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Are Short Sellers Really the Enemy of Efficient Securities Markets or Are They Just Public Patsies?

Abel C Ramirez, Jr., Southern Methodist University

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# ARE SHORT SELLERS REALLY THE ENEMY OF EFFICIENT SECURITIES MARKETS OR ARE THEY JUST PUBLIC PATSIES?: A DISCUSSION OF MISCONCEPTIONS AFTER THE 2008 FINANCIAL CRISIS

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INTRODUCTION

Short selling is a controversial investment practice. When the 2008 global financial crisis caused the stock market to drastically decline, short selling generated intense political and economic scrutiny that negatively characterized the practice as a predatory scheme. Industry observers, issuers, and much of the popular media argued that short sellers had employed oppressive trading strategies, damaged investor confidence, damaged market quality, and accelerated price declines.¹ Company directors, shareholders and the media even went so far as to blame short sellers for the collapse of several companies amid the 2008 financial crisis, such as Bear Stearns, Lehman Brothers, AIG, and Merrill Lynch. One specific example of short selling’s public scrutiny involves Richard Fuld, Jr., the former CEO of Lehman Brothers, who stated during hearings on the company’s bankruptcy that a host of factors including “short selling attacks” contributed to the collapse of both Bear Stearns and Lehman Brothers.

The attention and scrutiny brought to short selling during the 2008 financial crisis primarily involved statements made by the Securities and Exchange Commission (SEC) that short sellers had spread “false rumors” in an effort to manipulate firms “uniquely vulnerable to panic.”² In order to control these supposed “manipulative” strategies, the SEC instituted a multitude of new rules in order to limit or discourage short sales on the open market. Most notably, the SEC banned naked short selling for select financial institutions between July 21st and August 12th, 2008, stating that “false rumors can lead to a loss of confidence [and] panic selling, which may be further exacerbated by ‘naked’ short selling…. [As a result] the prices of securities may artificially and unnecessarily decline.”³

¹ See Taibbi, Matt. Wall Street’s Naked Swindle, Rolling Stone (October 2009).
² Cox, Christopher. What the SEC Really Did on Short Selling, Wall St. J. (24 July 2008).
Subsequently, on September 17, 2008, the SEC announced a higher standard of stock delivery requirements in order to “impose powerful disincentives to those who might otherwise exacerbate artificial price movements through ‘naked’ short selling.” Just two days later, on September 19, the SEC announced another significant limit to short selling – a temporary emergency ban of short selling in the securities of 799 financial companies, and the obligation to disclose short sales on a weekly basis became effective on the subsequent trading day (Monday, September 22) and applied to all stocks (not just financials) for trades exceeding 0.25 percent of the corresponding company’s capital. The order specifically stated that the action “should 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.” In a press release, SEC Chairman Christopher Cox stated that “unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation…” and “[t]he emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets.”

But, it didn’t stop there – as the 2008 financial crisis persisted, the SEC continued its mission to regulate short selling by issuing several more related rules. It adopted an interim final temporary rule, through August 1, 2009, requiring certain institutional investment managers to make non-public disclosures to the SEC on their short sales and short positions. This interim final rule modified an earlier emergency rule by expanding the coverage of the reporting

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7 Id.
requirements.\textsuperscript{9} The SEC also issued an interim final temporary rule, effective until July 29, 2009, that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred. This rule was intended to “provide a powerful disincentive to those who might otherwise engage in potentially abusive ‘naked’ short selling.”\textsuperscript{10} Finally, the SEC issued a rule explicitly stating that “short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date” are liable for fraud.\textsuperscript{11}

By imposing these various short-selling regulations, regulators hoped to stem financial panics, at least insofar as such panic was reflected in stock market prices. By restraining the short-selling trading activity, regulators hoped to slow down price discovery in the midst of such a catastrophic bear market phase. The belief being that “unwarranted” bad news would be prevented from being rapidly impounded in stock prices, and would thus prevent trading that might occur as a result of “herding” behavior (potentially leading to significant market shifts) rather than trading based on fundamental public company information.

But, what if there is actually no legitimate reason to fear short selling? In fact, what if this controversial investment practice positively contributes to an efficient market despite the detractors’ claims? While any investment practice carries the potential to be utilized in an unethical or illegal manner, short selling has unfairly become synonymous with unlawful practices such as market manipulation and insider trading. In fact, despite the stringent

\textsuperscript{9} Id.
\textsuperscript{10} Id. at 61,706.
regulations that are continuously placed on short selling, the current view of short selling is so negative that several investor associations continue to lobby for even more government restrictions on the practice.\textsuperscript{12}

The purpose of this paper is to disassociate the legitimate investment practice of short selling publicly traded stocks from misconceptions that this practice is a manner of market manipulation or insider trading. This paper will also discuss the practice’s positive contribution to organized securities markets such as the New York Stock Exchange and the Nasdaq Stock Market. Legitimate short selling is neither market manipulation nor insider trading. No more than traditional “long positions” do short sales target market movement, or facilitate trades based on material nonpublic information. Further, there is nothing inherently inappropriate or illegal about employing legitimate short sales. Short selling, despite its negative connotation, is a common and legitimate investment practice that enables an investor to capitalize on a belief that a stock is overpriced or to hedge a long position.\textsuperscript{13}

I. OVERVIEW OF SHORT SELLING

Short selling is an investment strategy defined by the SEC as “the sale of a stock an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor.”\textsuperscript{14} In order to complete the transaction “the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller

\textsuperscript{12} e.g., The Movement for Market Reform, The National Coalition Against Naked Short Selling (NCANS), and The Coalition for the Reform of Regulation SHO.

\textsuperscript{13} See GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 209 (“short selling – even in large volumes – is not in and of itself unlawful…”).

later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the borrowed security to the lender.”

A short sale is predicated on the belief that a particular stock will decline in price. Contrary to the traditional “long position,” where a stock is first purchased at a low price in hopes of a subsequent price increase in order to sell the stock at the higher price for profit, a short sale involves the purchase of the stock after the trader has already received funds from the sale. “Investors who sell stock short typically believe the price of the stock will fall and hope to buy the stock [on the open market] at the lower price and make a profit [from the difference between the high sale price and the subsequent low purchase price].” If the price of the stock declines, as anticipated, the trader can cover at a lower price than the price at which he sold the borrowed stock and profit from the difference.

A legitimate short sale can serve many functions. Typically, a short sale indicates that the short seller either: (1) believes a stock to be overvalued and thus seeks to capitalize on the stock’s price drop; or (2) is using the short sale to hedge a long position. Also, those defending short selling maintain that short sales positively contribute to efficient markets by creating price stability and share liquidity.

II. MARKET MANIPULATION

Federal securities laws prohibit acts or practices intended to manipulate securities markets or securities prices. The SEC defines manipulation as “intentional conduct designed to

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16 Id.
17 See 17 C.F.R. § 230.3b–3; Leviin v. PaineWebber, 159 F.3d 698, 700 (2d Cir.1998).
deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include [but are not limited to]: spreading false or misleading information about a company; improperly limiting the number of publicly-available shares; or rigging quotes, prices or trades to create a false or deceptive picture of the demand for a security. Those who engage in manipulation are subject to various civil and criminal sanctions.”

The prohibition of market manipulation is based on the concept that those who control or artificially manipulate the price of securities should not have an advantage over those from whom they buy, or to whom they sell, securities.

A common misconception regarding short selling is that the investment practice is a manner of unlawful market manipulation. This view was advanced during the 2008 financial crisis when short sellers were widely accused in the media for having contributed to the financial crisis by precipitating manipulative price declines. A specific example of this accusation occurred when SEC Chairman Christopher Cox publicly stated that short sellers had spread “false rumors” in an effort to manipulate firms “uniquely vulnerable to panic.” Legitimate short selling is not market manipulation. Short selling is generally “used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.”

As a legitimate, and (more importantly) legal investment practice, short selling can be differentiated from all forms of market manipulation. In order to differentiate short selling from market manipulation, a discussion is necessary of the provisions that detail unlawful

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20 See Cox, supra note 2.
manipulative activity. It is also necessary to discuss definitive cases that have identified
manipulative activity, as well as the legal standard that should be applied.

A. Provisions

i. Section 9

Section 9 provides a private remedy for purchasers and sellers who have been victimized
by stock manipulation (although prosecutors rarely bring manipulation proceedings under this
section of the Act because of the section’s very narrow language). To state a claim for
manipulation under § 9(a)(1), plaintiffs must specifically identify particular types of
manipulative transactions.\(^\text{22}\) Similarly, § 9(a)(2) requires plaintiffs to identify transactions in a
security that create actual or apparent trading in that security or transactions that effectually raise
or depress the price of that security with the intent to deceive or defraud investors.\(^\text{23}\) Because of
this very narrow language in § 9, manipulation proceedings have been primarily pursued under
Rule 10b-5 since the elements of manipulation under this section are easier to prove. For this
reason, this paper will focus on elements of market manipulation as defined by Rule 10b-5 and
its enabling provision, § 10(b).

\[\text{ii. Section 10(b)}\]

Section 10(b) of the Securities Exchange Act of 1934\(^\text{24}\) prohibits manipulation by fraud
or deception with respect to securities. Section 10(b) is a “catch-all” provision making it
unlawful for any person “to use or employ, in connection with the purchase or sale of any
security… any manipulative or deceptive device or contrivance in contravention of such rules

and regulations as the Commission may prescribe.…”25

iii. **Rule 10b-5**

Under the language of § 10(b), which limits unlawful activity to conduct “as the Commission may prescribe,” the SEC adopted Rule 10b-5 to specifically enumerate “Employment of Manipulative and Deceptive Devices.” Rule 10b–526 “more specifically delineates what constitutes a manipulative or deceptive device or contrivance”27 and creates liability for anyone who makes a misleading representation regarding the purchase or sale of a security. This encompasses all forms of fraud, manipulation and deception. Thus, Rule 10b-5 enables the SEC and private individuals to pursue claims for market manipulation. Rule 10b-5 provides:

“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. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”28

The broad and vague language of Rule 10b-5 has evolved in its application and has been applied in a wide variety of contexts since neither the courts, the SEC, nor Congress have been able to define the scope and limitations of this provision. Rule 10b-5 will be the primary

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25 Id.
26 17 C.F.R. § 240.10b–5(b).
28 17 C.F.R. § 240.10b-5.
provision used in this paper to discuss the law’s application to short selling since Rule 10b-5 is the basis of any claim regarding both: (1) market manipulation and (2) insider trading (discussed later). Beginning with a discussion of market manipulation, “a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”

**B. Definitive Cases Involving Market Manipulation**

The Supreme Court has defined market manipulation as “intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” Subsequently, the Supreme Court narrowed this definition by holding that the “deception” element of manipulation encompasses “practices, such as wash sales, matched orders or rigged prices, that are intended to mislead investors by artificially affecting market activity.” Although this list of manipulative practices subject to liability under Rule 10b-5 is not exclusive to only these practices, it may help to understand the concept of manipulation by describing what the enumerated practices entail. The SEC describes a *wash sale* as occurring “when you sell or trade stock or securities at a loss and within 30 days before or after the sale you: buy substantially identical stock or securities, acquire substantially identical stock or securities in a fully taxable trade, or acquire a contract or option to buy substantially identical stock or securities.”

A *matched order* “involves the prearranged purchase and sale, usually

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through different brokers, of the same amount of securities at substantially the same price and time.”

Wash sales and matched orders are intended to “give the appearance of legitimate market activity.”

In *Ernst & Ernst v. Hochfelder*, the Supreme Court established the scienter requirement to establish liability for market manipulation. This case involved investors who were defrauded in a scheme perpetrated by the president of a brokerage house. The investors brought a civil action against the brokerage house’s accounting firm, Ernst & Ernst. The investors sought to hold Ernst & Ernst liable for damages on the theory that the accounting firm was negligent for failing to conduct proper audits, and that such negligence was actionable under Rule 10b-5. In its opinion, the Supreme Court stated that the term “manipulation” in § 10(b) “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” As a result, the Court held that, in order to give rise to liability for market manipulation under Rule 10b-5, negligent conduct is not sufficient. Rather, an actor must have “a mental state embracing an intent to deceive, manipulate or defraud.”

Later, in *Santa Fe Industries, Inc. v. Green*, the Supreme Court narrowed the elements of market manipulation by illustrating a “conceptual tether between manipulation under 10b-5 and illegal or inherently deceptive conduct.” This case involved a merger in which a subsidiary company was absorbed by the subsidiary’s parent company. As a result of the merger, the

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33 Steinberg, Marc I., *Securities Regulation* 423 (5th ed. 2009).
34 Id.
36 Id. at 188.
37 Id. at 199.
38 Id. at 193 n. 12.
subsidiary’s minority shareholders were to receive $150 in cash for each of their shares. The parent company, Santa Fe, provided the subsidiary shareholders with financial statements that convinced one of the minority shareholders that the stock was worth substantially more – at least $772 a share, rather than the $150 promised. “Rather than alleging that these materials contained misrepresentations and nondisclosures, the plaintiff claimed that the gross undervaluation of his shares was itself a ‘fraud’ within the meaning of Section 10(b) and Rule 10b-5.” The Supreme Court did not agree with the plaintiff, and explained that market manipulation “generally refers to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” Therefore, the transaction at issue “was neither deceptive nor manipulative and therefore did not violate either § 10(b) of the [Exchange] Act or Rule 10b-5.”

C. “Open-Market” Manipulation

A market manipulation claim does not necessarily require “the making of an untrue statement of material fact or omission to state a material fact.” In order to further disassociate legitimate short selling from market manipulation schemes, it is necessary to discuss a variation of market manipulation that is outside of the narrow language established in Santa Fe Industries. While “traditional” manipulations involve inherently illegal behavior, some manipulative schemes involve no objectively fraudulent or illegal act. The SEC and various courts have found that illegal fictitious devices (e.g., wash sales or matched orders) are not essential elements to

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41 Santa Fe Industries at 467.
42 Steinberg, Marc I., Understanding Securities Laws 254 (5th ed. 2009).
43 Santa Fe Industries at 476.
44 Id. at 474.
prove manipulation. Rather, several courts have held that the Rule 10b-5 requirement that an actor act with intent “to mislead investors by artificially affecting market activity” can just as easily be satisfied by facially legal transactions as the enumerated illegal transactions. Known as “open-market” manipulations, this variation of a manipulative scheme is accomplished using entirely legitimate transactions, but is still subject to enforcement under Rule 10b-5 if the intended effect is “a false pricing signal to the market.”

In *U.S. v. Mulheren*, the Second Circuit addressed the issue of open-market manipulation. In this case, the prosecution alleged that the defendant made large securities purchases on the open market for the purpose of driving up the stock price, in order to allow the defendant’s acquaintance to sell his own securities back to the issuer pursuant to a contractual agreement. While the court dismissed the manipulation charges based on insufficient evidence of scienter, the court analyzed and opined the issue of whether facially legitimate transactions can give rise to liability for market manipulation. In its opinion, the court suggested that, where an investor purchased securities *solely* with the intent to affect the price, he *could* be held liable for manipulation.

**D. Legitimate Short Selling is Not Market Manipulation**

Legitimate short selling does not satisfy any of the elements of a market manipulation claim established by the Supreme Court in either *Ernst & Ernst v. Hochfelder* or *Santa Fe Industries, Inc. v. Green*. In *Ernst*, the Supreme Court held that market manipulation requires “intentional or willful conduct designed to deceive or defraud investors by controlling or

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47 *ATSI Communications, Inc. v. The Shaar Fund, Ltd.*, 493 F.3d 87, 100 (2d Cir. 2007).
48 938 F.2d 364 (2d Cir. 1991).
49 *Id.* at 368-369.
artificially affecting the price of securities.” Short selling does not qualify as a manipulative act under this requirement because a legitimate short sale is a legal transaction designed to generate profit to the investor based on the security’s natural movement amid market activity. A short sale does not involve deception, nor does it involve “controlling or artificially affecting the price of securities.” Thus, short selling cannot satisfy the element that requires an intent to commit such acts. As a result, legitimate short selling is not a manner of market manipulation under this test.

In *Santa Fe*, the Supreme Court narrowed the definition of traditional market manipulation by holding that the “deception” element established in *Ernst* encompasses fictitious transactions that are inherently illegal such as “such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” Short selling does not qualify as a manipulative act under this requirement because a legitimate short sale is a legal transaction that does not represent any of the enumerated examples, nor any other form of transaction “intended to mislead investors by artificially affecting market activity.”

Legitimate short sales are not “wash sales” because there is no sale or trade of stock at a loss with a subsequent purchase of identical stock in order to give a false appearance of market activity. Legitimate short sales are not “matched orders” because there is no prearranged purchase or sale of the same amount of securities at the same price and time in order to give a false appearance of market activity. Nor is legitimate short selling a device to “rig prices.” As a result, legitimate short selling is not a manner of market manipulation under any of these tests, and therefore does not violate § 10(b) or Rule 10b-5.

Neither does legitimate short selling satisfy the elements of “open-market” manipulation established by the court in *Markowski*. In *Markowski*, the court held that, despite being executed in a legitimate manner, stock transactions can be manipulative acts under § 10(b) if the
transactions are intended to induce further transactions of that stock by other investors. Short selling does not qualify as a manipulative act under this requirement because, as already stated, a legitimate short sale is a transaction designed to generate profit to the investor based on the security’s natural movement amid market activity – not artificial movement. Legitimate short sales are not transacted for the purpose of inducing further transactions, but rather because the investor believes that the stock is overpriced (as a result of naturally occurring supply and demand spreads), or to hedge a long position. Therefore, in addition to not violating § 10(b) or Rule 10b-5 under a traditional market manipulation test, neither does legitimate short selling violate § 10(b) or Rule 10b-5 as a manner of “open-market manipulation.”

E. Definitive Market Manipulation Cases Involving Short Selling

“Market manipulation by means of concerted short selling calculated to artificially bring down the price of stocks constitutes harmful conduct sufficient to establish loss causation.”\(^{51}\) While the Supreme Court has held that specific illegal practices such as “wash sales, matched orders or rigged prices”\(^ {52}\) may encompass traditional market manipulation schemes, the SEC and a number of courts have stated that the intentional creation of a false impression of market activity is sufficient to prove market manipulation, regardless of whether the practice is illegal or legitimate.\(^ {53}\) Some examples of potential market manipulation schemes effectuated by short selling involve: (1) attempts to depress share prices; (2) exploiting vulnerable investors; and (3) “pump-and-dump” manipulation.

Manipulation involving attempts to depress a company’s share price, occurs when sellers

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\(^{52}\) See Santa Fe Industries, supra note 31 at 476.

\(^{53}\) See, e.g., ATSI Communications, Inc. v. The Shaar Fund, Ltd., 493 F.3d 87 (2d Cir. 2007); Pagel, Inc., v. SEC, 803 F.2d 942 (8th Cir. 1986); In re Halsey, Stuart & Co., 30 SEC 106 (SEC 1949).
target companies by aggressively short selling the company’s stock. If successful, the depressed price will distort the company’s investment decisions, thereby harming fundamentals. As a result the short sellers are able to cover their positions at depressed prices, and thus gain increased profit.  

Manipulation involving investor exploitation occurs through predatory trading. Short sellers can profitably exploit investors that have a need to exit long positions, or undercapitalized arbitrageurs. Such trading leads to negative return reversals.

The “pump-and-dump” manipulation involves taking a position in a stock, inflating the price with techniques such as wash trades or false rumor spreading, at the same time attracting liquidity to the stock, and finally reversing the original position at a profitable price. Although the documented evidence of this strategy involves stock price inflation (profiting from long initial positions) it is not difficult to imagine a similar strategy involving initially short selling the stock and then manipulating the price downwards.

i. A Case in Which Short Selling Was Used as a Manipulative Act

In Markowski v. SEC, the chief executive officer and the chief trader of a securities firm were accused of maintaining artificially high bid prices for a security that it had underwritten. Markowski was the chairman, CEO, and majority shareholder of Global America, Inc. (Global). Global underwrote an initial public offering of Mountaintop Corporation, a vodka producer. After the IPO, “Global dominated the market for Mountaintop securities, accounting for an overwhelming majority of both purchase and sale volume. From the IPO in June 1990 until Global's closing in January 1991, Global supported the price of Mountaintop securities. The SEC

54 See generally Goldstein, I., and A. Guembel, Supra note 19 at 133.
56 274 F.3d 525 (D.C. Cir. 2001).
said that this support took two forms: Global (1) maintained high bid prices for Mountaintop securities, and (2) absorbed all unwanted securities into inventory, thereby preventing sales from depressing market prices.” When Global ceased operation, and thus stopped supporting the Mountaintop stock, the stock’s price immediately dropped nearly 75% in one day.

The “manipulative” practice in this case was unprecedented, and the court was tasked with the difficult decision of whether to impose liability on the defendant despite the absence of fictitious or fraudulent transactions encompassed under the traditional interpretation of § 10(b). The defendants argued against liability because their bids and trades were “real” – involving real money and real customers, and therefore should not have been classified as “unlawful manipulation.” The court rejected the defendants’ argument “in light of what appears to be Congress’s determination that ‘manipulation’ can be illegal solely based on the actor’s purpose.” Thus, the court essentially held that, if scienter can be proven, any transaction can give rise to liability for market manipulation (even if facially legitimate) if the investor purchased or sold securities solely with the intent to affect the price.

ii. A Case That Has Differentiated Short Selling From Market Manipulation

The court in *GFL Advantage Fund, Ltd. v. Colkitt* clearly distinguished legitimate short selling as a legal investment practice. The conduct in this case involved large-scale short selling allegedly intended to depress stock prices and allow conversion of promissory notes into a larger

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57 *Id.* at 527.
58 *Id.* at 525.
59 *Id.* at 529.
60 272 F.3d 189 (3d Cir. 2001).
number of shares. Ultimately, the court held that “it is unreasonable to infer unlawful intent from lawful activity alone.”

In GFL, the plaintiff converted promissory notes into several hundred thousand shares of stock. At the same time the plaintiff began the conversions, he also began short selling the defendant’s stock. The aggressive short selling resulted in lowering the price of the stock of the two companies. The plaintiff sued the defendant for breach of contract after the defendant refused to honor the plaintiff’s demands for conversion. The defendant counterclaimed that the plaintiff committed fraud and market manipulation by manipulating the company’s stock via aggressive short sales.

The court rejected the defendant’s claims of market manipulation. In order to prove a market manipulation claim, the court required evidence “that the alleged manipulator injected inaccurate information into the market or created a false impression of market activity.” The court noted that the purpose of § 10(b) is to prevent “market activities that artificially depress prices…. However, the court ultimately found that the price was not depressed “artificially” because the short sales were lawful, and because the defendant did not stand to gain from an artificially depressed stock price. Thus, the court found that the defendant had no intent to artificially depress the stock price and therefore held that the defendant did not violate § 10(b) or Rule 10b-5.

Further, in making the distinction between legitimate short selling and market manipulation, the court cited specific examples as to how short selling positively contributes to an efficient securities market. “Short selling—even in high volumes—is not, by itself, manipulative. Aside from providing market liquidity, short selling enhances pricing efficiency by

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61 Id. at 207.
62 Id. at 205.
63 Id. at 205.
helping to move the prices of overvalued securities toward their intrinsic values.” As a result of the court’s holding in *GFL*, legitimate short selling should not be incorrectly associated with market manipulation schemes – neither those manipulative schemes which are inherently illegal, nor those based on legal transactions.

**F. Research on Short Sales and Market Manipulation**

It is important to repeat that every investment practice or strategy carries the potential to be utilized in a manipulative manner, in violation of § 10(b) or Rule 10b-5. As such, for every manipulative scheme to which short sellers are prone or susceptible, long sellers are equally prone or susceptible. However, a recent objective study has proven that the majority of recent short selling transactions have not been utilized to effect any type of manipulative scheme. Rather, the study proved that most short sales are utilized only to further entirely legitimate and legal purposes.

The study, conducted by Credit Suisse, attempted to measure the effect of the SEC short selling regulations enacted as a result of the 2008 financial crisis. The study focused on the trading activity of several large-quantity trading hedge funds. Credit Suisse concluded that the regulations imposed were not proportionate to the supposed problem. The intended effect of the short selling regulations was “to prevent manipulative attacks from short sellers intent on driving down prices.” However, the study found that “the overwhelming majority of short selling occurring in the market is part of a hedged strategy that seeks to pair a short trade with a similar

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64 *ATSI Comm., Inc.*, *supra* note 47 at 101.
66 *Id.*
long position. The goal is not to drive the price of the short stock down, but rather to capture any relative mispricings between the two.”\textsuperscript{67}

III. INSIDER TRADING

Another common misconception regarding short selling is that the practice is somehow associated with the unlawful practice of “insider trading.” “Under certain conditions, the federal securities laws prohibit the trading of securities (or ‘tipping’ related thereto) when such person uses material nonpublic information.”\textsuperscript{68} Short selling’s detractors argue that short sellers are more informed as to material nonpublic information and have thus gained an unfair advantage. Specifically, one recent accusation is that short sellers consistently receive nonpublic information regarding impending negative analyst recommendation changes.\textsuperscript{69} While any investment transaction bears potential that the investor has based his decision to trade on material nonpublic information, this is not an inherent element of legitimate short selling.

The SEC defines insider trading as “buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.”\textsuperscript{70} The prohibition of insider trading of securities is based on the concept that those with access to material nonpublic information\textsuperscript{71} should not have an advantage over those from whom they buy, or to whom they sell, securities.\textsuperscript{72}

Legitimate short selling is not insider trading. As stated before, short selling is generally “used to profit from an expected downward price movement, to provide liquidity in response to

\textsuperscript{67} Id.
\textsuperscript{68} Steinberg, supra note 33 at 655.
\textsuperscript{69} See Cox, supra note 20 (Short sellers were accused of “distort and short” schemes).
\textsuperscript{71} See United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996) (“To constitute non-public information under the act, information must be specific and more private than general rumor.”).
unanticipated demand, or to hedge the risk of a long position in the same security….” As a legitimate, and legal investment practice, short selling is neither more, nor less prone to investors who might pursue an unfair advantage by executing trades based on material nonpublic information than are traditional long sellers. In order to refute the notion that insider trading is a necessary element of short selling, a discussion is necessary of the provisions that detail unlawful insider trading activity – Rule 10b-5 and Rule 14e-3. It is also necessary to discuss definitive cases that have dealt with insider trading, as well as the legal standard that should be applied.

A. **Provisions**

   i. **Rule 10b-5**

   Although enforceable under the same provision as market manipulation – Rule 10b-5, insider trading is analyzed under a different approach than the analysis utilized for market manipulation. Utilizing the same language (including the element of “deception”), insider trading involves a transaction in which someone “deceives” by omission (i.e., a lack of disclosure). The “omission” is that the person is in possession of material nonpublic information, which, if known, would impact the price of the security and result in unfair profit to the trader. Another difference in Rule 10b-5’s application is that, in terms of profit motivation, profit from market manipulation is solely based upon the trader’s successful deception of other investors, causing them to be defrauded based on their reliance of the trader’s artificially created circumstances. Profit from insider trading, on the other hand, is not based upon the trader’s attempt to deceive or defraud other investors, but rather it is the trader’s attempt to secretly profit personally from private knowledge of information that would naturally shift the supply and demand of the stock, causing a natural price movement in the security. Rule 10b-5 applies to both.

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The SEC has also adopted Rule 10b5-1 and Rule 10b5-2 to clarify the unresolved issues regarding insider trading. Rule 10b5-1 “provides that a person trades on the basis of material nonpublic information if a trader is ‘aware’ of the material nonpublic information when making the purchase or sale.”

Rule 10b5-2 “clarifies how the misappropriation theory applies to certain non-business relationships. This rule provides that a person receiving confidential information under circumstances specified in the rule would owe a duty of trust or confidence and thus could be liable under the misappropriation theory.”

Essentially, under these provisions, insider trading liability exists when a defendant learns of material nonpublic information regarding a company and (1) is bound by a fiduciary duty (or similar relationship of trust or confidence); (2) to either “the company in question’s shareholders” or “the source of the information”; and (3) the defendant engages in a transaction of the company in question’s stock; (4) based on the learned material nonpublic information; (5) before that information is made public.

ii. Rule 14e-3

Under the enabling provision, § 14(e) of the Exchange Act, the SEC adopted Rule 14e-3 in order to establish the “disclose or abstain from trading” rule in regard to tender offers. “Rule 14e-3 applies this disclosure-or-abstain provision to the possession of material information relating to a tender offer where the person knows or has reason to know the information is nonpublic and was received directly or indirectly from the offeror, the subject corporation, any of their affiliated persons, or any person acting on behalf of either company. Moreover, the rule contains a broad anti-tipping provision….”

Because of the very narrow scope of Rule 14e-3, insider trading proceedings have been primarily pursued under Rule 10b-5. For this reason, this

75 Id.
76 Steinberg, supra note 33 at 692.
paper will focus on elements of insider trading as defined by Rule 10b-5 and its enabling provision, § 10(b).

B. Definitive Cases Involving Insider Trading

The elements of an insider trading violation were established by three definitive Supreme Court rulings: Chiarella v. United States, Dirks v. SEC, and United States v. O’Hagan. In all cases, the Court consistently premised the “deceptive” element of Rule 10b-5 on the breach of a fiduciary duty or similar relationship of trust or confidence. “In Chiarella v. United States,77 the Supreme Court asserted that the imposition of liability under § 10(b) and Rule 10b-5 for trading on material nonpublic information must be premised upon a duty to disclose. In Dirks v. SEC, the Court held that the duty of tippers-tippees to disclose or abstain from trading under Rule 10b-5 depends on ‘whether the insider personally will benefit [e.g., by receipt of pecuniary gain or reputational enhancement that will translate into future earnings], directly, or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.’”78

The court in Dirks v. SEC,79 narrowed the scope of the SEC’s insider trading prohibition. In this case, Raymond Dirks, a security analyst, received confidential information from a former officer of an insurance company called Equity Funding Corporation (EFC). The former officer informed Dirks that EFC’s stock was grossly over valued and that the company’s assets were overstated, due primarily to a high number of fraudulent policies that the company had issued. While attempting to ascertain the truth of the allegations, Dirks communicated the information to (1) the Wall Street Journal and (2) several of his institutional clients. In regard to the Wall Street Journal, Dirks convinced the publication to write a series of articles that would expose EFC’s

78 Steinberg, supra note 33 at 653.
fraud. In regard to his clients, Dirks advised several of his clients (while investigating EFC’s
fraud, but before the Wall Street Journal published the story) to sell any of their outstanding
holdings in EFC. Acting on the information that Dirks provided, his clients sold large amounts of
EFC stock hoping to avoid the potential losses that would incur when the price of the stock later
declined. The allegations were confirmed soon after, and EFC subsequently went into
bankruptcy. As a result, the SEC brought a disciplinary proceeding against Dirks, alleging that
he violated Rule 10b-5 by giving the information to his clients. The Supreme Court held that
Dirks did not act illegally because (1) he owed no duty to the purchasers of EFC stock, and (2)
he could not be found to have aided and abetted a violation by the insider from whom he
obtained the information, since the insider had not acted with an improper motive in giving the
information to Dirks (the former employee’s motivation in giving Dirks the information was to
obtain his aid in exposing the fraud).80

The most recent theory of insider trading, known as the “misappropriation theory,” was
upheld in *United States v. O’Hagan*.81 In *O’Hagan*, the Supreme Court held that a trader
commits fraud “in connection with” a securities transaction, and thereby violates § 10(b) and
Rule 10b-5, when the trader misappropriates confidential information for the purpose of
engaging in a securities transaction, in breach of a duty owed to the source of the information.
“Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to
purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the
principal of the exclusive use of that information. In lieu of premising liability on a fiduciary
relationship between company insider and purchaser or seller of the company's stock, the

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80 Dirks at 666.
misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."  

Under a current application of Rule 10b-5, liability for insider trading exists if persons with a fiduciary duty of confidentiality misuse material nonpublic information in connection with the purchase or sale of a security. Further, in regard to the mentioned “fiduciary duty of confidentiality,” there are currently two theories under which the duty can be violated: (1) when a fiduciary nexus exists between the inside trader and the other party to the transaction; and (2) when a fiduciary nexus exists between the inside trader and the source of the information (both theories also invoke liability on the tippers and tippees related to the misuse of the information).  

C. Legitimate Short Selling is Not Insider Trading  

Just as manipulation can occur regardless of whether the investments are long or short positions, insider trading can also occur regardless of the investment position. What is essential to understand, however, is that legitimate short selling is not inherently a manner of insider trading. Therefore, any public consensus that short sellers have the ability to predict negative future returns as a matter of having knowledge of material and nonpublic information is an incorrect assumption.  

Legitimate short selling is not a securities transaction premised on the misuse of material and nonpublic information. Rather, legitimate short selling has proven to simply be premised on a contrarian strategy. This generally means that, after observing a security’s change in share price effected by public information, both long sellers and short sellers will respond, but perhaps with contrary actions. A particular company announcement may lead long-biased investors to believe that the price of a stock will rise, thus leading them to purchase shares in hopes of  

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profiting from the rise. By contrast, if a short seller were to trade based solely on this same public information, the sale simply signals that the short seller believes contrary to the popular or consensus opinion. There can be a variety of reasons to justify a contrarian strategy – the most simple of reasons being that, given “herding” behaviors effect on price movement, a contrarian might have reason to believe that such behavior, when focused on the purchase of a particular stock, will inaccurately result in an over-valued price, thus exposing the stock to an inevitable drop once the “herding” behavior ends. While the exact signals used by short sellers are not uniformly known, legitimate short sales are premised on public information, and trading, in any form, based on public information does not violate any securities laws.

**D. Definitive Insider Trading Cases Involving Short Selling**

Insider trading is most commonly known as “purchases or sales by persons who have access to information which is not available to those with whom they deal or to traders generally.”83 While every investment practice has the potential to be used in an unethical or illegal manner, short selling has been unfairly associated with this unethical and illegal practice. Regardless of the classification of the position (long or short), the SEC’s current prohibition of insider trading will invoke liability “when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.”84

**i. A Case in Which Insider Trading Occurred in the Form of Short Sales**

Two very recent cases involving short selling and insider trading are the cases involving the hedge fund, Galleon Management. The civil case, *SEC v. Galleon Management*85 and the

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85 Civil Action No. 09-CV-8811 (SDNY).
The corresponding criminal case against Galleon founder Raj Rajaratnam\(^\text{86}\) involve an insider trading scheme estimated to have generated approximately $45 million in profits and savings. Among several other various stocks traded (both long and short), Rajaratnam was convicted of insider trading for short selling the stock of the microprocessor manufacturing company, Intel, based on material and nonpublic information.

In both cases, Rajaratnam, was found to have received material and nonpublic information from his personal friend, Rajiv Goel. Goel was a managing director with Intel’s treasury group – Intel Capital, which made proprietary equity investments in various technology companies. In one particular instance, Goel spoke to Rajaratnam and told him to short sell Intel stock because, based on Goel’s personal knowledge of the company’s financial status, he was aware that Intel’s earnings would be below expectations. In return, Goel asked that Rajaratnam place similar trades in Goel’s personal brokerage account (to which Rajaratnam was an authorized manager) in order to falsely suggest that the trades in the account were not placed directly by Goel (which would have been a violation of Goels’ fiduciary duty owed to Intel).

On April 9, 2007, one week before Intel’s scheduled Q1 2007 earnings announcement, Rajaratnam and Galleon sold short 1,000,000 shares of Intel stock at $20.14 per share. Rajaratnam also fulfilled the requested trades in Goel’s personal brokerage account. When Intel ultimately released its Q1 2007 earnings, Rajaratnam and Galleon profited from the trades in the amount of $1.3 million, and avoided losses in the amount of $917,000.

The court found the subject of the confidential information discussed between Rajaratnam and Goel to be “material.” The court also found that Goel, a corporate insider based on his employment position with Intel, had violated his fiduciary duty to his employer by

communicating the information to Rajaratnam. As a result both Rajaratnam and Goel were held to have violated Rule 10b-5’s prohibition of trading based on material nonpublic information.

While possessing or even sometimes trading based on material nonpublic information is not necessarily a violation of the law; the court very clearly described how Rule 10b-5 was violated in this instance by both: (1) the trader and (2) the tipper. “Section 10(b) and Rule 10b–5 ‘are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a ‘deceptive device’ under § 10(b)… because ‘a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.’”

“The ambit of Rule 10b–5's prohibition on insider trading extends beyond the insiders who themselves have a fiduciary duty, but also to the ‘tippee’ recipients of insider information from those who are insiders.”

“An individual is liable as a tippee under Rule 10b–5 if (1) the tipper possessed material nonpublic information regarding a publicly traded company; (2) the tipper disclosed this information to the tippee; (3) the tippee traded in securities while in possession of the information; (4) the tippee knew… that the tipper had violated a fiduciary duty by providing the information to the tippee; and (5) the tippee benefitted from the disclosure of the information by the tipper.”

ii. A Case That Has Differentiated Short Selling From Insider Trading

In Log On America, Inc. v. Promethean Asset Mgmt. L.L.C., the plaintiff, Log On America (LOA), a telephone and Internet access provider, entered into an investment agreement with the defendant. The defendants purchased 15,000 shares of LOA’s Series A Convertible

88 Id. (quoting SEC v. Ballesteros Franco, 253 F.Supp.2d 720, 726 (S.D.N.Y. 2003)).
89 Id. at 497-98 (quoting SEC v. Ballesteros Franco, 253 F.Supp.2d 720, 726 (S.D.N.Y. 2003)).
Preferred Stock and 594, 204 warrants for the purchase of LOA common stock shares. The agreement between the parties granted the defendants the right to sell short LOA common stock. However, the defendant agreed not to sell short more than 594, 204 shares of the common stock (the amount of the purchased warrants).

Despite the limitations on the amount of short selling allowed under the purchase agreement, LOA claimed that Promethean Asset Management et al. engaged in “massive” short selling of LOA’s common stock.91 As a result, LOA brought suit alleging that the defendants intended to depress the price of LOA common stock. The suit alleged that the defendants violated federal securities laws and breached various terms of their contract by both: (1) market manipulation; and (2) insider trading. LOA claimed that Promethean allegedly intended for the short sales to artificially manipulate the market price of the common stock while Promethean was also in possession of material and nonpublic information concerning LOA's business “relating to LOA’s financing options, business plans and contingent liabilities.”92

In regard to the insider trading claim, the court did not agree with the LOA. The court found that LOA had “failed to provide adequate specifics regarding the circumstances surrounding Defendants’ possession of non-public information: e.g., among other things, what non-public information Plaintiff gave Defendants, when the information was given, etc. Plaintiff's insider trading claim is, therefore, inadequate.”93 In essence, the court’s holding in Log On America upheld the established standards that: (1) short selling is a legal investment practice;

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91 Log On America Compl., at P. 32.
92 Id. at P. 39.
93 Log On America at 447.
and (2) allegations of insider trading must be substantiated with evidence that the trader received material and nonpublic information through illegitimate means (breach of a fiduciary duty).94

E. Research on Short Sales and Insider Trading

It is important to repeat that every investment practice or strategy carries the potential to be utilized in a manipulative manner in violation of § 10(b) or Rule 10b-5. As such, for every incident of insider trading to which short sellers are prone or susceptible, long sellers are equally prone or susceptible. However, a recent objective study has proven that a large majority of recent short sales regarding the stock of companies that have made material public announcements were made only after the announcements were made – not before. This data suggests that the trades were based only on public information, and therefore did not violate any securities laws.

In an effort to measure the “informativeness” of short sales in the wake of the 2008 financial crisis university economists, K.B. Diether and I.M. Werner analyzed returns on stock trades, placed before and after the company representing the stock in question had publicly announced material information.95 The study compared the risk-adjusted performance of the stocks over several days and found that traders increased short sale trading only after the stock produced positive returns, resulting in correct predictions of future negative returns (profit for short sellers).

In regard to material nonpublic information, the study proved that any perceived “advantage” held by legitimate short sellers to “predict future negative returns” stemmed only from a superior ability to process and capitalize on public information, rather than an ability to uncover material nonpublic information. For instance, by connecting short sellers’ trading

94 See also In re Ultrafem Inc. Sec. Lit., 91 F.Supp.2d 678, 703–04 (S.D.N.Y.2000) (dismissing claim where complaint only alleged “this was a sale by an insider possessing material adverse information”).
patterns with news releases, short sellers were found to trade primarily after the majority of long traders had purchased the stock. Since a large amount of purchasers cause the demand of the stock to rise, the price also rises. Therefore, short sales made after the stock’s demand had settled were placed in anticipation of the inevitable price drop after the stock’s demand declined. As stated, the exact signals used by short sellers are not uniformly known, but, such behavior simply suggests that short sellers do not believe that markets have yet fully incorporated the publicly announced information.

The study concluded by finding that short sellers appeared to follow rational value-based strategies in response to public information. After a public announcement has been made, short sellers generally traded at the same time as did long traders, however the difference between the two was premised on strategy – one group believing that upward movement would result, and the other group believing that downward movement would result. Further, after the public announcement, to the extent that the timing of their trades differed, short sellers were shown to have traded after long traders. Thus, by connecting short sellers’ trading patterns with news releases, the study concluded that short sellers’ did not premise trades on material nonpublic information. Rather, the short sellers were responding only to public domain information about the companies, which does not violate any securities law.

IV. **NAKED SHORT SELLING**

As described, short selling is the sale of stock not owned by the seller in hopes of profiting from declining prices. In order to complete the short sale transaction, the shares of the security that have already been sold must be delivered to the purchaser. Generally, the stock is borrowed, or adequate borrowing arrangements are made, to ensure availability for delivery
within the standard three-day settlement period. This type of short selling is called “covered shorting.” On the other hand, “naked short selling” or “naked shorting” is a short sale in which “the seller does not arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due (known as a ‘failure to deliver’ or ‘fail’).”  

The broad issues of market manipulation and insider trading that have been previously discussed in this paper in regards to the over-arching topic of short selling also apply to naked short selling in the same manner, as naked short selling is a sub-category of short selling. Since the general legality of short selling has already been discussed, this section will narrow its focus. This section will instead focus only on the unique elements of market manipulation to which naked short selling is believed to contribute, but which are absent in covered short selling.

One negative misconception that exists among media commentators and some market regulators is the inaccurate belief that naked short selling is a manner of unlawful market manipulation. Specifically, short selling’s detractors believe that the short seller’s “failure to deliver” the stock that has been sold (which is the natural result of a naked short sale) is a violation of § 10(b) or Rule 10b-5, and that it is also unlawfully disruptive to the market. There is also the belief that naked short selling results in depressed stock prices as a result of: (1) “bear-raid” type activity, or (2) the creation of “counterfeit shares.”

Legitimate naked short selling is not market manipulation. In order to differentiate naked short selling from market manipulation, an explanation is necessary regarding naked short selling’s unique elements that have raised public concern. It is also necessary to discuss

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definitive cases that have identified naked short selling’s legitimacy, as well as the legal standard that should be applied.

**A. Failure to Deliver**

The “Failure to Deliver” that results from a naked short sale is not inherently unlawful. The SEC asserts that: “Failures to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. A fail may also result from naked short selling. For example, market makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.”

Despite the legitimacy of a “Failure to Deliver,” the SEC has nonetheless recognized that the associated settlement failures of large amounts of naked short sales definitely have the potential to disrupt the smooth functioning of the securities markets. Therefore, in order to minimize any substantial effect, the SEC enacted Regulation SHO, which establishes “uniform locate and delivery requirements in order to address problems associated with failures to deliver…” (See below for a detailed explanation of Regulation SHO).

**B. “Bear Raids”**

“Bear raids” are manipulative acts subject to liability under Rule 10b-5. “Bear raids” gained substantial recognition during the heavy and rapid falls in the prices of financial sector

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97 *Id.*

stocks in the wake of the 2008 financial crisis. Even more than covered short sellers, the media and the CEOs of affected firms have consistently painted naked short sellers as market manipulators, accusing them of deliberately causing, or accelerating, sharp declines in associated stock prices. The SEC defines “bear raid” activity as selling an equity security short “in an effort to drive down the price of the security by creating an imbalance of sell-side interest.”

The intent of the “bear raid” is that the “imbalance of sell-side interest” will create conditions that trigger credit downgrades, by which short sellers can profit from the declining stock price. The difference between this and the types of market manipulation already discussed is that a bear raid is also intended to result in the eventual collapse of the company whose stock is being traded. While this manipulative practice may arguably be a legitimate fear for publicly-traded companies, it does not occur as a result of lawful naked short selling.

i. A Definitive Case That Has Differentiated the “Bear Raid” from Lawful Naked Short Selling

In *In re Olympia Brewing Co. Securities Litigation*, the plaintiffs alleged that the defendants, by engaging in naked short selling, were responsible for market manipulations under Rule 10b-5. Specifically, the plaintiffs alleged that the “Defendant short sellers and other co-conspirators devised and engaged in a secret scheme or conspiracy to manipulate the price of the shares of Olympia. They willfully and consciously acted individually and in concert with each other to effect a pattern of short sales of shares of Olympia with the intent, purpose and effect of

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99 Four of the most notable casualties of the 2008 financial crisis were Bear Stearns, Lehman Brothers, AIG and Merrill Lynch.
100 See *e.g.*, *Watch Out, They Bite!*, Time Magazine (9 November 2005) (Robert J. Shapiro, former undersecretary of commerce for economic affairs, claims that naked short selling costs investors $100 billion and has driven 1,000 companies into the ground).
101 17 C.F.R. § 242.
depressing the price of such securities and for the purpose of inducing the sale of Olympia stock by others.”103

The court did not agree. Rather, the court held that the defendant’s naked short sales (regardless of how “aggressive” they were perceived) were not manipulative under Rule 10b-5, because they did not inject artificial information into the marketplace.104 As a result, the court granted the defendant's motion for summary judgment. The most important aspect of this case is the distinction that the court made while reaching its conclusion. The court stated that, in holding that the aggressive naked short sales were not manipulative, the decision was not because it is impossible for aggressive short sales to be manipulative, but rather because, in this case, the defendants acted on the genuine and sincere belief that the shares were overpriced.105 Therefore, any resulting decline in the market price was only a natural and appropriate result.

C. “Counterfeit Shares”

Another misconception regarding naked short selling involves the inaccurate belief that naked short sale transactions are manipulative due to the creation of “phantom” or “counterfeit shares” that artificially depress stock prices. This belief is based on the theory that, by selling a share of stock prior to obtaining it, and then subsequently failing to deliver it, the transaction is based on a non-existent share of stock, essentially creating a “counterfeit share.” Such “counterfeit shares” are believed to artificially depress the price of the stock as a whole due to inaccurate reporting that might show the market being flooded (or “diluted”) with the new “counterfeit shares.” The belief is that when the new shares are added to figures regarding the supply of the stock, the result is an inflated supply figure, resulting in a lower price.

103 Id. at 1289.
104 Id. at 1294.
105 Id. at 1294.
The SEC, however, has rejected the notion that naked short sale transactions even create “counterfeit shares,” let alone artificially depress stock prices as a result. Regarding this topic, the SEC has stated:

“Some believe that naked short sale transactions cause the number of shares trading to exceed the number of shares outstanding, which in turn allows broker-dealers to trade shares that don’t exist…. Naked short selling has no effect on an issuer’s total shares outstanding. There is significant confusion relating to the fact that the aggregate number of positions reflected in customer accounts at broker-dealers may in fact be greater than the number of securities issued and outstanding. This is due in part to the fact that securities intermediaries, such as broker-dealers and banks, credit customer accounts prior to delivery of the securities. For most securities trading in the U.S. market, delivery subsequently occurs as expected. However, fails to deliver can occur for a variety of legitimate reasons, and flexibility is necessary in order to ensure an orderly market and to facilitate liquidity.”

i. A Definitive Case Involving “Counterfeit” Shares

A recent case applied the legal standard of market manipulation to the issue of “phantom” or “counterfeit shares.” In Cohen v. Stevanovich, the plaintiffs alleged that the defendants, a financial institution, intended to “fail to deliver stock allowing them to earn more money through the charging of fees, commissions and/or interest through phantom securities transactions.” The plaintiffs also alleged that the defendants’ naked short sales resulted in an artificially depressed stock price. However, the court did not agree. In a lengthy and well-informed decision, the court went to great lengths to defend the practice of naked short selling and to distinguish the practice from incorrect assumptions that the practice is illegal or even unethical.

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108 Id. at 421.
Before the court applied the legal standard for market manipulation to the facts, the court made an important distinction. The court stated that “broad and conclusory allegations of naked short selling do not state a claim for market manipulation…. As a result, allegations of failures to deliver, without more, are insufficient to state a claim for market manipulation. Instead, ‘[t]o be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security.’”\(^\text{109}\)

The defendants could not prove that any unlawful market manipulation offenses had occurred. Nor could the defendants “assert that the parties to the alleged short sales were anything other than bona fide buyers and sellers trading at the reported price of the transaction.”\(^\text{110}\) As a result, the court admonishingly clarified the distinction between naked short selling and market manipulation, as well as the public policy that enforces the distinction: “The fact that the seller was allegedly unable to deliver the security on the settlement date—three days after the transaction—does not transform that legitimate sale into unlawful market manipulation. Even when the seller is unable to deliver the stock on the settlement date, both parties obtain contractual settlement and still bear the market risk of the transaction. This is far different from a wash sale or similar transaction in which a manipulator acts as both the buyer and seller in order to give the false appearance of actual trades without assuming any actual risk.”\(^\text{111}\)

**D. Legitimate Naked Short Selling is Not Market Manipulation**

The SEC clearly states that “[n]aked short selling is not necessarily a violation of the federal securities laws or the Commission’s rules.”\(^\text{112}\) However, the practice of naked short

\(^{109}\) Id. at 424 (quoting ATSI at 101).
\(^{110}\) Id.
\(^{111}\) Id.
selling has consistently been at the center of controversy. The practice invokes controversy from the belief that it is, more than other investment practices, highly susceptible to manipulative activity. This belief of susceptibility is aggravated by the fact that the practice is also very easy to accomplish (since it requires no initial purchase of the stock by the seller). Despite the practice’s reputation as an act to facilitate market manipulation, no regulator has yet produced evidence to link naked short selling to market manipulation. Nonetheless, the SEC has recognized that naked short sales still present a higher potential for manipulative behavior and that the associated settlement failures could potentially be disruptive to the smooth functioning of financial markets. Therefore, in order to ensure that naked short sales are not utilized in a manipulative manner, and that they do not disrupt the market, the SEC enacted Regulation SHO in 2004.

i. Regulation SHO

Regulation SHO imposed major restrictions on naked short selling. According to the SEC: “Regulation SHO provides a new regulatory framework governing short selling of securities. Regulation SHO is designed, in part, to fulfill several objectives, including (1) establish uniform locate and delivery requirements in order to address problems associated with failures to deliver, including potentially abusive “naked” short selling (i.e., selling short without having borrowed the securities to make delivery); (2) create uniform marking requirements for sales of all equity securities; and (3) establish a procedure to temporarily suspend Commission and SRO short sale price tests in order to evaluate the overall effectiveness and necessity of such restrictions. Moreover, the rules are consistent with the objective of simplifying and modernizing
short sale regulation, providing controls where they are most needed, and temporarily removing restrictions where they may be unnecessary.”¹¹³

V. BENEFITS

Financial economists generally consider short sellers to be important contributors to efficient stock prices. Academic research also suggests that short sellers improve market efficiency, and generally stabilize share prices by identifying and then leaning against overvalued stocks.¹¹⁴ In addition, short sellers play an important beneficial role in exposing the poor condition of companies as well as providing efficiency in the security-lending markets.

While uneducated investors may view the practice of short selling as having a negative impact on the nation’s stock market, nothing could be further from the truth. Legitimate Short sales do not impact the economy negatively. In fact, short sales serve a very real and necessary purpose in an efficient economy. In addition to the traditional short sale that anticipates a price decline, “Short selling is also used by market makers and others to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security”¹¹⁵ (contrary to the common perception of short sales as “bets against the market”). Short sales are also an important component of complex hedging strategies – in order to manage overall portfolio risk, participants may combine long positions, that increase in value as prices increase, with short positions that increase in value as prices go down.

Short selling is also a mechanism to improve the efficiency of security-lending markets

since the option to fail becomes particularly valuable when borrowing is too expensive for covered short sellers, which is exactly when liquidity is most needed. In this context, naked short sales can increase liquidity (by decreasing bid-ask spreads) and can also reduce order imbalances. In the intraday trenches, liquidity-supplying short sales are clearly a stabilizing force in stock markets. Short sales help to narrow spreads, limit price spikes, and provide liquidity at important times.

Liquidity-supplying short sellers are a stabilizing influence and provide important market quality benefits at the margin. Naked short selling is often employed by market makers and other liquidity providers to quickly and efficiently fulfill orders. As part of their market-making function, market makers may use naked short selling as a response to incoming buy orders for stocks they do not have in inventory. The SEC accordingly asserts on its website that “in certain circumstances, naked short selling contributes to market liquidity. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. This is especially true for market makers in thinly traded, illiquid stocks such as securities quoted on the OTC Bulletin Board, as there may be few shares available to purchase or borrow at a given time.”¹¹⁶

conclude, regulations that target short sellers should take care not to undermine these particular benefits and functions provided by short selling.

**CONCLUSION**

Every investment strategy or investment practice has the potential to be used in an unethical or illegal manner. Therefore, there will always exist a potential for manipulation and insider trading regardless of whether the investments are long or short positions. What is essential to understand, however, is that legitimate short selling is not a default manner of market manipulation or insider trading.

The evidence provided by objective research, as well as the SEC, emphasizes that short sales are not a homogeneous category of trades that should be condemned in blanket fashion. In fact, short sellers are important contributors to market quality and efficient stock prices. “[S]hort selling has positive benefits for securities markets. The SEC has documented the market benefits associated with traditional short selling and has even sanctioned the practice. The two main benefits usually associated with traditional short selling are increased market liquidity and pricing efficiency.”\(^{117}\) These benefits are accomplished “by helping to move the prices of overvalued securities toward their intrinsic values.”\(^{118}\)

Any fear that legitimate short sales (either “covered” or “naked”) negatively impact the securities markets is entirely unwarranted. Legitimate short selling is not a manner of market manipulation, nor is it a manner of insider trading. Legitimate short selling is not a bet in hopes that the market will fail, nor is it a wager in hopes that a company’s financial capacity will


\(^{118}\) ATSI Comm., Inc., *supra* note 47 at 101.
decline – it is simply an investment based on value-based strategies in response to public information. While short sellers may have profited from the market declines of the 2008 financial crisis, there is scant evidence to suggest that these short sellers caused or even contributed to these market declines. In fact, it has since become public knowledge that the real cause of the 2008 financial crisis was the culmination of: (1) the federal government encouraging growth of the subprime mortgage market in order to increase the percentage of families owning their own homes;\textsuperscript{119} resulting in (2) investment banks issuing large amounts of securities (collateralized debt obligations) backed by subprime mortgages; that (3) were purchased by banks in large quantities with borrowed funds, and when subprime foreclosures rose; (4) the value of the securities plummeted, resulting in financial turmoil for the banks who had purchased the securities.\textsuperscript{120}

So, this begs the question – Why were short sellers portrayed and publicized as the arch nemesis of securities markets (as well as the SEC) during the 2008 financial crisis? Why were so many regulations enacted to target short sellers? Was it an attempt by the SEC to restore investor confidence by publicly demonstrating an effort to “fix the problem” at all costs? Perhaps the question that should be asked is – Was it just a simple matter of scapegoating?

As a strategy, it is important to emphasize that legitimate short selling is a method by which investors can capitalize on over-valued stocks that decline – this is NOT the same as “contributing” to the stock’s decline, which short selling’s detractors might believe. The distinction can be summed up with a simple analogy – (numbers notwithstanding) a roulette wheel has two potential bets that can yield profit to the gambler – (1) a bet on red; and (2) a bet

on black. The roulette ball has an equal chance of landing on either color. If the roulette table is primarily composed of gamblers who bet red (long-position investors), the minority of gamblers who bet black (short sellers) cannot reasonably be believed to control the roulette wheel simply because their bet is contrary to the majority.

While there is no legitimate reason to suggest that short selling is more (or less) capable of manipulating securities markets than long positions, nor is there any reason to suggest that short sellers are more (or less) capable of insider trading than long-position investors, the judgment in the court of public opinion has been rendered. Despite the evidence that has proven that short selling improves market efficiency rather than hurts it, short selling regulation will continue to be more stringent and more oppressive than regulation imposed on long positions, if for any reason, to quell public concern. However, one victory that short sellers can claim is SEC Chairman Christopher Cox’s admission regarding the short selling ban on financial firm stocks during the 2008 financial crisis, in which he stated: “Knowing what we know now, I believe on balance the commission would not do it again. The costs appear to outweigh the benefits.”121

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121 Christopher Cox, Telephone Interview to Reuters (31 December 2008).