MORE MUSCLE BEHIND REGULATION
SHORT SELLING AND THE
REGULATION OF STOCK BORROWING
PROGRAMS

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MORE MUSCLE BEHIND REGULATION SHO? SHORT SELLING AND THE REGULATION OF STOCK BORROWING PROGRAMS

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Most experienced investors know what is involved with short selling. Betting that a stock’s price will go down, rather than up, a short seller borrows stock which she then sells in the market. Subsequently she re-enters the market to “cover,” hopefully buying an identical number of shares at a lower price. With the newly purchased shares, she replaces the shares she borrowed. Her profit, or loss, is the differential between the price at which she borrowed shares and the price at which she covered. She profits if the stock’s price went down. She loses if she covers at a price higher than that existent when earlier she had borrowed and sold.1

The standard margin account brokerage agreement gives the broker-dealer the unrestricted right to lend out stock customers hold in their margin accounts.2 In fact, the customers never know

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

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

2See National Financial Services, LLC, Supplemental Application for Margin Account Privileges, Note following § 20, at 4 (upper case in original): “YOU ARE HEREBY AUTHORISED TO LEND, HYPOTHECATE, OR REHYPOTHECATE SEPARATELY OR
that the broker dealer has lent their stock. In actively traded stocks, each day the principal clearing entity, the Depository Trust Clearing Corporation (DTCC), and its subsidiary, the National Stock Clearing Corporation (NSCC) circulate an “easy to borrow” list which short sellers and their brokers peruse.³

Less actively traded stocks do not appear on the easy to borrow list. In fact, experienced brokers opine that one of the more difficult tasks they face is to borrow less actively traded stocks.⁴

There are several reasons for this. Many of the shares may still be in the hands of founders and their families (record ownership), or in brokerage house cash accounts (nominee or “street” name), rather than in margin accounts. The corporation may have earlier issued shares in an exempt transaction which resulted in restrictions on re-sale. Neither the corporation nor the shareholder has seen fit or had the time to remove restrictive legends on the share certificates.⁵


⁴ See, e.g., Key Points About Regulation SHO, supra note 1, at 2 (“[M]arket-makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives”); Christian, supra note 2, at 1059 (“Often shares of small companies . . . are hard to find because founders and other initial investors hold most of the shares in restricted form,” or at least in cash rather than margin accounts so that broker-dealers cannot borrow the shares without the owner’s express consent).

⁵ See, e.g., notes 67-71 & accompanying text infra (SEC rule 144 and restrictions on
shareholders are long term investors who hold shares in record name, or in cash rather than margin accounts.

For those and other reasons, stock to borrow may be difficult to locate in small and medim cap stocks. For that reason, many financial service firms have formed stock borrowing departments and stock borrowing programs. Programs offer holders above average returns (8% or 10% interest) and other inducements if the holders will lend their stock. An attractive feature is that the loans seems potentially to be short term: contracts include the investor-lender’s right to withdraw shares at the end of any month.

This article is about the need for regulation of these stock borrowing programs which, among other things, may fail to disclose that the stock borrowed often will be sold short and such sales may lead to a gradual, or even precipitous, decline in the stock’s price. Using its police power over broker-dealers, the SEC could require that such programs provide a disclosure document, including what is known as a risk factor statement, to every investor to whom the financial services firm offers participation in a stock borrowing program. Alternatively, participants and their lawyers could argue that, under the common law, participations in such programs are investment contracts, and therefore securities, subject to formal or informal disclosure requirements.

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6 Small cap companies are those whose capitalization (outstanding shares times the current market price is less than (often much less than) $1 billion. With mid cap companies and midcap stocks, the aggregate capitalization is more than $1 billion and less than $5 billion in one common schematic, or less than $10 billion in another common schematic. The labels small cap and mid cap are not words of art. They are loosely used. See generally TEWLES & BRADLY, supra note 1, at 34.

7 See notes 72-80 & accompanying text infra.

8 See notes 81-104 & accompanying text infra.
Selling short without having borrowed the stock in the first place, and with perhaps the intention of never borrowing the stock, is know as “naked short selling.” Many stock market observers, and the SEC, believe that alone or in conjunction with other tactics (“short and distort”campaigns), unscrupulous sellers use naked short selling to manipulate securities prices, forcing prices below levels that bear no relationship to the underlying economic reality. Traders use naked short selling to accelerate downward spirals in share prices.

In 2004, the SEC promulgated Regulation SHO, to take effect early in 2005. Regulation SHO was the SEC’s first salvo against naked short selling. The rule required that broker dealers accept no more short sale orders for stock on the so-call threshold list, unless the short seller owned the stock or had a credible agreement to borrow the stock. In September, 2008, the SEC extended and broadened the regulation, to all equity stocks and requiring that market participants close out failures to deliver at the open of the day following the close date, in other words by the open of the day following T+3, rather than in 13 days, as of old. In July 2009, the SEC made permanent as

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9 See, e.g, Christian, supra note 2, at 1038; Amendments to Regulation SHO, SEC Securities Exchange Act Release No.34-60388 (July 27, 2009) at 5-6 (hereinafter referred to as “Strict Close Requirement Release”); Karl Thiel, The Naked Truth About Short Selling, THE MOTLEY FOOL, Mar. 24, 2005 (“Naked short sellers sell shares of stock they haven’t borrowed, have no intention of borrowing, and that may not exist”). Prolonged fails to deliver resulting from naked short selling may reach high levels. The amount of fails may exceed the number of shares in the public float of the security, resulting in great numbers of phantom shares. See Christian, supra note 2, at 1045-46. See also DOUG HENWOOD, WALL STREET at 31 (mechanics of various “naked” securities transactions).


11 See notes 15-25 & accompanying text infra.
Rule 204 what had been temporary as Rule 204T, with one significant addition. In addition to buying an identical number of shares to close out a failure to deliver, the permanent rule provides that for such purposes market participants may borrow shares as well as buying them.

Since 2004, then, the SEC has ratcheted up, and ratcheted up again, the pressure to borrow shares.\(^\text{12}\) Both regulatory and enforcement efforts aim at not only policing but eliminating altogether naked short sales and failures to deliver.\(^\text{13}\) In turn, those added pressures raise considerably the use and visibility of stock borrowing programs, along with the need to build into them protections which are “necessary or appropriate in the public interest or for the protection of investors.”\(^\text{14}\)

\(^{12}\)See generally Amendments to Regulation SHO, SEC Securities Act Release No. 34-59748 (April 10, 2009)(hereinafter cited as “SEC Reform Proposals”). See also Douglas M. Branson, \textit{Nibbling at the Edges - Regulation of Short Selling: Policing Failures to Deliver and Restoration of an Uptick Rule}, 64 Business Lawyer (2009). Although \textit{Nibbling at the Edges} to some degree overlaps with this article, \textit{Nibbling} is about SEC enactments and proposals for enactments (\textit{e.g.}, eliminating failures to deliver and curbing naked short selling, as well as restoration of an uptick rule versus installation of circuit breakers restricting short selling in declining markets). This article moves further afield, into areas into which the SEC has yet to venture, namely, stock borrowing.

\(^{13}\)The SEC, or the applicable SRO, have instituted disciplinary actions against licensed professionals, most particularly the broker dealer, for leaving open failures to deliver, thus violating Regulation SHO. See, \textit{e.g.}, Stephen Joyce, \textit{NYSE Imposes Largest Regulation SHO Fine in Case Involving Deutsch Securities}, 40 BNA Fed. Sec. Reg. & L. Rep. 1486 (September 22, 2008)($575,000 for failure by 5 trading desks to close positions after short sellers failed to produce borrowed securities in 13 days).

\(^{14}\)This phrase is the lodestar the Commission must always keep in the forefront as it considers regulation. The enabling legislation is shot through with commands that the SEC do so. See, \textit{e.g.}, Securities Exchange Act of 1934 §6(a), 15 U.S.C. §78f(a)(rules governing national securities exchanges which the Commission “may prescribe as necessary or appropriate in the public interest or for the protection of investors”); \textit{id.}§10(b), 78 U.S.C. §78j(b)(adoption of antifraud rules - same); \textit{id.} §14(a), 15 U.S.C. §78o(a)(adoption of proxy rules - same); \textit{id.} §14(e), 15 U.S.C. §78o(e)(tender offer antifraud rules).
I. THE SEC CAMPAIGN AGAINST NAKED SHORT SELLING

A. Adoption of Regulation SHO  As with the condemnation of “distort and short” manipulations, many market participants condemn the practice of naked short selling.\(^{15}\) In theory, if short sellers do not have to, or simply do not, deliver shares which they have purported to sell, short interest in a stock can exceed the total number of shares outstanding. On a more realistic scale, especially when naked short selling takes place, short interest in a stock can mount rapidly, exerting excessive downward pressure on a stock’s price. Combined with broadcast of false rumors, or an organized distort and short campaign, naked short selling can push a stock’s price so far down that the price level has no connection with underlying economic realities. Buyers of such stocks, deprived of delivery, do not have the right to receive dividends or to vote shares they have purchased. In the view of nearly every market participant, naked short selling, like the spread of false rumors, is a “hit out of bounds,” not considered to be within the boundaries marking a level playing field.\(^{16}\)

But how to police naked short selling? The SEC adopted Regulation SHO in August 2004, to take effect in January 2005.\(^{17}\) The regulation forbids a broker-dealer from accepting a short sale order unless the would-be short seller has already borrowed the shares he proposes to sell, or has identified the shares he intends to borrow (the “locate” requirement).\(^{18}\)


\(^{18}\) A short seller must possess “reasonable grounds to believe that the security may be
After the trade (sale of the shares), Regulation SHO reduces the duration for which failures to deliver are permitted to remain open. Broker-dealers must close out fail-to-deliver positions in “threshold securities” that have persisted for thirteen settlement days (the “closeout” requirement”). The closeout means that the broker essentially will have to cover “open fails,” that is, buy in the requisite number of shares, closing out the short position.

A security is a threshold security if it is issued by an SEC reporting company and, over any running five day period, fails to deliver equaled or exceeded 10,000 shares and 0.5% of the issuing company’s outstanding shares. A broker-dealer cannot accept from any trader an order to sell short a threshold security if the trader has an open position (unfilled) in that security.19 For two years following Regulation SHO’s adoption, the threshold list on average contained 300 names, averaged 414 stocks in the first nine months of 2008, and peaked at 529 stocks as naked short

19 Regulation SHO Rule 203(B); Key Points about Regulation SHO at 3.

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

21 At the time of SHO’s adoption, Wall Street spokespersons expressed concern that the existence of a list (“Threshold Securities”) and the presence of issuing corporations’ names on it would result in less short selling, in turn permitting higher prices to persist. See Henry Sender, New Rules Put the Squeeze on the Shorts, WALL ST. J., Jan. 27, 2006, at C-5. The concerns never materialized. See Floyd Norris, A New SEC Rule Fails to Raise Stock Prices, and Some Are Angry, N.Y. TIMES, Feb. 18, 2005, at C-1.
sells of banks and other financial stocks crescendoed.\textsuperscript{22}

B. \textit{July 2008 Modification of SHO’s Application to Certain Financial Stocks}

When the SEC re-visited the regulation of short selling, the Commission announced that, effective July 21, 2008 and with license to continue for up to 30 days, the SEC would suspend the locate prong of Regulation SHO as to 19 of the most widely traded financial stocks.\textsuperscript{23} Would-be short sellers in those stocks would either have to have borrowed the shares they proposed to sell short, or have a formal agreement from a lender to provide the requisite shares to the short seller on or before closing of a trade (T+3).\textsuperscript{24} The prices of financial stocks had declined greatly. The SEC thought that a high level of short sales had contributed to the decline, or to the steepness of its slope. The SEC thought further that a great number of those sales had been naked short sales.\textsuperscript{25}

On September 18, 2009, the SEC extended the T+3 mandate, requiring \textit{all} open short positions to be closed out by the fourth day after the trade.\textsuperscript{26} The number of stocks on the threshold

\begin{footnotesize}
\textsuperscript{22} Tom McGinty & Jenny Strasberg, \textit{Short Sellers Squeezed on All Sides}, Wall St. J., April 7, 2009, at C-1.

\textsuperscript{23} SEC Exchange at Release No. 58166 (July 15, 2008).

\textsuperscript{24} \textit{Id.} See also SEC Press Release 2008-143, SEC Enhances Investor Protections Against Naked Short Selling (announcing emergency rule making). “An arrangement to borrow requires more than a reasonable grounds to believe that the security may be borrowed. An arrangement to borrow means a bona fide agreement to borrow the security such that the security being borrowed is set aside at the time of the arrangement . . . .” SEC Division of Trading and Markets, Guidance Regarding the Commission’s Emergency Order Concerning Short Selling at 1 (July 18, 2008)(hereinafter cited as “Emergency Order”).

\textsuperscript{25} See, \textit{e.g.}, Robert Cyran & Antony Currie, \textit{Clumsy SEC Arrives Late}, Wall St. J., July 19, 2008, at B-16.

\textsuperscript{26} Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to the Market Developments, SEC Release No. 34-58572 (September 18, 2008). See also Statement from SEC Chairman Christopher Cox, SEC Press Release No. 2008-210(September 18, 2008)(we have “instituted a hard T+3 closeout” in cases of
\end{footnotesize}
list soon thereafter dropped well below 200, averaging 79 in the first quarter of 2009.\textsuperscript{27}

Criticism of the SEC’s efforts was nearly universal. Professor Owen Lamont, formerly of Yale, termed it a “silly but harmless effort.”\textsuperscript{28} President of the Managed Funds Association, the hedge fund industry group, termed the SEC’s actions “aberrant” and “without precedent.”\textsuperscript{29} On the other side of the issue, the American Bankers Association expressed fear that with naked short selling curtailed for the largest banks, short sellers would focus on the banks not covered by the new SEC rules.\textsuperscript{30} The rule’s effect was immediate and startling. Price increases in the financial stocks ranged from highs of 89.5\% (Fannie Mae), 74.5\% (Freddie Mac) and 48.4\% (Bank of America) to a mean of 25.6\% and a median of 25.2\%.\textsuperscript{31} Short interest in some of those stocks had been high: 14.22\% in Fannie Mae shares and 12.81\% in Freddie Mac.\textsuperscript{32} Relieved of naked short selling and its downward pressure on price, the share prices rebounded.

Of course, an argument may be made that curtailment of naked short sales merely prolonged the inevitable: Lehman Brothers shares, in which short interest had risen to 12.57\%, rebounded 44.6\%. Lehman Brothers, of course, entered bankruptcy in September 2009.\textsuperscript{33} The

\begin{footnotesize}
\textsuperscript{27} McGinty & Strasberg, \textit{supra} note 22.
\textsuperscript{28} Scannell & Lauricella, \textit{supra} note 10, at A-13.
\textsuperscript{29} Id.
\textsuperscript{31} Id. (Table).
\textsuperscript{32} Id.
\textsuperscript{33} See, \textit{e.g.}, Jonathan G. Glater & Gretchen Morgenson, \textit{Firm’s Creditors, Large and Small, Gather for What’s Left}, N.Y. Times, September 16, 2008, at C-8 (the previous Sunday Lehman
same may be said of Fannie Mae and Freddie Mac: although they rebounded temporarily, their
shares eventually became nearly worthless as well.\textsuperscript{34}

\textbf{C. The SEC Returns to the Drawing Board}

Many at the SEC believed that short selling had contributed to, \textit{inter alia}, the collapses of
Bear Stearns and Lehman Brothers.\textsuperscript{35} So, in September, the Commission adopted several
additional temporary rules:

\begin{itemize}
  \item The SEC increased penalties for short sellers who rely on the locate requirement and then
        fail to deliver on T+3. After any such failure to deliver, the SEC will bar the broker-dealer
        from executing any short sale unless the trader actually has borrowed the shares
        before placing the order.\textsuperscript{36}
  \item The SEC defined as misleading and per se fraudulent for any trader to mislead a
        broker-dealer that the trader has located shares to borrow when he hasn’t.\textsuperscript{37}
\end{itemize}

\footnotesize
\textsuperscript{34}See Eric Dash, \textit{Few Stand to Gain on this Bailout, and Many Lose}, N.Y. Times, September 8,
2008, at C-1 (shareholders to lose greatly in impending government takeover of mortgage giants).
Nonetheless, on July 29, 2008, the SEC announced continuation of temporary rules to the
maximum extent allowed for, thirty days, that is, until August 14, 2008. SEC Press Release

\textsuperscript{35}See, e.g, McDONALD, supra note 33, at 166; Susan Pulliam, Liz Rappaport, Aaron Luchetti,
Jenny Strasburg & Tom McGinty, \textit{Anatomy of the Morgan Stanley Panic—Trading Records Tell
(bear raids and possible naked short selling in many financial stocks).

\textsuperscript{36}SEC Exchange Act Release No. 58572 (Sept. 17, 2008) (adopting temporary Regulation
Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008).

\textsuperscript{37}SEC Rule 10b-21, 17 C.F.R. § 10b-21 (Sept. 21, 2008) (“It shall also constitute a
• The SEC banned, temporarily, all short selling in financial stocks.\(^{38}\)

The new rules, announced on September 17 and 18, went into effect at 12:01 AM on September 18\(^{39}\) and quickly expanded thereafter. The hard delivery requirement was thought especially to be efficacious. Open fails declined from an average of 1.1 billion shares per day before the rule to an average of 582 million shares per day after the SEC had adopted the provision.\(^{40}\)

Effective Monday, September 22, the SEC also 71 stocks to its list of 750 in which the Commission had prohibited short selling, including shares of General Motors, Credit Suisse First Boston, American Express, Moody’s, and Legg Mason, the brokerage firm.\(^{41}\) The trend (addition of stocks to the list) continued, with the SEC adding to the list any retail or industrial corporation with a financial subsidiary, including CVS, Ford, United Healthcare, IBM, Zale (jewelers), and Sears.\(^{42}\) Regulators around the world, also faced with the gyrations of a world crisis, enacted short


\[^{39}\text{Kara Scannell, SEC Issues Short-Selling Rules in Bid to Stop Manipulation, WALL ST. J., Sept. 18, 2008, at A-6.}\]

\[^{40}\text{SEC Reform Proposal at 23 & n. 81.}\]


\[^{42}\text{Kara Scannell & Serena Ng, SEC’s Ban on Short Selling Is Casting a Very Wide Net, WALL ST. J., Sept. 26, 2008, at C-3.}\]

Criticism mixed with bits of empathy for the SEC. “It looks like we have a bunch of amateurs [at the SEC] who don’t know what they are doing . . . [b]anning short selling shows the desperation of the regulators,” said Professor James Angel at Georgetown University.\footnote{Id.} The SEC just decided that “we needed a time-out [but] [t]here are a lot of us out there who are wondering what the SEC was thinking, whether they have gone off the rails . . . ,” said Professor Charles Jones at Columbia.\footnote{Scannell, \textit{SEC Revises “Short” Rules Already}, supra note 41.} “Stop the folly. End the ban,” opined a Swiss Professor (Bris), finding that stocks on the ban list reacted more slowly than stocks outside the umbrella.\footnote{Bris, \textit{Shorting Financial Stocks Should Resume}, \textit{WALL ST. J.}, Sept. 29, 2008, at A-25.}

II. REDUCING NAKED SHORT SALES BY POLICING FAILURES TO DELIVER: THE STRICT CLOSEOUT REQUIREMENT AND NEW RULE 204.

\textit{A. Interim Final Temporary Rule 204T Made Permanent}

In September 2004, the SEC added the temporary provision to Regulation SHO.\footnote{See notes 26-27 supra.} The temporary rule required participants in registered clearing agencies (broker-dealers mainly) to close out failures to deliver, by buying in securities sufficient to cure all fails, and to do so not within thirteen days, but at the market’s opening following the day on which settlement should
have occurred (that is, at the open on T+4). Further, these strict close requirements applied to
fails to deliver in equity securities, not merely to those on the Threshold List. The permanent rule
continues the strict close requirement but does permit participants either to buy in or borrow
securities to close out the failure to deliver position.

The SEC did so because its Office of Economic Analysis (OEA) had found the temporary regulation particularly effective in reducing the numbers of failures to deliver, which was the SEC’s penultimate goal, the ultimate goals being elimination naked short selling and of market manipulation. For example, fails to deliver in non-threshold securities averaged approximately 624 million shares or $4.6 billion in value per day from January to July 2008. After Rule 204T’s extension of strict close out requirements to non-threshold securities, from December 2008 to March 2009, OEA estimates of fails to deliver fell to 307 million shares or $1.1 billion per day.

As has been seen, the National Securities Clearing Corporation (NSCC), a subsidiary of

48SEC Rule 204T(a), Emergency Order at 3.
49“We have concluded that it is necessary to impose enhanced delivery requirements on sales of all equity securities ....” Emergency Order, supra note , at 2 (emphasis added).
50“A participant ... must deliver securities to a registered clearing agency for clearance and settlement on a long or a short sale ... by the settlement date, or if a participant has a failure to deliver position ... the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quality.” SEC Rule 204(a); Strict Close Requirement Release at 97.
51Strict Close Requirement Release at 27.
52Id.
53 Id. See also id. at 4: “[T]he average daily number of threshold Securities declined from 480 Securities to 108 securities ... a decline of 77.5%”
54See note 3 & accompanying text supra (discussion of easy to borrow list).
Depository Trust Clearing Corporation (DTCC), clears “virtually all broker-to-broker” transactions in publicly traded securities.\(^5^5\) In addition to circulating the easy to borrow list, each day NSCC notifies participants (broker dealers such as Merrill Lynch or Morgan Stanley) of their payment and delivery obligations for that day.\(^5^6\) If those participants fail to close out a fail to deliver position, in effect the rule requires the market participant to proffer no further naked short sales and that NSCC accept no further short sales from that broker-dealer for settlement.\(^5^7\) If the broker-dealer becomes net flat or net long in that security, across the board and not merely as to that particular client, it may again proffer short sales for settlement.\(^5^8\) In turn, to remove this disability, broker-dealers (participants) will require investor clients promptly to remedy deficiencies and also take added steps to prevent deficiencies from arising in the first place.\(^5^9\)

**B. Pleas for Expanded Windows In Which to Close Fails**

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\(^{55}\) Through its NSCC subsidiary, DTCC clears and settles most broker-to-broker equity transactions in the US. [Http://www.dtcc.com/products/cs/eq_ondex.php](http://www.dtcc.com/products/cs/eq_ondex.php) Strict Close Requirement Release at 10 & n. 35. See also id. at 23 (same).

\(^{56}\) Strict Close Requirement Release at 23.

\(^{57}\) “If a participant ... does not close out [a] fail to deliver position ... the participant and any broker or dealer from which it receives trades for clearance and settlement ... may not accept a short sale order ... without first borrowing the security ....” SEC Rule 204(b); Strict Close Requirement Release at 98.

\(^{58}\) SEC Rule 204(e)(4); Strict Close Requirement Release at 37.

\(^{59}\) A principal Wall Street objection to the strict close out requirement was that the bidding by securities firms for securities at the opening, occasioned by the need to cure fails to deliver at the beginning of day T+4, would distort market prices. See, e.g., Strict Close Requirement Release at 14. The SEC allowed that such might be the case in individual cases but that the SEC’s overall goal of vastly reducing failures to deliver outweighed any temporary market dislocations a strict close requirement might cause. See id. at 18 (“Although we recognize commentators’ concerns regarding the potential market impact of the close-out requirements ... particularly at the market open, we believe that these potential effects are justified by the benefits of retaining the strict close out rule.”).
Commentators requested that the window in which participants (broker-dealers) could close out fails to deliver be expanded to the close of T+4, or to three days, or to five days, following the settlement day on which a failure to deliver had occurred. They all recited a need to smooth out the upward pressure that an immediate close out requirement would cause on a security’s price as numerous firms conducted nearly simultaneous buy-ins. Other comment letters requested an exception for de minimus fails to deliver which often occur when the broker fails to deliver the odd number of shares (99 or less) at the tail end of a short sale transaction (say, the 67 on top of 600). The SEC abjured all such pleas for exceptions and expanded windows, reciting its mantra that the overall goal, reduction in fails to deliver, must be achieved. As adopted, the rule contains none of the expansions of time for which commentators contented. The only short sale relaxation the SEC permitted from Rule 204T was that, under Rule 204 as adopted, broker-dealers may borrow as well as purchase securities of like kind and quantity, using such securities to close failures to deliver.

C. Three and 35 day Extensions

The new SEC rule grants exemptions from the strict close requirement two types of transactions, which involve long rather than short sales. In some cases, investors hold share certificates in their own rather than brokerage firm nominee, or Wall Street, names. “[H]uman

60 See, e.g., Strict Close Requirement Release at 15-17.
61 Id.
62 Id. 46-47.
63 See SEC Rule 204, Strict Close Out Requirement Release at 97-100.
64 Rule 204(a)(3), discussed text accompanying note 50 supra; Strict Close Requirement Release at 39.
errors or processing delays can result from transferring securities in custodial ... rather than book-entry form, thereby causing a fail to deliver on a long sale.” If a broker-dealer can demonstrate that such a failure to deliver resulted from a long sale, the “participant” (broker-dealer) has a 3 day window in which to close out the failure to deliver.66

The SEC grants a much longer extension in cases of Rule 144 securities, which may have been received in a private placement or be control shares held by a control person. Re-sale of such shares is restricted until certain amounts of time have passed and/or information about the issuing company has become publicly available.67 Issuers and their lawyers may enforce such restrictions on transfer by “lettering the stock,” that is, placing a legend on the margin of the stock certificate.68 In turn, the legend often states that an opinion of corporate counsel will be required before the corporation will effect any transfer. SEC Rule 204 grants a 35 day period following a sale in which a seller of Rule 144 stock may seek removal of the legend.69 In the meanwhile, a failure to deliver, in a long sale, will remain open.70 Thereafter, the broker-dealer must close out the position by

65 Strict Close Requirement Release at 20 (footnote omitted).
69 SEC Rule 204(a)(2); Strict Close Requirement release at 97-98.
70 The new rule also continues 35 day windows in which to close fails to deliver may remain open in certain cases of “deemed to own securities,” which includes Rule 144 securities, but whose treatment is focused on cases in which a holder has a contractual right to receive securities (an option, warrant, right, conversion right), which she has exercised, but pursuant to which she has not yet received the securities. Regulation SHO lists six categories of “deemed to own” securities. See SEC Rule 200(b).
buying or borrowing sufficient securities and delivering them to the clearing agency for settlement.\footnote{71}{Rule 204 (a)(2); Strict Close Requirement Release at 40-45.}

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

A. Stock Borrowing. By now the picture should have become clearer. The SEC campaign against naked short selling and failures to deliver has steadily increased the pressure on broker-dealers and short sellers to locate and buy or borrow, often mostly borrow, shares to deliver to close short sale transactions. The Commissions rules and enforcement activities have the direct result of increasing pressure to borrow and to have the ability to borrow stock.\footnote{72}{Although neutral observers marvel at how long the SEC took to police what plainly have been fraudulent and manipulative practices of which naked short selling has been a principal ingredient. See, e.g., McGinty & Strasberg, supra note 22, at C-3: “the initial weakness of [Regulation SHO] and the years it took the SEC to stiffen it can be traced to the lobbying efforts of hedge funds and Wall Street” (comment of Peter Chepucavage, former SEC attorney who helped draft SHO).}

To recap, in 2004, as aforesaid,\footnote{73}{See supra notes 17-22 & accompanying text.} the SEC adopted Regulation SHO, which cracks down on naked short selling, making it imperative for shorts to borrow, or at least locate, stock. In July, 2008, and again in September, 2008, in large part, the SEC suspended the locate alternative under Regulation SHO.\footnote{74}{See supra notes 23-27 & accompanying text.} All of these recent developments put greatly added pressure on short sellers actually to borrow stock and to do so promptly, that is, before they sell short.
There have always been institutional investors who hold long positions in certain stocks, who will make certain of those shares available to brokers, who in turn will engineer loans to short sellers. The institution receives a negotiated fee, often consisting of an above market rate of interest and the right to call the stock back on specified notice, as well as at the end of each month. Brokering such transactions, market professionals operate firms that facilitate the lending and borrowing of stock. “LocateStock.com” is a web site one such professional operates. Back on the borrowing side, market participants other than short sellers also have needs to borrow stock. For example, an over-the-counter trader may find its inventory insufficient to fill an order it has taken. The trader may borrow shares with which to fill the order until such time as the trader can buy in additional inventory elsewhere.

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

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

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

75See, e.g., Scannell & Lauricella, supra note 12, at C-3 (“Many fund companies, such as Vanguard, lend out some of the stocks and bonds in their portfolios in exchange for a fee.”).

76Randall Smith, Jenny Strasburg & Kara Scannell, Short-Selling Rules Loom for Firms, WALL ST. J., July 17, 2008, at C-1, C-2 (“big funds get preferential access to borrow scarce shares”; LocateStock.com “helps hedge funds and small brokerages locate hard-to-borrow shares”).

77See, e.g., NATIONAL SECURITIES CLEARING CORP., RULES AND PROCEDURES 13 (2008).
seller not only wants to see the stock decrease in price. She may also be a participant in a concerted effort among several, or many, sophisticated traders to put downward pressure on price.

Stock borrowing remains unregulated. Individual investors asked to participate in stock borrowing programs receive little or disclosure. They certainly do not receive risk factor type disclosure, often seen in prospectuses and private placement memoranda. Risk factor disclosure would bring home to stock lenders the distinct possibility of developments adverse to their interests, namely, that short selling and bear raids which they are facilitating can reduce the value of their shares significantly in a matter of days. The shares that they continue to hold, as well as the shares the short seller eventually returns to them, via the stock borrowing intermediary, may be worth a fraction of their original value. Many of them (individual investors) are pigeons waiting to be plucked.

If stock lenders (investors) suffer damages and complain, their complaints go to arbitration, in which opinions are seldom published and the outcomes of most cases unknown. Since 1987, all customer-broker disputes have gone to arbitration, first by NASD or NYSE panels of arbitrators, and then by Financial Institutions Regulatory Authority (FINRA) panels of arbitrators, after the NASD and NYSE dispute resolution mechanisms merged.\(^78\) So we do not know if, as private attorneys general, stock lenders in any number have succeeded with claims that stock borrowing program participations are securities and, furthermore, securities as to which disclosure

\(^{78}\)In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and again in *Rodriquez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), the Supreme Court held that an arbitration clause in a customer agreement constituted merely a choice of forum rather than an illicit waiver of the securities laws’ protections. The Court thus overruled *Wilko v. Swan*, 435 U.S. 427 (1953), which held that an agreement to arbitrate violated the securities laws’ anti-waiver provisions and was therefore void. Since that time, virtually all customer disputes, employment disputes, and other securities cases as well, go to arbitration panels rather than courts.
accompanying their offer is insufficient or misleading.

C. Proposed Regulation.

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

D. Disciplining Brokers and Other Market Participants.

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

79 Securities Exchange Act of 1934 § 15(c)(1)(A), 78 U.S.C. § p(c)(1)(A), provides that “No broker dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase, or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance.” Pursuant to authority granted in the section, the SEC has adopted a number of rules to “define, and prescribe, means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.” Id. § 15(c)(2)(D).
security with such broker or dealer. requiring that brokers possess certain information, which
must be disclosed to investors with or before the offer of participation in a stock borrowing program,
bears a strong resemblance to what is known as 15c-2-11 disclosure.

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

A. Investment Contract.

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

The SEC challenged Howey Co. in court, in one of the first cases under the still relatively
new Securities Act of 1933. Howey defended, inter alia, on grounds that he was offering a sale of
real estate, not a security, and a service contract, also not a security. The SEC responded, and the
Supreme Court agreed, with the notion that Howey Co. offered the two items as a package.

81328 U.S. 293 (1946).
Securities law judges items as they are offered, not as how they may eventually be sold.\textsuperscript{82}

So constituted, the package fell within the catchall contained in the statute’s definition of a security. While enumerating specifically 24 or so other items (“any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness . . .” and so on), the statutory definition includes “investment contract.”\textsuperscript{83} Borrowing from state blue sky law jurisprudence, in \textit{Howey}, Mr. Justice Murphy defined investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”\textsuperscript{84} The test, which has remained the lodestar for 65 years and counting, has 4 elements: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profits; (4) solely from the efforts of others.

B. \textit{Investment of Money}.

\textsuperscript{82}“The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough the respondents merely offer the essential elements of an investment contract.” SEC v. W.J. Howey Co., 328 U.S. at 300-01 (footnote omitted). In the case at bar (\textit{Howey}), 85% of the land purchasers opted for the package (real estate plus a services contract) rather than the real estate alone. \textit{Id.} at 295.


\textsuperscript{84}298-99.
In a stock borrowing program, the offeree investor furnishes money's worth rather than money itself, namely, shares of common stock in a publicly held corporation. Cases have long held that contribution of items readily convertible into money is equivalent to the contribution of money itself.\footnote{See, e.g., In re Trade Partners, Inc. Investors Litigation, 2008 WL 3992168, at 5 (W.D. Mich.) (“The test to establish the existence of an investment contract requires (1) an investment in money or money’s worth,” quoting Howell v. Ballard, 801 P.2d 127, 128 (Okla. App. 1990) (viatical settlements); Battig v. Simon, 237 F. Supp. 2d 1139, 1148 (D. Or. 2001) (“Oregon applies the [investment contract] definition outlined in Securities and Exchange Commission v. Howey . . . . The relevant factors are: (1) an investment of money (or money’s worth”).}

C. *Common Enterprise.*

1. **Commonality.** This is the shorthand term used for this lynchpin element of the definition.\footnote{See, e.g., Susan S. McDonald, Toward Consistent Investor Protection Under the Securities Laws: The Solution to the Conflict Among the Circuits Regarding the So-called “Commonality” Requirement for an “Investment Contract, 32 SECURITIES REG. L. REV. 68 (2004); Rodney L. Moore, Defining an “Investment Contract”: The Commonality Requirement of the Howey Test, 43 WASH. & LEE L. REV. 1057 (1986). See also Mark K. Monaghan, An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis, 63 FORDHAM L. REV. 2135 (1995).} The sale of recreational real estate (say, a ski resort condominium) illustrates how, in many ventures, each investor’s fortunes are tied both to the overall success of the venture, including that of the promoter (vertical commonality), and to fellow investors’ fortunes as well (horizontal commonality). In typical recreational real estate sales, an exclusive rental agent requirement ties the investor’s fate to that of the promoter, or its affiliate, whose future may rise or fall depending upon the level of rentals. A rental pool feature, in which all investors’ units’ rents go into a single fund, ties every investor’s fate to the fates of other investors, supplying horizontal commonality as well. In that manner, an item ordinarily real estate (a ski condominium) by virtual of collateral arrangements (exclusive agent requirement, rental pool) becomes an investment contract and

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therefore a security.\textsuperscript{87}

2. **Horizontal Commonality.** The most restrictive of courts hold that horizontal commonality must be present and it, and only it, satisfies the common enterprise element of investment contract.\textsuperscript{88} The presence of multiple investors may not in itself suffice. In *Minarik v. M-S Commodities, Inc.*,\textsuperscript{89} the Seventh Circuit affirmed a finding of no horizontal commonality because profitability of the plaintiff’s account was not influenced by the profitability or loss of other similar accounts the same broker managed.

The paradigm for horizontal commonality is one in which investors’ contributions, as well as returns or losses are pooled, as in the ski condominium hypothetical above.\textsuperscript{90}

3. **Vertical Commonality.** At other end of the spectrum, vertical commonality is the least demanding interpretation of Howey’s common enterprise requirement. Vertical commonality requires an investor to allege and prove that her returns are dependent upon the promoter’s expertise

\textsuperscript{87}See SEC Release No. 33-5347 (Jan. 4, 1973) (SEC condominium release, outlining collateral arrangements which may convert recreational real estate interests into investment contracts).

\textsuperscript{88}Of courts coming down firmly on the issues, the Sixth and the Seventh Circuits require horizontal commonality exclusively. *See, e.g.*, SEC v. SG Ltd., 265 F.3d 42, 50 (lst Cir. 2001) (surveying circuit courts of appeal).

\textsuperscript{89}457 F.2d 274 (7th Cir. 1972) (Stevens, J.) (discretionary trading accounts in commodities futures found not to be investment contracts because no horizontal commonality).

\textsuperscript{90}See, *e.g.*, SEC v. Infinity Group Co., 212 F.3d 180, 187-88 (3d Cir. 2000) (investors promised different returns, ranging from 138% to 181%, in “Asset Enhancement Program” but the promoter pooled investors’ contributions, “to create highly-leveraged investment power that would yield high rates of return,” resulting in a finding of horizontal commonality). Other cases requiring a showing of horizontal commonality include *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994); *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994); and *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 22 & 224 (6th Cir. 1980), aff’d, 456 U.S. 353 (1982).
or efforts, or both. For example, in *SEC v. Payphones, Inc.*[^91] purchasers were dependent upon the promoters’ ability and efforts in choosing the model and location for pay telephones. Further returns may also be dependent upon the promoter attracting an ever expanding circle of investors. All the investor must do is furnish the money and sign a contract.

4. **Strict Vertical Commonality.** Strict vertical commonality requires more, namely that, the investor’s fortunes be “interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”[^92] *SEC v. Koscot Interplanatory, Inc.*[^93] began with the sale of various levels of participation, with every greater amounts of override commissions, in the pyramid sales of self-improvement combined with cosmetics sales programs. The investor produced the new prospects while the promoter’s sales staff closed the deals. Horizontal commonality was lacking but that was not determinative. “[T]hat an investor’s return is independent of that of other investors is not decisive. [T]he requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the Koscot meetings and guidelines on recruiting prospects and consummating a sale.”[^94]

5. **Offers Rather Than Sales.** Participation in stock borrowing programs may measure up as investment contracts, and therefore securities, in jurisdictions in which courts require vertical commonality but perhaps appear to fall short in jurisdictions in which judges have held that only

[^91]: 408 F.3d 727, 732 (11th Cir. 2005).

[^92]: SEC v. SG Ltd., 265 F.3d 42, 49 (lst Cir. 2001) (virtual stock exchange membership program, on which investors bought and sold shares of 11 virtual companies, nevertheless found also to evince horizontal commonality).

[^93]: 497 F.2d 473, 479 (5th Cir. 1974).

[^94]: 497 F.2d 479.
horizontal commonality will suffice. An investor who contributes her shares to an intermediary, to be lent out to a short seller, may not have her shares, and thus her fortunes, tied to the fortunes of other contributors to the program. Horizontal commonality is lacking. Whether an investment contract is present or not may depend on tracing, which may be difficult to do,\(^95\) and be determinable only a case-by-case basis.

A first principle of securities regulations, however, is that judges, practitioners, and regulators will judge items on the basis of how they are offered rather than how they eventually may be sold. At his resort hotel, William Howey and his company offered orange trees and service contracts as a package, even though, at the end of the day, a persistent purchaser could buy the real estate only.\(^96\)

In the very first case under the Securities Act, \textit{SEC v. C. M. Joiner Leasing Corp.},\(^97\) the promoters attempted to escape the statutory definition, which lists only “fractional undivided interests in oil, gas or mineral rights” among the items enumerated, by selling divided interests in oil and gas leases (for example, the Southeast eighth of the Southwest quarter section). The courts, though, judged the items as to how they were offered, interests in land expertly selected under the guidance of a promoter in the vicinity of where the promoter would drill a test well, rather than how it eventually may have been sold (as an interest in real estate). The leaseholds, divided interests in oil and gas leases, while falling out of the list of more specific items in the statute, came back within the definition of a security, by means of the investment contract catchall and judgments made as to

\(^{95}\text{See Peter Oh, Tracing, }80\text{ TUL. L. REV. 849 (2006).}\)

\(^{96}\text{See, e.g., supra note 82.}\)

\(^{97}\text{320 U.S. 344 (1943).}\)
how the items were offered rather than how they might have been sold. 98

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

D. Expectation of Profits.

In SEC v. Edwards, 99 10,000 persons invested $300 million in a payphone sale-and-leaseback arrangement. Promoters offered a sale of the payphone for $7,000, a 5 year leaseback, and payment to the investor of a fixed 14% annual return. The promoter defended an SEC complaint on the grounds that the arrangements were not investment contracts, and therefore not securities. The arrangements were not investment contracts because the expectations were not of profits from the efforts of a promoter or third party. Rather, as a matter of contract, the return was

98Mr. Justice Jackson noted that:
Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well it would have been quite a different proposition [e.g., only the offer of interests in real property]. Purchasers would have been left to their own devices for realizing upon their rights. . . . The exploration enterprise was woven into these leaseholds . . . .
320 U.S. at 348. Stock lenders here perceive their economic prospects (a loan of stock at favorable rates) to be enhanced by the prospect of co-mingling their stock with the stock of others if necessary to make a loan.

due because of the contractual provision and was due in any case.

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

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

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

There is no reason to distinguish between promises of fixed returns and promises of variable returns . . . . In both cases, the investing public’s attracted by representations of investment income . . . .

“[A] promise of a fixed return,” as here in the case of stock borrowing programs, “does not preclude a scheme from being an investment contract,” she concluded.101

E. Solely From the Efforts of Others.

Here the investor makes her contribution (the loan of stock) and does nothing further. The return, if any, comes necessarily from the efforts of others, namely, successful effort of the broker-dealer firm or other intermediary, to lend the shares, either alone or in combination with

100Id. at 394. Justice O’Connor observed that “[n]o distinction between fixed and variable returns was drawn in the blue sky law cases that the Howey court used,” citing People v. White, 124 Cal. App. 548, 550-51, 12 P.2d 1078, 1079 (1932), and Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 62-63, 161 A. 193, 193-94 (1932). 540 U.S. at 395.

101540 U.S. 396.
other lenders’ shares, to a short seller, and to receive therefor interest payments, a portion of which it passes through to the stock lender.

Even if the stock borrowing program’s provisions required stock lenders to perform some acts, which they usually do not, the critical inquiry is “whether the efforts made by those other that the investor are the undeniably significant ones, those managerial efforts which affect the failure or success of the enterprise.” 102 In the pyramid sale of self-improvement programs (“Dare To Be Great”), upper level members received commissions and override commissions on lower level members success in attracting prospects to meetings. But the court found that the efforts of the Dare To Be Great staff in making presentations and procuring investors’ signatures on purchase contracts had been “the undeniably significant ones.” 103

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

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

At least one case has so held. In Hughes v. Dempsey-Tegeler & Co., 104 a brokerage firm requested the loan by an investor of his portfolio of municipal bonds, along with an agreement to subordinate his interest in the bonds to that of the firm. In that way, “the firm could utilize them [the bonds] as additional capital in meeting the Exchange’s net capital requirements” applicable to brokerage firms. In return, the firm promised the lender an above market rate of interest “which


103474 F.2d at 482.

would realize an additional income to Hughes from the securities in the amount of $30,000.00.”

The district court found the arrangement (loan of securities and subordination agreement providing for payment of interest) to be an investment contract under the *Howey* analysis.

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

**CONCLUSION**

To require of stock borrowing intermediaries prospectus type disclosure regarding stock borrowing programs would be onerous, crimping the reach of such programs and the amount of stock investors would lend and short sellers could borrow. Regulation and probably restriction of stock borrowing would occur at a time when other SEC initiatives (for example, Regulation SHO amendments and enforcement) make the ability to borrow stock of vastly increased importance to short sellers. Because naked short selling will not be tolerated, as it was in the past, the ability to borrow stock becomes extremely urgent.

On Main Street, stock lenders tend to be much different than market professionals and stock borrowers. Market professionals (traders at Vanguard, T. Rowe Price, or a hedge fund, for example) make judicious loans of stock from time to time, after careful calculations of the likely returns, weighed against the probability and magnitude of downward movement in the stock’s share price. In other financial circles, however, brokerage firms and intermediaries ask individual investors to lend stock, with little or no disclosure of the principal use to which such shares of stock will be put—loans to short sellers and bear raid participants—and how antithetical to stock lenders’
interests the activities of typical borrowers are. The outcomes for investors, almost all of which are bad, should be set forth in plain, readable form (“plain English”) in a risk factor statement. Currently, individual investors are pigeons waiting to be plucked by sharp dealers from Wall Street.

105 Again, regulation vel non of stock borrowing programs is a Main Street versus Wall Street issue, as are the possible and actual adoption of other SEC regulations impinging on uninhibited short selling. See, e.g., Branson, supra note 12 (conclusion)(forthcoming). This author has previously written about the divergence in needs and attitudes between Main and Wall Streets. See Douglas M. Branson, Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law, 72 Neb. L. Rev. 258 (1993).