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The Short-Changing of Investors

WHY A SHORT SALE PRICE TEST RULE IS NECESSARY IN TODAY'S MARKETS

I. INTRODUCTION

The credit crisis that began in the United States in 2007 gripped the world financial system by September 2008, eventually leading to a global recession into 2009, and increased scrutiny of the governmental regulation of financial markets.¹ In the United States, a particular focus was placed on the short selling of equity securities, especially the stocks of financial sector companies most affected by the credit crisis.²

¹ In September 2008, the Inspector General of the Securities and Exchange Commission ("SEC") released a report blasting the agency for its lax oversight of Bear Stearns leading up to the collapse and subsequent sale of the investment bank to JPMorgan Chase in March 2008. Kara Scannell, *The Financial Crisis: SEC Faulted for Missing Red Flags at Bear Stearns—Inspector General's Scathing Report Says Agency Failed to Require the Investment Bank to Rein in Its Risk-Taking*, WALL ST. J., Sept. 27, 2008. The SEC issued an emergency ban on the short sale of hundreds of financial stocks and revised its orders three days later, prompting harsh criticism from numerous observers. See, e.g., Kara Scannell, *The Financial Crisis: SEC Quickly Revises Short-Selling Rules—Shift on Financials, Hedge Funds Sends Traders Scrambling*, WALL ST. J., Sept. 23, 2008, at A9 ("There are a lot of us out there who are wondering what the SEC is thinking, whether they've gone off the rails here." (internal quotation marks omitted) (quoting Charles Jones, Columbia Business School Finance Professor)).

² See Kara Scannell, *The Financial Crisis: SEC Issues Short Selling Rules in Bid to Stop Manipulation*, WALL ST. J., Sept. 18, 2008, at A6. The credit crisis began in the late 1990's as a result of a global increase in the availability in credit, spurred by investment in real estate. David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, N.Y. TIMES, Mar. 19, 2008, at A1. The United States housing market caught fire and many of these mortgages, and later other types of debt, were packaged into investment securities called collateralized debt obligations ("CDOs") and sold to investors globally. *Id.* Some of these CDOs consisted of subprime mortgages that had higher interest rates because the loans were made to less creditworthy individuals. *Id.* Many investors, including banks and investment firms, who purchased these securities used high levels of leverage to invest in these CDOs. *Id.* When the U.S. housing market started to decline in early 2007, some of the subprime borrowers began to default on mortgage payments, which in turn meant that the CDOs purchased by investors also turned into bad investments because investors stopped receiving payments on the mortgages associated with CDOs. *Id.* The decrease in the value of the assets forced investors to write down the value of these assets, further increasing the investor's leverage. As the financial system began to de-leverage, banks and other lenders were less willing to

Short selling is the “sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”³ A short seller will then return the borrowed shares “by purchasing equivalent securities on the open market.”⁴ A short seller expects to profit by purchasing the replacement shares at a price lower than the price at which he sold the borrowed shares.⁵ The financial news media speculated as to whether short sellers participated in market manipulation that drove down stock prices and possibly accelerated the demise of several large and established financial corporations including American International Group and Lehman Brothers.⁶

Following these accusations of manipulation, the Securities and Exchange Commission (“SEC”) and the New York State Attorney General announced in September 2008 that they would begin an inquiry into possible “short selling abuses.”⁷ At the height of the financial crisis, and in reaction to cascading stock prices as well as continued public scrutiny and speculation concerning market manipulation by short sellers, the SEC took unprecedented action and issued an emergency temporary ban on any short sales of the securities of 799 financial companies.⁸

extend credit to borrowers; investors providing capital began pulling money out because of a fear of being exposed to risky investments like CDOs. *Id.* The hesitance of banks and other lenders to extend credit to borrowers, even worthy ones, began to affect other areas of the economy. *Id.* The credit crisis and subsequent economic fallout are much more complicated than portrayed here. This simple summary is merely meant to illustrate why the stocks of financial institutions were particularly susceptible to short selling – the outlook for financial stocks in September 2008 was grim.

³ 17 C.F.R. § 242.200(a) (2007).

⁴ Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,044 (April 20, 2009) [hereinafter April 2009 Amendments to Regulation SHO].

⁵ *See id.*

⁶ *See, e.g.,* Vikas Bajaj & Jonathan D. Glater, *A Bid to Curb Profit Gambit as Banks Fall*, N.Y. TIMES, Sept. 19, 2008, at A1; Posting of Evan Newmark to Deal Journal, <http://blogs.wsj.com/deals/2008/09/19/mean-street-a-wall-street-conspiracy-of-course/> (Sept. 19, 2008, 10:35 EST).

⁷ Bajaj & Glater, *supra* note 6. New York State Attorney General Andrew Cuomo compared short sellers to “looters after a hurricane.” *Id.* (internal quotation marks omitted).

⁸ Press Release 2008-211, SEC, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), <http://www.sec.gov/news/press/2008/2008-211.htm>. The SEC put this ban into place for ten trading days to “prevent short selling from being used to drive down the share prices of issuers even where there is no fundamental basis for a price decline other than general market conditions.” Emergency Order Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592, 73 Fed. Reg. 55,169, 55,170 (proposed Sept. 18,

This extreme action banning short sales of certain securities was notable because it was a striking divergence from the actions the SEC took just a year earlier, when, in July 2007, it repealed the long-standing Rule 10a-1 under the Securities Exchange Act of 1934.⁹ Enacted in 1938 and commonly known as the “uptick rule,”¹⁰ Rule 10a-1 was intended “to restrict short selling in a declining market.”¹¹ The rule prohibited short selling a stock at a price less than the price of the “immediately preceding” sale of that stock.¹² The SEC rescinded Rule 10a-1 in 2007 to “modernize and simplify short sale regulation,” judging the rule “no longer . . . effective or necessary.”¹³ The SEC’s repeal of the uptick rule was, therefore, a complete repudiation of its longstanding judgment that unrestricted short selling could be dangerous in a falling stock market.

The stated mission of the modern-day SEC is to “protect investors, maintain fair, orderly, and efficient markets, and

2008) [hereinafter Sept. 2008 Emergency Order]. The SEC’s ban on short sales of financial stocks followed a similar ban issued in the United Kingdom by the Financial Services Authority and supported by that nation’s Treasury Chief. Kara Scannell et al., *SEC Is Set to Issue Temporary Ban Against Short Selling*, WALL ST. J., Sept. 19, 2008, at A1. The short selling ban was eventually extended to the stocks of almost 1000 companies. Kara Scannell & Serena Ng, *SEC’s Ban on Short Selling Is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C1. Because the standards for inclusion on the ban list were so broad, it included surprising names, such as CVS Caremark, the pharmacy company and IBM, the technology company. *Id.* The short sell ban ended up spanning a total of fourteen (14) trading days, from September 19 through October 8, 2008. Kara Scannell & Craig Karmin, *Crisis on Wall Street: Short-Sale Ban Ends to Poor Reviews*, WALL ST. J., Oct. 9, 2008, at C3.

⁹ Regulation SHO and Rule 10a-1 Final Rule, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348, 36,348 (July 3, 2007) [hereinafter Regulation SHO and Rule 10a-1 Final Rule Release]. In addition to eliminating Rule 10a-1, the Commission also prohibited any self-regulatory organization (SRO) from promulgating its own price test. *Id.* An SRO is a non-government entity that may implement regulations to protect investors, such as a stock exchange. Investopedia, Self-Regulatory Organization (SRO), <http://www.investopedia.com/terms/s/sro.asp> (last visited Oct. 6, 2009). Because the SEC repealed Rule 10a-1, it also repealed Rule 200(g), which required marking securities sales transactions exempted from Rule 10a-1 as “short exempt.” Regulation SHO and Rule 10a-1 Final Rule Release, at 36,348.

¹⁰ Scannell et al., *SEC Is Set to Issue Temporary Ban Against Short Selling*, *supra* note 8.

¹¹ Regulation SHO and Rule 10a-1 Final Rule Release, *supra* note 9, at 36,348.

¹² *Id.*

¹³ *Id.* Despite the fact the SEC loosened some restrictions on short selling by repealing the uptick rule, Regulation SHO tightened restrictions on naked short selling. *Id.*

facilitate capital formation.”¹⁴ The Commission was formed in 1934¹⁵ after the devastating effects of the stock market crash of 1929, and almost immediately, it examined the role of short selling in securities markets and recommended regulation of the practice.¹⁶ In the aftermath of the financial crisis of 2008, the SEC again reconsidered its regulation of short selling and whether the uptick rule or some other short sale price test is necessary to protect investors and preserve orderly financial markets.¹⁷ In April 2009, the SEC solicited public comments to reconsider whether the uptick rule was necessary and if such a rule “would help promote market stability and restore investor confidence.”¹⁸ The SEC also sought comment on whether a modified version of the uptick rule would be more appropriate.¹⁹ The SEC announced an additional public comment period to address “alternative approaches” to the uptick rule in August 2009.²⁰ Finally in February 2010, the SEC implemented Rule 201, a modified version of the original uptick rule.²¹ This version of the rule, which became effective in May 2010, will only be triggered “if the price of an individual security declines intra-day by [ten percent] or more from the prior day’s closing price for that security.”²² Once this ten percent decline occurs,

¹⁴ SEC, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwe.do.shtml> (last visited Oct. 5, 2009).

¹⁵ The SEC was established as a result of the Securities Exchange Act of 1934. *Id.*; see also 15 U.S.C. § 78d (2006). The Securities and Exchange Act is codified at 15 U.S.C. § 78.

¹⁶ SEC, FIRST ANN. REP. OF THE SEC 16 (1935), http://www.sec.gov/about/annual_report/1935.pdf. [hereinafter FIRST ANNUAL REPORT OF THE SEC] (“A detailed analysis of the subject of short selling was made for the purpose of determining the extent to which such selling is economically justified and the extent to which it should be curbed.”). At this time, the Commission also recommended to the exchanges that it should implement a version of the uptick rule, believing such a rule would “preserve those features of short selling which are in the *public interest*.” *Id.* (emphasis added).

¹⁷ When SEC Chairman Mary L. Schapiro was nominated by President Barack Obama in January 2009, she cited re-examination of the uptick rule by the SEC as part of her agenda during her confirmation hearing with the Senate Banking Committee. Stephen Labaton, *S.E.C. Nominee Offers Plan for Tighter Regulation*, N.Y. TIMES, Jan. 16, 2009, at B3.

¹⁸ Press Release 2009-76, SEC, SEC Seeks Comments on Short Sale Price Test and Circuit Breaker Restrictions (Apr. 8, 2009), <http://www.sec.gov/news/press/2009/2009-76.htm>.

¹⁹ *Id.*

²⁰ Press Release 2009-185, SEC, SEC Seeks Comment on Alternative Uptick Rule (Aug. 17, 2009), <http://sec.gov/news/press/2009/2009-185.htm>.

²¹ Amendments to Regulation SHO, Exchange Act Release No. 61,595, 75 Fed. Reg. 11,232, 11,233-34 (March 10, 2010) [hereinafter 2010 Amendments to Regulation SHO].

²² *Id.* at 11,234.

short sellers may not sell a security “at or below the current national best bid” for the “remainder of the day and the following day.”²³

The adoption of this alternative, compromise rule reflects both the SEC’s acknowledgment of the need for some regulation of short selling, and the tentativeness with which the Commission has proceeded in this area, having changed its position three times in just three years. Without attempting to assess the pros and cons of the new rule, this Note argues more generally that regulation of short selling—a feature of our regulatory regime for over seventy years—is necessary to ensure orderly markets and investor confidence. While the adoption of Rule 201 is undoubtedly a positive step, a look at the convoluted history of the rise and fall of the uptick rule reveals a deeper concern over existing justifications for the rule and what degree of short selling regulation is sufficient and appropriate.

This Note will discuss the practice and history of short selling and the uptick rule, including the reasons why the SEC repealed the rule in 2007, whether its removal was in line with the SEC’s mission, and why the rule is necessary to maintain orderly markets. Part II describes the mechanics of short selling equity stocks, the reasons for short selling and why some have a negative view of the practice, and surveys the history surrounding the implementation of the uptick rule in 1938. Part III examines the reasons why the SEC felt the uptick rule was no longer necessary for effective market regulation and the environment in which the SEC made this decision. Part IV discusses alternative statutory provisions the SEC could use to regulate short selling in the absence of the uptick rule. Finally, Part V argues why the reinstatement of the uptick rule or other price test on short selling as a backstop method of protecting investors is necessary because of the difficulty of proving fraudulent or collusive price manipulation through short selling. It also examines the different versions of price tests evaluated by SEC and the new alternative uptick rule that took effect in May 2010. Finally, this Part posits that the uptick rule can be used as a tool to preserve investor confidence and maintain order in troubled, declining markets, preventing both panic and any repeat of the type of radical

²³ *Id.* The best bid is “[t]he highest quoted bid for a particular stock among all those offered.” Investopedia, Best Bid, <http://www.investopedia.com/terms/b/bestbid.asp> (last visited Apr. 25, 2010).

measures taken by the SEC in September 2008, when it banned all short sales of financial stocks.

II. THE MECHANICS AND HISTORY OF SHORT SELLING AND THE UPTICK RULE

Concerns and skepticism about the effects of short selling of securities have led to regulation of the practice around the world for hundreds of years.²⁴ In 1922, J. Edward Meeker, an economist for the New York Stock Exchange, observed that although “prejudice against short selling of securities is not new,” the practice of short selling has “stood that hardest of all tests—the test of time.”²⁵

A. *The “Mysterious”²⁶ Practice of Short Selling: How It Works*

A short sale is, in simplest terms, a bet that the price of a particular stock will fall.²⁷ Investors initiate a short sale by borrowing an amount of stock and selling it in anticipation that they will be able to repurchase the same stock later, but at a lower price.²⁸ The borrower/investor (or his broker) later repurchases the stock at the lower price, returns it to the lender, and profits from the difference between the sale and repurchase price.²⁹ The borrower also pays the lender a fee for

²⁴ J. EDWARD MEEKER, *THE WORK OF THE STOCK EXCHANGE* 96-97 (1922), available at <http://books.google.com/books?id=KDBIAAAAMAAJ&printsec=frontcover&dq=The+work+of+the+stock+exchange>. The practice of short selling was prohibited in England in 1733, only to be reinstated in 1858. *Id.* France, the state of New York, and Germany have also passed and later repealed legislation forbidding the practice. *Id.* After Germany instituted a rule banning short sales on the Berlin Stock Exchange in 1896, at least one economist blamed the rule for an outflow of capital to other international markets leading to depressed markets in Berlin. *Id.* at 97.

²⁵ *Id.* at 96.

²⁶ *Id.* at 97. Because short selling is a somewhat sophisticated investment strategy that is not well known to the general public, short selling has also been described as an activity “cloaked in secrecy.” Gary Weiss, *The Long and Short of Short-Selling*, *BUS. WK.*, June 10, 1991, at 106.

²⁷ Jonathan R. Macey et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in the View of the October 1987 Stock Market Crash*, 74 *CORNELL L. REV.* 799, 799-800 (1989). While different types of assets can be sold short, this Note will focus on the short sale of equity securities.

²⁸ *Id.* at 799; see also David Chung, *Making Sense Out of Market Sentiment Indicators*, *INVESTOR'S BUS. DAILY*, June 16, 1999, at A3; Weiss, *supra* note 26.

²⁹ Macey et al., *supra* note 27, at 799-800. In the wake of the financial crisis of 2008, there also was much discussion by business and media commentators about the impact on financial markets of so-called naked short sales. A naked short sale operates similarly to the short sale described here; the major difference is that in a

the use of the stock in the transaction. Although there is no central, public marketplace for borrowing shares for short selling, short selling of stocks with a large market capitalization is not difficult, since these stocks are widely held and have high levels of institutional ownership.³⁰ It is not as simple or inexpensive to borrow stocks that have a smaller market capitalization, are closely held, or are believed to be overvalued, since these stocks are highly sought for borrowing.³¹

One important distinction between a short sale and a regular purchase of stock—when an investor purchases a stock in anticipation that its value will rise—is the “theoretically unlimited” risk of loss when an investor sells short.³² If an investor made a run-of-the-mill stock purchase to hold it for the long term (a “long” position), and the stock price later fell to zero, he would not lose any more than the amount he paid for that stock. But if the investor short sells a security (a “short” position) and the market price of that stock keeps rising, he continues to lose money because he is still required to replace the borrowed stock, and this purchase will now have to be made at a progressively higher price.³³ When a stock with a limited supply is in high demand by the market, forcing prices

naked short sale, an investor sells a stock without actually having borrowed it. When the seller fails to deliver the stock to the purchaser, the stock has been diluted and the transaction fails. Investopedia, Naked Shorting, <http://www.investopedia.com/terms/n/nakedshorting.asp> (last visited Oct. 6, 2009). In July 2008, the SEC banned the naked short sale of 19 financial stocks in reaction to the threatening credit crisis. Emergency Order Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166, 73 Fed. Reg. 42,379, 42,379-80 (proposed July 15, 2008) [hereinafter July 2008 Emergency Order]. When the SEC banned short sales on financial stocks in September 2008, it also passed emergency measures restricting naked short sales. Sept. 2008 Emergency Order, *supra* note 6, at 55,169-70. The SEC made these emergency measures permanent in July 2009. Amendments to Regulation SHO, Exchange Act Release No. 60,388, 74 Fed. Reg. 38,266, 38,266 (July, 31, 2009) [hereinafter July 2009 Final Rule Release — Rule 204]. This footnote serves for purposes of clarification only. Naked short selling is highly controversial, and as such, this Note will only address the uptick rule as it relates to standard short sales and the role of the rule in the market and in protecting investors.

³⁰ *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risks: Testimony Before the H. Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises 2* (2003), available at <http://financialservices.house.gov/media/pdf/052203ol.pdf>. (testimony of Owen A. Lamont, Graduate School of Business, University of Chicago and NBER) [hereinafter Owen A. Lamont].

³¹ *Id.* at 8.

³² Michael R. Powers et al., *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX L. REV. 223, 246-47 & n.49 (2004).

³³ Susan Lee, *The Dismal Science: Short-Sellers Keep the Market Honest*, WALL ST. J., Feb. 6, 2002, at A18.

up, a “short squeeze” may occur.³⁴ Thus, when short sellers rush to exit their positions, prices continue to increase, and losses to short sellers continue to mount.³⁵ In addition to the risk of unlimited financial loss, if an investor is holding a short position and dividends are declared on his borrowed stock, he will be responsible for reimbursing the lender for the total amount of the dividends.³⁶

1. Reasons for the Negative Perception of Short Selling

Many observers see short selling as a “bet[] against the team,”³⁷ anti-economic growth,³⁸ or “un-American” since short sellers profit when they correctly bet that a stock’s price will fall.³⁹ Consequently, in times of economic trouble and difficult world events, “shorts” are often looked upon as scapegoats,

³⁴ Investopedia, Short Squeeze, <http://www.investopedia.com/terms/s/shortsqueeze.asp> (last visited October 29, 2008).

³⁵ A recent example of a short squeeze occurred in October 2008 when Volkswagen AG stock rose 348% in two days after Porsche announced it would take a 75% stake in VW, rather than the 50% share investors had anticipated based on comments by Porsche executives the previous month. Gregory Zuckerman et al. *VW’s 348% Two-Day Gain is Pain for Hedge Funds*, WALL ST. J., Oct. 29, 2008, at C1. This surge in VW’s share price resulted in the company having the largest market capitalization of any public traded firm in the world at one point during the trading day on October 28, 2008. Alexis Xydias, *Porsche Gains, Volkswagen Drops on VW Stock Supply*, BLOOMBERG, Oct. 29, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=ai_m6Q0oIJ_U&refer=home. Many hedge fund investors around the world had short positions in VW stock because they considered the stock to be overvalued. Zuckerman, et al., *supra*. After the squeeze occurred, investors, who incurred billions in losses, accused Porsche of misleading them about its plans for investment in VW and called for an investigation into the matter by the German securities regulator and for more disclosure requirements in German markets. *Id.* Porsche owned options to purchase up to 31.5% of VW common stock; the public outcry accusing the company of market manipulation forced it to announce that it would settle up to 5% of its options in an attempt to increase liquidity of VW stock. Xydias, *supra*.

³⁶ SEC, Short Sales, <http://www.sec.gov/answers/shortsale.htm> (last visited Oct. 6, 2009).

³⁷ See Macey et al., *supra* note 27, at 800 (quoting SEC Commissioner Joseph Grundfest).

³⁸ See Robert D. Hershey Jr., *Investing; Betting That a Stock Will Drop*, N.Y. TIMES, December 7, 1986, at Sec. 3, p. 16. A bet against a stock through a short sale could create a conflict of interest if an individual sells a stock short but is also a shareholder and officer, director, or other employee of that company. To avoid such conflict, the SEC restricts shorts sales by corporate officers. 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, 142 (2008). If a corporate officer or director does not own any shares in his or her company, short selling is prohibited, but if the officer does own shares, he may not hold any short position for more than twenty (20) days. 15 U.S.C. § 78p(c) (2006).

³⁹ Lamont, *supra* note 30, at 6.

particularly in the wake of large stock market declines.⁴⁰ During World War I, the New York Stock Exchange (“NYSE”) imposed special restrictions on short sales because of fear that the Germans would use the practice to manipulate and drive down stock prices,⁴¹ and because it would harm the morale of the market.⁴² In the years following the stock market crash of 1929, when Congress began developing the extensive regulations of securities markets that are in place today, there was even a proposal to ban short selling altogether.⁴³ Congress and others again called for increased scrutiny of short sales of equity stocks after the precipitous stock market decline in 1987.⁴⁴ Additionally, after the terrorist attacks in New York and Washington, D.C. on September 11, 2001, U.S. and European market regulators even investigated a spike in short sales of airline and insurance stocks in the days leading up to the attacks to determine if short sellers knew about the plan.⁴⁵

In addition to being criticized for profiting from falling stock prices, another reason for the vilification of short sellers is the fear that they aim to benefit from market manipulation.⁴⁶ In a “bear raid,” investors continually short sell an equity stock in an attempt to influence “less informed” shareholders of a negative price outlook on the security, in the hopes they will sell off their shares.⁴⁷ This is problematic because the rapid decline of a stock price caused by market manipulation could prompt margin calls or liquidations.⁴⁸ Many investors trade on the margin, meaning that they trade with borrowed money

⁴⁰ *Nasty, Brutish and Short; Short-Selling*, ECONOMIST, June 21, 2008, at 46; see also Lamont, *supra* note 30, at 7.

⁴¹ *Id.* at 8.

⁴² Macey et al., *supra* note 27, at 801.

⁴³ *Id.* at 799. Representative Adolph Sabath of Illinois called short sales “the greatest evil that has been permitted or sanctioned by the Government that I know of.” *Id.* (internal quotations omitted).

⁴⁴ *Id.* at 799.

⁴⁵ Cassell Bryan-Low, *Initial Investigation Fails to Dig Up Evidence Linking Level of Short Selling to Terrorists*, WALL ST. J., Sept. 24, 2001, at C2. The SEC investigated thirty-eight firms whose stock was identified as having unusual trading activity in the days before the terrorist attacks, but no connection was affirmed. Susanne Craig, *SEC Examines Trading in Firms Before Sept. 11*, WALL ST. J., Oct. 3, 2001, at C1.

⁴⁶ Proposed Amendments to Regulation SHO and Rule 10a-1, Exchange Act Release 54,891, 71 Fed. Reg. 75,068, 75,070 (Dec. 13, 2006) [hereinafter 2006 Proposed Amendments to Regulation SHO and Rule 10a-1].

⁴⁷ *Id.*

⁴⁸ *Id.*; see also Rob Curran & Geoffrey Rogow, *Margin Calls, Redemptions Weigh on Market*, WALL ST. J. ONLINE, Oct. 28, 2008, http://online.wsj.com/article/SB122513281830072753.html?mod=googlenews_wsj.

while keeping a certain level of cash with brokers as collateral.⁴⁹ Brokers and exchanges determine the level of cash necessary, based on risk.⁵⁰ Generally, declining stock prices and increasing market volatility increase the risk of loss, prompting brokerages to ask for more collateral. This demand is known as a margin call.⁵¹ Often, to raise cash for margin calls, investors sell stock which can depress prices and create a cycle which results in another margin call.⁵² In addition, when investors continue to sell stocks to raise cash for margin calls, they are less likely to buy stocks, further depressing market prices.⁵³

The 2008 credit crisis illustrated this fear of short sellers manipulating the market when, once again, regulators singled out the shorts for contributing to financial chaos.⁵⁴ After the failure of Bear Stearns in March 2008 there were accusations that short sellers spread rumors about companies to put downward pressure on stock prices, thus allowing investors with a short position to reap profits.⁵⁵ These accusations eventually led the SEC to issue an emergency order in July 2008 announcing that it was going to begin investigating whether short sellers were colluding to manipulate the markets for their own gain.⁵⁶

The subsequent failure of Lehman Brothers and concerns about market volatility led the Commission to issue a total ban on the short sale of financial stocks a few months later.⁵⁷ In September 2008, by installing a ban on the short sale

⁴⁹ Investopedia, Margin, <http://www.investopedia.com/terms/m/margin.asp> (last visited Oct. 29, 2008).

⁵⁰ Curran & Rogow, *supra* note 48.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Jenny Anderson, *A New Wave of Vilifying Short Sellers*, N.Y. TIMES, Apr. 30, 2008, at C1. During a Senate hearing probing the failure of Bear Stearns, Senator Christopher Dodd suggested that there was collusion in the marketplace targeting the bank. *Id.*

⁵⁵ *Id.*

⁵⁶ See July 2008 Emergency Order, *supra* note 29, at 42,379.

⁵⁷ Press Release 2008-211, *supra* note 8. The Chicago Board of Exchange Volatility Index (VIX) "is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices." Chicago Board of Exchange—Micro Site, Introduction to VIX Futures and Options, <http://www.cboe.com/micro/vix/introduction.aspx> (last visited Oct. 6, 2009). The VIX is considered a barometer of investor sentiment (it is often called the "fear index") and uses options prices to estimate the range of movement of the S&P 500 for the following 30 days. Tom Lauricella & Aaron Lucchetti, *Dow Slides Again, Down 514.45—S&P at a 5-Year Low; What's Behind the Surge in the VIX 'Fear' Index?*, WALL ST. J., Oct. 23, 2008. After Lehman declared bankruptcy on September 16, 2008, the VIX Index rose above 30 for

of financial stocks, the SEC sought to avert a “crisis of confidence” resulting from sharp declines in stock prices.⁵⁸ The Commission posited that a drop in stock prices would potentially affect the “liquidity” and “ultimate viability” of financial institutions and damage the broader securities market.⁵⁹ Though it soon became apparent that this ban was temporary,⁶⁰ it provoked much negative reaction in the financial community.⁶¹ Regulators in other nations soon followed suit, hoping to prevent the volatile equities markets from spiraling further out of control.⁶²

Legislators are not the only ones who have criticized the practice of short selling. Companies have also taken actions against short sellers in a number of ways, including issuing stock with certain restrictions that make short selling impossible, taking legal action against short sellers, and reporting short sellers to regulatory agencies.⁶³ At the same

the first time since 2007, which was when the first news of a coming subprime crisis hit the markets. The VIX remained above 30, hitting a high of 81 in October 2008. For comparison, the VIX rose above 30 on only three trading days in 2007 (and went no higher than 31.09). VIX Daily Closing Prices 2004-Present, Chicago Board of Exchange, <http://www.cboe.com/micro/vix/historical.aspx> (click on link to VIX data for 2004 to present) (last visited Oct. 6, 2009). The previous high for the VIX was 52.05 on September 21, 2001, when fear was high following the September 11, 2001 terrorist attacks. Lauricella & Lucchetti, *supra*.

⁵⁸ Sept. 2008 Emergency Order, *supra* note 8, at 55, 175.

⁵⁹ *Id.*

⁶⁰ See Scannell & Karmin, *supra* note 8.

⁶¹ See Jonathan Macey, *The Government is Contributing to the Panic*, WALL ST. J., Oct. 11, 2008, at A15; Scannell & Karmin, *supra* note 8; Menachem Brenner & Marti G. Subrahmanyam, *End the Ban on Short-Selling*, FORBES.COM, Oct. 1, 2008, http://www.forbes.com/2008/09/30/short-selling-ban-oped-cx_mb_1001brenner.html; Post of David Gaffen to Market Beat, http://blogs.wsj.com/marketbeat/2008/09/19/five-reasons-why-the-short-selling-ban-stinks/?mod=rss_WSJBlog?mod=marketbeat (Sept. 19, 2008, 13:03 EST).

⁶² See Kara Scannell, *Short Sale Ban Spreads Around Globe*, Sept. 22, 2008, at C3 (detailing implementation of short sale ban by Australia, the Netherlands and Taiwan.).

⁶³ Lamont, *supra* note 30, at 3. In a 2003 study, Professor Lamont examined the long-term returns of 270 firms that attempted to actively discourage short selling through threats, legal action or accusations of improper activity. *Id.* at 4-5. In the year following these firms' actions against short sellers, they had an average return compared to the overall stock market of -24%. *Id.* at 3. This indicates that the short sellers were correct and that the securities of the firms in question were overpriced. *Id.* An example of a company issuing securities creatively to prevent short selling occurred in 2006 when Pegasus Wireless granted a dividend to stockholders for every 10 shares held; the dividend was distributed as a stock warrant, but the company refused to issue the warrant unless investors held their shares in their own name. Jenny Anderson, *A Bet Against Those Who Bet Against the Company*, N.Y. TIMES, Sept. 1, 2006, at C7. Brokers often hold shares in their accounts (and in the broker's name) for clients and then lend the shares held to short sellers. *Id.* This dividend structure was problematic because it forced brokers to recall the stock to prove shareholders' identities, which put

time that the SEC announced the temporary ban on short selling of financial stocks in 2008, it also enacted a rule that required hedge funds and other institutional investors to disclose which companies' securities they were holding short.⁶⁴ This provoked an immediate backlash from the investment community over concerns that company executives would no longer provide information to investors who were known to be shorting their company's stock.⁶⁵ The SEC eventually backed down from this rule over the investors' concerns.⁶⁶

2. The Positive Effect of Short Selling on the Markets

Despite the persistent animosity toward shorts during troubled economic times, short sales of securities do have several positive effects on stock markets. Two of the most important areas of the market that are positively affected by short selling are "pricing efficiency" and "liquidity."⁶⁷ If stock markets were perfectly efficient, short sales would not be necessary because all stocks would be correctly valued.⁶⁸ However, since markets are in fact imperfect, short sales can help correct inefficiencies created by "asymmetric information, taxes, or other imperfections" by moving prices closer to equilibrium.⁶⁹ This is because a short sale is an investor's way of "inform[ing] the market of [his negative] evaluation of future

a short squeeze on the stock. *Id.* The CEO of Pegasus claimed that these actions were taken not to harm short sellers but because the company was concerned that phantom (fake) shares of its stock were being traded. *Id.* Nonetheless, the company's share price rose 30% after the warrant plan was announced. *Id.*

⁶⁴ See Emergency Order Pursuant to Section 12(K)(2), Short Sale Disclosure, Exchange Act Release No. 58,592, 73 Fed. Reg. 55,169, 55,170 (Sept. 18, 2008).

⁶⁵ One prominent investor, Jim Chanos, called the SEC's rule "akin to the government suddenly requiring Coca-Cola to disclose their secret formula for free to all their competitors." Beth Healy & Ross Kerber, *Short-sellers Cry Foul After Ban*, BOSTON GLOBE, Sept. 26, 2008, (internal quotation marks omitted).

⁶⁶ See Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 58,785, 73 Fed. Reg. 61,678, 61,679 (Oct. 17, 2008). The SEC still required investment funds to disclose short positions, but decided to make this information nonpublic; the requirement ended on Oct. 19, 2008. *Id.*

⁶⁷ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069.

⁶⁸ The efficient market theory posits that in an efficient market, all investors would have perfect information, thus investments would be properly valued and as a result, short selling would be unnecessary. See WILLIAM W. BRATTON, CORPORATE FINANCE 15 (6th ed. 2008).

⁶⁹ See Powers et al., *supra* note 32, at 235-36.

stock price performance.”⁷⁰ Many feel that short sellers keep exuberance in check and help to quiet “noise traders.”⁷¹ Moreover, short sellers provide liquidity because not only must shorts cover their sales by buying stocks,⁷² but an investor may also be more willing to take a bigger risk on a long position if he can hedge himself with a short position.⁷³ In 1931, Richard Whitney, then-President of the NYSE, testified before Congress that he believed the exchange would have been forced to close after the 1929 stock market crash if it were not for the willingness of short sellers, the only investors that made money when the NYSE crashed, to put their money back into the depressed market after stock prices dropped.⁷⁴

The perceived skepticism or pessimism of short sellers plays a very important role in the market. Short sellers are often among the first to detect corporate fraud and were among the first to issue warnings about ill-fated companies such as Enron and Tyco.⁷⁵ Since many short sellers are among the most informed and sophisticated investors, they may perceive financial malfeasance before market regulators, despite the best attempts of the SEC and other regulatory agencies to keep tabs on companies. Individual investors that research the fundamentals of a company and its stock, operating only with an eye for profit, may simply have more resources and perhaps more motivation to delve into the details of a firm’s financial information when making an investment decision.⁷⁶

⁷⁰ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,070.

⁷¹ Crisp, *supra* note 38, at 142. Noise traders act “for reasons generally unrelated to an accurate measure of an asset’s fundamental value. . . . [and] might act on market momentum, misinformation or poor strategy.” *Id.* at 141 (citation omitted). An overly positive view on a stock is less likely to be challenged than a view that is excessively negative. See Powers et al., *supra* note 32, at 241.

⁷² 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069.

⁷³ See Macey et al., *supra* note 27, at 800.

⁷⁴ *Id.* at 801-02.

⁷⁵ See Anderson, *supra* note 54. Jim Chanos, who runs one of the largest short funds in the world for Kynikos Associates, calls short sellers “financial detectives.” *Nasty, Brutish and Short*, *supra* note 40, at 46 (internal quotation marks omitted). Coincidentally, Mr. Chanos is also credited for being one of the first skeptics of Enron’s financial statements. *Id.*

⁷⁶ See Richard Sauer, *Bring on the Bears*, N.Y. TIMES, Oct. 6, 2006, at A25 (“By putting their money where their mouths are, short sellers are the only market participants with an incentive to deflate bubbles and inject pessimistic information into the market.”).

B. *The History of the Uptick Rule—1938-2007*

Considering the historic sentiment against short selling, it is not surprising that following the 1929 market crash, short selling was a concern to legislators.⁷⁷ However, the Securities Exchange Act of 1934 (“Exchange Act”) did not specifically govern short sales; it instead delegated regulation of short selling to the SEC.⁷⁸ In 1934, the newly-created SEC released a list of rule recommendations for adoption by national exchanges.⁷⁹ One of the sixteen rules recommended was to prohibit the short sale of a security at a price below the last previous sale price of that security.⁸⁰ The SEC believed this formulation of the short selling rule would prevent abusive short selling on exchanges while also “preserv[ing] those features of short selling which are in the public interest.”⁸¹ Thus, the rule would protect the investing public while enabling markets to operate unhindered, allowing them to reap the inherent benefits of short selling.

After a decline in the market in the fall of 1937, the SEC undertook a study to examine whether short selling exacerbated the drop in stock prices.⁸² Though several studies of short selling were still under way at the time, the SEC released some data publicly in January 1938 that suggested that short selling increased in a declining market and that in such a

⁷⁷ Macey et al., *supra* note 27, at 801-03.

⁷⁸ *Id.* at 802-03. Regulatory power over short selling is codified at 15 U.S.C. § 78j (a)(1) (2006). This provision states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange – (a) (1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

⁷⁹ See FIRST ANNUAL REPORT OF THE SEC, *supra* note 16, at 40-44.

⁸⁰ OFF. OF ECON. ANALYSIS, SEC, ECONOMIC ANALYSIS OF THE SHORT SALE PRICE RESTRICTIONS UNDER REGULATION SHO PILOT 12 (2007), <http://www.sec.gov/news/studies/2007/regshopilot020607.pdf> [hereinafter OEA ECONOMIC ANALYSIS]. The SEC recommended as its Sixteenth Rule governing exchanges that “[n]o member shall use any facility of the exchange to effect on the exchange a short sale of any security in the unit of trading at a price below the last sale price of such security on the exchange,” but the rule was not implemented at that time. FIRST ANNUAL REPORT OF THE SEC, *supra* note 13, at 44.

⁸¹ FIRST ANNUAL REPORT OF THE SEC, *supra* note 16, at 16.

⁸² Exchange Act Release No. 1548, 1938 WL 32911, *1 (Jan. 24, 1938).

market, “short sales are seriously destructive of stability.”⁸³ It was based on this limited information that the SEC concluded that short selling needed to be further regulated, and it adopted a set of rules, effective February 8, 1938, which attempted to “prohibit short selling in a declining market.”⁸⁴ These rules included the uptick rule,⁸⁵ previously recommended for adoption by the exchanges, as well as a rule that all sell orders be marked “short” or “long.”⁸⁶ It is notable that when the SEC implemented this rule change, it made clear that it wished to formulate the short selling rules in such a way as to “avoid placing undue burden or inconvenience on transactions,” and that it would revisit the necessity of these rules if they were deemed unnecessary by the Commission’s ongoing studies or if they had a negative impact on the market.⁸⁷

The 1938 version of the uptick rule went virtually unchanged until the SEC removed all price test rules for short sales in July 2007.⁸⁸ In 1939, the SEC modified the rule slightly to allow short selling on a zero uptick, making a short sale permissible if the sale occurred at the same price as the last trade, if the price of the next-to-last trade was an uptick.⁸⁹ The

⁸³ *Id.* at *5.

⁸⁴ *Id.* at *1.

⁸⁵ *Id.* at *2 (Rule X-10A-1(a)). A tick refers to a move upward or downward in the price of a security.

⁸⁶ *Id.* (Rule X-10A-1(b)).

⁸⁷ *Id.* at *1. The 1937 study has been criticized as inadequate due to its limited scope and the short time frame for which it was performed. Short Sales of Securities, Exchange Act Release No. 13,091, 41 Fed. Reg. 56,530, 56,533 (Dec. 28, 1976). In addition, after the tick rule was implemented, no further data compiled from the 1937 study was publicly released despite being promised in the initial report. *Id.*

⁸⁸ The “downtick” and “uptick” distinction is a matter of semantics. The early (downtick) version of the rule prevented a short sale when the last price movement was downward, while the later (uptick) version of the rule prohibits a short sale at a price that is not at a tick price higher than the last previous trade. *See* Exchange Act Release No. 1548, 1938 WL 32911, *supra* note 82, at *1 (“No person shall . . . effect a short sale of any security at or below the price at which the last sale thereof, regular way, was effected on such exchange.”).

⁸⁹ An illustration of the zero plus tick test and compliance with Rule 10a-1 in a sale sequence follows:

Last sale: 47

Next sale: 47.04 — Plus tick compared to last trade; short sale permitted

Next sale: 47.04 — Zero-plus tick compared to next-to-last trade; short sale permitted

Next Sale: 47.00 — Minus tick compared to next-to-last trade; no short sale permitted

SEC felt that this rule met three important objectives: (1) it did not unfairly restrict short sales when the market was increasing; (2) it prevented bear raiders from driving down prices in a declining market; and (3) it prevented short sellers from using all bids at one price level, thereby causing long sellers to set progressively lower prices.⁹⁰ The uptick rule applied to all securities registered on national securities exchanges and also regulated trades of securities “admitted to unlisted trading privileges”⁹¹ on national securities exchanges, if the trades were reported in accordance with an “effective transaction reporting plan.”⁹² However, the uptick rule did not apply to over-the-counter bulletin board securities or pink sheets, as neither of these types of securities are traded on a national exchange.⁹³

The short sale price test rule operated slightly differently as applied to securities trading on the National Association of Securities Dealers Global Market (NASDAQ).⁹⁴ Before becoming a national securities exchange, the NASDAQ operated a price test for short selling called a bid test.⁹⁵ The bid test did not allow short sales at or below the current highest bid when that bid was less than the previous highest bid.⁹⁶ When the NASDAQ applied to the SEC to become a national exchange in January 2006, it requested, and received, an

Next Sale: 47.00 — Zero-minus tick compared to next to last trade; no short sale permitted

2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,070.

⁹⁰ See *id.* (citation omitted); Macey et al., *supra* note 27, at 803-04 (citation omitted).

⁹¹ 17 C.F.R. § 240.10a-1(a)(1)(i) (2007).

⁹² *Id.* (internal quotations omitted). “Effective transaction reporting plan means any transaction reporting plan approved by the Commission pursuant to § 242.601.” 17 C.F.R. § 242.600(b)(22). Section 242.601 describes minimum reporting requirements for securities transactions. See 17 C.F.R. § 242.601 (2007).

⁹³ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,070. Over-the-counter bulletin board securities (OTCBB) are generally small, risky, and traded infrequently. Investopedia, Over-The-Counter Bulletin Board (OTCBB), <http://www.investopedia.com/terms/o/otcbb.asp> (last visited November 5, 2008). There are no listing requirements to trade on the OTCBB, though companies must file financial statements with the SEC. *Id.* Pink sheets are securities that are not traded on an exchange, do not have listing requirements and are not required to file with the SEC. Investopedia, Pink Sheets, <http://www.investopedia.com/terms/p/pink-sheets.asp> (last visited Oct. 6, 2009).

⁹⁴ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,070-71.

⁹⁵ *Id.* The SEC granted temporary approval in 1994 for the NASD to use this bid test (former NASD Rule 3350). *Id.*

⁹⁶ *Id.* at 75,071 & n.29.

exemption from the uptick rule.⁹⁷ The bid test remained in place until the repeal of all short sale price tests in 2007.⁹⁸ Though the NASDAQ-listed securities were technically exempt from the uptick rule, these securities were still regulated by a price test.

To enforce the uptick rule the SEC used a marking requirement. When stock trades were executed, each order placed with a broker-dealer had to be marked as “short” or “long.”⁹⁹ As such, if an investor mismarked a trade as a purchase of shares for a long position, but actually purchased a short position, and did not observe the price test requirement of the uptick rule, the investor would be found in violation of Rule 10a-1. For example, the SEC brought an enforcement action against Sandell Asset Management after the firm began short selling shares of Hibernia Corporation, a New Orleans bank holding company, immediately after Hurricane Katrina.¹⁰⁰ Sandell “held a large long position in Hibernia.”¹⁰¹ The firm was apparently concerned that the natural disaster would decrease the offer price for Hibernia in a pending acquisition of the bank by another company.¹⁰² To protect Sandell against potential losses if the acquisition deal fell through, Sandell employees allegedly tried to short sell as many shares as possible to hedge its Hibernia investment and in the process, “short” sale orders were falsely marked as “long” sale orders.¹⁰³

Until its repeal in 2007, the uptick rule was in place as a backstop to regulate harmful or manipulative short selling in a declining market for nearly as long as the existence of the

⁹⁷ *Id.* at 75,071.

⁹⁸ *Id.* The SEC granted this exemption in large part due to the fact it was in the process of conducting a Pilot to study the effect of removing a short sale price test rule. *Id.*; see also *infra* Part III. The Commission did not want to jeopardize the quality of the pilot data or impose costs on the NASDAQ to implement a rule when it was possible the rule would be temporary. 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,071. After the NASDAQ was accepted as a national exchange, the bid test was codified as NASD Rule 5100. At this time, the SEC also exempted NASDAQ securities, newly listed on a national exchange, from the bid test when traded on non-national exchanges. *Id.*

⁹⁹ See Regulation of Short Sales, 17 C.F.R. § 242.200(g) (2007). If the sale of a stock was subject to a particular exemption from the uptick rule, the order was required to be marked “short exempt.” *Id.* § 242.200(g)(2).

¹⁰⁰ Press Release 2007-216, SEC, SEC Charges New York Hedge Fund Adviser With Short Sale Violations in Connection With Hibernia-Capital One Merger (Oct. 10, 2007), <http://sec.gov/news/press/2007/2007-216.htm>. Sandell Asset Management settled with the SEC for approximately \$8 million without admitting or denying the charges. *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

SEC itself.¹⁰⁴ However, as a result of market modernization and a growing list of exceptions to the rule, the SEC sought to revisit whether the rule needed to be modified to fit the trading practices of the twenty-first century.¹⁰⁵

III. THE REPEAL OF THE UPTICK RULE AND RENEWED CONSIDERATION OF A PRICE TEST RULE

The uptick rule has been considered controversial for decades. During the seventy years the uptick rule was in effect, the SEC studied its efficacy and necessity on several occasions, but it made no significant changes to the rule until its repeal in 2007. In addition to studying the effects of short selling on the market crash in fall 1938, another extensive study was performed in 1962.¹⁰⁶ Between 1939 and 1963, the NYSE lobbied unsuccessfully for the SEC to change the price test rule and allow short sales of a security at any price, so long as that price was higher than the closing price of the security on the previous trading day.¹⁰⁷ The necessity of this rule was examined again in 1976.¹⁰⁸ Given the history of the uptick rule, it was no surprise that when the SEC issued a Concept Release in 1999 in order to garner public comments on the short selling rules in an effort to “modernize” regulation of short selling, it received more than 2700 comment letters.¹⁰⁹

A. *The 2007 Repeal of the Uptick Rule*

The SEC felt it was necessary to re-examine the short selling rules due to several market developments, including the

¹⁰⁴ Short Sales, Exchange Act Release No. 48,709, 68 Fed. Reg. 62,972, 62,972 (Nov. 6, 2003).

¹⁰⁵ See *id.* at 62,973.

¹⁰⁶ Short Sales of Securities, Exchange Act Release No. 13,091, *supra* note 87, at 56,534. The Special Study, published in 1963, was more extensive than the 1937 study and concluded that while short sales as a percentage of total market volume increased in a declining market, the tick rule should be accompanied by a rule to “cope” with short selling during market declines because plus and zero plus ticks could occur in “sharply declining markets.” *Id.*

¹⁰⁷ The uptick rule only applied to transactions on national exchanges regulated by the SEC (such as the New York Stock Exchange) and to securities traded on national exchanges. Thus the rule did not apply to over the counter (OTC) sales of securities that are not traded on an exchange. See David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255, 1261 (1990).

¹⁰⁸ Short Sales of Securities, Exchange Act Release No. 13,091, *supra* note 87, at 56,530.

¹⁰⁹ Short Sales, Exchange Act Release No. 48,709, *supra* note 104, at 62,973.

increase in NASDAQ-listed securities trading off that market, the impact of electronic trading and decimalization, and the effect of the now-commonplace practice of trading of options.¹¹⁰ There was also speculation that hedge funds heavily pressured the SEC to re-evaluate the short selling regulations.¹¹¹

In 2003, after receiving and examining comments on its 1999 Concept Release, the SEC submitted Regulation SHO for public consideration.¹¹² Rather than rescind the uptick rule immediately, Regulation SHO proposed a pilot test period (the “Pilot”) during which time the uptick rule would be inapplicable to certain stocks.¹¹³ This would allow the SEC to obtain and study information about the trading activity for stocks not subject to a short sale price test.¹¹⁴ After an initial delay, the Pilot began in May 2005.¹¹⁵ Although the test was supposed to end in April 2006, the SEC extended the Pilot until August 2007 to give the Commission enough time to evaluate the data and determine whether to modify or repeal the price test rules in place.¹¹⁶ The Pilot exempted approximately 1000 stocks, chosen from the Russell 3000 Index, from the uptick rule.¹¹⁷ The SEC selected the Pilot stocks using a methodology that it felt would “giv[e] due consideration to the liquidity, volatility, market depth and trading market of these securities.”¹¹⁸

¹¹⁰ See *id.*

¹¹¹ See Jeff Benjamin, *Did Repeal of the Uptick Rule Unleash Market Havoc? Surge of Volatility, Rising Number of Short Sales Cited as Evidence*, 11 INV. NEWS 3, 3 (2007).

¹¹² Short Sales, Exchange Act Release No. 48,709, *supra* note 104, at 62,973.

¹¹³ *Id.* at 62,983.

¹¹⁴ *Id.*

¹¹⁵ Order Extending Term of Short Sale Pilot, Exchange Act Release No. 53,684, 71 Fed. Reg. 24,765, 24,765 (proposed Apr. 20, 2006).

¹¹⁶ *Id.* The primary reason for the extension was to prevent securities markets from having to make costly modifications to their systems and procedures more than once in the event the Commission decided to repeal a short sale price test rule. *Id.* The end of the Pilot coincided with the expiration of the temporary order suspending price tests. *Id.*

¹¹⁷ Order Suspending the Operation of Short Sale Price Provisions, Exchange Act Release No. 50,104, 69 Fed. Reg. 48,032, 48,032 (proposed July 28, 2004). The Russell 3000 Index includes the largest 3000 U.S. companies and its composition is updated annually. Russell 3000 Index Fact Sheet, http://www.russell.com/Indexes/characteristics_fact_sheets/us/Russell_3000_Index.asp (last visited Oct. 6, 2009); see also OEA ECONOMIC ANALYSIS, *supra* note 80, at 23.

¹¹⁸ Order Suspending the Operation of Short Sale Price Provisions, 69 Fed. Reg. at 48,032. The securities included in the Pilot were chosen from the Russell 3000 as of June 25, 2004 and the test group included only those stocks subject to Rule 10-(a)(1), which were all those traded on the NASDAQ and those listed on the NYSE or American Stock Exchange (Amex). *Id.* The stocks were grouped by the three exchanges

Following the conclusion of the first year of the Pilot period, the SEC Office of Economic Analysis (“OEA”) analyzed the Pilot data and issued a report in early 2007 to assist the Commission in deciding whether to repeal the price test rule, to install an alternative price test, or to retain the price test already in place.¹¹⁹ Based on the results of the OEA’s analysis, a public roundtable discussing the OEA report, and four additional studies performed by independent parties, the SEC concluded that “[g]enerally, the Pilot Results supported removal of current price test restrictions.”¹²⁰ The Pilot data revealed little relationship between “manipulative short selling” and the restrictions imposed by the uptick rule.¹²¹

Another factor that contributed to the SEC’s decision to reconsider and eventually repeal the uptick rule was the Commission’s goal of creating a “more consistent regulatory environment for short selling.”¹²² During the nearly seventy years the uptick rule was in effect, the SEC granted numerous exceptions to the rule, primarily as a result of the modernization of the markets and the evolution of trading practices.¹²³ Generally, the SEC allowed statutory or written exemptions for types of transactions that the uptick rule was not designed to prevent or for activities that were not deemed abusive.¹²⁴ For example, a statutory exception to the uptick rule was granted for exchange-traded funds, and another was

and then ranked by “average daily dollar volume” during the preceding year. *Id.* Every third stock (beginning with the second stock on the list), was then chosen in order to have “a more representative daily dollar volume sample.” *Id.* at 48,032, n.7. 50% of the test stocks were listed on NYSE, 2.2% on the Amex, and 47.8% on the NNM. *Id.* at 48,032. The approximately 2000 stocks in the index not chosen for the Pilot constituted the control group and the percentage distribution across the three exchanges were nearly identical. *Id.*

¹¹⁹ See Regulation SHO and Rule 10a-1 Final Rule Release, *supra* note 9, at 36,349, n.17.

¹²⁰ *Id.* at 36,349. See generally OEA ECONOMIC ANALYSIS, *supra* note 80. Though much of the economic analysis in this report is beyond the legal scope of this Note, the conclusions of the report that the SEC utilized in determining to rescind the uptick rule will be discussed in this Part and *infra* Part V.

¹²¹ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,073.

¹²² *Id.* at 75,068.

¹²³ *Id.* at 75,071. The statutory exceptions to the uptick rule can be found in section *e* of Rule 10a-1. 17 C.F.R. § 240.10a-1(e)(1)-(12) (2007). The SEC may also exempt transactions from the uptick rule upon “written request.” See 17 C.F.R. § 240.10a-1(f) (“This rule shall not prohibit any transaction or transaction which the Commission, upon written request or upon its own motion, exempts, either unconditionally or on specified terms and conditions.”).

¹²⁴ Short Sales, Exchange Act Release No. 42,037, 64 Fed. Reg. 57,996, 57,997-98 (Oct. 28, 1999).

granted to allow market makers and specialists to sell short on a zero minus tick, to ensure maintenance of prices and market liquidity.¹²⁵ In addition to these exceptions, in 2000-2001, U.S. securities markets implemented decimalization, which changed the pricing of shares from 1/16th minimum increments to \$.01 increments.¹²⁶ In a decimalized trading environment, one tick of a stock price now had a value of \$.01 as compared to the old minimum tick of 1/16th of one dollar, or \$.0625. In repealing the rule, the SEC and other critics of the uptick rule argued that decimalization made the rule less effective since a penny tick test would be less effective at slowing down short sellers.¹²⁷

The SEC also felt repealing the uptick rule was necessary to prevent exchange arbitrage. This is because regulatory differences between exchanges could put exchanges with a price test rule at a competitive disadvantage to exchanges without such a rule.¹²⁸ For example, in 1985, the NYSE publicized that it wanted the price test rule relaxed in order to combat competition from the London Stock Exchange, an exchange without a short sale price test.¹²⁹ As financial markets have continued to globalize over the past twenty years, this competition still exists. The results of the Pilot lent support to these concerns, as it indicated that short selling as a portion of total volume increased by 2% in the absence of price test restrictions.¹³⁰ The Commission construed this data to mean that investors could be more inclined to conduct their short sale transactions at market centers without short sale price tests.¹³¹

¹²⁵ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,072.

¹²⁶ See *Testimony Concerning the Effects of Decimalization on the Securities Markets: Hearing Before the Subcomm. on Sec. and Investment Comm. on Banking, Hous. and Urban Aff.*, 107th Cong. (2001) (statement of Laura S. Unger, Acting Chair, U.S. SEC), available at <http://www.sec.gov/news/testimony/052401tslu.htm>.

¹²⁷ See April 2009 Amendments to Regulation SHO, *supra* note 4, at 18,061 (“[T]he Commission noted [at the time of repeal of the uptick rule] that decimal increments had resulted in a rule that was no longer suited to the wide variety of trading strategies and systems used in the marketplace.”).

¹²⁸ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,075.

¹²⁹ Macey et al., *supra* note 27, at 804.

¹³⁰ OEA PILOT STUDY, *supra* note 80, at 35.

¹³¹ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,075; see also OEA PILOT STUDY, *supra* note 80, at 35-36.

Whether hedge funds influenced the SEC's decision to remove price test restrictions on short selling is debatable.¹³² But the timing of the Pilot test and the repeal of the uptick rule certainly coincided with the ascension of hedge funds.¹³³ While there is no agreed-upon, clear-cut definition of a hedge fund,¹³⁴ managers of these private investment funds often rely heavily on short selling as an investment strategy.¹³⁵ Traditional investment companies, which are regulated by the Investment Company Act,¹³⁶ are subject to stringent rules requiring extensive disclosure of short sales in the companies' investor prospectuses and annual reports.¹³⁷ Because hedge funds are not subject to the same regulation, the growth of hedge funds likely increased the visibility and incidence of short selling since they may freely use short selling strategies to maximize returns.¹³⁸ Predictably, hedge funds were publicly supportive of both the SEC's initial 2003 proposal suggesting the Pilot study,¹³⁹ and the 2006 proposal to repeal the uptick rule.¹⁴⁰

¹³² See Benjamin, *supra* note 111, at 3; Editorial, *Opposing Uptick Rule is Truly Short-Sighted*, INVESTOR'S BUS. DAILY, Oct. 16, 2008, at A10.

¹³³ Hedge fund employees are famously secretive about their investments and strategies, partly due to the competitive nature of the industry and partly because they raise funds privately, without advertising or public solicitation. Jenny Anderson, *Hedge Funds Walk a Hard Line Between Silence and Sharing*, N.Y. TIMES, Feb. 9, 2007, at C7. Private fundraising means that hedge funds fall outside the scope of the Securities Act of 1933. *Id.* This secrecy and the fact that there are no public reporting requirements make it difficult to estimate the precise increase in the amount of assets under management by hedge funds. However, for the sake of perspective, one estimate approximates that the number of global assets under management in hedge funds increased from "\$50 billion in 1990 to approximately \$1 trillion at the end of 2004." Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 80 (2005). In 2003, the "significant growth" of hedge funds prompted the SEC to compile a report to study implications of this growth given the "lack of information" available about hedge funds. SEC, STAFF REPORT TO THE SEC. EXCH. COMM'N, IMPLICATION OF THE GROWTH OF HEDGE FUNDS vii (2003), available at <http://www.sec.gov/news/studies/hedgelfunds0903.pdf>.

¹³⁴ In a 2003 Staff Report, the SEC provided its general definition, calling a hedge fund "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." SEC, STAFF REPORT TO THE SEC. EXCH. COMM'N, *supra* note 133, at 3.

¹³⁵ See *id.* at 5.

¹³⁶ See 15 U.S.C. §§ 80a-1 to -64 (2006).

¹³⁷ SEC, STAFF REPORT TO THE SEC. EXCH. COMM'N, *supra* note 133, at 43, n.147.

¹³⁸ *Id.* at 42-43.

¹³⁹ See Letter from John G. Gaine, President, Managed Funds Assoc., to Jonathan G. Katz, Sec'y, SEC (Jan. 26, 2004) (<http://www.sec.gov/rules/proposed/s72303/managedfunds012604.htm>). On behalf of the Managed Funds Association, an organization which represents an industry group of alternative investment fund professionals (including those employed by some of the largest hedge funds), Mr. Gaine

However, despite initially strongly supporting the SEC's decision to repeal the uptick rule, some hedge funds lobbied for the reinstatement of the rule once the SEC imposed the emergency ban on short sales in September 2008.¹⁴¹ These calls by hedge funds to reinstate the uptick rule came fast and furious after the SEC banned short sales and began requiring funds to disclose short positions.¹⁴² This outcry over the disclosure requirement was part of the reason the SEC softened its stance and modified the regulations slightly so that only short positions in excess of a fair market value of \$10 million had to be reported (as opposed to the initial requirement of \$1 million).¹⁴³

In 2006, the SEC announced a proposal to repeal the uptick rule and solicited another round of public comments, most of which were in favor of the rule change.¹⁴⁴ The comments submitted were mostly in line with the SEC's view expressed in the proposal, pointing out that improvement in market surveillance and transparency rendered the backstop of a price test rule unnecessary.¹⁴⁵ The comments asserted that the elimination of price test restrictions would allow the market to benefit from the merits of short selling, such as pricing efficiency and liquidity, while eliminating investors' operational costs directly associated with compliance with the rule.¹⁴⁶ Interestingly, two individual investors urged the SEC to keep the uptick rule in place to prevent bear raids.¹⁴⁷ Another comment letter from a finance professor agreed vigorously with the SEC's decision, but also made an interesting point that perhaps if more short sale data were publicly available, shorts

"encourage[d] the Commission to . . . move expeditiously toward the complete removal of short sale price regulation." *Id.*

¹⁴⁰ See Letter from John G. Gaine, President, Managed Funds Assoc., to Nancy M. Morris, Sec'y, SEC (Feb. 12, 2007) (<http://www.sec.gov/comments/s7-21-06/s72106-31.pdf>) (urging the SEC to repeal all price test restrictions and applauding its efforts "towards removing obsolete and unnecessary regulations").

¹⁴¹ See Anuj Gangahar & Joann Chung, *Funds Want 'Uptick' Rule Back*, FIN. TIMES.COM, Sept. 25, 2008, <http://www.ft.com/cms/s/0/0362e760-8b24-11dd-b634-0000779fd18c,s01=1.html>; Healy & Kerber, *supra* note 65.

¹⁴² See Healy & Kerber, *supra* note 65.

¹⁴³ See Disclosure of Short Sales and Short Positions By Institutional Investment Managers, SEC Exchange Act Release No. 58,785, 73 Fed. Reg. 61,678, 61,680 (Oct. 17, 2008).

¹⁴⁴ Regulation SHO and Rule 10a-1 Final Rule Release, *supra* note 9, at 36,350.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

would not always be the first parties blamed during market declines.¹⁴⁸

One comment letter the NYSE submitted following the announcement of the proposal to repeal the uptick rule was particularly notable. The NYSE expressed concern that the entire Pilot test took place during a period in which the market was relatively stable.¹⁴⁹ As such, the NYSE noted that removal of the rule during a period of “unusually rapid and large market decline” could not be measured.¹⁵⁰ Conversely, when the SEC established the rule in 1938, it did so in part based on a study of two one week periods in September and October of 1938 that were “characterized by a large volume of trading, erratic intermediate price movements and intensive liquidation.”¹⁵¹ The NYSE also expressed its belief that national exchanges should have the option to suggest price-testing rules in unstable markets.¹⁵² Not surprisingly, immediately following the SEC’s ban on short selling of financial stocks in 2008, the Chief Executive of the NYSE, Duncan Niederauer, publicly announced that he favored the return of the uptick rule, especially in volatile market conditions.¹⁵³

B. *The SEC’s Reconsideration of the Uptick Rule*

Following the financial upheaval in 2008 and the appointment and confirmation of a new SEC Chairman in 2009, revisiting the regulation of short selling was an immediate priority for the SEC, due to the “extreme market conditions” and “deterioration in investor confidence.”¹⁵⁴ In April 2009, the SEC sought comment on its proposal of two different approaches to regulate short selling.¹⁵⁵ The extensive

¹⁴⁸ Letter from James J. Angel, Assoc. Prof. of Fin., Georgetown Univ., to Nancy M. Morris, Sec’y, S.E.C (Feb. 14, 2007), <http://www.sec.gov/comments/s7-21-06/s72106-35.pdf>.

¹⁴⁹ See Letter from Mary Yeager, Assistant Sec’y, N.Y. Stock Exch., to Nancy M. Morris, Sec’y, SEC (Feb. 14, 2007), <http://www.sec.gov/comments/s7-21-06/s72106-34.pdf>.

¹⁵⁰ Regulation SHO and Rule 10a-1 Final Rule Release, *supra* note 9, at 36,350; see also Letter from Mary Yeager, Assistant Sec’y, N.Y. Stock Exch., to Nancy M. Morris, *supra* note 149.

¹⁵¹ Exchange Act Release No. 1548, 1938 WL 32911, *supra* note 82, at *1.

¹⁵² Letter from Mary Yeager, Assistant Sec’y, N.Y. Stock Exch., to Nancy M. Morris, *supra* note 149.

¹⁵³ Geoffrey Rogow, *NYSE Chief Leans Toward Uptick Rule*, WALL ST. J., Oct. 2, 2008, at C5.

¹⁵⁴ April 2009 Amendments to Regulation SHO, *supra* note 4, at 18,043.

¹⁵⁵ See *id.* at 18,042.

proposal detailed the approaches and included nearly two hundred questions for commenters to consider related to the proposed rules when providing feedback.¹⁵⁶ The SEC received approximately four thousand comment letters regarding these proposals.¹⁵⁷ Predictably, there was a wide range of responses, with many institutional commenters expressing concern that a short sale price test would have a deleterious effect on the efficiency and liquidity of the market,¹⁵⁸ and many others urging the reinstatement of a price test regulation.¹⁵⁹ This volume of responses helped prompt the announcement of a second public comment period in August 2009, proposing an additional version of a price test rule.¹⁶⁰ In connection with the proposed rule releases, the SEC held a roundtable to discuss short sale price test regulation in May 2009 with various industry professionals.¹⁶¹

The SEC suggested two different regulatory schemes in April 2009, the market-wide approach, with a permanent rule regulating short selling, and the circuit breaker approach that would implement a short selling regulation once the price of a security dropped precipitously, and could operate in conjunction with a market-wide or price test rule, or stand alone.¹⁶² As to the market-wide approach, the SEC solicited comments on two different price test rules, the “proposed uptick rule,” similar to the repealed Rule 10a-1 and the “proposed modified uptick rule,” similar to the bid test used by

¹⁵⁶ See generally *id.*

¹⁵⁷ Amendments to Regulation SHO, Exchange Act Release No. 34-60,509, 74 Fed. Reg. 42,033, 42,033 (Aug. 20, 2009) [hereinafter August 2009 Amendments to Regulation SHO].

¹⁵⁸ See, e.g., Letter from Richard Chase, Managing Dir. & Gen. Counsel, Royal Bank of Can. Capital Markets Corp., to Elizabeth Murphy, Sec’y, SEC (Sept. 21, 2009), available at <http://www.sec.gov/comments/s7-08-09/s70809-4665.pdf>; Letter from Paul M. Russo, Managing Dir., Head of U.S. Equity Trading, Goldman, Sachs & Co., to Elizabeth Murphy, Sec’y, SEC (June 19, 2009), available at <http://www.sec.gov/comments/s7-08-09/s70809-3809.pdf>.

¹⁵⁹ See, e.g., Letter from Edward D. Herlihy and Theodore A. Levine, Wachtell, Lipton, Rosen & Katz, to Elizabeth Murphy, Sec’y, SEC (June 17, 2009), available at <http://www.sec.gov/comments/s7-08-09/s70809-3690.pdf>; E-mail from Glen Shipway to SEC, (June, 19, 2009) (<http://www.sec.gov/comments/s7-08-09/s70809-3795.pdf>).

¹⁶⁰ August 2009 Amendments to Regulation SHO, *supra* note 157, at 42,033.

¹⁶¹ See generally SEC, Roundtable to Discuss Short Sale Price Tests and Short Sale Circuit Breakers, May 5, 2009, <http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf>. Roundtable participants included bankers, traders, regulators, economists, lawyers, and academics. SEC, Panelists’ Biographies, Roundtable to Discuss Short Sale Price Tests and Short Sale Circuit Breakers, May 5, 2009, <http://www.sec.gov/spotlight/shortsales/roundtable050509/bios.htm>.

¹⁶² April 2009 Amendments to Regulation SHO, *supra* note 4, at 18,043.

NASDAQ before it became a national exchange.¹⁶³ The Commission also suggested two alternative rules for the circuit breaker approach.¹⁶⁴ The first is a “proposed circuit breaker halt rule” that would be “triggered by a severe price decline” in a stock and prohibit any short selling of that security.¹⁶⁵ The second is a “circuit breaker price test rule[]” that would take effect when the price of a stock declined, while still allowing investors to short sell the security.¹⁶⁶ Additionally, two alternative circuit breaker price test rules, the “proposed circuit breaker uptick rule” and the “proposed circuit breaker modified uptick rule,” were also suggested, paralleling the price test rules discussed under the market-wide approach.¹⁶⁷ The SEC also discussed an “alternative uptick rule” in April 2009, but did not seek formal comment on this proposed regulation until August 2009.¹⁶⁸ The alternative uptick rule is a price test rule that could be utilized in either a market-wide approach or a circuit breaker approach and would allow short selling of a stock only “at a price above the current national best bid.”¹⁶⁹

Before determining how to act, the SEC stated that it would also evaluate empirical data as it became available.¹⁷⁰ The OEA had provided the Commission some preliminary data analyzing how a short sale price test would have affected the markets and whether short selling created downward pressure on stock prices during September 2008, at the height of the credit crisis.¹⁷¹ The SEC’s April 2009 proposal noted that the requests it received urging reinstatement of the uptick rule had not included any empirical data in support of these requests, but that it was “looking forward to receiving analysis of relevant data” related to the market effects of a price test rule, and the “costs and benefits of reinstating” some type of price test or circuit breaker rule.¹⁷²

In late February 2010, the SEC announced that it voted to adopt an alternative uptick rule that would take effect if a

¹⁶³ *Id.* (internal quotation marks omitted); see also notes 88-89, 94-96 and accompanying text.

¹⁶⁴ April 2009 Amendments to Regulation SHO, *supra* note 4, at 18,043.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ August 2009 Amendments to Regulation SHO, *supra* note 157, at 42,033.

¹⁶⁹ *Id.*

¹⁷⁰ See April 2009 Amendments to Regulation SHO, *supra* note 4, at 18,049.

¹⁷¹ See *id.*

¹⁷² *Id.*

stock traded down more than ten percent in a day.¹⁷³ Once the ten percent decline threshold is reached, short selling may occur only at a price above the best bid.¹⁷⁴ During both of the 2009 comment periods, the SEC received a plethora of empirical data, but it did not point to any particular study that it found to be especially persuasive and conclusive when it implemented the new rule.¹⁷⁵ This new regulation, Rule 201, will have broad coverage and “generally cover all securities . . . listed on a national exchange.”¹⁷⁶ Once the price of a security declines 10%, the trading limits will continue in effect for the rest of the trading day as well as the following day.¹⁷⁷ In enacting Rule 201, the SEC aims to regulate manipulative short selling and maintain investor confidence without “hav[ing] any negative effect on market liquidity and price efficiency.”¹⁷⁸

IV. REGULATION OF SHORT SELLING IN THE ABSENCE OF A PRICE TEST RULE

Upon announcing its decision to repeal the uptick rule in 2007, the SEC made sure to point to other statutes and regulations that enable the agency to police abusive short selling practices in the absence of a price test rule.¹⁷⁹ Even without the uptick rule, it is still illegal to short sell stocks in contravention of the other securities rules and regulations.¹⁸⁰ These statutes and rules were likewise enacted to protect investors and to maintain stable markets, and are the same regulations the agency would have used to enforce price manipulation and fraud through short selling even if the uptick rule were in place.

¹⁷³ See Floyd Norris, *S.E.C. Restricts Short-Selling and Addresses a Global Accounting Shift*, N.Y. TIMES, Feb. 25, 2010, at B3.

¹⁷⁴ See *id.*; see also *supra* note 23 and accompanying text.

¹⁷⁵ 2010 Amendments to Regulation SHO, *supra* note 21, at 11,241-44.

¹⁷⁶ *Id.* at 11,245. Options are not covered by Rule 201. *Id.*

¹⁷⁷ *Id.* at 11,244.

¹⁷⁸ *Id.* at 11,248.

¹⁷⁹ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069 n.16. In addition to the laws discussed in this Part, the SEC also regulates short sales in connection with public securities offerings in Regulation M, Rule 105. Regulation M, 17 C.F.R. § 242.105 (2009). Public offerings have specific regulations that differ from rules that govern day-to-day trading activities. See Regulation M, 17 C.F.R. § 242.100-105 (2009).

¹⁸⁰ See *supra* note 78.

The Securities Act of 1933 (the “Securities Act”) section 17(a) is an anti-fraud provision that prohibits the use of interstate commerce to effect “fraud or deceit” through the sale of securities.¹⁸¹ A violation of subsection (a)(1) of this provision requires scienter.¹⁸² The Exchange Act also has two provisions that can be utilized to regulate abusive short selling. The first, section 9(a), prohibits the manipulation of securities prices, although this section applies only to securities listed on an exchange.¹⁸³ The second provision, section 10(b), prohibits the use of any “manipulative or deceptive device[s]” in connection with the purchase or sale of securities and applies to any security, whether exchange-listed or not.¹⁸⁴ Section 10(b) of the Exchange Act is extremely important in SEC enforcement because it is the general “catch-all” regulation that the SEC uses to implement needed rules to protect the investing public.¹⁸⁵ The SEC enforces section 10(b) through Rule 10b-5.¹⁸⁶ The activities proscribed under Rule 10b-5 are similar to those proscribed under section 17(a) of the Securities Act, but Rule 10b-5 is the farthest reaching anti-fraud rule promulgated by the Exchange Act, since it applies to *any* security.¹⁸⁷

Section 9(a) of the Exchange Act is the most important provision prohibiting price manipulation of securities listed on a national exchange.¹⁸⁸ Since the securities of the largest and most frequently-traded companies are listed on national exchanges like the NYSE and the NASDAQ, this provision has bite. Several subsections of section 9(a) can be applied to manipulative short selling.¹⁸⁹ The primary anti-manipulation

¹⁸¹ Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006).

¹⁸² See *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

¹⁸³ Securities Exchange Act of 1934 § 9(a), 15 U.S.C. § 78i (2000).

¹⁸⁴ Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j.

¹⁸⁵ Joseph I. Goldstein et al., *An Overview of Market Manipulation: Legal and Practical Aspects*, in SECOND ANNUAL MARKET MANIPULATION 99, 105 (Joseph I. Goldstein et al. eds., 1990) [hereinafter *An Overview of Market Manipulation*] (“[§ 10(b)] is a broad ‘catch-all’ provision that empowers the Commission to prescribe rules that it deems necessary and appropriate to protect investors and the public interest.” (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976))).

¹⁸⁶ *Id.* at 105.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 103.

¹⁸⁹ Section 9(a)(1) primarily applies to “wash sales” and “matched orders.” *Id.* at 104. A wash sale is a transaction “which involves no change in the beneficial ownership” of a security. Securities Exchange Act of 1934 § 9(a)(1)(A), 15 U.S.C. § 78i(a)(1)(A) (2006). A matched order occurs when a purchaser (or seller) of a security enters an order for the purchase (or sale) of that security, when he knows that another party will be ordering a sale (or purchase) in the same security “at substantially the

provision is subsection 9(a)(2).¹⁹⁰ To establish a violation of this provision, the SEC or the plaintiff¹⁹¹ must establish that: 1) a person made “a series of transactions in any security”; 2) that those transactions resulted either “in actual or apparent active trading in such security” or in a rise or decline in the price of such security; and 3) that the transactions were made “for the purpose of inducing the purchase or sale of such security by others.”¹⁹² Section 9(a)(2) also requires the plaintiff to establish manipulative intent.¹⁹³ A would-be violation of section 9(a)(2) that is effected with a security not listed on an exchange is a violation of section 17(a) of the Securities Act.¹⁹⁴

Other provisions of section 9(a) that are relevant to the regulation of short selling include subsections 9(a)(3) and 9(a)(4), both of which apply to broker-dealers, as well as anyone else trading (purchasing or selling) stocks.¹⁹⁵ Subsection 9(a)(3) prohibits any trader of a listed security from “inducing the purchase or sale” of a security by “circulating or disseminating information that market activity may occur that will cause the security’s price to rise or fall.”¹⁹⁶ Subsection 9(a)(4) prohibits

same size, at substantially the same time, and at substantially the same price.” *Id.* § 9(a)(1)(B).

¹⁹⁰ Manipulation of securities prices is a “term of art” that is defined in different ways. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (“[Manipulation] connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” (citation omitted)); see also *In re Pagel, Inc.*, Exchange Act Release No. 22,280, 33 SEC Docket 1003, 1985 WL 548387, at *3 (1985) (“In essence, a manipulation is intentional interference with the free forces of supply and demand.” (citation omitted)).

¹⁹¹ There is a statutorily provided private cause of action for any person who “purchase[s] or sell[s] any security” that was “affected by [an] act or transaction” in violation of Exchange Act § 9. Securities Exchange Act of 1934 § 9(e), 15 U.S.C. § 78i(e) (2006).

¹⁹² Securities Exchange Act of 1934 § 9(a)(2), 15 U.S.C. § 78i(a)(2) (2006). A plaintiff in a private cause of action would also be required to prove that he relied on the transactions in question and that the transactions affected the plaintiff’s purchase or selling price. See *Chemetron Corp. v. Business Funds*, 682 F.2d 1149, 1164 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983).

¹⁹³ *In re Sharon M. Graham*, Initial Decision Release No. 82, 1995 SEC Lexis 3457, at *26 (Dec. 28, 1995) (“Section[] . . . 9(a)(2) require[s] that the proscribed activities be engaged in with the requisite manipulative intent.”).

¹⁹⁴ *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 975 (S.D.N.Y. 1973) (“It is well settled that the manipulative activities expressly prohibited by § 9(a)(2) of the Exchange Act with respect to a listed security are also violations of § 17(a) of the Securities Act and § 10(b) of the Exchange Act when the same activities are conducted with respect to an over-the-counter security.”). For background on over-the-counter securities, see *supra* note 93.

¹⁹⁵ Securities Exchange Act of 1934 § 9(a)(3)-(4), 15 U.S.C. 78i(a)(3)-(4) (2006).

¹⁹⁶ *An Overview of Market Manipulation*, *supra* note 185, at 104; see also Securities Exchange Act of 1934 § 9(a)(3), 15 U.S.C. § 78i(a)(3) (2006).

buyers and sellers of listed securities from making “false or misleading” statements regarding any material fact related to a security to encourage a purchase or sale of that security, when the buyer or seller “had reasonable ground to believe” such statement to be “false or misleading.”¹⁹⁷

Section 10(b), the main anti-fraud provision of the Exchange Act, and Rule 10b-5, promulgated thereunder, are commonly used enforcement tools.¹⁹⁸ Section 10(b) prohibits any person, by any means, from the “use . . . in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device.”¹⁹⁹ Further, Rule 10b-5 makes it unlawful to use “any device, scheme, or artifice to defraud,” to make material omissions or misrepresentations, or to engage in a fraudulent act “in connection with the purchase or sale of any security.”²⁰⁰ Section 10(b) and Rule 10b-5 do not require that a security transaction in question be effected on a national exchange, but they do require proof of scienter.²⁰¹ Negligence has not been held sufficient to establish scienter under Rule 10b-5, but courts have held that proof of recklessness is adequate to establish a cause of action.²⁰²

In addition to the general securities laws that the SEC can utilize to regulate short selling, the SEC has also made permanent Rule 204T, which was initially adopted as a temporary measure in October 2008.²⁰³ Rule 204 now imposes a borrowing delivery requirement to try to reduce “potentially abusive ‘naked’ short selling.”²⁰⁴ This rule requires market participants who fail to deliver securities at settlements to close out the position (by borrowing or purchasing securities)

¹⁹⁷ Securities Exchange Act of 1934 § 9(a)(4), § 15 U.S.C. 78i(a)(4) (2006).

¹⁹⁸ Rule 10b-5 is used so commonly because it is also the rule by which the SEC enforces violations of insider trading. *See SEC v. Zandford*, 535 U.S. 813, 819-20 (2002); *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833, 847-50 (2d Cir. 1968) (en banc).

¹⁹⁹ Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

²⁰⁰ 17 C.F.R. § 240.10b-5 (2009).

²⁰¹ *See Aaron v. SEC*, 446 U.S. 680, 691 (1980). (“[S]cienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.”).

²⁰² *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (“[R]eckless conduct may be defined as . . . involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.” (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976))).

²⁰³ *See* July 2009 Final Rule Release — Rule 204, *supra* note 29, at 38,266.

²⁰⁴ *Id.*

by the start of the trading day following the settlement date.²⁰⁵ If the failure to deliver is not timely closed out, then the participant

may not accept a short sale order in the equity security from another person, or effect a short sale in the equity security for its own account, to the extent that the broker or dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.²⁰⁶

This rule is particularly designed to address potentially abusive naked short selling, which can also affect investor confidence and create “unwarranted reputational damage.”²⁰⁷ The SEC clearly has a variety of enforcement provisions available to address fraud or price manipulation through short selling, but these rules all require targeted enforcement, while a price test rule theoretically provides a general backstop for abusive practices without requiring the SEC to prove intentional conduct or targeted manipulative action toward a specific security.

V. THE IMPORTANCE OF A PRICE TEST RULE IN TODAY’S MARKETS

At the time the uptick rule was repealed in 2007, the SEC felt that short selling regulation could be scaled back because of the “high levels of transparency and regulatory surveillance” in modern markets.²⁰⁸ The Commissioners felt that the “abusive or manipulative” short selling the uptick rule was designed to curb was less likely to occur in what the agency felt to be a highly-regulated environment.²⁰⁹ However, during the eighteen months following the removal of the uptick rule, a series of events occurred, indicating that modern U.S. markets were neither transparent nor well-regulated. The federal government was required to bail out the United States

²⁰⁵ *Id.* at 38,292.

²⁰⁶ *Id.* at 38,292 (quoting 17 C.F.R. § 242.204(b)).

²⁰⁷ *Id.* at 38,267-68.

²⁰⁸ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069.

²⁰⁹ *Id.*

banking system due to toxic securities that threatened liquidity; one major investment bank was sold at a fire-sale price to avoid collapse, while another investment bank holding company filed for Chapter 11; and the federal government was forced to take an equity stake in the world's largest insurance company as a result of the company's liabilities for credit default swaps.²¹⁰ The proverbial icing on the cake was the discovery of a massive Ponzi-style fraud scheme costing investors untold billions of dollars and perpetrated by a well-known financier.²¹¹ While these incidents were unrelated to short selling per se, and despite the many securities regulations in place, modern markets appeared to be far less transparent than posited when deciding to repeal the uptick rule.

A. *Why Regulation in the Absence of a Price Test Rule Is Insufficient*

The fact that the SEC relied on its assumption of transparent and well-regulated markets when it repealed the uptick rule is troublesome. The SEC performed the Pilot and reviewed several academic studies based on the Pilot before repealing the uptick rule, all of which indicated that repeal of the rule would not affect investors and the market.²¹² However, after the markets proved to be inadequately regulated in 2008, the SEC was tasked with reevaluating the uptick rule or

²¹⁰ See Ellen Simon, *Business Year in Review: At Least You've Got Your Health*, ATL. J. CONST., Dec. 26, 2008, available at <http://www.ajc.com/services/content/business/stories/2008/12/26/topstories.html>.

²¹¹ In December 2008, Bernard Madoff was accused of bilking investors out of billions of dollars through his investment fund. See generally Ross Kerber, *The Whistleblower*, BOSTON GLOBE, Jan. 8, 2009, available at http://www.boston.com/business/articles/2009/01/08/the_whistleblower/. The SEC was alerted by at least one tipster who had worked for a competing investment fund, several times over the *eight-year* period before the scheme was uncovered. *Id.* Mr. Madoff was investigated numerous times by the SEC but was never charged with a single offense. *Id.* This scheme was not one that affected only unsophisticated investors. Major banks, investment funds and institutions lost money in the scam, such as Banco Santander, Union Bancaire Privee, HSBC, BNP Paribas, Fairfield Greenwich, Yeshiva University and New York Law School. Madoff's Victims, WALL ST. J., Jan. 28, 2009, available at http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html. As a result of Madoff's actions, many other investors sought to recoup their money from other investment funds and similar Ponzi schemes have been uncovered. David Glovin & Joe Schneider, *Nadel, Missing Hedge Fund Adviser, Arrested by FBI*, BLOOMBERG, Jan. 27, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=a64niaXczcys&refer=home>.

²¹² 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069.

coming up with another type of price test regulation to police manipulative or fraudulent short selling and to preserve investor confidence in a volatile market.

1. Importance of Investor Protection

After various corporations, hedge funds, and individual 401(k)s were wiped out in 2008, there was a call for the SEC to get back to basics by focusing on investor protection.²¹³ Reinstating a price test rule for short selling is one way for the SEC to enhance investor protection. A major underlying goal of all federal securities laws is to protect investors by preventing price manipulation in securities markets.²¹⁴ In its Proposed Rule Release discussing the results of the Pilot, the SEC noted that while “there is concern regarding the possibility of manipulation using short sales,” the Pilot report did not note any increases in this practice during the Pilot period.²¹⁵ However, the Pilot report claims that the analysis it performed was not designed to directly examine whether instances of market manipulation through short selling occurred during the Pilot.²¹⁶ The OEA also noted that there was a possibility that “traders with manipulative intentions” may have been more reluctant to act during the Pilot because of the additional layer of analysis of the trades due to the Pilot.

In spite of this possibility, one of the major reasons the SEC felt comfortable removing the uptick rule was the availability of the “general anti-fraud and anti-manipulation

²¹³ See Charles R. Schwab, *Restore the Uptick Rule, Restore Confidence*, WALL ST. J., Dec. 9, 2008, at A17.

²¹⁴ See, e.g., Trading Practices Rules Concerning Securities Offerings, Securities Act Release No. 7282, Exchange Act Release No. 37,094, 61 Fed. Reg. 17,108, 17,108 (Apr. 18, 1996). This SEC proposed rule release stated:

A fundamental goal of the federal securities laws is the prevention of manipulation. Manipulation impedes the securities markets from functioning as an independent pricing mechanism, and undermines the integrity and fairness of those markets. Congress granted broad rulemaking authority to the Commission to combat manipulative abuses in whatever form they might take, including anti-fraud, prophylactic, and general rulemaking authority.

Id.

²¹⁵ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,069, n.16.

²¹⁶ OEA PILOT STUDY, *supra* note 80, at 47-48 (“The type of analysis conducted in this study cannot directly prove whether market participants are engaging in manipulative practices, because it is inherently difficult to measure whether the Pilot has had any impact on the degree to which markets are susceptible to manipulation.”).

provisions²¹⁷ under the Securities Act and the Exchange Act that allow the agency to enforce fraud or price manipulation effected through short selling.²¹⁸ While the SEC can utilize these statutes and rules to prevent manipulation and fraud in the absence of a price test rule for short selling, these regulations have several elements that must be established in order for the SEC to prove that fraud or manipulation related to short selling actually occurred.²¹⁹ Proving fraud or manipulation can be particularly problematic when delineating whether or not information is a rumor. Trading and investment decisions on Wall Street are based partially on research and partially on instinct and opinions. At times, opinions may also be nothing more than thinly-veiled rumors. The difficulty in regulating the spread of rumors is especially obvious today, when the sheer number of communication methods available allows rumors to spread like wildfire. Regulating the flow of information in the market is a mammoth task. Thus, a permanent backstop to prevent manipulative short selling would supplement the other securities regulations and give investors, companies, and markets as a whole consistent protection.

2. Whispers on the Street—the Rumor Problem

The difficulty of regulating rumors in the markets has been acknowledged by the SEC. Testifying before the Senate Banking Committee in July 2008, then-SEC Chairman Christopher Cox admitted that the SEC did not historically bring enforcement action against those spreading false rumors about a stock because of the complexities involved in determining who originated a false rumor and whether that originator knew that the information he or she spread was false.²²⁰ During this testimony, Mr. Cox also pointed to the Commission's April 2008 lawsuit against a trader as a prime example of the SEC's new attempts to enforce the spread of false rumors.²²¹ In April 2008, the SEC filed a suit against Paul

²¹⁷ 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,075.

²¹⁸ *Id.*

²¹⁹ *See supra* Part IV.

²²⁰ SEC, Testimony Concerning Recent Developments in U.S. Financial Markets and Regulatory Responses by Christopher Cox, Chairman, July 15, 2008, <http://www.sec.gov/news/testimony/2008/ts071508cc.htm>.

²²¹ *Id.*

S. Berliner, a trader, for allegedly spreading a false rumor about a pending acquisition transaction and charged him with securities fraud and market manipulation.²²² In the case, the SEC used records of electronic communications, specifically instant messages, to obtain evidence of the fraud and manipulations.²²³ The complaint in this matter alleges that the trader spread rumors about the pending acquisition of Alliance Data Systems Corp. (“ADS”) by the Blackstone Group.²²⁴ ADS had agreed to sell its shares to Blackstone for \$81.75 per share.²²⁵ The SEC alleged that the trader sent instant messages to thirty-one investment professionals claiming Blackstone amended its per-share offer and would now offer only \$70.00 per share for ADS’s stock.²²⁶ The media eventually picked up on this rumor and further disseminated the alleged misinformation.²²⁷ To illustrate the incredible swiftness with which a rumor can spread through the modern financial world, the stock price of ADS dropped *seventeen percent* in the *thirty minutes* after the trader sent the first instant message.²²⁸ Later the same day, the NYSE put temporary curbs on trading in ADS stock, and ADS was forced to issue a press release denying the rumor.²²⁹ Concurrently with sending instant messages, the trader also began to short sell 10,000 shares of ADS stock, for a profit of \$25,509.²³⁰

This case was eventually settled,²³¹ but is notable for several reasons. First, the availability of electronic evidence in this case made the SEC’s task of proving who originated the rumor, whether or not the rumor was material information,

²²² Complaint at 1-2, SEC v. Berliner, 08-CV-3859 (Sec. & Exch. Comm’n Apr. 24, 2008). Mr. Berliner was charged with fraud under sections 17(a) of the Securities Act and 10(b) of the Exchanges Act (and Rule 10b-5 there under) and with market manipulation under section 9(a)(4) of the Exchange Act. *Id.* at 6-8. See SEC Litigation Release No. 20,537, Apr. 24, 2008, <http://www.sec.gov/litigation/litreleases/2008/lr20537.htm>; see also *supra* Part IV for more information on these statutes.

²²³ Complaint, *supra* note 222, at 4.

²²⁴ *Id.* at 1.

²²⁵ *Id.*

²²⁶ *Id.* at 4.

²²⁷ *Id.* at 5.

²²⁸ *Id.* at 4.

²²⁹ *Id.* at 4-5.

²³⁰ *Id.* at 5-6.

²³¹ The trader accused agreeing to settlement without admitting or denying wrongdoing. SEC Litigation Release No. 20,537, *supra* note 222. He had to pay back his illicit profits, pay a civil penalty of \$130,000 and he was banned from “association with any broker or dealer.” *Id.*

and whether or not there was scienter²³² far easier to prove than if the information in question was spread with an offhand comment made during a phone call or over a business lunch. This type of concrete evidence certainly will not be available in every case of short selling fraud or manipulation, which further hampers SEC enforcement attempts. Second, the trader in this case only made a profit of \$25,509.²³³ While not negligible, this amount is far from remarkable. However, while making this nominal illicit profit of just \$25,000, the trader caused the total market capitalization of ADS to decline by nearly \$1.2 billion in just thirty minutes.²³⁴

Reliable information is paramount to market confidence. The decline in the market capitalization of ADS stock related to the *Berliner* case illustrates how quickly markets can react and the devastating effect certain information can have on the price of a security.²³⁵ A price test rule to regulate short selling may help mitigate potential consequences of the spread of false information or merely unconfirmed information. Although short sellers provide a positive service by bringing securities prices close to equilibrium, harmful rumors, true or not, can wreak havoc and cause extreme volatility. ADS's stock price recovered by the end of the trading day in question as a result of the company taking quick action to quash the rumor, but the fact remains that the information that drove down the stock price spread all over Wall Street in a matter of minutes.²³⁶

When rumors persist over a longer period of time and are not blatantly fraudulent on their face or easily rebuttable

²³² See *supra* Part IV.

²³³ See Kara Scannell & Gregory Zuckerman, *SEC Accuses Ex-Trader of Blackstone Ruse*, WALL ST. J., April 25, 2008, at C1 ("SEC staff searched data embedded in electronic communications, called meta data, which can trace emails from sender to sender.").

²³⁴ Market capitalization is the value of a company's outstanding shares and is calculated by multiplying the share price of a security by the total number of shares outstanding. Forbes Investopedia, Market Capitalization, <http://investopedia.com/terms/m/marketcapitalization.asp> (last visited Jan. 22, 2009). As of December 31, 2007, in its audited financial statements, ADS had 87.786 million shares issued, which is the estimate that will be used for this calculation. Alliance Data Systems, 2007 Annual Report (Form 10-K), at F-5 (Feb. 28, 2008), available at http://www.sec.gov/Archives/edgar/data/1101215/000119312508041317/d10k.htm#toc41827_21. Using the share prices contained in the SEC's complaint, if ADS's stock dropped from approximately \$77.00 to \$63.65, this is a difference of \$1.17 billion dollars—(($\$77 * 87.786\text{MM} = \6.76B) less ($\$63.65 * 87.786\text{MM} = \5.59B)). Complaint, *supra* note 222, at 4.

²³⁵ Testimony Concerning Recent Developments in U.S. Financial Markets and Regulatory Responses, *supra* note 220.

²³⁶ Complaint, *supra* note 222, at 4.

by a company (like the rumor in the *Berliner* case), those rumors could potentially have a more devastating effect. One method of self-help against abusive short selling is for a company to repurchase its own stock, creating a short squeeze,²³⁷ and showing that the company has access to the capital markets.²³⁸ In fact, at least one commentator has blamed the SEC for *preventing* companies from protecting themselves from manipulative short sellers in this manner because of uncertainty about whether the companies themselves will be charged with illicit market manipulation.²³⁹ In cases of rumors spread over a protracted period, a price test on short selling could slow down the race to short a company's stock, perhaps allowing a company a bit more time to deal with their financial issues in a more orderly fashion, ensuring compliance with all other SEC regulations and ultimately protecting investors.

In the thick of the 2008 credit crisis, politicians and Wall Street executives speculated that protracted rumors were what killed Bear Stearns.²⁴⁰ On July 15, 2008, the SEC issued a warning that it would begin investigating these rumors to ensure that there was no fraud or collusion occurring to drive down Bear Stearns's stock price.²⁴¹ Similar concerns regarding rumors were voiced in regard to Lehman Brothers in the months before the bank collapsed.²⁴² Since Wall Street "deals in rumors,"²⁴³ regulators have no easy task in proving that short sellers knowingly spread false information in order to profit. The SEC has maintained throughout the credit crisis that it was investigating accusations of fraud and price manipulation through short selling, but because some enforcement

²³⁷ See *supra* note 35 and accompanying text.

²³⁸ Macey, *The Government is Contributing to the Panic*, *supra* note 61.

²³⁹ *Id.* The SEC publicly acknowledged this problem after the demise of Bear Stearns and Lehman. *Id.*

²⁴⁰ See Anderson, *supra* note 54.

²⁴¹ See July 2008 Emergency Order, *supra* note 29, at 47,379. ("False rumors can lead to a loss of confidence in our markets. Such loss of confidence can lead to panic selling, which may be further exacerbated by 'naked' short selling . . . During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns' stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms."). The order also effected a ban on naked short sales of 19 financial stocks that was effective immediately and ended on July 29, 2008. *Id.*

²⁴² See Louise Story, *Lehman Being Besieged by Investor Betting Against It*, N.Y. TIMES, June, 4, 2008.

²⁴³ Anderson, *supra* note 54.

investigations can take years, it will be some time before the findings of these investigations come to light.²⁴⁴

B. The Uptick Rule as a Backstop

Some critics of reinstating the short sale price test rule have pointed to the SEC's recent implementation of Rule 204, regulating naked short sales, as another method to combat manipulation through short selling, rendering a price test rule unnecessary.²⁴⁵ While this rule will certainly reduce the number of "fails to deliver" and thus reduce the chances of manipulation through short selling, Rule 204 does not provide an overall backstop like a price test rule and thus would limit investor protection.²⁴⁶

The uptick rule was also designed to prevent short selling from hastening a decreasing market so that even down markets would remain orderly.²⁴⁷ However, during the twelve month span of the Pilot, the Standard & Poor's 500 Index increased nearly 12.8%,²⁴⁸ while the Dow Jones Industrial Average was up 10.9%.²⁴⁹ The Pilot study occurred when the market was increasing in an "orderly" fashion, but provided no data that the SEC could use to make an informed conclusion about the effect of the repeal of the uptick rule in volatile, declining markets, similar to those of the third and fourth quarters of 2008.²⁵⁰ The sharp increase in short selling that occurred at the height of the credit crisis in 2008 was exactly the scenario the NYSE warned of in its 2006 comment letter, even though it ultimately supported repeal of the rule.²⁵¹ The

²⁴⁴ See *supra* notes 93-96 and accompanying text. The defendant was accused of illicit short selling in August 2005, and the complaint was not filed until October 2007.

²⁴⁵ See, e.g., Letter from Paul M. Russo to Elizabeth Murphy, *supra* note 158.

²⁴⁶ See *supra* notes 205-207 and accompanying text.

²⁴⁷ See, e.g., 2006 Proposed Amendments to Regulation SHO and Rule 10a-1, *supra* note 46, at 75,070.

²⁴⁸ Yahoo Finance, S&P 500 Historical Prices, May 2, 2005-April 28, 2006, <http://finance.yahoo.com/q/hp?s=%5EGSPC&a=04&b=2&c=2005&d=03&e=28&f=2006&g=d> (last visited Oct. 27, 2008). The S&P closed at 1162.16 on May 2, 2005 and 1310.61 on April 28, 2006. *Id.*

²⁴⁹ Yahoo Finance, Dow Jones Industrial Average Historical Prices, May 2, 2005-April 28, 2006, <http://finance.yahoo.com/q/hp?s=%5EDJJI&a=04&b=2&c=2005&d=03&e=28&f=2006&g=d&z=66&y=198> (last visited Oct. 27, 2008). The Dow Jones closed at 10,251.70 on May 2, 2005 and 11,357.13 on April 28, 2006. *Id.*

²⁵⁰ *Opposing Uptick Rule Is Truly Short-Sighted*, *supra* note 132.

²⁵¹ Letter from Mary Yeager, Assistant Sec'y, N.Y. Stock Exch., to Nancy M. Morris, Sec'y, SEC, *supra* note 149.

author of an independent empirical study using Pilot test data warned that the Pilot results only supported the SEC's decision to repeal the uptick rule "conditionally, . . . the condition being the absence of extreme market conditions."²⁵²

It would be simplistic to blame the increase in short selling and market volatility following the repeal of the uptick rule on the removal of the rule alone; many factors contributed to the upheaval, creating a "perfect storm" of sorts.²⁵³ Some have said that they "doubt whether the continued existence of the short sale rule is justified, other than perhaps to provide investors with a semblance of confidence in the markets."²⁵⁴ However, the absence of the uptick rule or any other price test restriction or circuit breaker on short selling during a period of high market volatility and declining stock prices was seen by some as a factor in exacerbating this credit crisis.²⁵⁵ Even if the uptick rule is viewed as a mere prophylactic measure, allowing investors to retain some "semblance of confidence"²⁵⁶ in a falling market, this underlying confidence can be helpful in calming volatile markets and stabilizing cascading stock prices.

The volatility and uncertainty in the market is what led the SEC to issue its September 2008 short sale ban. The temporary ban on short sales of financial stocks was thrown in place to prevent the collapse of more financial institutions and further liquidity issues. Despite the lip service paid to short sellers by the SEC about the positive benefits of short sales, such as preventing bubbles, properly valuing stock, and detecting corporate fraud, short sellers were among the first blamed during the financial crisis.²⁵⁷ One major complaint after the SEC announced this ban was whether financial stocks could be properly valued. For example, on September 15, 2008, the stock price of Washington Mutual closed at \$2.00.²⁵⁸ When the short sell ban took effect on September 19, the stock price of the company, which was included on the banned list, closed at \$4.25.²⁵⁹ On September 25, the share close price was \$1.69,²⁶⁰

²⁵² Lynn Bai, *The Uptick Rule of Short Sale Regulation: Can it Alleviate Downward Pressure from Negative Earnings Shocks*, 5 RUTGERS BUS. L. J. 1, 62 (2008).

²⁵³ Benjamin, *supra* note 111, at 3 (quoting Peter Chepucavage, an SEC lawyer from 2001-2005, who worked on the Pilot program).

²⁵⁴ Macey et al., *supra* note 27, at 805.

²⁵⁵ Schwab, *supra* note 213.

²⁵⁶ Macey et al., *supra* note 27, at 805.

²⁵⁷ July 2008 Emergency Order, *supra* note 29, at 42, 379.

²⁵⁸ Bloomberg Investment Service, Historical Quotes.

²⁵⁹ *Id.*

and that evening, the federal government seized the bank and sold its assets to JPMorgan Chase. From the date the short sell ban took effect until the day the bank failed, its stock price never dipped below \$2.26²⁶¹ per share, 13% above its value on September 15, the day that Lehman declared Chapter 11.²⁶² On September 16, Washington Mutual issued a statement saying that it “shouldn’t be judged by its stock price,” and that the bank would not “go the way of Lehman Brothers” even though there were already rumors circulating that JPMorgan Chase was considering a merger.²⁶³

In this case, the shorts were right about Washington Mutual, and it is conceivable that the short sale ban artificially prolonged the company’s life, but in light of the crisis surrounding the markets, this was not necessarily a negative result. Any breathing room provided by the short sale ban may have allowed the relatively orderly demise of Washington Mutual. In a market regulated by a short sale price test rule, the hope is that an extreme full-out ban on short sales would not be necessary to achieve this result. Ideally, a short sale price test rule would provide a backstop during troubled times, without impinging on beneficial short selling in an advancing market.

VI. CONCLUSION

After a period of market deregulation beginning in the mid-1990s, the financial crisis of 2008 devastated the American economy and resulted in an increase in support for more regulation of financial markets.²⁶⁴ The credit crisis of 2008 was certainly not caused by short sellers; bear raids and stock price manipulation were not what put the global economy on the precipice of collapse and the existence of the uptick rule during this period certainly would not have been a panacea to heal all market woes. Investors continued to lose confidence once the

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² See Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008, at A1.

²⁶³ Lisa LaMotta, *WaMu Defiant*, FORBES.COM, Sept. 16, 2008, http://www.forbes.com/2008/09/16/washington-mutual-closer-markets-equity-cx_lal_0916markets42_print.html.

²⁶⁴ Michael Mandel, *Is It the Dawn of the Re-Regulation Era?*, BUSINESSWEEK.COM, Sept. 18, 2008, http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080917_918673.htm.

global securities markets started cascading downward. In any case, the uptick rule or other price test backstop could have certainly helped instill some confidence in the stability of the markets. The fact that the uptick rule remained intact and unchanged since the advent of modern securities regulation until 2007 is remarkable, particularly considering that it was challenged and debated in so many instances.²⁶⁵ Perhaps a price test rule for short selling is merely a placebo to make investors feel better during tough times, but that does not mean the rule cannot be effective; it is difficult to argue that confidence in the securities markets is unimportant.

The SEC's dire decision to place an emergency ban on the short sale of securities of nearly 1000 companies in September 2008 points to the fact that either short selling was causing problems in a declining, nervous market environment or that there was a perception among market participants that this was the case. The decision to ban short selling of certain stocks is the sort of panicky and rash decision-making in a declining market that the uptick rule was designed to prevent.²⁶⁶ Depending on regulators to piece together a last-minute ban in emergency situations in lieu of a permanent price test is an unwise decision. The SEC has powers to pass emergency orders when it sees fit, but waiting until a crisis occurs before taking regulatory action is not a wise practice, particularly if the action is too little or too late. Further, defining an emergency is not always simple.

Finally, relying solely on fraud or anti-manipulation provisions of the Securities and Exchange Acts to combat abusive short selling will be a losing proposition for the SEC, even with the addition of a rule to prevent naked short selling. The agency is already strapped for resources,²⁶⁷ but more salient is the fact that stock markets deal regularly with rumors and opinions. It is nearly impossible to stop whispers on the Street. The SEC has gone so far as touting its actions concerning the *Berliner* case on its website as a "landmark" action that shows the Commission was "[a]ggressively [c]ombatting" market

²⁶⁵ See *supra* notes 107-110 and accompanying text.

²⁶⁶ See *supra* note 90 and accompanying text.

²⁶⁷ See Robert Chew, *Can Mary Schapiro Revitalize the SEC?*, TIME.COM, Jan. 27, 2009, <http://www.time.com/time/business/article/0,8599,1874218,00.html> (discussing SEC's declining levels of enforcement staff).

manipulation during the credit crisis.²⁶⁸ If this one case, which ended in settlement, without adjudication, is a “landmark,” it seems that using enforcement actions as the only way to prevent market manipulation through short selling will likely prove to be very difficult and ultimately, ineffective.

After considering several iterations of a short sale price test rule, the SEC settled on Rule 201, an alternative version of the original uptick rule to help protect investors and restore confidence. The implementation of Rule 201 should help prevent short sale manipulation, but some feel the rule does not go far enough.²⁶⁹ Moreover, the Rule is likely to be challenged by those who believe that regulation of short selling is market-restricting and comes at too high of an economic cost. It will thus remain to be seen if the new rule both proves effective in combating abusive short selling practices and achieves the same longevity as the original uptick rule.

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²⁶⁸ SEC, SEC Actions During Turmoil in Credit Markets, <http://www.sec.gov/news/press/sec-actions.htm> (last visited November 1, 2008).

²⁶⁹ See, e.g., David Weidner, *SEC Hedges Its Bets on Short-Sale Rule*, MARKETWATCH.COM, Feb. 24, 2010, <http://www.marketwatch.com/story/shorting-the-new-short-sale-curb-2010-02-24>.

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