selling that the Commission believes has undercut the stability of financial institutions and undermined investor confidence in U.S. markets. According to the SEC, this practice has created "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."

In addition to Fannie Mae and Freddie Mac, the seventeen other firms included in the SEC's emergency order are:

- BNP Paribas Securities Corp.
- Bank of America Corporation
- Barclays PLC
- Citigroup Inc.
- Credit Suisse Group
- Daiwa Securities Group Inc.
- Deutsche Bank Group AG
- Allianz SE
- Goldman Sachs Group Inc.
- Royal Bank ADS
- J.P. Morgan Chase & Co.
- Lehman Brothers Holdings Inc.

- Merrill Lynch & Co.
- Mizuho Financial Group, Inc.
- Morgan Stanley
- UBS AG

The SEC's emergency order takes effect on July 21, 2008 at 12:01 a.m. and will terminate on July 29, 2008 at 11:59 p.m. The SEC can extend the order, but for no more than thirty days in total duration.

SEC Subpoenas 50 Hedge Fund Advisers

On Monday, July 14, 2008, the SEC also announced that it had issued subpoenas to more than 50 hedge funds as part of a probe into whether financial advisers may have spread false rumors in connection with the alleged manipulation of Bear Stearns' and Lehman Brothers' shares. The subpoenas seek documents concerning communications and trading data relating to short selling and options trading of shares in these two investment banks.

Dissemination of false rumors can negatively affect an issuer's stock price, thus creating a situation in which short sellers can take advantage of an artificial decline in price. The SEC is investigating whether such false rumors caused the collapse of Bear Stearns and the drastic decline in the price of Lehman Brothers' shares. As described by the SEC, "[d]uring the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns' stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week."

SEC Cracks Down on Spread of False Rumors That Manipulate Securities Prices

On Sunday, July 13, 2008, before the Monday morning opening of the markets in Asia, the SEC took the unusual step of announcing that it would immediately conduct industry "sweep" examinations "aimed at the prevention of the intentional spread of false information intended to manipulate securities prices." These examinations are in addition to the SEC enforcement investigations into alleged intentional manipulation through rumor-mongering and abusive short selling already underway. The next day, in an interview with Bloomberg News, SEC Chairman Cox commented that reliable information is vital to market confidence, and thus, these examinations "are aimed at ensuring that investors continue to get reliable, accurate information about public companies in the marketplace."

In April of this year, the SEC brought the first case of its kind against a Wall Street trader for the spreading of false rumors. *See SEC v. Paul Berliner*, No. 08-CV-3859 (JES) (SDNY), SEC Litigation Rel. No. 20537 (April 24, 2008).

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For more information, please contact:

Thomas V. Sjoblom
 202.416.5805 – tsjoblom@proskauer.com
 New York – 212.969.3110

Gregg M. Mashberg
 212.969.3450 – gmashberg@proskauer.com

Ronald E. Wood
 310.284.5660 – rwood@proskauer.com

Scott J. Carpenter
 202.416.5825 – scarpenter@proskauer.com

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