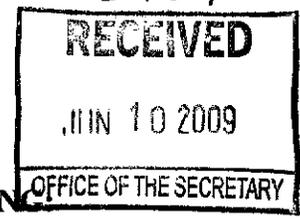


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**NIBBLING AT THE EDGES—REGULATION OF SHORT SELLING,  
STOCK BORROWING AND RESTORATION OF AN UPTICK RULE**

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Short selling is a means whereby an investor seeks to capitalize on her mental fix that a particular company's shares, an entire industry's shares, or most shares in the market, will go down, rather than up, in price.<sup>1</sup> Temporarily, at least, a short seller is a bear, betting that prices will go down, rather than a bull, who believes that prices will rise.

Traders and veteran investors know well the mechanics of a typical short sale. First, the investor borrows shares, often from a broker dealer who, under the terms of the standard customer's agreement,<sup>2</sup> has the power to hypothecate shares in margin accounts.<sup>3</sup> Second, the

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<sup>1</sup>See, e.g., Securities and Exchange Commission (SEC), Division of Market Regulation, *Key Points About Regulation SHO* 1 (Apr. 11, 2005) (footnote omitted):

A short sale is generally the sale of a stock you do not own (or that you will borrow for delivery). Short sellers believe the price of the stock will fall, or are seeking to hedge against price volatility in securities that they own.

If the price of a stock drops, short sellers buy the stock at the lower price and make a profit. If the price of the stock rises, short sellers will incur a loss.

<sup>2</sup>See National Financial Services, LLC, Supplemental Application for Margin Account Privileges, Note following § 20, at 4 (upper case in original): "YOU ARE HEREBY AUTHORISED TO LEND, HYPOTHECATE, OR REHYPOTHECATE SEPARATELY OR WITH THE PROPERTY OF OTHERS, EITHER TO YOURSELF OR TO OTHERS, ANY PROPERTY YOU MAY BE CARRYING FOR ME ON MARGIN." Nowhere in the typical margin agreement does the broker-dealer drive home to the customer that, pursuant to the clause, the broker may lend her shares to short sellers, thereby possibly contributing to decreases in the price of the stock but regulators consider the present disclosure to be adequate. See, e.g., James W. Christian, Robert Shapiro & John-Paul Whalen, *Naked Short Selling: How Exposed are*

short seller sells the borrowed shares in the market. Third, sometime later, the short seller “covers,” buying replacement shares in the market, hopefully now at a lower price, returning the shares to the account from which she had borrowed them in the first place. Her profit is the differential between the proceeds realized when she borrowed shares and sold them, and the price (hopefully lower) at which she covered, less transaction costs (for example, commissions and possibly interest paid to the person from whom she borrowed the shares, if shares were not available in margin accounts).

Short selling has always been subject to varying opinions as to its worth. Many corporate CEOs, some of whom whose stock has been subject to extensive short selling, want the Securities and Exchange Commission (SEC) or the Congress to regulate the practice extensively.<sup>4</sup> From time to time, governments have banned short selling.<sup>5</sup> The Malaysian

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*Investors?*, 43 HOUS. L. REV. 1033, 1057 & n.183 (2006).

<sup>3</sup>In margin trading, an investor uses the shares to be purchased as collateral for the funds borrowed to buy the shares. The Federal Reserve sets the amount (*e.g.*, 40% of the securities value) as payment she must make from her own resources (the margin), while the SEC enforces the Federal Reserve’s regulations as to broker-dealer loans and maintenance of the margin thereafter (Regulation T), the Comptroller of the Currency as to bank loans (Regulation U), and the Federal Reserve as to other lenders (Regulation G). Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78(g). *See also* JAMES COX, ROBERT HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATION 1071-73 (5th ed. 2006). If the investor purchases securities with funds borrowed using other collateral, for instance, the equity in her house, margin trading regulations do not apply. Margin transactions then are equivalent to money purchase mortgages in the commercial world in which the item purchased (*e.g.*, an automobile) will be the collateral for the loan used to purchase it.

<sup>4</sup>*See, e.g.*, Staff, *Nasty, Brutish and Short*, THE ECONOMIST, June 21, 2008, at (actions by MNBA, Inc., and other large public companies).

<sup>5</sup>*See, e.g.*, Kara Scannell, *SEC Moves to Curb Short Selling*, WALL ST. J., July 16, 2008, at A-1 (bans by British House of Commons in 1733, following the South Sea Bubble, and by the New York state legislature in 1792); James S. Chanos, *Short Sellers Keep the Market Honest*, WALL ST. J., Sept. 22, 2008, at A-23 (ban by English government in 1630s following tulipmania

government once advocated criminal penalties for short selling, including caning (lashes with a whip) for the trader.<sup>6</sup>

At the other extreme, free marketers have argued for few restrictions on short selling, tending toward none.<sup>7</sup> Short selling has been an arrow in many traders' quivers, including some famous ones.<sup>8</sup> No serious student of securities regulation advocates either a ban on short selling or severe restrictions. All concede that short selling, although historically equivalent to 4% of total shares listed on the New York Stock Exchange (NYSE),<sup>9</sup> serves valuable purposes, is in the mainstream, and should not go away.

Yet today, in contrast to years past, massive amounts of short selling takes place, by the 7,000 or so hedge funds in existence, by exchange traded funds (ETFs) whose primary bailiwick is short selling, and by investment company (mutual) funds who market their shares by promotion

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collapse in the Netherlands). Such proposals resurface from time-to-time. See Mark Wolski, *South Dakotans Reject Proposal to Ban Short Sales of Stock*, 40 BNA Fed. Sec. Reg. & L. Rep. 1854 (November 10, 2008)(43% "for," 57% "against").

<sup>6</sup>Scannell, *supra* note 5. In 1932, Representative Adolph Sabath wanted to ban short selling, terming it "the greatest evil that has been permitted or sanctioned by the Government." *Hearings on H.R. 4, 4604, 4638 & 4639, House Committee on the Judiciary, 72d Cong., 1st Sess., pt. 1, at 7 (1932).*

<sup>7</sup>See, e.g., 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 (2008); Jonathan R. Macey, Mark Mitchell & Jeffrey Netter, *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October, 1987 Stock Market Crash*, 74 CORNELL L. REV. 799 (1989); Michael R. Powers, David M. Schizer & Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 N.Y.U. TAX L. REV. 233 (2004).

<sup>8</sup>See, e.g., ALICE SCHROEDER, *THE SNOWBALL: WARREN BUFFET AND THE BUSINESS OF LIFE* 19 (2008) ("Short selling is normally risky: you are betting against the long term trend of the market," but Buffett indicates he has sold short many times).

<sup>9</sup>Chanos, *supra* note 5, at A-23.

of their strong biases in favor of shorting.<sup>10</sup> Today's volume of short selling dwarfs the volume which existed in the eras in which the SEC and stock exchanges adopted current regulations, or deleted other long existing rules, such as the uptick rule.<sup>11</sup> Everyone agrees that short selling, as we now know it, is a contributor to the volatility which exists in the markets. The Dow Jones or S & P 500 averages can go down 2-3% in not a day, not even an afternoon, but in 30 minutes of trading. Something has changed radically.

On April 10, 2009, the SEC promulgated for comment a 273 page concept-like release, putting forth 2 basic approaches, 2 variations of each of those approaches, and countless possible refinements of those approaches and their variations, regarding further regulation of short selling.<sup>12</sup> On May 5, the SEC held a roundtable in Washington, D.C. on whether the SEC should impose any of the proposed or any other restrictions on short selling.<sup>13</sup>

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<sup>10</sup>For example, Morningstar, Inc., now tracks 159 mutual funds specializing in short selling. See Kara Scannell & Tom Lauricella, *SEC To Extend Short Selling Ban*, WALL ST. J., July 20, 2008, at C-1 (featuring, *inter alia*, Federated Investors, Inc.'s Prudent Bear Funds); Eleanor Laise, *Short Sale Ban Is Hitting Mutual Funds*, WALL ST. J., Sept. 24, 2008, at C-3 (use by ETFs of derivatives to imitate short selling).

<sup>11</sup>Short interest equaled 18 trillion shares on the NYSE at the end of June, 2008, up from 9 trillion plus shares in January, 2007. Scannell & Lauricella, *supra* note 10, at A-13 (graph). In 1987 there were 3.98 billion shares sold short on the NYSE and in 1986 there were 3.11 billion shares. NEW YORK STOCK EXCHANGE, NYSE FACTBOOK (1988). Thus, short selling increased roughly 600 fold between 1986 and 2008.

<sup>12</sup> Amendments to Regulation SHO, SEC Release No. 34-59748 (April 10, 2009)(hereinafter cited as "SEC Reform Proposals"). See also Kara Scannell, *Wrangling Ahead on Short-Sale Plans*, Wall St. J., April 9, 2009, at C-1 ("comments from two Republican commissioners signaled tussling ahead"); Jesse Westbrook, *SEC Weighs New Rules on Short-Selling*, Pittsburgh Post-Gazette, April 9, 2009, at C-4.

<sup>13</sup>See, e.g., *SEC Announces Roundtable to Discuss Proposals to Curb Short Sales*, 41 BNA Fed. Sec. Reg. & L. Rep. 753 (April 27, 2009).

The questions are should we do something about out-sized market gyrations? If so, what?

How much of the “what” relates to short selling?

The restrictions, or “reforms,” advocated for short selling include:

1. An *outright ban* on short selling.
2. A *partial ban*, as to critical stocks (issues) and/or for periods of time, which was attempted in late Summer, 2008, as to the stocks of financial firms.
3. A *strengthened prohibition on “naked short selling,”* that is, selling the stock in the market before borrowing it, with the trader delaying the delivery of the stock that was supposed to have been borrowed, or never delivering it at all.
4. *Regulation of stock borrowing programs* in which broker dealers and other market participants seek to borrow shares from individuals holding long positions, in the main to lend to erstwhile short sellers.<sup>14</sup> In recent years, those short sellers have faced increased efforts to enforce regulations against naked short selling, making stock borrowing imperative.

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<sup>14</sup>Brokers representing short sellers may attempt to borrow stock from other brokers, as well as from individuals. The other brokers remove the stock from margin accounts that their customers maintain with them. The intermediary among brokers is the Stock Borrow Program run by Depository Trust Clearing Corporation (DTCC), which operates through its subsidiaries Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC). *See, e.g.,* Christian, *supra* note 2, at 1042 & 1053-55; SEC Short Selling Concept Release, SEC Exchange At Release No. 42,037 (Oct. 28, 1999). In its vault, DTC holds certificates representing over 97% of public company shares in circulation. NSCC clears 99% of the trades which take place, amounting to 4.5 trillion shares per day and 1.5 quadrillion shares per year. Christian at 1086. Each day DTCC promulgates an Easy to Borrow list of companies whose shares are readily available through the Stock Borrow Program. The emphasis in this article is on borrowing stock directly from investors rather than through the DTCC program, which results in another set of alleged abuses that are beyond the scope of this article. *See, e.g.,* Christian, *supra* note 2, at 1070-71.

5. Recognition of now ubiquitous, and vital to much short selling, *stock borrowing programs as investment contracts*. Stock borrowing programs would hence be securities, which must be registered or have an exemption from registration and the offer of participation would have to be accompanied by full disclosure.
6. *Restoration of the uptick rule*, SEC Rule 10a-1, which the SEC implemented in 1938, and repealed in July 2007,<sup>15</sup> in modernized form (for example, applicable to NASDAQ and other OTC stocks as well as NYSE stocks (National Market Systems, or NMS, stocks) and in decimalized form).<sup>16</sup> The rule mandated that trader could sell short only at a price one eighth higher than the previous trade (an uptick). Alternatively, a short could sell borrowed shares at a price equal to the last sale if the price of that last trade exceeded the previous sales price (“a zero plus uptick”). In April, 2009, one of several proposed rules, which the Commissions promulgated for comment, would by-and-large replicate the uptick rule.<sup>17</sup>

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<sup>15</sup>17 C.F.R. § 240.10a-1 (1988). Repeal was by means of SEC Release No. 34-55970 (June 28, 2007).

<sup>16</sup>Many more corporations are moving share listings from the NYSE to the Nasdaq than in the past. From 2000-2007, 144 Nasdaq companies moved listings to the NYSE while only 20 moved the other way. In 2008, however, companies with market capitalizations of \$80 billion moved to the Nasdaq while only \$8 billion moved the other way, to the NYSE. Serena Ng, *Nasdaq Pulls Harder for Listing Switches*, WALL ST. J., Feb. 26, 2009, at C-1. Share trading converted to decimalization in 2004 while previously, and in the heyday of the uptick rule, trading was in fractions (1/8, 1/4, etc.) of a dollar.

<sup>17</sup>SEC Reform Proposals at 69-85.

This article is about numbers 4, 5 and 6, stock borrowing programs (as subject to SEC regulation, or as investment contracts), restoration in some form of an uptick rule, and approaches and variations to those approaches, to which new SEC Chair Mary Shapiro is open<sup>18</sup> and for which certain members of Congress have called. It is not about severely hamstringing, or banning altogether, short selling.<sup>19</sup>

Further, this article is about the SEC's latest proposals, which necessitate adding numbers 7, 8 and 9, and which include further:

7. *A Modified Uptick Rule*, which would be based upon the national best bid price, as produced by the securities information processor under the National Market System's consolidated information processing system, rather than upon the previous sales price.<sup>20</sup> The NMS system will yield a national best bid price despite trading having occurred in several disparate and geographically remote markets.
8. *A Circuit Breaker Halt Rule*, which would prohibit, for the remainder of the trading day, any person from selling short a security following a 10% decline in that day's price for that security.<sup>21</sup>
9. *A Circuit Breaker Modified Uptick Rule* pursuant to which a severe decline in a particular security's price would trigger application of a temporary short sale price

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<sup>18</sup>See Yin Wilczek, *Shapiro Directs Trading & Markets Division to Review Uptick Rule, NRSRO Pay Models*, 41 BNA FED. SEC. REG. & L. REP. 247 (Feb. 16, 2009).

<sup>19</sup>Malini Manickavasagam, *Ackerman Urges SEC's New Leader to Act on Uptick Rule, Citing Cox's Support*, 41 BNA FED. SEC. REG. & L. REP. 198 (Feb. 9, 2009).

<sup>20</sup>SEC Reform Proposals at 3 & 29-69.

<sup>21</sup>*Id.* at 4 & 89-99.

test (uptick or modified uptick test) for that security, rather than halting short selling altogether.<sup>22</sup>

To use a sports metaphor, although short selling should co-exist with other forms of trading, and do so on a level playing field, level playing fields have boundaries. The rules should prohibit hits out of bounds (off the playing field), but nothing more. This article is about hits out of bounds or, about establishing where the boundaries are in the first place.

## I. PROPOSED AND HALF-HEARTED “REFORMS”

### A. *Why We Want Short Selling.*

“We need the shorts in the market for balance so that we don’t have bubbles,” says (former) SEC Chairman Christopher Cox.<sup>23</sup> Short sellers’ transactions help bring prices into line with levels supported by a corporate issuer’s and the market’s fundamentals (revenues, costs, profits, competitive outlook, growth rate, and so on). Short sales damp down irrational exuberance through their downward effect on securities prices.

Short selling facilitates many trading strategies. Arbitrage attempts to profit by taking advantage of price disparities in different markets or between comparable items with different names, sometimes in the same market. Index arbitrage, for example, exploits differences in the price of stock indexes and the basket of stocks upon which the index bases itself.<sup>24</sup> Convertible arbitrage notes small differences between the prices of convertible bonds and the common stocks

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<sup>22</sup>*Id.* at 4 & 99-104.

<sup>23</sup>Quoted in Chanos, *supra* note 5.

<sup>24</sup>*See, e.g.,* Macey et al., *supra* note 7, at 809.

into which they are convertible.<sup>25</sup> These and other trading strategies use short selling to create or to unwind positions.

Traders who wish to lock in a profit but not realize a gain until they have held a asset for 1 year, and therefore will pay only the 15% tax rate applicable to capital gains, rather than higher rates (33% or 35%) applicable to ordinary income, often sell short the same number of shares as they hold. Known as “going short against the box,” from the days when investors kept share certificates in safety deposit boxes, the strategy dictates that the investor unwind the short positions after the required year has passed.<sup>26</sup>

Overall the most laudatory aspect of short selling is as a mechanism of informational efficiency. Short selling tends to help prices move promptly in the correct direction and to the correct extent, or magnitude. It thereby enhances confidence in the market, as fewer investors buy or sell at prices not in accord with underlying economic realities. In other words, there are fewer surprises.

Statistics on short interest in various stocks, which is regularly published and widely followed, also send what finance professional term “noisy signals”: increasing short interest figures inform other traders, who are not short sellers themselves, that a well informed segment of the markets has taken progressively dimmer view of a particular stock or industry.<sup>27</sup> They thus may not sell short but they may reduce or eliminate their long positions.

B. *Why Some Restrictions on Short Selling May Be in Order.*

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<sup>25</sup>See, e.g., Powers et al., *supra* note 7, at 237.

<sup>26</sup>Described in, *inter alia*, Powers et al., *supra* note 7, at 239 & n.20.

<sup>27</sup>*Id.* at 243.

Efforts tantamount to at least a partial ban nonetheless surface from time to time. Grandstanding for corporations and investors (also voters) back home, several senators and congressmen say they want legislation forcing hedge funds to register with the SEC, disclosing their trading strategies, such as aggressive short selling, and who their investors are.<sup>28</sup> Wealthy investors would desert hedge funds in droves if funds' short selling strategies became public knowledge as did investors' identities. Short selling, especially of well-known stocks or of the shares of hometown companies, has never been popular.<sup>29</sup> Such legislation would not ban short selling altogether but would constitute painting bull's-eyes on hedge funds' and investors' backs, which is probably the legislators' objective.

On the other hand, some restrictions may be in order because the factual premises of laissez faire advocates have been wrong. "Only for thinly traded stocks is there a remote possibility of manipulative short sellers stampeding the price down," asserts Yale law professor Jonathan Macey.<sup>30</sup> "It is unlikely in today's highly developed market that 'bear raids' could seriously disrupt the workings of the market. Bear raids are most likely to be a problem for OTC firms," concludes Professor Macey. Of course, in a bear raid, groups of traders sell short a corporation's stock, pursuant to an express or tacit agreement among the traders. The further hope

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<sup>28</sup>See Jenny Strasburg, *Legislators Seek Hedge-Fund Disclosure*, WALL ST. J., Feb. 2, 2009, at C-2. See also Stephen Joyce, *New Rules for Hedge Funds Likely, Analysts Say, Due to Systemic Risk Proposal*, 41 BNA FED. SEC. REG. L. & REP. 131 (Jan. 26, 2009).

<sup>29</sup>Short-sellers have been described as "evil people": "they have robbed us of our money and they must be stopped." Reported in Nick Evans, *Don't Shoot the Short Sellers*, 33 EUROMONEY 20 (2002). Japanese Finance Minister Maajuro Shiokawa opined that "[s]hort-sellers are mean-spirited sorts bent on making money by getting a jump on other investors." 13 ASIA MONEY 1 (2002).

<sup>30</sup>Macey et al., *supra* note 7, at 817.

is that the group's short selling will depress the market price enough to trigger stop loss orders persons which long positions have placed several points beneath the current market price. Price declines of any magnitude will also trigger sell orders by institutional holders who adhere to programmed trading strategies often automatically generated by computers. Such further sales will increase, becoming a cascade and then a torrent, which will depress a stock's market price further, increasing the short sellers' profits.

These premises (that bear raids only affect thinly traded shares in OTC markets) are wrong. Bear raids are difficult to detect but we now have evidence that they have occurred in several "large cap" companies, such as Morgan Stanley or Long Term Capital Management.<sup>31</sup> Bear raids in such large companies affect not only investors in those companies. Raids in those stocks receive wide publicity, impugning market confidence over a front much broader than in the case of smaller, somewhat obscure OTC companies.<sup>32</sup>

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<sup>31</sup>See, e.g., Susan Pulliam, Liz Rappaport, Aaron Luchetti, Jenny Strasburg & Tom McGinty, *Anatomy of the Morgan Stanley Panic—Trading Records Tell Tale of How Rivals Bearish Bets Pounded Stock in September*, WALL ST. J., Nov. 24, 2008, at A-1, chronicles a bear raid on a high visibility large cap stock. Morgan Stanley (MS), which had just announced quarterly profits exceeding all forecasts, saw its stock price decline 24% in a single day. Short interest shot up to 9 times normal, although traders also used derivatives, including credit default swaps, to make bearish bets on the stock. While later analysis revealed no express agreements, conscious parallelism and herd mentalities by a number of major traders occurred. Citigroup, Merrill Lynch (then independent), Deutsche Bank, UBS, Royal Bank of Canada, and Swiss Re, among others, sold MS short in great quantities. False rumors, that Deutsche Bank had pulled a \$25 billion line of credit, or that Morgan Stanley would enter bankruptcy, accompanied and caused some of the further short selling. Among hedge funds, King Street Capital Management, LLC, Owl Creek Asset Management, LLC, and Third Point, LLC, engaged in short selling of MS. The Morgan Stanley affair, as well as other instances, discredits the conclusion that bear raids and short selling cannot affect a large cap company and its stock.

<sup>32</sup>See, e.g., John R. Emshwiller, "Naked Shorting" Lurks in Refco's Past, WALL ST. J., Oct. 25, 2005, at C-3.

Free market advocates have lost sight of the greater goal, which is overall market efficiency. In turn, a market is efficient if large numbers of buyer and sellers are in that market. Large numbers of buyers and sellers will be in the market if the spread between bid and asked prices is small and transactions costs are low. As the gap between bid and ask prices widens, price continuity disappears, volatility increases, prices gyrations occur, and roller coaster price changes and stomach churning price drops cause erstwhile traders to retreat from the markets.

*It is manifest error to equate informational efficiency with market efficiency overall, as most academic writers do. In an efficient market, there will be fewer surprises. Prices will move promptly in the correct direction and toward a new equilibrium. There will be a sizeable degree of informational efficiency. But there also will be price continuity. Prices will move to new highs, or to new lows, in, for lack of better words, an orderly and stately fashion. Fewer investors will be repelled by activity in market. The two goals, informational efficiency and price continuity, work at cross purposes, but both are necessary prerequisites for overall market efficiency.*<sup>33</sup>

Academic commentary flatly asserts that investors' trading, including short selling, should "move prices *quickly* to their equilibrium level."<sup>34</sup> Another concludes that "[l]egal rules should

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<sup>33</sup>See, e.g., 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) ("A healthy market is one not characterized by roller-coaster gyrations which frighten participants away"); Solomon, *The Impact of the Emerging System on Securities Trading and the Economy*, in WALL STREET IN TRANSITION 111, at 130-31 (H. Manne & E. Solomon eds., 1974) (same). See also RICHARD R. WEST & SEHA M. TINIC, *THE ECONOMICS OF THE STOCK MARKET* 5-8 (1974) (price continuity as symptomatic of an efficient market); BIRL E. SCHULTZ, *THE SECURITIES MARKET AND HOW IT WORKS* 134 (1942) (importance to companies and traders of individual stocks' reputations for price continuity).

<sup>34</sup>Macey et al., *supra* note 7, at 821.

nurture the dynamic processes that develop and incorporate information into market prices. . . . Our law should recognize the legitimate—indeed, necessary—role of short sales.”<sup>35</sup>

Speed isn’t everything. To the extent that they nibble around the edges, and contribute to price continuity and to investor confidence, some restrictions on short selling are in order. That has been heresy to say for the last 25 years but the events of 2008—publicized bear raids on well-known stocks, huge waves of short selling by some investors, wholesale retreats from the markets by others, and a precipitous fall in the Dow Jones (13,000 to below 7,000 in 6 months) and other market averages—call for re-examination of what has become the received wisdom.<sup>36</sup>

Informational efficiency *uber alles* may not be the correct mantra.

*C. Is Continued Vigilance Against “Distort and Short” Bear Raids and Similar Tactics Sufficient?*

Short sellers may attempt to manipulate the market by spreading disparaging rumors about a particular company. Simultaneously the rumor’s author, or her confederates, sell short, hoping to profit by the price decrease the rumor causes. Groups of traders may engage in concerted action of the same sort, labeled “distort and short” campaigns.<sup>37</sup> These types of cases surface from time to time.

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<sup>35</sup>Powers et al., *supra* note 7, at 270.

<sup>36</sup> Between July, 2008, and March, 2009, the Dow Jones Industrial Average lost 50% of its value and the S & P 500 Index lost 54%. SEC Reform Proposals at 24.

<sup>37</sup>SEC Chair Christopher Cox perceives distort and short campaigns as having “drastic consequences,” leading the Commission staff to target them for special enforcement efforts. See Cox, *What the SEC Really Did on Short Selling*, WALL ST. J., July 24, 2008, at A-15. Earlier the SEC had issued 50 subpoenas to hedge funds suspected of spreading false rumors about companies and stocks. Scannell & Lauricella, *supra* note 10, at A-13.

The occasional revelation of these sorts of manipulation, along with the evident potential for many more, combined with the difficulty of detection, gives impetus to advocates of additional regulation of short selling. By contrast, those who support unfettered short selling point out that vigilance by the self regulatory organizations (SROs, such as stock exchanges) and the SEC will lead to criminal and civil actions under, for example, SEC Rule 10b-5.<sup>38</sup> The goal, of course, is a sufficient number of prosecutions to deter the practice, not a zero defect approach which would adversely affect legitimate short sales.

*D. Regulation SHO and the Campaign Against Naked Short Selling.*

As with the condemnation of “distort and short” manipulations, many market participants condemn the practice of naked short selling.<sup>39</sup> In theory, if short sellers do not have to, or simply do not, deliver shares which they have purported to sell, short interest in a stock can exceed the total number of shares outstanding. On a more realistic scale, without the constraint of having to deliver shares within 3 days after selling them (T+3), short interest in a stock can mount rapidly, exerting excessive downward pressure on a stock’s price. Combined with broadcast of false rumors, or an organized distort and short campaign, naked short selling can push a stock’s price so far down that the price level has no connection with underlying economic realities. In the view of

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<sup>38</sup>Two cases involving manipulative short selling schemes are *SEC v. Russo*, 74 F3d 1383, 1392 (2d Cir. 1996), and *SEC v. Gardiner*, 48 SEC Docket 9121 (SDNY 1991).

<sup>39</sup>*See, e.g.*, Liz Moyer, *Crying Foul in Short Selling*, Forbes.com, June 21, 2006, <http://w.w.w.forbes.com/2006/06/20/naked-short-selling-overstock.html>; Karl Thiel, *The Naked Truth About Short Selling*, THE MOTLEY FOOL, Mar. 24, 2005 (“Naked short sellers sell shares of stock they haven’t borrowed, have no intention of borrowing, and that may not exist”). Prolonged fails to deliver resulting from naked short selling may reach high levels. The amount of fails may exceed the number of shares in the public float of the security, resulting in great numbers of phantom shares. *See* Christian, *supra* note 2, at 1045-46.

nearly every market participant, naked short selling, like the spread of false rumors, is a “hit out of bounds,” not considered to be within the boundaries marking the level playing field.<sup>40</sup>

But how to police it? The SEC adopted Regulation SHO in August, 2004, to take effect in January, 2005.<sup>41</sup> The regulation forbids a broker-dealer from accepting a short sale order unless the would-be short seller has already borrowed the shares he proposes to sell, or has identified the shares he intends to borrow (the “locate” requirement).<sup>42</sup> As to widely traded shares, the trader, or his broker, can usually find them in the firm’s own accounts or on the Depository Trust Clearing Corporation’s (DTCC’s) Easy to Borrow list, which in normal times would satisfy the locate requirement.<sup>43</sup>

After the trade (sale of the shares), Regulation SHO reduces the duration for which failures to deliver are permitted to remain open. Broker-dealers must close out fail-to-deliver positions in “threshold securities” that have persisted for 13 settlement days (the “closeout” requirement”).<sup>44</sup> Closeout means that the broker essentially will have to cover “open fails,” that is, buy in the requisite number of shares, closing out the short position. The SEC, or the applicable SRO, any

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<sup>40</sup>*Cf. Crisp, supra* note 7, at 145.

<sup>41</sup>Regulation SHO, SEC Release No. 34-50,103 (Aug. 6, 2004).

<sup>42</sup>A short seller must possess “reasonable grounds to believe that the security may be borrowed so that it can be delivered on the date delivery is due,” that is, by the close of the third business day after the trader purported to sell stock (T+3). SEC Rule 203(b)(1)(ii), 17 C.F.R. § 240.203(b)(1)(ii) (2006). “This locate must be made and documented prior to effecting the short sale.” SEC Division of Market Regulation, Key Points About Regulation SHO at 2 (Apr. 11, 2005).

<sup>43</sup>That is, satisfy the locate requirement, absent actual knowledge by the broker that there have been repeated fails to deliver in the particular stock. *See Christian, supra* note 2, at 1070-71.

<sup>44</sup>Regulation SHO Rule 203(B); Key Points about Regulation SHO at 3.

also institute disciplinary actions against licensed professionals, most particularly the broker dealer, for violating Regulation SHO.<sup>45</sup>

A security is a threshold security if, over any running 5 day period, fails to deliver equaled or exceeded 10,000 shares and .5% of the issuing company's outstanding shares, which is an SEC reporting company.<sup>46</sup> A broker-dealer cannot accept from any trader an order to sell short a threshold security if the trader has an open position (unfilled) in that security.<sup>47</sup> For 2 years following Regulation SHO's adoption, the threshold list on average contained 300 names, averaged 414 stocks in the first nine months of 2008, and peaked at 529 stocks as naked short selling of banks and other financial stocks crescendoed.<sup>48</sup>

E. *July 2008 Modification of SHO's Application to Certain Financial Stocks.*

It is commonly stated that the SEC instituted a "ban" or a "curb" on short sales. It did no such thing, at least at first. Instead, on July 15, 2008, the SEC announced that, effective July 21,

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<sup>45</sup>See, e.g., Stephen Joyce, *NYSE Imposes Largest Regulation SHO Fine in Case Involving Deutsch Securities*, 40 BNA Fed. Sec. Reg. & L. Rep. 1486 (September 22, 2008)(\$575,000 for failure by 5 trading desks to close positions after short sellers failed to produce borrowed securities in 13 days).

<sup>46</sup>*Id.* The various self regulatory organizations (SROs), such as stock exchanges and the Nasdaq, are to disseminate daily lists of threshold securities which, *inter alia*, they publish on their websites. *Id.* at 4. Approximately 16,200 corporations (the number fluctuates daily) file periodic reports with the SEC. See ARTHUR PINTO & DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 150 & n.19 (2d ed. 2004).

<sup>47</sup>At the time of SHO's adoption, Wall Street spokespersons expressed concern that the existence of a list ("Threshold Securities") and the presence of issuing corporations' names on it would result in less short selling, in turn permitting higher prices to persist. See Henry Sender, *New Rules Put the Squeeze on the Shorts*, WALL ST. J., Jan. 27, 2006, at C-5. The concerns never materialized. See Floyd Norris, *A New SEC Rule Fails to Raise Stock Prices, and Some Are Angry*, N.Y. TIMES, Feb. 18, 2005, at C-1.

<sup>48</sup>Tom McGinty & Jenny Strasberg, *Short Sellers Squeezed on All Sides*, Wall St. J., April 7, 2009, at C-1.

and with license to continue for up to 30 days, the SEC would suspend the locate prong of Regulation SHO, as to 19 of the most widely traded financial stocks. Would-be short sellers in those stocks would either have to have borrowed the shares they proposed to sell short, or have a formal agreement from a lender to provide the requisite shares to the short seller on or before closing of a trade (T+3).<sup>49</sup> The prices of financial stocks had declined greatly. The SEC thought that a high level of short sales had contributed to the decline, or to the steepness of its slope. The SEC thought further that a great number of those sales had been naked short sales. So the Commission engaged in technical belt tightening.<sup>50</sup>

On September 18, 2009, the SEC extended the T+3 mandate, requiring *all* open short positions to be closed out by the fourth day after the trade. The number of stocks on the threshold list soon thereafter dropped well below 200, averaging 79 in the first quarter of 2009.<sup>51</sup>

Criticism of the SEC's efforts was nearly universal. Professor Owen Lamont, formerly of Yale, termed it a "silly but harmless effort."<sup>52</sup> President of the Managed Funds Association, the hedge fund industry group, termed the SEC's actions "aberrant" and "without precedent."<sup>53</sup> On

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<sup>49</sup>SEC Exchange at Release No. 58166 (July 15, 2008). *See also* SEC Press Release 2008-143, SEC Enhances Investor Protections Against Naked Short Selling (announcing emergency rule making). "An arrangement to borrow requires more than a reasonable grounds to believe that the security may be borrowed. An arrangement to borrow means a bona fide agreement to borrow the security such that the security being borrowed is set aside at the time of the arrangement . . . ." SEC Division of Trading and Markets, Guidance Regarding the Commission's Emergency Order Concerning Short Selling at 1 (July 18, 2008).

<sup>50</sup>*See, e.g.,* Robert Cyran & Antony Currie, *Clumsy SEC Arrives Late*, WALL ST. J., July 19, 2008, at B-16 (a "technicality," "actually only [to] clarify a gray area").

<sup>51</sup>McGinty & Strasberg, *supra* note 48.

<sup>52</sup>Scannell & Lauricella, *supra* note 10, at A-13.

<sup>53</sup>*Id.*

the other side of the issue, the American Bankers Association expressed fear that with naked short selling curtailed for the largest banks, short sellers would focus on the banks not covered by the new SEC rules.<sup>54</sup> The rule's effect, although short-lived, was immediate and startling. Price increases in the financial stocks ranged from a highs of 89.5% (Fannie Mae), 74.5% (Freddie Mac) and 48.4% (Bank of America) to a mean of 25.6% and a median of 25.2%.<sup>55</sup> Short interest in some of those stocks had been high: 14.22% in Fannie Mae shares and 12.81% in Freddie Mac. Relieved of naked short selling and its downward pressure on price, the share prices rebounded.

Of course, an argument may be made that curtailment of naked short sales merely prolonged the inevitable: Lehman Brothers shares, in which short interest had risen to 12.57%, rebounded 44.6%. Lehman Brothers, of course, entered bankruptcy in September. The same may be said of Fannie Mae and Freddie Mac: although they rebounded temporarily, their shares eventually became worthless as well.

The counter argument is that informational efficiency is not everything. Relieved of naked short selling's effects, Lehman's, Fannie's and Freddie's share prices moved to equilibrium (zero, or near zero) in a more orderly fashion and investors' confidence was (slightly) less shaken.

Nonetheless, on July 29, the SEC announced continuation of temporary rules to the maximum extent allowed for, 30 days, that is, until August 14, 2008.<sup>56</sup>

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<sup>54</sup>Scannell, *SEC Short-Sale Rule Gets Negative Reviews*, WALL ST. J., July 19, 2008, at B-1.

<sup>55</sup>*Id.* (Table).

<sup>56</sup>SEC Press Release 2008-155, SEC Extends Order Limiting Naked Short Selling (July 29, 2008); Scannell & Lauricella, *supra* note 10.

F. *SEC September, 2008 Expansion of Restrictions on Short Selling.*

Many at the SEC believed that short selling had contributed to, *inter alia*, the collapses of Bear Stearns Cos. and Lehman Brothers Inc. So, in September, the SEC went back to the drawing boards. The Commission adopted several temporary rules:

- The SEC increased penalties for short sellers who rely on the locate requirement and then fail to deliver on T+3. After any such failure to deliver, the SEC will bar the broker-dealer from executing any short sale unless the trader actually has borrowed the shares before placing the order (the hard delivery requirement, to expire August 1, 2009).<sup>57</sup>
- The SEC defined as misleading and per se fraudulent for any trader to mislead a broker-dealer that the trader has located shares to borrow when he hasn't.<sup>58</sup>
- The SEC banned, temporarily, all short selling in financial stocks.<sup>59</sup>

The new rules, announced on September 17 and 18, went into effect at 12:01 AM on September 18<sup>60</sup> and quickly expanded thereafter.

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<sup>57</sup>SEC Exchange Act Release No. 58572 (Sept. 17, 2008) (adopting temporary Regulation SHO Rule 204T and Rule 10b-21). *See also* SEC Press Release No. 2008-204, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008).

<sup>58</sup>SEC Rule 10b-21, 17 C.F.R. § 10b-21 (Sept. 21, 2008) (“It shall also constitute a ‘manipulative or deceptive device or contrivance’ . . . for any person to submit an order to sell an equity security if such person deceives a broker-dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date”).

<sup>59</sup>SEC Exchange Act Release 58592 (Sept. 18, 2008) (Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934).

<sup>60</sup>Kara Scannell, *SEC Issues Short-Selling Rules in Bid to Stop Manipulation*, WALL ST. J., Sept. 18, 2008, at A-6.

The hard delivery requirement was thought especially to be efficacious. Open fails declined from an average of 1.1 billion shares per day, before the rule, to an average of 582 million shares per day, after the SEC had adopted the provision.<sup>61</sup>

Effective Monday, September 22, the SEC adopted a temporary rule requiring higher volume short sellers, such as hedge funds and other money managers, to disclose their short positions on the Mondays following their trades.<sup>62</sup> The SEC also added 71 stocks to its list of 750 in which the Commission had prohibited short selling, including shares of General Motors, Credit Suisse First Boston, American Express, Moody's, and Legg Mason, the brokerage firm.

The latter trend (addition of stocks to the list) continued, with the SEC adding to the list any retail or industrial corporation which had a financial subsidiary, including CVS, Ford, United Healthcare, IBM, Zale (jewelers), and Sears.<sup>63</sup> Regulators around the world, also faced with the gyrations of a world crisis, enacted short selling bans in their own countries.<sup>64</sup>

Criticism mixed with bits of empathy for the SEC. "It looks like we have a bunch of amateurs [at the SEC] who don't know what they are doing . . . [b]anning short selling shows the desperation of the regulators," said Professor James Angel at Georgetown University. The SEC

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<sup>61</sup>SEC Reform Proposal at 23 & n. 81.

<sup>62</sup>SEC Exchange Act Release No. 58591A (Sept. 21, 2008). *See also* SEC Division of Corporate Finance, Division of Investment Management, and Division of Trading and Markets, Guidance Regarding the Commission's Emergency Order Concerning Disclosure of Short Selling (Sept. 24, 2008); Kara Scannell, *SEC Revises "Short" Rules Already*, WALL ST. J., Sept. 23, 2008, at A-3.

<sup>63</sup>Kara Scannell & Serena Ng, *SEC's Ban on Short Selling Is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C-3.

<sup>64</sup>*See, e.g.*, Scannell, *Short Sale Ban Spreads Around the World*, WALL ST. J., Sept. 22, 2008, at C-1 (Australia, UK, Taiwan, Netherlands); Staff, *Korea Tightens Its Rules*, WALL ST. J., Sept. 25, 2008, at C-2.

just decided that “we needed a time-out [but] [t]here are a lot of us out there who are wondering what the SEC was thinking, whether they have gone of the rails . . . ,” said Professor Charles Jones at Columbia.<sup>65</sup> “Stop the folly. End the ban,” opined a Swiss Professor (Ibis), finding that stocks on the ban list reacted more slowly than stocks outside the umbrella.<sup>66</sup>

Of course, Professor Ibis may have missed the whole point, which was to cause shares prices to react in a more orderly and slower fashion. Again, there are those who believe that informational efficiency is not the sole objective of regulators.

Nonetheless, the short selling ban expired on October 17, 2008.<sup>67</sup> Around the world, other regulators followed, allowing bans on short selling to lapse.<sup>68</sup> In the final analysis, one may question whether the U.S. ban accomplished anything. The Dow Jones Industrial average slipped below 8,000 in January 2009, the worst January on record. Perhaps roiled by turbulent prices, and certainly adversely affected by falling prices, investors continued to desert the markets, pushing the Dow Jones average toward 6,000.

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<sup>65</sup>Scannell, *SEC Revises “Short” Rules Already*, *supra* note 50.

<sup>66</sup>Ibis, *Shorting Financial Stocks Should Resume*, WALL ST. J., Sept. 29, 2008, at A-25.

<sup>67</sup>See SEC Exchange Act Release No. 58723 (Oct. 2, 2008) (extended ban to terminate “at the earlier of (i) three business days from the President’s signing of the Emergency Economic Stabilization Act of 2008 (H.R. 1424), or (ii) 11:59 p.m. E.D.T. on Friday, October 17, 2008”); Yin Wilczek & Richard Hill, *SEC Order Banning Short Sales in Financial Company Stocks to End 10/8*, 40 BNA Fed. Dec. Reg. & L. Rep. 1583 (October 6, 2008).

<sup>68</sup>See, e.g., Simon Nixon, *Short Ban Was Short Lived*, WALL ST. J., Jan. 6, 2009, at C-10 (UK Financial Services Authority ends ban effective January 16); Ali Qassim, *U.K. Regulator Ends Ban on Short Selling, Extends Disclosure Regime Until Mid-2009*, 41 BNA Fed. Sec. Reg. & L. Rep. 62 (January 12, 2009). By contrast, Australia, which outlawed all short selling as of September 21, 2008, lifted the ban as to non-financial stocks (November 13) but kept in place the ban on short selling financial stocks for 8 months, until May 25, 2009. Lyndal McFarland, *Australia Lifts Ban on Short Sales*, Wall Street Journal, May 26, 2009, at C-2.

## II. RESTORATION OF AN UPTICK RULE?

### A. *Short Selling in Days Goneby and Abolition of the Rule.*

To refresh the reader's recollection, the uptick rule existed from 1938 until 2007. The rule limited a would-be short seller to selling short only following a transaction at a price greater than the previous transaction (uptick), or one step removed (zero plus tick). In announcing rescission of the rule, the SEC pointed to the transparency and the intense surveillance of today's markets, which make market manipulation using rumors and short sales easier to detect and therefore less likely to occur. The brake of the uptick rule, which would slow the progress of any bear raid or short selling campaign, including manipulative ones, was no longer needed.<sup>69</sup>

The SEC also relied on its own empirical study of the effects of the uptick rule. From May 2, 2005, until July 3, 2007, the SEC suspended the uptick rule for 1,000 stocks.<sup>70</sup> The result of the "pilot program" was a conclusion that the presence or absence of an uptick rule had no effect on the volume or character of short selling. A pilot program stock, free of the uptick rule constrain, experienced no volume of short selling greater or less than comparable stock subject to

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<sup>69</sup>See SEC Release No. 34-55970 (June 28, 2007).

<sup>70</sup>SEC Release No. 34-50204 (July 28, 2004) (initiating pilot study).

the uptick rule.<sup>71</sup> Using the data the SEC's study had generated, researchers at major universities backed the SEC's conclusions.<sup>72</sup> The uptick rule was gone.

But not without misgivings. Members of Congress introduced a bill which would have reinstated the uptick rule, extending its application beyond NYSE to many over-the-counter stocks, as statutory requirement.<sup>73</sup>

#### B. *Reactions to Abolition.*

When the *Wall Street Journal* published an editorial on the question of restoring the rule, letters to the editor, or at least the published ones, ran 5 to 1 in favor of restoring the rule or something comparable. “[T]he absence of the rule has created selling cascades in certain stocks. I have shorted stocks my whole career, but this selling is crazy,” concluded one trader in December, 2008.<sup>74</sup> “We don’t need that meaningless rule to be restored. We need a new rule . . . that is unambiguous and impossible to manipulate. No stock can be sold short unless it is sold at a price above yesterday’s close.”<sup>75</sup>

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<sup>71</sup>See, e.g., SEC Reform Proposals at 14: the SEC’s Office of Economic Analysis (OEA) “[did not find] a significant difference in short interest positions between those securities subject to a short sale price test versus those securities that were not subject to such a test . . .” (footnote omitted).

<sup>72</sup>See Lynn Bai, *The Uptick Rule of Short Sale Regulation—Can It Alleviate the Downward Pressure From Negative Earnings Shocks?* (University of Cincinnati College of Law Working Paper Series, 2007), available at <http://ssrn.com/abstract=956106>; Karl Diether, *It’s SHO Time! Short-Sale Price-Tests and Market Quality* (Ohio State University Fisher College of Business Working Paper Series, 2007), available at <http://ssrn.com/abstract=910614>; Julie Wu, *Short Selling and the Informational Efficiency of Prices* (University of Georgia Working Paper Series, 2008), available at <http://ssrn.com/abstract=9726230>.

<sup>73</sup>H.R. 6517, 110th Cong., 1st Sess. (2008).

<sup>74</sup>Letter from Jon Groveman, Letters to the Editor, WALL ST. J., Dec. 15, 2008, at A-18.

<sup>75</sup>Letter from Jon R. Alden, Letters to the Editor, WALL ST. J., Dec. 15, 2008, at A-18.

The lone dissenter weighed in in favor of informational efficiency rather than giving lip service, or otherwise, to any notion of price continuity: “The faster the [share] price goes to its proper level [assisted by short selling] the fewer innocent victims will buy on the way down. The ‘confidence’ that the uptick rule would ‘restore’ is nothing but a prolongation of the agony, and another form of manipulation.”<sup>76</sup>

Much of this dustup was most immediately precipitated by an op-ed column authored by Charles Schwab, founder of the eponymous online brokerage firm. He was exceedingly critical of the SEC’s abolition of the rule:

[T]he SEC repealed the uptick rule after a brief study. Manipulative short sellers couldn’t believe their luck.

The SEC’s study took place during a period of low volatility and overall rising stock prices in 2005 through part of 2007 and didn’t anticipate the kind of market we are experiencing today. We live in an environment where 200 point drops or more in the Dow Jones Industrial Average are increasingly common, where a stock losing 20%, 30% or even more in a single day barely warrants a second glance at the ticker. Ironically, it was just this sort of volatility that inspired the regulators in the 1930s to implement the uptick rule in the first place. Without this mechanism, short sellers have been having a field day, betting heavily on lower prices and triggered panicked investors to sell even more.<sup>77</sup>

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<sup>76</sup>Letter from S. Paul Posner, Letters to the Editor, WALL ST. J., Dec. 15, 2008, at A-18.

<sup>77</sup>Charles R. Schwab, *Restore the Uptick Rule, Restore Confidence*, WALL ST. J., Dec. 9, 2008, at A-17.

Mr. Schwab intimates that the SEC should have studied the uptick rule in generally down markets as well in more bullish times, as it did in 2006-2007. In a rising market, buyers are plentiful. Certain of their purchases produce upticks. For the short seller, then, in a bullish market an uptick is not hard to find.

On the other hand, in a market which is flat, or trending downward, buyers are more scarce. There will more downticks. An uptick will be harder to find. The presence of an uptick rule will delay, or in some instances forestall altogether, putative short sellers. In terms of the SEC's study, in a down stock market, stocks subject to the uptick rule would experience less short selling than would comparable stocks to which the rule did not apply. That would be true even though in a generally rising market the presence or absence of an uptick rule would make no difference.<sup>78</sup>

At a minimum, then, the SEC should conduct additional studies which might illustrate the differing effects of the uptick rule, and variants thereof, in differing sorts of markets. A separate question is whether the SEC should re-instate, temporarily at least, some version of an uptick rule, or some similar brake or check on stomach churning roller coaster volatility, and the short selling which contributes to it.

### *C. Proposals: Circuit Breakers or Sale Price Restrictions?*

The SEC first proposes a "modified uptick rule," based upon the national best bid price in a particular "covered" security,<sup>79</sup> followed by a proposal for "proposed uptick rule," which would

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<sup>78</sup>See, e.g., Jeff D. Opdyke, *Uptick Rule Gets Debate Amid Turmoil*, WALL ST. J., Dec. 24, 2008, at C-1 ("Charles Whitehead, a securities-law professor at Boston University, notes that the SEC study occurred during a generally rising market. When the market is declining, an uptick rule would at least abate the relentless downward pressure . . .").

<sup>79</sup>SEC Reform Proposal at 3 & 29-69.

be based upon the last sale price, as of old.<sup>80</sup> Generically, the SEC staff refers to these proposals as “price restriction rules” or “Short Sale Price Restrictions.” A best bid, of course, is the highest price any bona fide investor is willing to pay, while the best asked would be the lowest price at which an erstwhile seller is willing to accept.<sup>81</sup> The short sale price restriction proposals are discussed below.

Covered securities would be National Market System (NMS) securities (e.g., NYSE, AMEX, Nasdaq and actively traded other OTC). The Commission invites commentary on extension of whatever rules are adopted to stocks listed on the OTC Electronic Bulletin Board and the like, because in those markets many small (“micro cap”) issuers believe their shares are “particularly vulnerable to abusive short selling.”<sup>82</sup>

The great watershed among proposals is between short sale price restrictions, as just outlined, and “proposed circuit breaker rules.” The SEC omits to tell its readers what a circuit breaker is, although most interested commentators will have familiarity with the device and its use in financial regulation.<sup>83</sup> The circuit breaker proposals divide into 2 basic variants: the “Proposed

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<sup>80</sup>*Id.* at 69-96.

<sup>81</sup>The difference between the bid and the ask is referred to as the spread.

<sup>82</sup>*Id.* at 31.

<sup>83</sup>For the uninitiated, a circuit breaker (fuses in days-gone-by) is an electrical device which opens an electrical circuit when the electricity flowing through the circuit is too great or at too great a rate. By popping open, the breaker prevents damage to appliances on the circuit or, indeed, an electrical fire. The homeowner must then manually reset the circuit breaker (or replace the blown fuse) so that the circuit is again complete, allowing electricity to flow to appliances, light fixtures, etc.

Circuit Breaker Halt Rule,”<sup>84</sup> and the “Proposed Circuit Breaker Price Test Rule.”<sup>85</sup> A decline of 10% in the day’s price of a particular security would “pop” the circuit breaker as to the security.<sup>86</sup> The effect of a pop would differ between the 2 proposed rules. With the halt rule, no more short selling could occur that day. With the price restriction rule, only short selling on an uptick, or on a modified uptick (national best bid price or better), could be done for the remainder of the trading day.

The SEC repeatedly states its policy goal: to attempt to prevent “potentially abusive or manipulative short selling, from being used as a tool to drive down a market and from being used to accelerate a declining market ... [b]y seeking to advance these goals, the proposed [rules and their variants] might help restore investor confidence.”<sup>87</sup> When it fashioned proposed circuit breaker rules, however, the SEC staff seems to have forgotten what the policy goal of the exercise is.

Simply put, the circuit breaker proposals consist of closing the barn door after the horse is gone. By the time a security’s price had declined 10%, many individual investors would be considering selling, or at least be taking note of the volatility in the particular stock. Short selling could resume the next morning. If short selling resumed and 10% declines occurred on successive, or nearly successive days, even more damage to investors’ psyches’ would occur. Even declines of 5-6-7% on successive days, which would not trigger either circuit breaker

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<sup>84</sup>SEC Reform Proposal at 89-99.

<sup>85</sup>*Id.* at 99-104.

<sup>86</sup>The Commission believes that a 10% decline “would be an appropriate level at which to trigger a circuit breaker,” SEC Reform Proposal at 90.

<sup>87</sup>SEC Reform Proposal at 65. *See also id.* at 30, 72.

proposed, can have an adverse effect on investor attitudes. If those declines occur over spectrums of the market, even though overall the market is up, the type damage we wish to lessen will take place.

But we may not be able to do anything about the latter. Regulation cannot, and should not, stunt market forces. It can only smooth their effect. Circuit breaker rules conjure up visions of jarring jolts in price movements. The aim is to take out, or reduce, the jolt in the price before, and not after, it occurs. Circuit breakers would only do the latter.

#### D. *Uptick or Modified Uptick?*

The SEC release, its dedication of various page amounts to various proposals, and its juxtaposition of the various proposed rules seem strongly to indicate the SEC's predisposition to a modified uptick rule.<sup>88</sup> This seeming thumb on the scale, however, makes sense.

A rule based upon the last sale, as an uptick rule would be, and as SEC Rule 10a-1 was before repeal, is outmoded. Since 1975, we have been moving toward a National Market System (NMS).<sup>89</sup> NMS does not contemplate one market, or the consolidation of various disparate markets. Instead, the National Market System contemplates promoting and making more visible

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<sup>88</sup>For example, the SEC puts the uptick rule proposal after the modified uptick rule discussion, when, in the ordinary course of things, the old rule, with which readers would most be familiar, would come first. See SEC Reform Proposal at 69-96 (old rule) & at 29-69 (modified uptick rule discussion first). The SEC devotes far more pages, 40, to the modified rule, as compared to the updated version of the old rule, 16, although much of the 40 page discussion is of exemptions which would apply to both rules. The Commission then sticks the proposed circuit breaker rules way in the back. See SEC Reform Proposal at 89-99 (Circuit Breaker Halt Rule) & 99-104 (Circuit Breaker Modified Uptick Rule).

<sup>89</sup>See generally Douglas M. Branson, *supra* note 33, at 871-876. Securities Exchange Act §11A, 15 U.S.C. §78 k(A), added by the Securities Act Amendments of 1975, describes the ingredients of the National Market System. See also Jonathan Macey & David Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. Ill. L. Rev. 315, 321-330.

the prices and other terms of trade various markets (say, NYSE, Nasdaq, Midwest Stock Exchange, Pacific Stock Exchange, Instinet, etc.) offer as to a particular stock. The first step in that process is consolidation of trading information. All market participants, no matter where they trade, must report their trades to the securities information processor for the particular security.<sup>90</sup>

Seemingly, such consolidated reporting aids implementation of a short selling uptick rule based upon the last sale but it does not. Trades get reported out of sequence. Information processors publish trades in "reporting sequence, not trade sequence."<sup>91</sup> Market participants report their trades, as the law requires, but delays may occur. Trading takes place at different prices in "multiple, dispersed, and diverse markets."<sup>92</sup> More often than not, the purported last sale price is not the true last sale price.

The National Association of Securities Dealers (NASD) implemented a modified uptick rule in 1994, applicable to a portion of the Nasdaq list, which was in effect for over 10 years.<sup>93</sup> The restriction on short selling was "modified," because the NASD based the prohibition of the national best bid rather than the last sale price. The NASD experience, as well as its own observations, inform the SEC's preference for a best bid based short selling restriction. "The national best bid would have advantages over a test based upon the last sale [and would be] a more accurate reflection of current prices for a security than the last sale prices due to delays that can occur in the reporting of last sale information."<sup>94</sup>

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<sup>90</sup>See Branson, *supra* note 33, at 873 & n. 99;

<sup>91</sup>SEC Reform Proposal at 42.

<sup>92</sup>*Id.* at 38.

<sup>93</sup>NASD Rule 3350, *discussed* SEC Reform Proposal at 7.

<sup>94</sup>SEC Reform Proposal at 6.

Securities information processors already collect, calculate and disseminate the national bid price. Under the SEC's proposed rule, "a trading center shall establish, maintain and enforce policies and procedures reasonable designed to prevent the execution or display of a short sale order in a covered security at a down bid price." The rule would further define "down bid" price as a "price that is less than the current national best bid price."<sup>95</sup>

E. *Policies and Procedures for Trading Centers or Flat Prohibitions on Market Participants?*

In framing its proposals, and rules which would implement them, the SEC seems to favor an approach which would put the onus of compliance on industry professionals rather than short sellers themselves. The SEC prefers a branch of the "modified uptick rule which would require trading centers to have policies and procedures reasonably designed to prevent the execution or display of short sales at impermissible prices."<sup>96</sup> Trading centers could reject an impermissibly priced short sale or require that it be re-priced and re-submitted.<sup>97</sup> Trading centers' procedures would have to require that the trading center monitor, on a real time basis, the national bid price and to conduct continuous surveillance of short selling.<sup>98</sup>

The "old" uptick test put the onus of compliance on the trader (short seller) herself. The purpose of the rule is to retard or stop altogether the activities of abusive and manipulative shorts sellers, who use short selling as a tool to accelerate a declining market. If that is so, keep the onus

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<sup>95</sup>SEC Rule 201(b)(1)(proposed), *discussed* SEC Reform Proposal at 29.

<sup>96</sup>SEC Reform Proposal at 28.

<sup>97</sup>*Id.* at 36.

<sup>98</sup>*Id.* at 37.

of compliance on the would-be prime movers, the short sellers themselves, rather on trading centers who may or may not be innocent bystanders, depending upon the case.

Those who render substantial assistance to another who violates the law (the primary violator), and who do so possessed of the requisite state of mind (knowingly, or at least consciously unmindful of the effect their conduct may have on others), are aiders and abettors. In *Central Bank of Denver v. First Interstate Bank*,<sup>99</sup> the Supreme Court struck down aiding and abetting causes of action under the federal securities laws.<sup>100</sup> Two years later, however, the Private Securities Litigation Reform Act (PSLRA) added section 20(f) to the Securities Exchange Act, permitting the SEC enforcement actions against collateral participants who aid and abet an illegal securities transaction, at least if they did so knowingly.<sup>101</sup> By its regulation, the SEC could put the onus of compliance with the modified short sale rule on short sellers themselves, where it belongs, leaving the prolonged failure to adopt policies and procedures, or to enforce those they have adopted, to aiding and abetting enforcement actions against the trading centers who have assisted short sellers in violating the short sale price restrictions.

## II. REGULATORY REFORM: DEFINING SECURITY TO INCLUDE STOCK BORROWING PROGRAMS, OR DISCIPLINING INTERMEDIARIES WHO FACILITATE STOCK BORROWING WHEN THEY FAIL TO MAKE REQUIRED DISCLOSURES

### A. *Stock Borrowing.*

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<sup>99</sup>511 U.S. 164 (1994).

<sup>100</sup>The Court reiterated its position in *Stoneridge Investment Partners LLC v. Scientific Atlanta, Inc.*, 128 S. Ct. 761 (2008).

<sup>101</sup>15 U.S.C. § 78u(f) (1996).

The most difficult thing to find, according to experienced registered representatives, is stock for a short seller customer to borrow.<sup>102</sup> Or, at least that is true for the stock of mid cap and small cap companies. Some such issues are not eligible collateral for margin, borrowing.<sup>103</sup> Traditionally, too, holders of such shares tend not to keep them in margin accounts. If the shares were in margin accounts, as many of the shares of household name stocks are, brokers (registered representatives) could engineer the loan of them to short sellers. The margin account holder would never know that her shares temporarily had been in another set of hands.<sup>104</sup>

In 2004, as aforesaid,<sup>105</sup> the SEC adopted Regulation SHO, which cracks down on naked short selling, making it all the more imperative for shorts to borrow, or at least locate, stock. In July, 2008, and again in September, 2008, in large part, the SEC suspended the locate alternative under Regulation SHO.<sup>106</sup> All of these recent developments put greatly added pressure on short sellers actually to borrow stock and to do so promptly, that is, before they sell short.

There have always been institutional investors who hold long positions in certain stocks, who will make certain of those shares available to brokers, who in turn will engineer loans to

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<sup>102</sup>See, e.g., Key Points About Regulation SHO, *supra* note 42, at 2 (“[M]arket-makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives”); Christian, *supra* note 2, at 1059 (“Often shares of small companies . . . are hard to find because founders and other initial investors hold most of the shares in restricted form,” or at least in cash rather than margin accounts so that broker-dealers cannot borrow the shares without the owner’s express consent).

<sup>103</sup>Some securities of smaller companies may not be in margin accounts because they are not eligible collateral for margin borrowing.

<sup>104</sup>See *supra* note 2 & accompanying text.

<sup>105</sup>See *supra* notes 41-48 & accompanying text.

<sup>106</sup>See *supra* notes 49-5 & accompanying text.

short sellers.<sup>107</sup> The institution receives a negotiated fee, often consisting of an above market rate of interest and the right to call the stock back on specified notice, or at the end of each month. Brokering such transactions, market professionals operate firms that facilitate the lending and borrowing of stock. “LocateStock.com” is a web site one such professional operates.<sup>108</sup> Back on the borrowing side, market participants other than short sellers also have needs to borrow stock. For example, an over-the-counter trader may find its inventory insufficient to fill an order it has taken. The trader may borrow shares with which to fill the order until such time as the trader can buy in additional inventory elsewhere.<sup>109</sup>

*B. Borrowing Stock from Individual Investors and Risks Pandemic to Such Ventures.*

The truth, though, is that stock borrowing efforts aim themselves mostly at individual investors. All of the large financial firms have formal stock borrowing departments whose principal role is to locate and facilitate the lending of shares. They promise above market rates of interest to individual investors who will make their stock available.

What is not disclosed to the lender is that all, or most all, of those shares are lent to hedge funds and other aggressive short sellers whose interests are antithetical to the lender. The lender wishes to see the shares increase in value, or at least trade sideways. The stock borrowing short

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<sup>107</sup>See, e.g., Scannell & Lauricella, *supra* note 10, at C-3 (“Many fund companies, such as Vanguard, lend out some of the stocks and bonds in their portfolios in exchange for a fee.”).

<sup>108</sup>Randall Smith, Jenny Strasburg & Kara Scannell, *Short-Selling Rules Loom for Firms*, WALL ST. J., July 17, 2008, at C-1, C-2 (“big funds get preferential access to borrow scarce shares”; LocateStock.com “helps hedge funds and small brokerages locate hard-to-borrow shares”).

<sup>109</sup>See, e.g., NATIONAL SECURITIES CLEARING CORP., RULES AND PROCEDURES 13 (2008).

seller not only wants to see the stock decrease in price but may also be a participant in a concerted effort to put downward pressure on price.

Stock borrowing remains unregulated. Individual investors asked to participate in stock borrowing programs receive little or no disclosure. They certainly do not receive risk factor type disclosure, often seen in prospectuses and private placement memoranda. Risk factor disclosure would bring home to stock lenders the distinct possibility of developments adverse to their interests, namely, that short selling and bear raids which they are facilitating can reduce the value of their shares significantly in a matter of days. The shares that they continue to hold, as well as the shares the short seller eventually returns to them, via the stock borrowing intermediary, may be worth a fraction of their original value. Many of them (individual investors) are pigeons waiting to be plucked.

If stock lenders (investors) suffer damages and complain, their complaints go to arbitration, in which opinions are seldom published and the outcomes of most cases unknown. Since 1987, all customer-broker disputes have gone to arbitration, first by NASD or NYSE panels of arbitrators, and then by Financial Institutions Regulatory Authority (FINRA) panels of arbitrators, after the NASD and NYSE dispute resolution mechanisms merged.<sup>110</sup> So we do not know if, as private attorneys general, stock lenders in any number have succeeded with claims that

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<sup>110</sup>In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and again in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), the Supreme Court held that an arbitration clause in a customer agreement constituted merely a choice of forum rather than an illicit waiver of the securities laws' protections. The Court thus overruled *Wilko v. Swan*, 435 U.S. 427 (1953), which held that an agreement to arbitrate violated the securities laws' anti-waiver provisions and was therefore void. Since that time, virtually all customer disputes, employment disputes, and other securities cases as well, go to arbitration panels rather than courts.

stock borrowing program participations are securities and, furthermore, securities as to which disclosure accompanying their offer is insufficient or misleading.

*C. Proposed Regulation.*

The point of this subsection is that another regulation somewhat peripheral to short selling may be needed. That regulation is SEC regulation of stock borrowing programs. The Commission should adopt regulations making clear that the offer of participation in such a program is a security, which should be registered or have an exemption from regulation. As the offer of a security, the offer of any such participation should be accompanied by a formal disclosure document which brings home to investors the risks they are undertaking by lending their stock, and the precise nature of their withdrawal rights, or the lack thereof.

*D. Disciplining Brokers and Other Market Participants.*

On the regulatory front, an alternative would be for the SEC to add to its list of prohibited broker-dealer practices (the SEC Rule 15c series) the offer of participation in a stock lending program without certain specified disclosure to the putative lender.<sup>111</sup> The SEC has long required broker-dealers to have in their possession certain basic information about less well-known corporations and their securities before those broker-dealers can facilitate trading in those securities. The regulation requires that “the broker or dealer . . . make reasonably available,” the specified information “upon the request of any person expressing an interest in a proposed

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<sup>111</sup>Securities Exchange Act of 1934 § 15(c)(1)(A), 78 U.S.C. § 15(c)(1)(A), provides that “No broker dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase, or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance.” Pursuant to authority granted in the section, the SEC has adopted a number of rules to “define, and prescribe, means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.” *Id.* § 15(c)(2)(D).

transaction in the security with such broker or dealer.”<sup>112</sup> Requiring that brokers possess certain information, which must be disclosed to investors with or before the offer of participation in a stock borrowing program, bears a strong resemblance to what is known as 15c-2-11 disclosure.

#### IV. APPLICATION OF EXISTING LAW: STOCK BORROWING PROGRAMS AS INVESTMENT CONTRACTS

##### A. *Investment Contract.*

*SEC v. W.J. Howey Co.*<sup>113</sup> involved Northern tourists who barged over a series of lakes and rivers from Jacksonville, Florida, to Howey’s inland resort, Howey in the Hills. When they came down from their hotel rooms, the tourists saw advertisements offering rows of orange groves. With the purchase of a fee simple on which was located a row of trees, the purchaser could also buy a service contract: Howey-in-the Hill’s employees would prune and spray the trees, pick the fruit, pack it, and market it. Under the arrangement, purchasers had no rights to specific fruit (that is, from their trees), limited rights of entry, and a right only to receive a limited quantity of fruit at holiday time.

The SEC challenged Howey Co. in court, in one of the first cases under the still relatively new Securities Act of 1933. Howey defended, *inter alia*, on grounds that he was offering a sale of real estate, not a security, and a service contract, also not a security. The SEC responded, and the Supreme Court agreed, with the notion that Howey Co. offered the two items as a package. Securities law judges items as they are offered, not as how they may eventually be sold.<sup>114</sup>

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<sup>112</sup>SEC Regulation 15c2-11(a)(5), 17 C.F.R. § 15c2-12(a)(5).

<sup>113</sup>328 U.S. 293 (1946).

<sup>114</sup>“The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough the respondents merely offer the essential elements of an

So constituted, the package fell within the catchall contained in the statute's definition of a security. While enumerating specifically 24 or so other items ("any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness . . ." and so on), the statutory definition includes "investment contract."<sup>115</sup> Borrowing from state blue sky law jurisprudence, in *Howey*, Mr. Justice Murphy defined investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."<sup>116</sup> The test, which has remained the lodestar for 65 years and counting, has 4 elements: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profits; (4) solely from the efforts of others.

B. *Investment of Money.*

In a stock borrowing program, the offeree investor furnishes money's worth rather than money itself, namely, shares of common stock in a publicly held corporation. Cases have long held that contribution of items readily convertible into money is equivalent to the contribution of money itself.<sup>117</sup>

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investment contract." SEC v. W.J. Howey Co., 328 U.S. at 300-01 (footnote omitted). In the case at bar (*Howey*), 85% of the land purchasers opted for the package (real estate plus a services contract) rather than the real estate alone. *Id.* at 295.

<sup>115</sup>Securities Act of 1933 § 2(a)(1), 77 U.S.C. § 77(b)(a)(1).

<sup>116</sup>328 U.S. at 298-99.

<sup>117</sup>*See, e.g., In re Trade Partners, Inc. Investors Litigation*, 2008 WL 3992168, at 5 (W.D. Mich.) ("The test to establish the existence of an investment contract requires (1) an investment in money or money's worth," quoting *Howell v. Ballard*, 801 P.2d 127, 128 (Okla. App. 1990) (viatical settlements); *Battig v. Simon*, 237 F. Supp. 2d 1139, 1148 (D. Or. 2001) ("Oregon applies the [investment contract] definition outlined in *Securities and Exchange Commission v. Howey* . . . . The relevant factors are: (1) an investment of money (or money's worth)").

C. *Common Enterprise.*

1. Commonality. This is the shorthand term used for this lynchpin element of the definition.<sup>118</sup> The sale of recreational real estate (say, a ski resort condominium) illustrates how, in many ventures, each investor's fortunes are tied both to the overall success of the venture, including that of the promoter (vertical commonality), and to fellow investors' fortunes as well (horizontal commonality). In typical recreational real estate sales, an exclusive rental agent requirement ties the investor's fate to that of the promoter, or its affiliate, whose future may rise or fall depending upon the level of rentals. A rental pool feature, in which all investors' units' rents go into a single fund, ties every investor's fate to the fates of other investors, supplying horizontal commonality as well. In that manner, an item ordinarily real estate (a ski condominium) by virtue of collateral arrangements (exclusive agent requirement, rental pool) becomes an investment contract and therefore a security.<sup>119</sup>

2. Horizontal Commonality. The most restrictive of courts hold that horizontal commonality must be present and it, and only it, satisfies the common enterprise element of investment contract.<sup>120</sup> The presence of multiple investors may not in itself suffice. In *Minarik v.*

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<sup>118</sup>See, e.g., Susan S. McDonald, *Toward Consistent Investor Protection Under the Securities Laws: The Solution to the Conflict Among the Circuits Regarding the So-called "Commonality" Requirement for an "Investment Contract"*, 32 SECURITIES REG. L. REV. 68 (2004); Rodney L. Moore, *Defining an "Investment Contract": The Commonality Requirement of the Howey Test*, 43 WASH. & LEE L. REV. 1057 (1986). See also Mark K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135 (1995).

<sup>119</sup>See SEC Release No. 33-5347 (Jan. 4, 1973) (SEC condominium release, outlining collateral arrangements which may convert recreational real estate interests into investment contracts).

<sup>120</sup>Of courts coming down firmly on the issues, the Sixth and the Seventh Circuits require horizontal commonality exclusively. See, e.g., *SEC v. SG Ltd.*, 265 F.3d 42, 50 (1st Cir. 2001)

*M-S Commodities, Inc.*,<sup>121</sup> the Seventh Circuit affirmed a finding of no horizontal commonality because profitability of the plaintiff's account was not influenced by the profitability or loss of other similar accounts the same broker managed.

The paradigm for horizontal commonality is one in which investors' contributions, as well as returns or losses are pooled, as in the ski condominium hypothetical above.<sup>122</sup>

3. Vertical Commonality. At other end of the spectrum, vertical commonality is the least demanding interpretation of *Howey*'s common enterprise requirement. Vertical commonality requires an investor to allege and prove that her returns are dependent upon the promoter's expertise or efforts, or both. For example, in *SEC v. Payphones, Inc.*,<sup>123</sup> purchasers were dependent upon the promoters' ability and efforts in choosing the model and location for pay telephones. Further returns may also be dependent upon the promoter attracting an ever expanding circle of investors. All the investor must do is furnish the money and sign a contract.

4. Strict Vertical Commonality. Strict vertical commonality requires more, namely that, the investor's fortunes be "interwoven with and dependent upon the efforts and success of those

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(surveying circuit courts of appeal).

<sup>121</sup>457 F.2d 274 (7th Cir. 1972) (Stevens, J.) (discretionary trading accounts in commodities futures found not to be investment contracts because no horizontal commonality).

<sup>122</sup>See, e.g., *SEC v. Infinity Group Co.*, 212 F.3d 180, 187-88 (3d Cir. 2000) (investors promised different returns, ranging from 138% to 181%, in "Asset Enhancement Program" but promoter pooled investors' contributions, "to create highly-leveraged investment power that would yield high rates of return," resulting in a finding of horizontal commonality). Other cases requiring a showing of horizontal commonality include *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994); *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994); and *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 22 & 224 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982).

<sup>123</sup>408 F.3d 727, 732 (11th Cir. 2005).

seeking the investment or of third parties.”<sup>124</sup> *SEC v. Koscot Interplanatory, Inc.*,<sup>125</sup> began with the sale of various levels of participation, with every greater amounts of override commissions, in the pyramid sales of self-improvement combined with cosmetics sales programs. The investor produced the new prospects while the promoter’s sales staff closed the deals. Horizontal commonality was lacking but that was not determinative. “[T]hat an investor’s return is independent of that of other investors is not decisive. [T]he requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the Koscot meetings and guidelines on recruiting prospects and consummating a sale.”<sup>126</sup>

5. Offers Rather Than Sales. Participation in stock borrowing programs may measure up as investment contracts, and therefore securities, in jurisdictions in which courts require vertical commonality but perhaps appear to fall short in jurisdictions in which judges have held that only horizontal commonality will suffice. An investor who contributes her shares to an intermediary, to be lent out to a short seller, may not have her shares, and thus her fortunes, tied to the fortunes of other contributors to the program. Horizontal commonality is lacking. Whether an investment contract is present or not may depend on tracing, which may be difficult to do,<sup>127</sup> and be determinable only a case-by-case basis.

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<sup>124</sup>*SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) (virtual stock exchange membership program, on which investors bought and sold shares of 11 virtual companies, nevertheless found also to evince horizontal commonality).

<sup>125</sup>497 F.2d 473, 479 (5th Cir. 1974).

<sup>126</sup>497 F.2d 479.

<sup>127</sup>*See Peter Oh, Tracing*, 80 TUL. L. REV. 849 (2006).

A first principle of securities regulations, however, is that judges, practitioners, and regulators will judge items on the basis of how they are offered rather than how they eventually may be sold. At his resort hotel, William Howey and his company offered orange trees and service contracts as a package, even though, at the end of the day, a persistent purchaser could buy the real estate only.<sup>128</sup>

In the very first case under the Securities Act, *SEC v. C. M. Joiner Leasing Corp.*,<sup>129</sup> the promoters attempted to escape the statutory definition, which lists only “fractional undivided interests in oil, gas or mineral rights” among the items enumerated, by selling divided interests in oil and gas leases (for example, the Southeast eighth of the Southwest quarter section). The courts, though, judged the items as to how they were offered, interests in land expertly selected under the guidance of a promoter in the vicinity of where the promoter would drill a test well, rather than how it eventually may have been sold (as an interest in real estate). The leaseholds, divided interests in oil and gas leases, while falling out of the list of more specific items in the statute, came back within the definition of a security, by means of the investment contract catchall and judgments made as to how the items were offered rather than how they might have been sold.<sup>130</sup>

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<sup>128</sup>*See, e.g., supra* note 114.

<sup>129</sup>320 U.S. 344 (1943).

<sup>130</sup>Mr. Justice Jackson noted that:

Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well it would have been quite a different proposition [*e.g.*, only the offer of interests in real property]. Purchasers would have been left to their own devices for realizing upon their rights. . . . The exploration enterprise was woven into these leaseholds . . . .

320 U.S. at 348. Stock lenders here perceive their economic prospects (a loan of stock at favorable rates) to be enhanced by the prospect of co-mingling their stock with the stock of

The offer of participation in stock borrowing programs always incorporates a right of the intermediary to combine the shares an investor contributes with the shares which other investors contribute. Yet the ultimate loan of the securities may end up strictly as a passthrough, with a single investor's shares lent out to a single short seller. No commingling occurs; horizontal commonality appears to be lacking. But we judge items are to how they are offered (reserving the right to commingle), not as to how they are sold. Participations in stock borrowing programs thus satisfy even the strictest interpretation of the common enterprise requirement central to investment contract analysis.

*D. Expectation of Profits.*

In *SEC v. Edwards*,<sup>131</sup> 10,000 persons invested \$300 million in a payphone sale-and-leaseback arrangement. Promoters offered a sale of the payphone for \$7,000, a 5 year leaseback, and payment to the investor of a fixed 14% annual return. The promoter defended an SEC complaint on the grounds that the arrangements were not investment contracts, and therefore not securities. The arrangements were not investment contracts because the expectations were not of profits from the efforts of a promoter or third party. Rather, as a matter of contract, the return was due because of the contractual provision and was due in any case.

The promoter of a stock borrowing scheme would make a similar argument. The above-market rate of interest the intermediary (a broker-dealer firm) pays to the stock lender (an investor) may be due in any event, as a matter of the contract, rather than of the success or failure of the ultimate borrower of the shares.

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others if necessary to make a loan.

<sup>131</sup>540 U.S. 389 (2005).

Ms. Justice O'Connor had no difficulty rejecting such an argument. In investment contract analysis cases such as *Howey*,

[W]e were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest. We used profits in the sense of income or return . . . .

There is no reason to distinguish between promises of fixed returns and promises of variable returns . . . . In both cases, the investing public is attracted by representations of investment income . . . .<sup>132</sup>

“[A] promise of a fixed return,” as here in the case of stock borrowing programs, “does not preclude a scheme from being an investment contract,” she concluded.<sup>133</sup>

E. *Solely From the Efforts of Others.*

Here the investor makes her contribution (the loan of stock) and does nothing further. The return, if any, comes necessarily from the efforts of others, namely, successful effort of the broker-dealer firm or other intermediary, to lend the shares, either alone or in combination with other lenders' shares, to a short seller, and to receive therefor interest payments, a portion of which it passes through to the stock lender.

Even if the stock borrowing program's provisions required stock lenders to perform some acts, which they usually do not, the critical inquiry is “whether the efforts made by those other than the investor are the undeniably significant ones, those managerial efforts which affect the failure

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<sup>132</sup>*Id.* at 394. Justice O'Connor observed that “[n]o distinction between fixed and variable returns was drawn in the blue sky law cases that the *Howey* court used,” citing *People v. White*, 124 Cal. App. 548, 550-51, 12 P.2d 1078, 1079 (1932), and *Stevens v. Liberty Packing Corp.*, 111 N.J. Eq. 61, 62-63, 161 A. 193, 193-94 (1932). 540 U.S. at 395.

<sup>133</sup>540 U.S. 396.

or success of the enterprise.”<sup>134</sup> In the pyramid sale of self-improvement programs (“Dare To Be Great”), upper level members received commissions and override commissions on lower level members success in attracting prospects to meetings. But the court found that the efforts of the Dare To Be Great staff in making presentations and procuring investors’ signatures on purchase contracts had been “the undeniably significant ones.”<sup>135</sup>

*F. Stock Borrowing Programs as Investment Contracts and Therefore Securities.*

Under the foregoing analysis, with or without SEC regulation, stock borrowing programs are securities, the offer of which must be accompanied by full and fair disclosure.

At least one case has so held. In *Hughes v. Dempsey-Tegeler & Co.*,<sup>136</sup> a brokerage firm requested the loan by an investor of his portfolio of municipal bonds, along with an agreement to subordinate his interest in the bonds to that of the firm. In that way, “the firm could utilize them [the bonds] as additional capital in meeting the Exchange’s net capital requirements” applicable to brokerage firms. In return, the firm promised the lender an above market rate of interest “which would realize an additional income to Hughes from the securities in the amount of \$30,000.00.” The district court found the arrangement (loan of securities and subordination agreement providing for payment of interest) to be an investment contract under the *Howey* analysis.

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<sup>134</sup>SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

<sup>135</sup>474 F.2d at 482.

<sup>136</sup>[1973 Transfer Binder] CCH Sec. L. Rep. § 94,133 (C.D. Cal. 1973), *aff’d*, 534 F.2d 156 (1976).

No court, however, has so held recently and probably never will, as such claims by stock lenders disappear behind the veil of arbitration, which shields from view the outcomes of customer-broker-dealer disputes.

## V. CONCLUSION

These are Main Street versus Wall Street issues.<sup>137</sup> On Wall Street, brokerage firms and other financial intermediaries wish to be free of the yoke of regulation on as many fronts as possible. To require of them prospectus type disclosure regarding stock borrowing plans would be onerous, severely crimping the reach of such programs and the amount of stock investors would lend and short sellers could borrow. Regulation and probably restriction of stock borrowing would occur at a time when SEC initiatives (Regulation SHO enforcement) make the ability to borrow stock of vastly increased importance to short sellers. Because naked short selling will not be tolerated, as it was in the past, the ability to borrow stock becomes extremely urgent.

On Main Street, stock lenders tend to be much different than market professionals and stock borrowers. Market professionals (traders at Vanguard, T. Rowe Price, or a hedge fund, for example) make judicious loans of stock from time to time, after careful calculations of the likely returns, weighed against the probability and magnitude of downward movement in the stock's share price. In non financial circles, however, brokerage firms and other intermediaries ask

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<sup>137</sup>An issue I have raised before in conjunction with revisions of corporate law. See Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258 (1993).

individual investors to lend stock, with little or no disclosure of the principal use to which such shares of stock will be put—loans to short sellers and bear raid participants—and how antithetical to stock lenders' interests the activities of typical borrowers are. The outcomes for investors, almost all of which are bad, should be set forth in plain, readable form ("plain English," in a risk factor statement). Currently, individual investors are pigeons waiting to be plucked by Wall Street sharpies.

Restoration of an uptick rule, or comprehensive re-examination of it, is another Wall Street versus Main Street issue. For years, free marketers, hedge fund managers, and frequent short sellers have heaped scorn upon the uptick rule. Short selling promotes informational efficiency, they contend. Anything which stands in the way of short selling, such as a sales price restriction of some kind, is outmoded, and inimical to accomplishment of what they regard as market efficiency.

As the late Paul Harvey would say, however, that is only "half of the story." Wall Street traders have an entirely different mental fix than do Main Street, hinterland investors. Traders' time horizons generally are a few hours, or a few days; their expectations as to price a few cents, albeit over a large block of shares. To them, a quarter or three-eighths point (\$.25 or \$.375) surprise occasioned by an information asymmetry, exaggerated by a lack of an optimal amount of short selling, eats considerably into, or eliminates altogether, prospects for profits of cents per share.

The Main Street investor has a 3 year, 5 year, or 10 year time horizon. Her profit expectations are quite different as well: a 20 point, 25 point, or 30 point (\$20, \$25, or \$30) gain rather than a dollar or cents per share. A quarter point differential, contributed to by a lack of uninhibited short selling is of no moment to her, as it might be to the market professional.

Moreover, price continuity in the markets, aided by implementation of an uptick or similar rule, has a significant effect on keeping individual and long term investors in the markets over the medium and long terms.

My surmise is that, in its proposals, the SEC favors Wall Street rather than Main Street, perhaps because rank-and-file investors have few if any advocates, or knowledgeable advocates, while hedge funds and financial firms flood the SEC with comments, and sophisticated ones at that, which oppose specific proposals and any regulation at all.<sup>138</sup> For example, in abolishing the old uptick rule, in 2007 the SEC gave as a principal reason the disintegrating effect myriad exceptions were having on the basic uptick rule.<sup>139</sup> Nonetheless, in its newest proposals the SEC begins with the exceptions from the old rule intact and goes from there. In addition to marking tickets “long” or “short,” as Regulation SHO requires them to do, registered representatives (brokers) can label a seemingly infinite variety of trades not bound by the uptick or similar rule, marking tickets “short exempt.”<sup>140</sup> To paraphrase Shakespeare’s *Hamlet*, the ban’s the thing. The

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<sup>138</sup>See, e.g., McGinty & Jenny Strasberg, *supra* note 48, at C-3: “the initial weakness of [Regulation SHO] and the years it took the SEC to stiffen it can be traced to the lobbying efforts of hedge funds and Wall Street” (comment of Peter Chepucavage, former SEC attorney who helped draft SHO).

<sup>139</sup>See, e.g., SEC Reform Proposals at 72 (so many exemptions under old SEC Rule 10a-1 that confusion and “an unlevel playing field” resulted, necessitating abolition of the rule).

<sup>140</sup>From the get-go, the SEC proposed 9 exemptions from the proposed modified uptick rule. See SEC Reform Proposals at 44-62 : (1) Broker-Dealer Exemption (when due to, e.g., “bid flickering” execution price becomes a down bid price even though price at time of submission was not); (2) Seller’s Delay in Delivery (e.g., because of need to remove Rule 144 re-sale restrictions); (3) Old Lot Transactions; (4) Domestic Arbitrage; (5) International Arbitrage; (6) Over-Allotments and Lay-Off Sales (e.g., by underwriting participants in a public offering); (7) Riskless Principal Transactions; (8) Transactions on a Volume-Weighted Average Price (VWAP) Basis. The 9<sup>th</sup> would be an exemption for after hours short selling, when securities information processors would no longer be calculating and disseminating a national best bid price. SEC Reform Proposals at 67. The old rule flatly prohibited short sales unless the last sale had been an

emphasis should be on a sales price restriction on short sales, its possible effects on helping restore a measure of price continuity, and its possible deleterious effects on informational efficiency. That is where emphasis should first be put, with exceptions to be evolved as time goes by and as the industry petitions for them.<sup>141</sup> All the exemptions seems to indicate not only a lingering obeisance to the industry but that the SEC does not really have it heart in any of this.<sup>142</sup>

The conflicting goals a sales price or other restriction of short selling would serve, namely, price continuity and overall market efficiency, versus informational efficiency, seem mutually exclusive. Nonetheless, a basket of the two, rather than one or the other, is necessary. What precise mixture seems utilitarian, producing the greatest good for the greatest number, is a thorny question which only the SEC can attempt to answer. What is clear is how, over the years, commentators, market professionals, and even to some extent regulators such as the SEC, have shown little regard for the Main Street view of issues such as short selling, the uptick rule, and stock borrowing.

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uptick. There was no exception for after hours trading. The proposed rule seems a roadmap for evasion of the price restriction rule, albeit probably only a low volume evasion.

<sup>141</sup>On top of the first 9 exemptions, *supra* note 140, the SEC layers proposals for 4 more in its discussion of the proposed uptick rule, which follows discussion of the proposed modified uptick rule. *See, e.g.*, SEC Reform Proposals at 71. They are: (1) Error in Marking Short Sale; (11) Electronic Trading Systems; (12) Trade Throughs; and (13) Facilitation of Customer Buy Orders. *Id.* at 77-84.

<sup>142</sup>For instance, early on in its 273 page release, the Commission laments that “[w]e recognize that the proposed short sale price restrictions would result in increased costs to short selling .... [R]equiring all short sales to be executed above the best bid ... in a declining market may slow down the speed of executions and impose additional costs on market participants ....” SEC Reform Proposals at 10. That is precisely point of the whole exercise, to slow down the speed of execution and to deprive short sellers of some of their out sized profits, if not to impose added costs on them. The SEC is to act in the public interest and for the protection of investors, not as an auxiliary for the industry, for hedge funds, or for the short selling community.