

# FALLING SHORT: HAS THE SEC’S QUEST TO CONTROL MARKET MANIPULATION AND ABUSIVE SHORT-SELLING COME TO AN END, OR HAS IT REALLY JUST BEGUN?

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## I. BACKGROUND

### A. Brief Introduction

Despite continued attempts by regulators to curtail abusive short-sales and increase transparency, the pattern and practice of fraudulent manipulation continues to proliferate and threaten the capitalization of a wide variety of issuers within the securities market. Identifying a meaningful resolution requires analyzing capital market objectives and addressing the inequities of our current regulatory scheme.

### B. Capital Market Objectives

The key attribute of a sophisticated capital market system is overall market efficiency.<sup>1</sup> In an efficient market, the price of a security generally

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reflects all current public and private information that is available to investors.<sup>2</sup> Since all market participants are privy to the same information, no investor has the ability to significantly outperform another.<sup>3</sup> Market efficiency requires a delicate balance of two critical elements. The first element, informational efficiency, is defined as the speed and accuracy with which prices in the market reflect new information.<sup>4</sup> The second element, price continuity, is a characteristic of a liquid market whereby the price movements between transactions are relatively small as a result of the large number of buyers and sellers of a security.<sup>5</sup>

An efficient market functions optimally when both of these ends operate in unison. The market value of securities would reflect the present value of expected future cash flows and revaluation would occur as new information is produced and disseminated.<sup>6</sup> The U.S. Supreme Court effectively affirmed this concept in 1988 when it held:

With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.<sup>7</sup>

The relationship between informational efficiency and price continuity allows valuation to reach new highs or lows in a methodical manner while maintaining confidence and liquidity within the market.<sup>8</sup> The sustained liquidity would result in low transaction costs, reduced risk and a nominal market rate of return for investors.<sup>9</sup> Issuers of securities within the

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<sup>1</sup> See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

<sup>2</sup> See *Id.* at 383.

<sup>3</sup> See Jay Shanken & Clifford W. Smith, *Implications of Capital Markets Research for Corporate Finance*, 25 FIN. MGMT., 98, 98 (1996).

<sup>4</sup> See Douglas M. Branson, *Nibbling at the Edges—Regulation of Short Selling: Policing Fails to Deliver and Restoration of an Uptick Rule*, 65 BUS. LAW. 67, 75 (2009).

<sup>5</sup> See *Id.*

<sup>6</sup> See Shanken & Smith, *supra* note 3, at 99.

<sup>7</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 244 (1988).

<sup>8</sup> See Douglas M. Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy and the Individual Investor*, 75 NW. U. L. REV. 857, 896-97 (1980).

<sup>9</sup> See Yakov Amihud & Haim Mendelson, *Liquidity, Asset Prices and Financial Policy*, 47 FIN. ANALYSTS J., 56, 56-57 (1991).

market would experience stable asset pricing, which is of particular importance in the capital budgeting process as the issuers strive to meet their operating capital obligations and maintain solvency.<sup>10</sup> Moreover, the liquidity would offer issuers quick access to capital and preferential financing opportunities to grow or downsize their businesses as they deem appropriate.

Imbalances in the relationship between informational efficiency and price continuity may have detrimental effects on the market. An overabundance or dearth of information would cause prices to move quickly and erratically, often revaluing securities some distance away from a previous equilibrium.<sup>11</sup> The resulting volatility would increase risk and transaction costs, and reduce liquidity as more investors exit the market in search of more stable investment opportunities.<sup>12</sup> Issuers would be faced with a higher cost of capital, as risk-averse investors require higher expected returns to match the increased risk.<sup>13</sup> These factors may interfere with the issuers' ability to raise capital to meet their operating obligations and remain solvent, as well as their capacity to obtain favorable financing opportunities.<sup>14</sup> Accordingly, while informational efficiency and price continuity often work at cross-purposes, a degree of both is necessary for overall market efficiency.<sup>15</sup>

### C. Short-Selling

The securities market is made up of buyers and sellers – all of whom utilize various strategies to effectuate transactions and maximize their return. Among these strategies is the short-sale, which is generally defined by the SEC as the sale of a security that the seller does not own but has borrowed for delivery to the buyer.<sup>16</sup> In a short-sale, the investor speculates that the price of a particular security will decline and subsequently proceeds to borrow the stock from a broker or institutional investor for sale in the market at its present value.<sup>17</sup> If the price falls as predicted, the seller can purchase an equivalent security at the lower price from the market, return it

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<sup>10</sup> See Shanken & Smith, *supra* note 3, at 101.

<sup>11</sup> See Branson, *supra* note 4, at 74-76.

<sup>12</sup> See *Id.*

<sup>13</sup> See Amihud & Mendelson, *supra* note 9, at 56.

<sup>14</sup> See Zachary T. Knepper, *Future Priced Convertible Securities and the Outlook for "Death Spiral" Securities Fraud Litigation*, 26 WHITTIER L. REV. 359 (2004).

<sup>15</sup> See Branson, *supra* note 4, at 74-76.

<sup>16</sup> See SEC Rule 200(a) of Regulation SHO, 17 C.F.R. § 242.200(a) (2011).

<sup>17</sup> See Alexis Brown Stokes, *In Pursuit of the Naked Short*, 5 N.Y.U. J. L. & BUS. 1, 3 (2009).

to the lender, and keep the difference as profit.<sup>18</sup> Although short-selling poses obvious risks to the seller, it is a legitimate trading strategy regulated by the SEC and a practice generally endorsed for its positive effects on securities markets.<sup>19</sup>

Short-selling facilitates market efficiency by increasing liquidity and the number of sellers in the market at any given time.<sup>20</sup> The increase in liquidity occurs when market makers and other market specialists use short-sales to offset temporary imbalances in the supply and demand of a security.<sup>21</sup> The added selling interest makes more shares available to purchasers and lowers the risk that the price paid for the shares will be artificially high due to a temporary shortage in the available supply of shares.<sup>22</sup> The increase in liquidity also occurs when investors purchase securities to cover the shares borrowed from lenders in a short-sale transaction.<sup>23</sup>

In addition to increasing market liquidity, short-selling also improves informational efficiency by informing the market of the trader's selling interest and reflecting the short-seller's prediction of the security's lower future value within its current market price.<sup>24</sup> The subsequent variation in buying and selling interests is precisely the type of information that affects the present value of the security.<sup>25</sup> Short-selling provides investors with an incentive to seek out inefficient or corrupt companies and bet against them, contributing to the exposure of firms like Enron and WorldCom.<sup>26</sup> In 2007, the Second Circuit Court of Appeals held that short-selling can help move the market price of an overvalued stock toward its true value, thus creating a more efficient marketplace in which stock prices reflect all available information about the stock's economic value.<sup>27</sup> Accordingly, short-selling can be a beneficial market correction device that identifies weak and fraudulent companies as well as those that are overvalued so as to prevent wasteful allocation of resources and provide for a liquid and efficient market.

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<sup>18</sup> See Branson, *supra* note 4, at 74-76.

<sup>19</sup> See James W. Christian, Robert Shapiro & John-Paul Whalen, *Naked Short Selling: How Exposed are Investors?*, 43 HOUS. L. REV. 1033, 1042 (2006).

<sup>20</sup> See Knepper, *supra* note 14, at 369.

<sup>21</sup> See *Id.*

<sup>22</sup> See *Id.*

<sup>23</sup> See Exchange Act Release No. 48,709 (Oct. 28, 2003), 68 Fed. Reg. 62,972, 62,974 (Nov. 6, 2003) ("Short Selling").

<sup>24</sup> See Christian et al., *supra* note 19, at 1043.

<sup>25</sup> See Exchange Act Release No. 48,709, *supra* note 23.

<sup>26</sup> See Matt Taibbi, *Wall Street's Naked Swindle*, ROLLING STONE, Oct. 2009, available at <http://www.rollingstone.com/politics/news/wall-streets-naked-swindle-20100405>.

<sup>27</sup> See *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101 (2d Cir. 2007).

#### D. Manipulation and Deception

The benefits of short-selling come at a high price as the practice may be abused to manipulate the market. Abusive short-sellers often create and exploit inefficiencies in the market to exceed the nominal market rate of return on their investments.<sup>28</sup> The U.S. Supreme Court has long recognized market manipulation and defined the process as intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>29</sup> The manipulation often manifests itself in cases where short-sellers spread false market rumors about the issuer to perpetuate the decline in value of a particular security in order to maximize their profits.<sup>30</sup> This practice can be especially dangerous in large-scale scenarios called “bear raids,” where groups of traders take a short position in the stock of a particular corporation pursuant to an express or implied agreement with the intention of reducing the market price enough to trigger stop-loss orders placed by investors and institutions with long positions in the stock.<sup>31</sup> As the overwhelming number of sell orders cascade into the market, the stock price continues to spiral downward while the short-sellers realize tremendous profits.<sup>32</sup> Although bear raids are difficult to detect, there is now evidence that they have occurred in several large companies, affecting not only investors in those companies, but also obstructing market confidence over a relatively broad horizon.<sup>33</sup>

#### E. Naked Short-Selling

The naked short-sale is a perverse variation of the short-sale that has been increasingly scrutinized by regulators for its ability to dilute and depress markets – particularly when used in conjunction with manipulative trading tactics.<sup>34</sup> It is identical to the traditional short-sale at the outset of the transaction because both are motivated by the speculated decline in price of

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<sup>28</sup> See David Weidner, *Hedge Funds Back Under Fire*, MARKETWATCH (Mar. 10, 2011), <http://www.marketwatch.com/story/pequot-probe-may-serve-as-warning-to-hedge-fund-industry>.

<sup>29</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

<sup>30</sup> See George H. White, *Short Sale Restrictions: SEC Releases Short Sale Rule Proposals and Seeks Comments on Price Test and Circuit Breaker Proposals*, 1783 PLI/Corp 155, \*158 (2010).

<sup>31</sup> See Branson, *supra* note 4, at 75.

<sup>32</sup> See *Id.*

<sup>33</sup> See *Id.*

<sup>34</sup> See Gary Matsumoto, *Naked Short Sales Hit Fraud in Bringing Down Lehman*, BLOOMBERG (Mar. 10, 2011), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB1jlqmFOTCA>.

a particular security.<sup>35</sup> However, the transactions are distinguished by the fact that the naked short-seller does not borrow or arrange to borrow the securities from a lender in time to make delivery to the buyer within the standard three-day settlement period required by the SEC.<sup>36</sup>

The SEC generally requires the short-seller to deliver securities to the buyer within three days from the date of sale to settle or “cover” the transaction.<sup>37</sup> This is known as the close-out requirement.<sup>38</sup> Settlement is regulated because brokers and investors are exposed to more market risk as the length of time between trade execution and trade settlement increases.<sup>39</sup> Settlement is of particular importance to the parties because it allows the short-seller to be paid and the buyer to receive legal and equitable title to the securities and all rights therein – including voting rights and the right to receive dividend payments.<sup>40</sup> The SEC defers to the Depository Trust and Clearing Corporation (DTCC) for settlement oversight.<sup>41</sup> The DTCC maintains custody of the physical securities and effectuates settlement between the parties through a change in electronic records.<sup>42</sup> When the short-sale is not covered within the three-day settlement period it is effectively “naked” and classified by the DTCC as a failure-to-deliver (FTD) until the short-seller delivers the shares.<sup>43</sup> In the interim, the DTCC proceeds to credit the buyer with equitable title through a security entitlement to the undelivered shares,<sup>44</sup> commonly referred to as FTDs, which the buyer may hold or trade in place of the actual securities.<sup>45</sup>

The basis of the naked short-selling dilemma is the independent value and alienability of the FTDs. The market makes no distinction between the undelivered securities and the FTDs.<sup>46</sup> The most logical explanation for this indifference is that the naked short position divides the ownership interest of the securities between the buyer and the lender from whom the short-seller

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<sup>35</sup> See Stokes, *supra* note 17, at 3.

<sup>36</sup> See Exchange Act Release No. 57511 (Mar. 17, 2008), 73 Fed. Reg. 15,376 (Mar. 21, 2008) (“Anti-Fraud Rule”).

<sup>37</sup> See Rule 204 of Regulation SHO, 17 C.F.R. § 242.204 (2011).

<sup>38</sup> See *Id.*

<sup>39</sup> See 15 U.S.C. § 78q-1(a)(1)(A)-(D) (2011).

<sup>40</sup> See James J. Angel & Douglas M. McCabe, *The Business Ethics of Short Selling and Naked Short Selling*, 85 J. BUS. ETHICS, 239, 241 (2009).

<sup>41</sup> See SEC Rule 17(a) of Exchange Act, 17 C.F.R. § 242.17(a).

<sup>42</sup> See Christian et al., *supra* note 19, at 1050 (2006).

<sup>43</sup> See Stokes, *supra* note 17, at 6.

<sup>44</sup> See Angel & McCabe, *supra* note 40, at 242.

<sup>45</sup> See *Id.* at 6-7.

<sup>46</sup> See *Id.* at 7.

would obtain shares.<sup>47</sup> The buyer holds equitable title by virtue of the FTDs while the lender retains legal title through possession of the securities.<sup>48</sup> Accordingly, the two ownership interests may be freely traded and circulated within the market until the naked short-seller covers, after which legal title would transfer to the buyer. The significance is that the undelivered securities and FTDs may be in circulation for an indefinite period of time, and there is no limit to naked short-interest or the extent of FTDs in circulation.<sup>49</sup> In extreme cases of naked short-selling, the amount of shares sold could exceed the amount of the issuer's public float.<sup>50</sup> This would dilute the market with FTDs and create an artificial oversupply of the security akin to the overprinting of currency. There would be an increase in the security's circulation but no increase in the underlying assets upon which its value is based. Accordingly, the dilution by prolonged FTDs would significantly reduce share value and create numerous challenges for the issuer as it struggles to obtain capital and meet its operating obligations until the naked short position is covered.<sup>51</sup>

The extent to which naked short-selling occurs continues to be the subject of significant debate. Current short-sale volume overshadows that which existed prior to the adoption of recent regulation and repeal of longstanding rules.<sup>52</sup> The DTCC does not typically release information on FTDs, but in 2005 it reported FTDs in 1/10 of 1 percent of all transactions settled and processed by the DTCC – accounting for approximately \$6 billion daily.<sup>53</sup> Many market participants believe that short-selling is a contributor to the volatility that exists in the markets today.<sup>54</sup>

It is important to note that not all FTDs are the result of manipulative naked short-selling.<sup>55</sup> The Federal Reserve Bank of New York has stated that FTDs occur for a variety of reasons, including misunderstandings between traders over transaction details, technical problems and “daisy chain” reactions in which one FTD prevents a subsequent delivery.<sup>56</sup> These

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<sup>47</sup> See Knepper, *supra* note 14, at 373.

<sup>48</sup> See *Id.*

<sup>49</sup> See Stokes, *supra* note 17, at 7.

<sup>50</sup> See Peter Koh & Helen Avery, *Naked Shorting: The Curious Incident of the Shares that Didn't Exist*, EUROMONEY (Mar. 10, 2011), <http://www.euromoney.com/Article/1001047/Naked-shorting-The-curious-incident-of-the-shares-that-didnt-.html>.

<sup>51</sup> See Stokes, *supra* note 17, at 7.

<sup>52</sup> See Branson, *supra* note 4, at 69-70.

<sup>53</sup> See Angel & McCabe, *supra* note 40, at 241.

<sup>54</sup> See Branson, *supra* note 4, at 70.

<sup>55</sup> See Angel & McCabe, *supra* note 40, at 242.

<sup>56</sup> See Michael J. Fleming & Kenneth D. Garbade, *Explaining Settlement Fails*, 11 CURRENT ISSUES IN ECON. & FIN., no. 9, Sept. 2005, at 2-3, available at [http://www.newyorkfed.org/research/current\\_issues/ci11-9.pdf](http://www.newyorkfed.org/research/current_issues/ci11-9.pdf).

erroneous FTDs do not violate SEC regulations. They have a minimal effect on the market because they are quickly settled upon discovery.<sup>57</sup>

In contrast, the prolonged FTDs caused by manipulative naked short-selling are unethical and illegal.<sup>58</sup> They challenge the efficient operation of capital markets and create significant obstacles for the distressed and/or undercapitalized companies therein.

#### F. Effects of Market Manipulation and Naked Short-Selling

The economic effects of market manipulation and naked short-selling pose a viable threat to the securities market. Small companies with limited capital are especially vulnerable to manipulation and abusive short-selling. The ability of a naked short-seller to diminish the value of stock is amplified in smaller markets that operate with reduced liquidity and higher transaction costs.<sup>59</sup> The subsequent decline in value can impair the company's ability to attract investors, raise capital, and negotiate financing.<sup>60</sup> In these situations and in the absence of other options, the company will reluctantly obtain future-priced convertible financing, commonly known as "toxic" or "death spiral convertible" financing, under which capital is accepted on unfavorable terms.<sup>61</sup> The lender acquires the contractual right to convert the debt into a fixed value of the issuer's stock at some future date for a variable, discounted market price.<sup>62</sup> For example, if the future-priced security is convertible into \$10 million of common stock at some future date, the lender would receive one million shares if the borrower's common stock is valued at \$10 per share or ten million shares if the borrower's common stock is valued at \$1 per share.<sup>63</sup> The lender will receive more shares and gain a greater share of control of the borrower's company upon conversion if the stock price is lower. Accordingly, the lender is motivated to encourage or participate in manipulation and naked shorting of the company's stock – which could push the company into insolvency and eliminate investors.

The collateral damage from death spiral convertibles and manipulative naked short-selling can be devastating. According to former Under Secretary of Commerce, Robert Shapiro, naked short-selling has caused one thousand companies to collapse and cost investors nearly \$100

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<sup>57</sup> See Christian et al., *supra* note 19, at 1045.

<sup>58</sup> See SEC Rule 10(b) of Exchange Act, 15 U.S.C. § 78j; SEC Rule 10b-5 of Exchange Act, 17 C.F.R. § 240.10b-5; and SEC Rule 17(a) of Securities Act, 15 U.S.C. § 78c.

<sup>59</sup> See Christian et al., *supra* note 19, at 1059.

<sup>60</sup> See Stokes, *supra* note 17, at 7.

<sup>61</sup> See Knepper, *supra* note 14, at 362.

<sup>62</sup> See *Id.*

<sup>63</sup> See *Id.*



billion since 1997.<sup>64</sup> It destroyed companies that could have made valuable contributions to the economy through technology and employment and eliminated investors' savings and retirement accounts.<sup>65</sup> In 2003, the SEC settled a civil action against the Rhino Advisors investment firm and its President, Thomas Badian, in connection with allegations of manipulative short-selling of Sedona common stock to enhance their client's economic interest in a future-priced convertible instrument.<sup>66</sup> The complaint, filed by the SEC in a related proceeding against agents of the lender, alleged that defendants were ordered to short-sell massive amounts of Sedona stock with "unbridled levels of aggression" until it collapsed.<sup>67</sup> The complaint further alleged that short-selling accounted for 40 percent of all trading activity in the stock.<sup>68</sup> Small companies are often affected by a great deal of manipulation and naked short-selling within the small-cap market. This is a significant policy issue because these practices limit the growth of our economy and prevent legitimate companies from developing.

The plight of these smaller companies has drawn little concern from mainstream market commentators because many small and micro-cap companies are often revealed to be overvalued and/or fraudulent.<sup>69</sup> Some commentators argue that the overvalued micro-cap stocks during the dot-com bubble would have climbed even higher but for the practice of naked short-selling.<sup>70</sup>

The practice has been under increased scrutiny since manipulative short-sellers broadened their horizons to prey on larger companies. Overstock.com, an internet retailer, has become an icon for its campaign against naked short-selling.<sup>71</sup> The company alleges that naked short-sellers reduced its share price by 77 percent in less than two years.<sup>72</sup> Moreover, the company's trading volume has reached four to five times its float on distinct occasions.<sup>73</sup> CEO Patrick Byrne has stated that naked short-selling warps the

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<sup>64</sup> See Christian et al., *supra* note 19, at 1040.

<sup>65</sup> See *Id.*

<sup>66</sup> See *Rhino Advisors and Thomas Badian Settle Claims and Agree to Pay Jointly a \$1 Million Penalty*, SEC Litigation Release No. 18003, 2003 SEC LEXIS 461 (Feb. 27, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18003.htm>.

<sup>67</sup> See Complaint, SEC v. Andreas Badian et al., No. 06 Civ. 2621 (S.D.N.Y. Apr. 4, 2006), available at <http://www.sec.gov/litigation/complaints/2006/comp19639.pdf>.

<sup>68</sup> See *Id.*

<sup>69</sup> See Stokes, *supra* note 17, at 10.

<sup>70</sup> See *Id.*

<sup>71</sup> See *Id.* at 11.

<sup>72</sup> See *Id.* at 12.

<sup>73</sup> See *Id.*

price of small-cap companies and destroys American entrepreneurship.<sup>74</sup> Byrne has been a very active supporter of naked short-sale restrictions. In 2006, the state of Utah passed a law that allowed local companies like Overstock.com to collect fees from brokerage firms that failed to disclose when they could not deliver securities to the buyer.<sup>75</sup> However, immediately after its passage the Securities Industry and Financial Markets Association (SIFMA) filed a claim alleging violation of federal law on the basis of preemption.<sup>76</sup> The Utah legislature eventually repealed the law and settled the claim in 2007.<sup>77</sup>

The events surrounding the financial crisis of 2008 demonstrated that large corporations are not immune to the hazardous economic effects of market manipulation and naked short-selling. On March 11, 2008, approximately \$1.7 million was invested on a series of options betting that shares of Bear Stearns & Co., a well-respected American investment bank, would lose more than half their value within nine days.<sup>78</sup> In less than one week, the number of FTDs in Bear Stearns increased nearly seventy-fold while negative rumors in the media concerning the bank's creditworthiness spawned panic.<sup>79</sup> By March 17, 2008, Bear Stearns stock had fallen from \$62.97 to \$2 per share as regulators facilitated the sale of the formerly glorified investment bank to JPMorgan Chase & Co.<sup>80</sup> Senator Edward E. Kaufman publicly admitted having no doubt that naked short-selling helped destroy Bear Stearns,<sup>81</sup> and former SEC Counsel Brent Baker argues that the large number of FTDs over the course of the week amounted to one of the most obvious cases of stock manipulation in Wall Street history.<sup>82</sup>

Following the crash of Bear Stearns stock in March 2008 and concerns about deteriorating stock prices at other major financial institutions later in the summer, regulators sought to introduce new restrictions on short-selling and increase their commitment to investigating naked short-sales.<sup>83</sup> Unfortunately, their efforts were too late to stabilize the system. Within six

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<sup>74</sup> See Bob Drummond, *Games Short Sellers Play*, BLOOMBERG MARKETS, Sept. 2006, at 120, 122, available at <http://www.buyins.net/articles/gamesshortsellersplay.pdf>.

<sup>75</sup> See Christopher M. Salter & Christopher F. Chase, *Short Selling and Naked Shorts in the Regulation SHO Environment*, 1617 PLI/Corp 289, \*303-305 (2007).

<sup>76</sup> See *Id.* at 304.

<sup>77</sup> See *Id.*

<sup>78</sup> See Taibbi, *supra* note 26.

<sup>79</sup> See *Id.*

<sup>80</sup> See *Id.*

<sup>81</sup> See Press Release, Sen. Edward F. Kaufman, Kaufman Turns Up Heat on SEC to Curb Abusive Short Sales, (June 25, 2009) (on file with author).

<sup>82</sup> See Taibbi, *supra* note 26.

<sup>83</sup> See Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225, 253 (2009).

months of the demise of Bear Stearns, abusive short-sellers targeted Lehman Brothers Holdings, another prestigious American investment bank, with the same pattern and practice of market manipulation and naked short-selling. As Lehman struggled to survive, as many as 32.8 million shares in the company were sold and not delivered to buyers – resulting in a 57-fold increase over the prior year’s peak of 567,518 failed trades.<sup>84</sup> Former SEC Chairman Harvey Pitt attributed the massive increase in FTDs to fraud because hundreds of thousands of failed trades coincided with false speculation that Lehman was being acquired by Barclays Bank at a significant discount.<sup>85</sup> Subsequent speculation that the company was losing two trading partners also proved untrue.<sup>86</sup> Some commentators felt the collapses of Bear Stearns and Lehman Brothers were nothing more than financial assassinations committed by malicious short-sellers who infected the marketplace with disinformation to reap a murderous profit.<sup>87</sup> While greed may have been the motivating factor behind their behavior, the collapses highlighted several flaws in the regulatory scheme, prompting a whirlwind of reform and raising the question of whether the benefits of short-selling outweigh its risks.

#### G. Justification for Speculation

There is a significant policy argument against allowing short-sales in the market and it is ultimately premised on the potential for abuse by market manipulators. As discussed in the preceding sections, short-sales may be abused to exploit inefficiencies in the market and severely reduce stock prices through dilution and excessive selling pressure. Moreover, short-sale profits encourage disingenuous investors to manipulate the market through fraudulent statements and misrepresentations of fact to initiate bear raids on targeted companies.

In spite of these issues, there is at least one fundamental justification for allowing short-sales in the market. The unadulterated practice of short-selling is critical to the core operation of a fair and efficient market. Eliminating the short-sale will reduce overall market efficiency through higher prices and diminished liquidity. It is essential to an efficient market because it contributes information necessary for the proper valuation of securities and encourages investors to seek out inefficient or fraudulent companies. It also increases liquidity by allowing market makers to offset

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<sup>84</sup> See Matsumoto, *supra* note 34.

<sup>85</sup> See *Id.*

<sup>86</sup> See *Id.*

<sup>87</sup> See Robert L.D. Colby, David L. Portilla & Christian L. Land, *The Bear “Naked” Truth: Short Sales and Rumors*, PRACTICAL COMPLIANCE & RISK MANAGEMENT FOR THE SECURITIES INDUSTRY, Sep-Oct. 2009, at 45, 45.

temporary contractions in the supply of securities and reduces the risk that investors acquire overpriced stock.

The market is based on the speculation of buyers and sellers and it would be both fundamentally unfair and operationally inefficient to create an imbalance in the ability of either market participant to contribute information. Speculation is defined as the buying or selling of something with the expectation of profiting from price fluctuations.<sup>88</sup> There is no distinction between the act of buying or selling. The short-seller who speculates that the future value of a security will be lower is no different from the long-buyer who speculates that the future value of a security will be higher. In fact, when a short-sale is stripped of all manipulative and fraudulent externalities, it is nothing more than the inverse of a long-buy, where the investor acquires a position pursuant to speculation of an increased future value. The potential for short-sale abuse will only exist in the absence of the appropriate laws and strict enforcement. Accordingly, the goal of a free and fair efficient market can be achieved through effective regulation and enforcement to reduce market exposure to abusive practices.

## II. REGULATORY LANDSCAPE

### A. Historical Background

The potential for abuse has led to the regulation of short-sales throughout the history of organized markets. In fact, concern over abusive short-selling and its role as a possible catalyst behind the market crash of 1929 played an important part in the formation of the original U.S. securities regulations.<sup>89</sup> Following the market crash of 1929, several periodicals and prominent individuals cited bear raids as reasons for both the crash and for the long recovery period.<sup>90</sup> Congress considered short-selling during the enactment of the Exchange Act of 1934 but was unable to determine how it would be regulated.<sup>91</sup> In fact, the Senate Banking and Currency Committee observed that few subjects relating to exchange practices have been characterized by greater difference in opinion than that of short-selling.<sup>92</sup> Congress subsequently granted authority to the SEC under Section 10(a) of the Exchange Act to regulate short-selling and purge the market of abuses connected to short-selling.<sup>93</sup> The regulatory structure governing short-sales

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<sup>88</sup> See BLACK'S LAW DICTIONARY (3rd ed. 2006).

<sup>89</sup> See Christian et al., *supra* note 19, at 1043.

<sup>90</sup> See *Id.*

<sup>91</sup> See White, *supra* note 30, at \*158.

<sup>92</sup> See S. REP. NO. 73-1455, at 55 (1934). See also H.R. REP. NO. 73-1383, at 11 (1934).

<sup>93</sup> See *Id.*

that emerged from the stock market crash of 1929 remained mostly unchanged for over sixty years, but additional reform became necessary as trading technology and strategies progressed.<sup>94</sup>

The first major reform took place in 1973 when the DTCC was created to organize and control the increasingly high volume of paperwork and diminishing level of security associated with the settlement of transactions.<sup>95</sup> The DTCC was designed to provide a safe and efficient mechanism for market participants to buy and sell stock. The DTCC would retain custody of the physical securities and the transfer of shares would be effectuated by a simple change in records.<sup>96</sup> Prior to its formation, brokers employed a complicated network of couriers to physically deliver stock certificates to buyers for settlement of previously executed transactions.<sup>97</sup> This haphazard system grew increasingly difficult, inefficient, and expensive during the late 1960s after the U.S. securities market experienced an unprecedented surge in trading volume.

The advent of the new paperless system may have resolved all of the inequities of the system it replaced, but, in doing so, it created a series of legal loopholes under which financial innovators could cheat the market. Under the old system, short-sellers had to physically borrow paper shares prior to execution of a short-sale.<sup>98</sup> The new system, however, merely required short-sellers to make a good faith effort to locate the shares they wanted to borrow.<sup>99</sup> There was no requirement in place to prevent a disingenuous broker, who promises to loan one short-seller a particular allocation of its shares, from making the same promise to numerous others. Brokers were essentially able to lend shares they did not possess while short-sellers could sell shares they never borrowed.

The most significant loophole in the new system was the absence of a requirement for the short-seller to deliver actual shares to the buyer.<sup>100</sup> If the short-seller defaulted on delivery, either because the located shares were now unavailable or because he simply had no intention of borrowing them, the DTCC would credit the buyer with phantom FTD shares in place of the originals.<sup>101</sup> These FTDs had economic value and could be traded as if they were original shares of the stock purchased by the buyer.<sup>102</sup> In the short-

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<sup>94</sup> See Christian et al., *supra* note 19, at 1043.

<sup>95</sup> See *Id.* at 1050.

<sup>96</sup> See *Id.*

<sup>97</sup> See Taibbi, *supra* note 26.

<sup>98</sup> See *Id.*

<sup>99</sup> See SEC Rule 10a-2 of Exchange Act, 40 Fed. Reg. 25,445 (June 16, 1975).

<sup>100</sup> See *Id.*

<sup>101</sup> See Koh & Avery, *supra* note 50.

<sup>102</sup> See Matsumoto, *supra* note 34.

term, only the DTCC, which maintains records of delivery obligations, would recognize the absence of the real assets in the buyer's account.<sup>103</sup> Furthermore, there was no requirement for the actual shares to be delivered by the defaulting short-seller, allowing the market to grow saturated with phantom FTD shares.<sup>104</sup> Accordingly, the new system provided financial innovators with a legal loophole for the counterfeiting of stock and the foundation for naked short-selling.

The problems stemming from the DTCC loopholes were largely unnoticed until 1993, when Susanne Trimbath, an economist working for the DTCC, was approached by a group of transfer agents who found a discrepancy between the number shares outstanding and the number of votes cast in corporate elections.<sup>105</sup> In a traditional short-sale, the lending party gives up his right to vote when he lends the shares to the short-seller for delivery. The buyer will then become the shareholder of record and the only person who can vote with those shares. Trimbath concluded that naked short-sales did not account for share ownership and because of that, multiple owners were assigned to one share.<sup>106</sup> This effect of this problem, which has yet to be resolved, could be widespread in the context of corporate governance if naked short-selling is used to control the outcome of the shareholder vote.

The DTCC has often been criticized for its neglect and indifference to short-selling. In the early 1990s, Trimbath approached the DTCC and expressed concern over the effects of naked short-selling.<sup>107</sup> The DTCC virtually ignored the problem and held that naked short-sales only accounted for a small percentage of the \$1.8 quadrillion in assets handled by the DTCC in any given year.<sup>108</sup> This paradoxical explanation neglected to consider the fact that virtually any percentage of such a significant value would be material. Moreover, the opportunity costs of that percentage and the financial leverage they could provide to the shorted companies are worth noting. In 2004, the SEC finally sought to address the naked short-sale issue, pursuant to numerous complaints from investors, with the adoption of Regulation SHO.

## B. Evolution of Regulation

### *1. Regulation SHO (2004)*

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<sup>103</sup> *See Id.*

<sup>104</sup> *See Taibbi, supra note 26.*

<sup>105</sup> *See Id.*

<sup>106</sup> *See Id.*

<sup>107</sup> *See Id.*

<sup>108</sup> *See Id.*

Regulation SHO represented the first significant change to the regulation of short-selling since 1938, when the SEC began to regulate the practice in a declining market.<sup>109</sup> It also represented a significant change of direction for the SEC in combating naked-short selling after many years of silence on the issue. Promulgated in 2004, Regulation SHO was comprised of SEC Rules 200, 202T and 203 – the latter of which adopted a three-part approach for dealing with manipulative short-selling.<sup>110</sup>

The first component established uniform locate requirements which restricted broker-dealers from accepting short-sales unless, pursuant to Rule 203(b)(1), the short-seller borrowed the security or entered into a bona fide arrangement to borrow the security, or pursuant to Rule 203(b)(2), the short-seller had reasonable grounds to believe that the security could be borrowed by the delivery due date. The second component, pursuant to Rule 203(b)(3), required exchanges to publish a daily list of threshold securities, which represents individual companies with at least 10,000 shares or more than 0.5% of the company's total outstanding shares sold short and not delivered to a buyer for five consecutive trading days. The third component, pursuant to Rule 203(b)(3), required broker-dealers to cover their FTD positions in the threshold securities within thirteen days and restricted them from engaging in any further short-selling of the threshold securities until their positions were settled.

Ambiguity within the language of Regulation SHO undermined its efficacy in reducing persistent and prolonged FTDs. In particular, the construction of Rule 203(b)(2), which allowed broker-dealers to execute a short-sale if the short-seller had "reasonable" grounds to believe that the security could be borrowed, included a potential loophole for market participants that surreptitiously intended on using naked short-sales to manipulate the market.<sup>111</sup> The loophole revolved around what might constitute a reasonable belief when the broker-dealer did not rely on an easy-to-borrow list,<sup>112</sup> and the extent to which the lack of firm guidelines would motivate manipulative broker-dealers to substitute their own subjective interpretation of a "reasonable belief" to meet the standard.<sup>113</sup>

Regulation SHO contained two questionable exemptions to the uniform locate requirement. The first exemption applied when a broker-

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<sup>109</sup> See Exchange Act Release No. 34-1548 (Jan. 24, 1938), 3 Fed. Reg. 213 (Jan. 26, 1938).

<sup>110</sup> See Stokes, *supra* note 17, at 45-46.

<sup>111</sup> See Christian et al., *supra* note 19, at 1071-1072.

<sup>112</sup> List that is published daily and contains securities with a high degree of liquidity or shares outstanding to help ascertain delivery for short-sellers who plan to borrow the securities and sell them immediately. See Release No. 34-50103 (July 28, 2004), 48 Fed. Reg. 48,008 (Aug. 6, 2004) ("Short Sales").

<sup>113</sup> See *Id.*

dealer accepted a short-sale from another broker-dealer.<sup>114</sup> This exemption was problematic because the thirteen-day clock for mandatory settlement would reset with each trade, allowing broker-dealers to refrain from settling their positions for an indefinite amount of time.<sup>115</sup> The second exemption applied when a naked short-seller was engaging in bona fide market making.<sup>116</sup> This was arguably the most problematic of the three exemptions because almost anyone could apply to become a market maker and take advantage of the exemption to engage in legalized naked short-selling.<sup>117</sup> Identifying abuse under this exception was very difficult because a bona fide market making transaction could evolve into an aggressive naked short-selling scheme over an extended period of time if the shares are never covered and the transaction results in prolonged FTDs.<sup>118</sup> In addition to the two exemptions, the SEC also reserved discretionary power to exempt people, transactions, and practices from the rules without public disclosure.<sup>119</sup> Accordingly, public confidence in the ability of Regulation SHO to effectively control abusive short-selling was undermined by its provision of numerous avenues for short-sellers to continue with the manipulation that Regulation SHO was intended to eliminate.

Regulation SHO failed to address or provide a solution to companies that remained on the threshold list for extended periods of time.<sup>120</sup> In theory, a market participant responsible for an extended FTD would purchase the equivalent securities on the market and deliver them to reduce the number of FTDs, increase market price, and cause the threshold stock to be removed from the list. In practice, these threshold stocks remained on the list for months, or even years, at a time with no upward movement in stock price and no significant change in FTDs.<sup>121</sup> The likely explanation for this phenomenon lies within the first exemption to the locate requirement, which resets the clock for mandatory settlement and subsequently allows broker-dealers to refrain from covering for an indefinite period of time if they continue to trade amongst themselves.<sup>122</sup> Several companies, including Delta Airlines, Overstock.com, Krispy Kreme, and Martha Stewart Omnimedia, have

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<sup>114</sup> See Stokes, *supra* note 17, at 47.

<sup>115</sup> See *Id.*

<sup>116</sup> See *Id.*

<sup>117</sup> See *Id.* at 48.

<sup>118</sup> See Christian et al., *supra* note 19, at 1073.

<sup>119</sup> See Stokes, *supra* note 17, at 47-48.

<sup>120</sup> See Karl Thiel, *The Naked Truth on Illegal Shorting*, THE MOTLEY FOOL. (Mar. 10, 2011), <http://www.fool.com/investing/dividends-income/2008/09/22/the-truth-about-naked-shorts.aspx>.

<sup>121</sup> See *Id.*

<sup>122</sup> See *Id.*



appeared on the list for extended periods of time.<sup>123</sup> The threshold list succeeded in alerting investors, regulators, and the issuers that something was wrong – but Regulation SHO failed in its inability to fix and correct the underlying problem.<sup>124</sup>

### *2. Elimination of the Uptick Rule (2007)*

While the SEC promulgated Regulation SHO in 2004, it contemporaneously undertook a pilot study through the SEC Office of the Inspector General (OIG) to determine the continued efficacy of SEC Rule 10a-1(a), also known as the Uptick Rule.<sup>125</sup> The rule generally prohibited the short-selling of stock except upon an uptick in its price.<sup>126</sup> It was adopted in 1938 in response to an increasingly negative sentiment towards short-sellers and designed to prevent short-selling from being used to drive down share prices, particularly during bear raids.<sup>127</sup> The SEC abolished the Uptick Rule pursuant to the results of the pilot study, which cited empirical evidence in concluding there was no association between manipulative short-selling activities and price test restrictions on short-selling.<sup>128</sup> The SEC argued that market changes, such as increased transparency and regulatory surveillance, rendered the rule less effective and less essential in modern markets.<sup>129</sup> Moreover, the SEC also cited the need for regulatory simplicity and uniformity in further justifying its decision.<sup>130</sup> Ironically, the trading pattern that emerged from 2008 SEC data just one year later clearly indicates that naked short-selling contributed to the fall of both Bear Stearns and Lehman Brothers.<sup>131</sup>

At the peak of the financial crisis in 2008, critics denounced the SEC's decision to eliminate the Uptick Rule<sup>132</sup> and cited various limitations to the OIG pilot study – including its narrow scope and implementation during a

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<sup>123</sup> See Stokes, *supra* note 17, at 50.

<sup>124</sup> See *Id.*

<sup>125</sup> See Release No. 34-50103, *supra* note 112, at 36.

<sup>126</sup> See SEC Rule 10a-1(a), 17 Fed. Reg. 242.10a-1(a) (Jan. 24, 1938).

<sup>127</sup> See Dan Slater, *The Latest Wachtell Memo on Short Selling: Did it Move the SEC?*, THE WALL STREET JOURNAL LAW BLOG, (July 16, 2008), <http://blogs.wsj.com/law/2008/07/16/the-latest-wachtell-memo-on-short-selling-did-it-move-the-sec/>.

<sup>128</sup> See Regulation SHO and Rule 10a-1, Release No. 34-55970 (June 28, 2004), 72 Fed. Reg. 36,348 (July 3, 2004), at 16.

<sup>129</sup> See *Id.*

<sup>130</sup> See *Id.*

<sup>131</sup> See Taibbi, *supra* note 26.

<sup>132</sup> See Memorandum from Edward D. Herlihy & Theodore A. Levine, *It's Time for the SEC to Constrain Abusive Short Selling* (June 17, 2009) (on file with author).

period of rising market and unusually low volatility.<sup>133</sup> The SEC was criticized for its blind dependence on mere surveillance and enforcement efforts to address abusive activities after the damage was done.<sup>134</sup> Shortly after the collapse of Lehman Brothers in late 2008, the SEC announced emergency actions to stabilize the market – including the institution of a ban on the short-selling of financial stocks for 14 trading days.<sup>135</sup> However, the SEC did not extend the ban to bona fide market makers because of their role in providing liquidity to the market.<sup>136</sup> Former SEC Chairman, Christopher Cox, stated that the emergency order was not a response to unbridled naked short-selling, but instead, a preventative measure to restore market confidence. I suspect the emergency order was a combination of both because diminishing market confidence would have a direct effect on speculation and the expectation that prices would continue to decrease – motivating more legal and illegal short-selling thereafter. In retrospect, thousands of critics have blamed repeal of Rule 10a-1(a) for the significantly increased market volatility that led to severe price declines associated with the 2008 financial crisis.<sup>137</sup>

### *3. Naked Short-Sale Antifraud Rule (2008)*

In 2008, the SEC adopted Rule 10b-21 as part of new SEC efforts to combat naked short-selling and highlight the liability of short-sellers who misrepresent their ability to obtain shares for trade settlement.<sup>138</sup> In particular, the rule prohibits short-sellers from deceiving their brokers about their ability to locate shares.<sup>139</sup> These deceptive practices include selling short without a bona fide good faith effort to locate the shares, misrepresenting the quantity of owned or deliverable shares, and making a bona fide good faith effort to locate but never actually attempting to borrow the shares.<sup>140</sup> The SEC has acknowledged that Section 10(b) of the Securities Exchange Act of 1934 already provides plaintiffs with a cause of action for manipulative and fraudulent activity – including the type that 10b-21 seeks

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<sup>133</sup> *See Id.*

<sup>134</sup> *See Id.*

<sup>135</sup> *See* Emergency Order Taking Temporary Action to Respond to Market Developments, Release No. 34-58592 (Sep. 18, 2008), 73 Fed. Reg. 55,169 (Sep. 24, 2008).

<sup>136</sup> *See Id.*

<sup>137</sup> *See* Letter from Jim Cramer, William Furber, Eric Oberg & Scott Rothbort to Mary Schapiro, Chairman, Securities and Exchange Commission (July 8, 2009) (on file with the SEC).

<sup>138</sup> *See* Release No. 34-58774 (Oct. 14, 2008), 73 Fed. Reg. 61,666 (Oct. 17, 2008) (“Anti-Fraud Rule Adopting Release”).

<sup>139</sup> *See Id.* at 2.

<sup>140</sup> *See Id.* at 41.

to address.<sup>141</sup> The SEC further stated that the rule imposes no additional liability or requirements beyond existing Exchange Act rules<sup>142</sup> and was simply intended to supplement the existing federal antifraud rules.<sup>143</sup>

The adoption of Rule 10b-21 adds nothing to the regulatory landscape because deceptive naked short-selling has always been illegal under Section 10(b) and Rule 10b-5 therein. The SEC appears to acknowledge this fact and proceeds to state that deceptive activities are detrimental to markets and the rule should restore some measure of predictability for market participants.<sup>144</sup> I suspect the SEC recognized manipulative naked short-selling to be more of a problem than it was originally willing to admit. The adoption of this rule appeared to be nothing more than a reaction to political scrutiny for the 2008 financial crash as well as an attempt to stimulate and increase investor confidence in the market.

#### *4. Firm Delivery and Settlement Rule (2009)*

In addition to the antifraud provisions of Rule 10b-21, the SEC adopted temporary Rule 204T, which imposed strict penalties for delivery failures.<sup>145</sup> Specifically, if a short-seller fails to deliver within three days of the sale, its broker-dealer will be prohibited from facilitating any further short-sales of that security for any of its customers unless it previously arranged to borrow the shares.<sup>146</sup> The penalty was designed to encourage broker-dealers to prevent naked short-selling by their own customers.

Contemporaneous with temporary Rule 204T, the SEC adopted amendments to Rule 203(b)(3) to reduce FTDs in threshold securities by eliminating the options market maker exception to the firm close-out requirements of Regulation SHO.<sup>147</sup> The SEC conducted a balancing test and concluded that the benefits of protecting and enhancing the operation, integrity and stability of the markets as well as reducing potential short-selling abuses outweighed the costs and burdens on market makers required to cover their short positions.<sup>148</sup>

In 2009, the SEC concluded that it had seen a significant reduction in the number of FTDs in all equity securities since the adoption of temporary

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<sup>141</sup> *See Id.* at 23.

<sup>142</sup> *See Id.* at 24.

<sup>143</sup> *See Id.* at 23.

<sup>144</sup> *See Id.* at 27.

<sup>145</sup> *See* Release No. 34-58773 (Oct. 14, 2008), 73 Fed. Reg. 61706 (Oct. 17, 2008) (“Amendments to Regulation SHO”).

<sup>146</sup> *See Id.* at 43.

<sup>147</sup> *See* Release No. 34-56213 (Aug. 7, 2007), 17 Fed. Reg. 242 (Aug 14, 2007) (“Amendments to Regulation SHO”).

<sup>148</sup> *See Id.* at 16.

Rule 204T and the elimination of the options market maker exception in Rule 203(b)(3).<sup>149</sup> Consequently, the SEC adopted final Rule 204 and made permanent, with some differences, the firm delivery and close-out requirements for the sale of securities contained in temporary Rule 204T.<sup>150</sup> The differences included increased flexibility to broker-dealers by allowing them to settle FTDs by either borrowing or repurchasing securities in certain cases where a strict repurchase was required by Rule 204T and expanding the class of securities eligible for a 35-day close-out period to include certain securities the seller is deemed to own.<sup>151</sup>

The SEC also indicated that it would not renew temporary Rule 10a-3T, which required institutional investment managers to report their short positions, because of the significant compliance burden it placed on them.<sup>152</sup> In allowing the rule to expire, the SEC announced a joint effort with SROs aimed at increasing public availability of short-sale data by providing short-sale volume and transaction data on SRO websites.<sup>153</sup> No details have been announced, but it seems as though the agency has no intention of publicly identifying individual short-sellers or position holders.<sup>154</sup>

Although the disclosure requirement was dropped, the SEC issued new rules to govern short-selling and promised to provide investors with more information concerning the volume and speed of short-sales in the market.<sup>155</sup> The new rules are a middle-ground that highlight the SEC's struggle to identify the best way to regulate short-selling without obstructing market activity.<sup>156</sup>

##### *5. The Alternative Uptick Rule (2010)*

The SEC continued to experience intense political scrutiny because, despite recent rulemaking efforts, it failed to eliminate the manipulative practice of naked short-selling within the securities market.<sup>157</sup> The SEC subsequently held a roundtable discussion with market participants for

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<sup>149</sup> See Release No. 34-60388 (July 27, 2009), 74 Fed. Reg. 38,265 (July 31, 2009) (“Amendments to Regulation SHO”).

<sup>150</sup> See *Id.* at 1.

<sup>151</sup> See *Id.* at 43.

<sup>152</sup> See Release No. 34-58785 (Oct. 15, 2008), 73 Fed. Reg. 61,678 (Oct. 17, 2008) (“Disclosure of Short Sales and Short Positions by Institutional Investment Managers”).

<sup>153</sup> See Kara Scannell, *U.S. Issues New Rules on Short-Selling*, WALL ST. J., July 29, 2009, at M3.

<sup>154</sup> See *Id.*

<sup>155</sup> See *Id.*

<sup>156</sup> See *Id.*

<sup>157</sup> See Letter from Senator Edward Kaufman to Mary Schapiro, Chairman, Securities and Exchange Commission, (Mar. 3, 2009) (on file with the SEC).

comments on reinstatement of the Uptick Rule or a variation thereof.<sup>158</sup> In February 2010, the SEC adopted an Alternative Uptick Rule under Rule 201 of Regulation SHO.<sup>159</sup> It was designed to restrict short-selling from further reducing the price of a stock that has dropped more than 10 percent in one day and enable long-sellers to sell their shares before the short-sellers once the circuit breaker is triggered.<sup>160</sup> The rule applies to all equity securities – regardless of whether traded on an exchange or in over-the-counter markets.<sup>161</sup>

The Alternative Uptick Rule is more narrowly tailored than the original. The original rule provided that, subject to certain exceptions, a listed security could be sold short only at a price above that at which the preceding sale was effected, or at the last sale price if it was higher than the last different price.<sup>162</sup> In simpler terms, the original rule broadly required every short-sale to be entered at a price higher than the price of the previous trade. In contrast, the Alternative Uptick Rule generally requires short-sellers to reduce the price of a security by at least 10 percent in one day before the rule takes effect, after which the security may only be sold short at a price above the national best bid.<sup>163</sup>

I suspect the broad application of the older rule would provide prolonged protection against bear raids and naked short-selling as compared to the limited scope of the new rule. The narrow application of the Alternative Uptick Rule requires a whole 10 percent decrease in price, which can account for a significant amount of capital for a large issuer to lose within one day before the new rule offers its protection. In spite of its narrow application, the subsequent restriction on short-selling might be more effective than that of the original rule because it will only accept a short-sale at a price higher than anyone else is willing to pay – as opposed to the price of the previous trade. However, the restriction under the Alternative Uptick Rule only lasts for one day – as opposed to an indefinite period of time. This allows uncontrolled naked short-selling to promptly resume and decrease share price by another 10 percent until the cycle repeats itself again. Accordingly, the Alternative Uptick Rule represents a step in the right direction but fails to provide adequate safeguards against clever market manipulators as compared to its predecessor.

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<sup>158</sup> See Release No. 34-59855 (May 1, 2009), 74 Fed. Reg. 21,423 (May 7, 2009) (“Roundtable on Short Selling Price Test Restrictions and Short Sale Circuit Breakers”).

<sup>159</sup> See Release No. 34-61595 (Feb. 26, 2010), 17 Fed. Reg. 242 (Mar. 10, 2010) (“Amendments to Regulation SHO”).

<sup>160</sup> See *Id.* at 121.

<sup>161</sup> See *Id.* at 92.

<sup>162</sup> See SEC Rule 10a-1(a), 17 C.F.R. § 240.10a-1(a).

<sup>163</sup> See Release No. 34-61595 (Feb. 26, 2010), 17 Fed. Reg. 242 (Mar. 10, 2010) at 125 (“Amendments to Regulation SHO”).

### C. Enforcement and Challenges

The Securities Exchange Act of 1934 ('34 Act) was promulgated to regulate securities trading in secondary markets and designed to protect investors against manipulation of stock prices.<sup>164</sup> The legislative philosophy underlying the adoption of the '34 Act's extensive disclosure requirements emphasized that there could not be honest markets without honest publicity – and manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy.<sup>165</sup> In furtherance of its goal, Congress formed the SEC under Section 4 of the '34 Act with broad authority over all aspects of the securities industry – including the power to register, regulate and oversee brokerage firms, transfer agents, clearing agencies, and self-regulatory organizations.<sup>166</sup> In addressing the manipulation and dishonest practices, Congress granted the SEC authority under Section 10(a) of the Exchange Act to regulate short-selling and purge the market of abuses connected to short-selling.<sup>167</sup> Accordingly, the core functions of the SEC, as intended by Congress, are to enforce the rules, purge the market of short-selling abuse, and further the goal of an honest market.

The SEC has demonstrated its intention to combat manipulative short-selling in recent years through the adoption of new rules and regulations; however, enforcement actions involving naked short-selling have been extremely rare.<sup>168</sup> In fact, over 5,000 tips on naked short-selling abuses were emailed to the SEC between January 2007 and June 2008 – but only 123 were forwarded for further investigation and none led to enforcement actions.<sup>169</sup> In March 2009, SEC Inspector General David Kotz stated that the enforcement division was reluctant to expend additional resources to investigate complaints because they did not include sufficient information.<sup>170</sup> Kotz subsequently recommended that the division increase analysis of tips and designate a person or office to provide oversight of complaints.<sup>171</sup> In September 2009, the SEC announced a sweeping investigation into possible market manipulation in the securities of certain financial institutions, but findings have yet to be publicly released.<sup>172</sup>

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<sup>164</sup> See S. REP. NO. 73-792, at 1-5 (1934).

<sup>165</sup> See H.R. REP. NO. 73-1383, at 11 (1934).

<sup>166</sup> See Securities Exchange Act of 1934, 17 C.F.R. § 240 (1934).

<sup>167</sup> See S. REP. NO. 73-1455, at 55 (1934). See also H.R. REP. NO. 73-1383, at 11 (1934).

<sup>168</sup> See Ceresney et al., *supra* note 83, at 256.

<sup>169</sup> See Matsumoto, *supra* note 34.

<sup>170</sup> See SEC SEMIANNUAL REP. (Oct. 1, 2008 – Mar. 31, 2009), at 28.

<sup>171</sup> See *Id.*

<sup>172</sup> See Press Release, Securities and Exchange Commission, SEC Expands Sweeping Investigation of Market Manipulation, (Sep. 19, 2009) (on file with the SEC).

Subsequently, SEC Chairman Mary Schapiro vowed to revitalize enforcement efforts after drawing scrutiny from lawmakers and investors for failing to follow up on tips that Bernard Madoff's money management business was a Ponzi scheme.<sup>173</sup>

Enforcement faces a significant challenge in proving that the market participants had the requisite intent to manipulate.<sup>174</sup> The dissemination of false or inaccurate information about a company is not illegal unless it is motivated by manipulative intent – even if the information has a material impact on the issuer's stock price.<sup>175</sup> The U.S. Supreme Court has applied a presumption of reliance on market integrity and the credibility of information circulated therein.<sup>176</sup> In its application, the court held:

The presumption is also supported by common sense and probability. An investor who trades stock at the price set by an impersonal market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations may be presumed for purposes of a Rule 10b-5 action.<sup>177</sup> Accordingly, short-sellers who contribute to the excessive selling pressure or circulate negative rumors about an issuer at a time of market distress may escape liability if they lacked manipulative intent.

Many market participants circulate rumors without manipulative intent because the dissemination of information is critical to their role as buyers and sellers as well as the overall goal of market efficiency.<sup>178</sup> One commenter stated that rumors, gossip, and idle speculation are the lifeblood of investors.<sup>179</sup> Market speculation often involves ideas and opinions that are difficult to label objectively false, unless it can be shown that the speaker had no reasonable basis for the statement or that she deliberately misrepresented her actual opinion.<sup>180</sup> Accordingly, the fraudulent intent of the person originating the rumor is easier to demonstrate than the intent of those who simply contribute to its dissemination.

#### D. Ethical and Practical Crossroads

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<sup>173</sup> See *Hearing Before the Subcomm. on Fin. Serv. and Gen. Gov't of the S. Comm. on Appropriations*, 111th Cong. 1-2 (2009) (statement of Mary Schapiro, SEC Chairman).

<sup>174</sup> See Ceresney et al., *supra* note 83, at 256.

<sup>175</sup> See *Id.*

<sup>176</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 225 (1988).

<sup>177</sup> See *Id.*

<sup>178</sup> See *Id.*

<sup>179</sup> See Jonathan D. Glater, *Whispering with Intent*, N.Y. TIMES, July 20, 2008, at WK4.

<sup>180</sup> See *In re Salomon Analyst AT&T Litig.*, 350 F. Supp. 2d 455, 465-466 (S.D.N.Y. 2004) (citing *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-1096 (1991)).

With the advent of recent proposed and newly adopted rules, the SEC has been able to overcome certain challenges in the regulatory environment, but other concerns remain. The SEC is faced with numerous policy issues as it tries to offset the balance of stringent and relaxed market regulation. Many corporate CEOs want the SEC to regulate short-selling extensively because of the impact it has on their businesses.<sup>181</sup> In contrast, many free market investors have argued for more relaxed restrictions on the practice because of its contribution to informational efficiency.<sup>182</sup>

The SEC must weigh ethical considerations as it strives to balance the competing interests of relaxed and stringent regulation. Traditional business ethics literature has devoted little attention to the ethical issues involved in the context of short-selling.<sup>183</sup> However, the facts have clearly demonstrated that short-selling creates an incentive for unethical activity – such as the rumor-mongering associated with bear raids and the conflicts of interest associated with death spiral financing. I suspect that proponents of relaxed regulation would argue that short-sellers owe no social or ethical duty to the market – and they may in fact be correct. This is why our ethical concerns should not focus on the short-sellers, but instead, the SEC. The SEC is a public government agency developed by Congress pursuant to the '34 Act – which was designed to protect investors against manipulation of stock prices.<sup>184</sup> Accordingly, the SEC has both a legal and ethical duty to ensure that short-selling abuses do not occur within the markets. Short-selling should co-exist with other forms of trading on a level playing field with clear boundaries established and enforced by the SEC.<sup>185</sup>

### III. ADJUDICATION

#### A. Preemption and Pleading Challenges

In passing the federal securities laws after the stock market crash of 1929, Congress preserved the oversight role of the states with respect to the various blue sky laws.<sup>186</sup> These laws generally provided for the registration of securities and sellers of securities, required a permit from the state before the sale of securities, and gave state regulators the power to investigate

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<sup>181</sup> See Stokes, *supra* note 17, at 12.

<sup>182</sup> See Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and a Modest Proposal for Letting More Shorts Go Naked*, 8 J. BUS. & SEC. L. 135, 156 (2008).

<sup>183</sup> See Angel & McCabe, *supra* note 40, at 243.

<sup>184</sup> See S. REP. NO. 73-792, at 1-5 (1934).

<sup>185</sup> See Branson, *supra* note 4, at 72.

<sup>186</sup> See Ceresney et al., *supra* note 83, at 260.



firms.<sup>187</sup> As years passed, much of the states' authority was preempted under federal law in response to criticism that the various state approaches led a "balkanized" or inconsistent patchwork of regulations.<sup>188</sup>

The first challenge to adjudication arose after Congress adopted the Private Securities Litigation Reform Act of 1995 (PSLRA), which was created to reduce the outbreak of frivolous Rule 10b-5 securities litigation.<sup>189</sup> The PSLRA achieved this goal by increasing the pleading standards in three ways. The first component requires the plaintiff to plead each false or misleading statement with particularity.<sup>190</sup> If the plaintiff is unable to identify the fraudulent or misleading statements made by the defendant, the complaint will be dismissed. It should be noted that a plaintiff might be able to overcome this challenge by alleging fraud-on-the-market, where the market price of a security reflects the alleged misrepresentation and the plaintiff relies therein.<sup>191</sup> The second component requires the plaintiff to demonstrate a strong inference of scienter, or intent to deceive or defraud.<sup>192</sup> In 2007, the U.S. Supreme Court raised the standard by holding that an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.<sup>193</sup> This is a difficult standard to meet because the plaintiff does not have the benefit of discovery or access to circumstantial evidence that might help prove the requisite intent. The third component requires the plaintiff to prove causation, or the nexus between the plaintiff's loss and the defendant's act or omission.<sup>194</sup> This requires the plaintiff to be an actual purchaser or seller of the securities.<sup>195</sup> Moreover, the plaintiff must incur the loss after the relevant truth is revealed in order to meet the requirement.<sup>196</sup>

The PSLRA was flawed because it only applied to securities class action claims brought in federal courts.<sup>197</sup> This allowed plaintiffs to avoid the heightened pleading requirements by filing securities class action claims in state court. This forum shopping strategy resulted in a significant increase in state securities litigation for several years after the PSLRA was enacted.

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<sup>187</sup> *See Id.*

<sup>188</sup> *See Id.*

<sup>189</sup> *See* Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 308-309 (2003).

<sup>190</sup> *See* Private Securities Litigation Reform Act of 1995, § 101(a), 15 U.S.C. § 78u-4(b)(1).

<sup>191</sup> *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).

<sup>192</sup> *See* 15 U.S.C. § 78u-4(b)(2), *supra* note 190.

<sup>193</sup> *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

<sup>194</sup> *See* 15 U.S.C. § 78u-4(b)(4), *supra* note 190.

<sup>195</sup> *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

<sup>196</sup> *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

<sup>197</sup> *See* Radom, *supra* note 189, at 309-310 (2003).

Congress sought to close this loophole by adopting the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The SLUSA amended portions of the Securities Act of 1933 and Securities Exchange Act of 1934 to preempt certain class action lawsuits alleged under state law in connection with the purchase or sale of securities.<sup>198</sup> The effect of both laws is state preemption and higher pleading standards for class action securities claims.

#### B. Litigation

In both federal and state courts, no plaintiff has ever won a final judgment based on naked short-selling claims and most suits do not progress beyond the initial pleadings.<sup>199</sup> The DTCC has often been the target of state action by plaintiffs unable to obtain relief from broker-dealers.<sup>200</sup> These plaintiffs typically assert common law negligence claims, by arguing that the DTCC should force settlement of FTDs to curb naked-short selling.<sup>201</sup> They also assert state law fraud claims, by arguing that the DTCC stock borrow program, which credits a buyers account with FTD shares, fraudulently counterfeits shares of stock.<sup>202</sup> The DTCC usually defends itself against the fraud claim by maintaining the position that it always holds someone accountable for an FTD, and accordingly, does not enable short-selling or fraudulent market manipulation.<sup>203</sup> The DTCC contends that its functions are regulated and overseen by the SEC – so any naked short-selling claims based in common law negligence would be preempted by federal law.<sup>204</sup> Unless Congress broadens the scope of the preemption doctrine, which already allows a state law cause of action for antifraud claims, plaintiffs' only recourse is to rely on the SEC to fulfill its responsibilities as a federal regulator.

### IV. CONCLUSION

The threat of market manipulation and naked short-selling continues to proliferate and threaten the capitalization of a wide variety of issuers within the securities market. These fraudulent and manipulative practices disrupt overall market efficiency by increasing informational efficiency and reducing price continuity – causing investors to retreat from otherwise liquid

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<sup>198</sup> *See Id.* at 310.

<sup>199</sup> *See Stokes, supra* note 17, at 1.

<sup>200</sup> *See Id.* at 34.

<sup>201</sup> *See Id.*

<sup>202</sup> *See Id.*

<sup>203</sup> *See Id.* at 35.

<sup>204</sup> *See Id.*

markets and issuers to struggle with their capital obligations. The effects of these abusive practices have manifest themselves in both the failure of small companies and the collapse of highly respected investment banks.

The practice of short-selling is a very important market device that provides increased liquidity and information to the market. It helps investors identify overvalued, inefficient or even fraudulent companies – and it should not be fully restricted. The potential for short-sale abuse will only exist in the absence of the appropriate laws and strict enforcement. History has taught us the importance of adequate market regulation through the market crash of 1929 and the recent financial collapse of 2008. In both cases, market manipulation and uncontrolled short-selling contributed to the collapse of the securities market – and ultimately the U.S. economy.

The SEC has recognized market manipulation and naked short-selling to be valid problem within the securities market, but it has failed to address the problem despite active rulemaking on the subject since 2004. The SEC faces several enforcement challenges in proving intent to manipulate, because the nature of the market requires the constant dissemination of speculative information. It is also faced with balancing over-regulation and under-regulation of the market with its duty to eliminate fraud and manipulation therein. Plaintiffs are procedurally and substantively limited in their ability to actively pursue claims against alleged manipulators. Accordingly, the burden falls on the SEC to actively regulate the market and strictly enforce the federal securities laws.

The SEC should reinstate the original Uptick Rule because of its stated advantages over the recently adopted Alternative Uptick Rule at preventing potentially harmful bear raids in the market. Moreover, the SEC should establish a mandatory pre-borrow requirement similar to the system that was in effect prior to the formation of the DTCC because the uniform locate requirements of Regulation SHO clearly do not work. Manipulation and fraud have no place in a sophisticated market. If the SEC is not up to the challenge of carrying out the spirit of the federal securities laws, then we need to determine who is because the efficiency of our markets clearly depends on it.