100% CAPITALIST, 90% OF THE TIME: THE 20 DAY SHORT-SALE BAN†

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INTRODUCTION

"You have to save them now or they'll be gone while you're still thinking about it."

—*Henry Paulson, September 18, 2008*[1]

† Inspiration for the title comes from characterizations of Alexander Bickel's approach to political question doctrine. *See, e.g.*, Gerald Gunther, *The Subtle Vices of the "Passive Virtues"—A Comment on Principle and Expediency in Judicial Review*, 64 COLUM. L. REV. 1, 3 (1964) (characterizing the Bickel thesis as "100% insistence principle, 20% of the time").

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1. James B. Stewart, *Eight Days: The Battle to Save the American Financial System*, THE NEW YORKER, Sept. 21, 2009, at 78.

During the week beginning September 12, 2008, regulators scrambled to avoid financial calamity. On September 18, the Securities and Exchange Commission (SEC) put short selling into a twenty-day coma as part of the effort to "save" the failing banking institutions. The short-selling ban, ultimately affecting the stocks of nearly 1,000 financial companies,[2] stemmed from the supposed belief that traders were engaging in manipulation.[3] The move was ostensibly intended to "restore equilibrium to markets,"[4] though the move may be better described as an ill-informed attempt to support stock prices. Whatever the metric, several recent studies conclude that the ban not only failed to achieve its goals, but also produced unintended and detrimental consequences.[5] Ultimately, Christopher Cox, then-chairman of the SEC, conceded as much: "The costs [of the short sale ban] appear to outweigh the benefits," he said.[6] Cox may admit that the ban did not meet its equilibrium-enhancing goals, but because the public debate continues to focus on the presence or absence of market manipulation there is the possibility of public pressure and support for a future ban even where it is sure to fail in bringing about equilibrium. It may be that one need only find manipulation to generate support for such a ban. Cox later said, "Knowing what we know now . . . the commission would not do it again."[7] However, review of the episode and an analysis of the relevant interests suggest otherwise; the SEC may very well do it again.

This Note explores the influences on the SEC that resulted in its exercise of emergency powers to institute the ban on short selling. It analyzes the successful strategy undertaken by opponents of short selling, namely public company CEOs, to reframe the debate in terms of the wrong factor—manipulation—as opposed to "equilibrium." It further analyzes interagency and international pressure that contributed to the ultimate decision to ban short sales.

If, "knowing what [they] know now," the SEC would not decide to institute a short-selling ban, the place to start an analysis of this ban is with what they knew *then*, i.e., what we knew before the ban.

2. The ban ultimately included many companies that would not ordinarily be characterized as "financial" firms. *See infra* notes 112–116.

3. *See* Press Release, SEC, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), http://www.sec.gov/news/press/2008/2008-211.htm.

4. *Id.*

5. *See infra* Part III.A.

6. Rachelle Younglai, *SEC Chief Has Regrets Over Short-Selling Ban*, REUTERS, Dec. 31, 2008, http://www.reuters.com/article/idUSTRE4BU3GG20081231.

7. *Id.*

Part I of this Note briefly presents the historical debate on short selling, including lessons learned from the Great Depression, a summary of the law facing short sellers, and a breakdown of some of the relevant interests inherent in short selling. Part II analyzes the particular interests that influenced the 2008 ban on short selling by drawing on three narratives: the raging conflict between company executives and hedge fund managers, the lead roles played by the Treasury and the Federal Reserve in bringing about the ban, and the influence of international rhetoric and efforts to curb short selling. The resulting picture is one in which public opinion fixated on the wrong factor, Cox was more notable for his absence than his leadership, and hurried decisions were made at the discretion of very few individuals based on limited input. Part III considers the outcomes of the ban, which was a failure on its own terms as well as from a regulatory behavior perspective. The ban did not decidedly support prices; it choked important liquidity from the financial system, and it slowed price recovery.[8] Furthermore, the political result of having based the decision ostensibly on manipulation is that no beneficial lesson can be learned about the poor efficacy of the ban. Part IV considers the SEC's decision to make its antifraud rule permanent and its more recent decision to impose a "circuit breaker" price test on short selling, which is designed to pacify investor sentiment should stock prices of a given stock experience a sudden drop. A brief conclusion follows.

Because the factor at the heart of public opinion on this issue—manipulation—is one which can be triggered simply by allegations, speculation, or rumors, the SEC has been left in a very flexible position. If it were to decide that a ban was desirable in the future, or if it were to be the subject of intense public pressure again, the SEC could easily justify another ban by framing it as an effort to resist manipulation. Furthermore, the likelihood of its doing so may depend on the outcome of ongoing investigations into the behaviors of short sellers during the 2008 crisis. If illegal market manipulation were taking place, the public would likely respond to future crises with calls for similar action, despite the failure of the 2008 ban to restore equilibrium to markets.[9] The re-

8. *See infra* note 194 and accompanying text.

9. This Note does not quibble about the meaning of "equilibrium" nor its legitimacy as an end in itself. One might argue that price support is not a legitimate goal for the SEC, or that its legitimacy is limited to the context of panic with respect to financial institutions only, for some of the reasons discussed below. *See infra* notes 91–94 and accompanying text. Instead this Note explores how the ban did not achieve its stated goal of equilibrium, which I take generally to at least

cent regulations contribute to the political forces that make this kind of regulatory behavior possible.

I.
CLASSIC AND MODERN DEBATES

A. Short Sellers as Villains or as Information-Bearers?

An ordinary stock purchase leaves an investor in the position of holding a stock and carrying the risks associated with its change in value—otherwise known as a "long position."[10] A short sale, on the other hand, involves selling a stock that the investor does not already hold, resulting in a "short position."[11] A short seller "borrows" stock and sells it with the intention of buying stock at a later date, i.e., covering the position, in order to return it to the lending party.[12] The short seller turns a profit on the transaction if the price of the stock declines between the sale and the later purchase.[13] However, where the price increases, a short seller who wishes to close her position by purchasing the stock must do so at a loss, since the purchase price will have exceeded the sale price.[14] The transaction is structured such that the investor profits with the decline of a company's stock price.

History is riddled with financial disasters for which short sellers have been blamed.[15] One of the first and most widely cited examples of this phenomenon is the regulatory response that followed the price collapse accompanying the Dutch tulip craze of the

include liquidity and the absence of rapid price decline. Discussion regarding whether the appropriate equilibrium should be market driven, or some other interpretation of "accurate," is left for another day.

10. B. O'NEILL WYSS, FUNDAMENTALS OF THE STOCK MARKET 64 (2001).

11. *Id.* at 64, 72.

12. *Id.* at 72.

13. *Id.* at 72–73.

14. *Id.* at 73.

15. The Dutch tulip bulb craze of the 1600s led to attempts to regulate short selling; it was banned by British Parliament after the South Sea bubble burst in the 1700s; Germany banned a set of agricultural securities when commodity prices collapsed in 1896; the New York state legislature banned short selling from 1812 until 1858; NYSE required brokers to identify short sellers, who would be revealed upon unusual price behavior, and then banned shorting for two days in 1931. *See* Charles M. Jones, *Shorting Restrictions: Revisiting the 1930's* 5–6 (unpublished working paper, 2008), *available at* http://www4.gsb.columbia.edu/finance/faculty/workingpapers; Kara Scannell & Jenny Strasburg, *SEC Moves to Curb Short-Selling; Controversial Step Comes Amid Claims That Financial Stocks Were Manipulated*, WALL ST. J., July 16, 2008, at A1; Daniel Trotta, *Short Sellers Have Been the Villain for 400 Years*, REUTERS, Sept. 23, 2008, http://www.reuters.com/article/idUSTRE48P7CS20080926.

1600s.[16] Indeed, "[s]hort sellers, or 'shorts,' have been blamed for almost every financial crisis in the 400 years since the Dutch episode."[17]

One force underlying the hostility toward short sellers is the common moral objection to profiting from another's loss.[18] However, in neither a long-sale nor a short-sale scenario can both parties capture the profits from a change in price.[19] Unsurprisingly, however illogically, few identify this problem in the context of long positions, in which a buyer captures profits from stock price increases—increases that the seller would have captured had she held the stock. To the extent that short sellers are immoral for exacting a profit, an analogous criticism can be levied against those taking long positions. When a long investor buys low, she profits from the failure of the seller to anticipate the future price increase. Both buy stock at a low price and sell for a high price. The short seller simply does so in the reverse order. Many supporters of short selling have discussed this imbalance at length and recommend financial-sector policy that treats long sales and short sales similarly.[20]

The two main concerns relevant to short selling are manipulation by short selling, and the role of short selling in stock price panics. Short selling as a method of manipulation is illegal.[21] For example, "bear raids" are strategies by which a short seller intentionally depresses the value of stock, perhaps by spreading false rumors or timing large volumes of short sales in conjunction with other short sellers.[22] If a short seller sells the stock, then spreads a false rumor that initiates sales, this could result in a decrease in

16. Jones, *supra* note 15, at 5.

17. Trotta, *supra* note 15.

18. *See, e.g.*, *Japan Sells Itself Short*, ASIAMONEY, May, 2002, at 1 ("Short sellers—are mean-spirited sorts bent on making money by getting a jump on ordinary investors.") (quoting finance minister Masajuro Shiokawa).

19. However, society can benefit from the diffuse positive externalities of these trades, which contribute to an efficient pricing market that allows for efficient allocation of resources. *See infra* text accompanying note 46.

20. *See, e.g.*, Michael R. Powers et al., *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX L. REV. 233, 248–49 (2004); Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and a Modest Proposal for Letting More Shorts Go Naked*, 8 J. BUS. & SEC. L. 135, 142–43, 147 (2008).

21. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006) (fraud); Securities Exchange Act of 1934 §§ 9(a)(4), 10(b) (2006), 15 U.S.C. §§ 78i(a)(4), 78j(b) (2006) (fraud); Rule l0b-5, 17 C.F.R. § 240.10b-5 (2009) (market manipulation).

22. *See* Powers, *supra* note 20, at 246–49. These are particularly "successful" strategies with thinly traded stocks which decline faster. *Id.*; *see* Crisp, *supra* note 20, at 142.

price. The short seller can then buy back the shares at a profit. Similarly, large timed transactions can create perceived supply in the market that reduces the price relative to demand, thus allowing the short seller to cover her position at the lower price. Large timed transactions can also trigger more sales by garnering negative media attention with respect to a particular stock or industry.

To combat such practices, the SEC brings enforcement actions for fraud and manipulation under Section 17(a) of the Securities Act of 1933, Sections 9(a)(4) and 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.[23] For example, in April of 2008, the SEC filed a settled civil action against Paul S. Berliner, formerly of Schottenfeld Group, LLC, for "intentionally disseminating a false rumor" concerning the acquisition of Alliance Data Systems Corp by The Blackstone Group.[24] The complaint alleged that Berliner sent instant messages to traders at brokerage firms and hedge funds about an alleged Alliance meeting featuring the discussion of a new Blackstone proposal at a significantly lower price.[25] When the news media disseminated the story, Alliance stock fell 17% in thirty minutes.[26] The trading impact was significant enough to provoke the New York Stock Exchange (NYSE) to halt trading on the stock.[27]

Short selling in the context of panic—in which the short seller rides a wave of public behavior—is a more complicated issue for two reasons: myriad factors can contribute to a panic, making it difficult to dissect and dampen; and blanket responses, such as a ban, are not tailored to illegal behavior. First, short selling is just one factor contributing to price collapse; a panic can be triggered and maintained by legitimate, non-manipulative sales, which can be based on true, false, or simply malicious information.[28] Thus, it is

23. 15 U.S.C. § 77q(a) (2006); 15 U.S.C. §§ 78i(a)(4), 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2009).

24. SEC Litigation Release No. 20,537, SEC v. Berliner, Civil Action No. 08-CV-3859 (S.D.N.Y.) (Apr. 24, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20537.htm.

25. *Id.*

26. *Id.*

27. *Id.*

28. For example, American International Group (AIG) and Lehman Brothers, organizations whose stocks fell rapidly in the week preceding the ban, were both facing serious financial strain that threatened their viability. *See* Michael J. de la Merced & Andrew Ross Sorkin, *Report Details How Lehman Hid Its Woes*, N.Y. TIMES, Mar. 12, 2010, at A1; Stewart, *supra* note 1 (discussing AIG). Even beyond the actual financial risk posed by these conditions, the fact that the banks' officers were meeting with government officials, see Stewart, *supra* note 1, communicated concerns to the market and likely contributed to sales.

difficult to identify root causes of price decline, which can then be eliminated. Furthermore, it is unclear whether eliminating those root causes will have any effect on price, considering that the public is already reacting to the information by that time. In other words, banning short selling may have no impact on stock prices if members of the public are convinced that others will sell shares anyway, and indeed, they must sell as well to mitigate their own personal losses.

Second, the speed and anonymity with which rumors spread make it difficult to know what is true and good-intentioned, what is false and good-intentioned, and what is false and maliciously intended. There may be reason to worry about all of these scenarios since each can dramatically impact price, but only short selling accompanied by manipulation or the spread of knowingly false rumors is illegal.[29] Thus, immediate interference with short sales would require restraint on potentially innocent market actors who may suffer losses or forgo potentially lucrative opportunities as a result of government action.

Short selling has many benefits, both for individuals and society as a whole.[30] The most common rationale for resisting the regulation of short sales is that short positions operate against long positions in producing an efficient asset price market.[31] Ordinary purchases of stock—"long" purchases—communicate optimistic information to the market, the presumption being that one who buys stock at a given price believes that the stock is undervalued at that price and anticipates either appreciation in the stock price or higher than expected dividends.[32] The market incorporates this positive information; the additional demand for the stock will increase its price. Short selling, on the other hand, communicates

29. *See supra* note 21. This is, of course, an over-simplification. Short selling can also be illegal for more technical reasons. *See infra* Part I.C.

30. *See, e.g.*, Powers, *supra* note 20, at 235–41; Crisp, *supra* note 20, at 141–42 ("Empirical evidence supports that short-selling increases informational efficiency by increasing the speed of price adjustments to new information.").

31. *See* Powers, *supra* note 20, at 240; Crisp, *supra* note 20, at 139–42. **R**

32. See Judge Posner's articulation:

> For every short seller—a pessimist about the value of the stock that he's selling short—there is, on the other side of the transaction, an optimist, who thinks the stock worth more than the short-sale price. Unless the shorts are trading on insider information, all that a large volume of short selling proves is a diversity of opinions about the company's future . . . . Of course, if there were more pessimists, all wanting to sell short, than there were optimists, the price of a stock would plunge . . .

Law v. Medco Research, Inc., 113 F.3d 781, 784 (7th Cir. 1997).

negative information about a company's health and earnings potential, which is incorporated into the market.[33] To the extent that such negative information is constrained, it will not be incorporated; and market price will reflect an overvaluation of the stock.[34] In this respect, short sales mitigate over-pricing and contribute to the prevention of bubbles.[35]

Empirical studies suggest that short selling provides a social benefit by detecting and exposing corporate fraud.[36] By pouring over filings and financial statements, short sellers have been able to identify companies that appear to be overvalued, sometimes by purposeful deceit of management.[37] The data shows that short sellers' sales have brought values down, such that when the fraud is finally revealed the market does not have to swing as wildly to reach the lower, more appropriate price that reflects the new negative information.[38] One famous example of detection was that of David Einhorn, who suspected accounting misrepresentation by Allied Capital and therefore recommended shorting its stock at a 2002 charity event.[39] Allied shares opened the next day at 20% below the previous day's price, and the company was later investigated by

33. *See id.*

34. *See* Powers, *supra* note 20, at 237–40; Crisp, *supra* note 20, at 139–42. Options markets can potentially provide an alternative avenue for bearish bets, to the extent that a given stock has tradable options. Where it does, movement away from short sales and into put options is influenced by a number of factors, but primarily the equity borrowing cost, which is driven by the supply and demand of borrowable securities. Benjamin M. Blau and Chip Wade have seen a pattern characterized by short sales in the wake of positive returns and a shift to put options following negative returns. Benjamin M. Blau & Chip Wade, *A Comparison of Short Selling and Put Option Activity* 25 (unpublished working paper, Feb. 23, 2009), *available at* http://ssrn.com/abstract=1348133. *But see* Paul Asquith et al., *Short Interest and Stock Returns* 30 (Nat'l Bureau of Econ. Research, Working Paper No. 10434, 2004) ("Hedge fund managers and other practitioners involved in short selling maintain that they cannot effectively use the options market. In interviews, they repeatedly claimed that the options market provides less liquidity and is more expensive than the short sales market when trying to establish a large position."). R

35. *See* Powers, *supra* note 20, at 235–41; Crisp, *supra* note 20, at 142.

36. *See* Powers, *supra* note 20, at 241; Crisp, *supra* note 20, at 142; Jonathan M. Karpoff & Xiaoxia Lou, *Short Sellers and Financial Misconduct* (unpublished working paper, 2009), *available at* http://ssrn.com/abstract=1443361 (empirically finding that short selling "conveys external benefits to uninformed investors, by helping to uncover financial misconduct and by keeping prices closer to fundamental values when firms provide incorrect financial information").

37. Karpoff & Lou, *supra* note 36, at 38–39.

38. *Id.*

39. Fooling Some of the People All of the Time: A Long Short Story—The Speech (May 2002) (audio recording), *available at* http://www.foolingsomepeople.com/main/speeches.html. Einhorn is back in the news currently because

both the SEC and the United States Attorney's Office.[40] Allied ultimately settled with the SEC, which found that the company had violated securities laws regarding recordkeeping and internal controls.[41]

Short positions also provide tools for more nuanced investment strategies. Most notably, they provide a mechanism for mitigating the risks associated with a particular long position and thus can facilitate more net-long positions.[42] Short sellers also provide liquidity and capital-raising opportunities. Liquidity is the ease with which an asset can be converted to cash, ideally without suffering a discount in value in order to do so.[43] Shares that are traded more frequently are more liquid.[44] Furthermore, short sales can be critical to certain investment strategies. For example, many investors will not purchase convertible bonds, a key capital-raising avenue, without hedging their position with a short sale.[45] Lastly, because secondary-market investments impact the primary market and the cost of capital, overvaluing particular stocks subsidizes the cost of capital for less healthy companies.[46] In other words, artificially high stock prices can lead to capital flow to less healthy companies. Thus, by reducing over-valuation, short selling contributes to efficient resource allocation.

B. *Lessons from the Great Depression*

For the Great Depression-era public, the dangers of short selling were perceived to outweigh the benefits. Similar to other historical patterns involving short selling, the stock market crash of 1929 was followed by public outcry blaming short sellers for the collapse, despite the fact that short interests represented only 0.15% of

some indication has surfaced that his statements regarding questionable accounting practices at Lehman Brothers had merit. *See* Merced & Sorkin, *supra* note 28.

40. Gretchen Morgenson, *Following Clues the S.E.C. Didn't*, N.Y. TIMES, Feb. 1, 2009, at BU1.

41. *Id.*

42. A net-long position occurs where the investor owns more than she has sold and thus still benefits when prices rise, not fall. Some other practices or strategies involving short sales include market-making, hedging, and volatility bets among others. Powers, *supra* note 20, at 235–41.

43. DAVID LOGAN SCOTT, WALL STREET WORDS 213 (2003).

44. WYSS, *supra* note 10, at 8.

45. *See infra* note 124 and accompanying text. However, any practice used with manipulation is illegal. *See supra* note 21; *see, e.g.*, Deepa Nayini, Comment, *The Toxic Convertible: Establishing Manipulation in the Wake of Short Sales*, 54 EMORY L.J. 721 (2005). R

46. Crisp, *supra* note 20, at 142–43.

shares at the time.[47] Responding to public sentiment, J. Edgar Hoover launched an investigation into potentially illegal behavior by short sellers,[48] but nothing ever came of it. However, the exchanges themselves, and then later the regulatory agencies, implemented several restrictive initiatives that shed some light on the potential effects and desirability of short-sale restraints in the context of panic.

First, there was a ban on short sales in September of 1931, coinciding with England's transition off the gold standard.[49] The ban did not respond to price declines; rather, it was planned in advance, based on the anticipation of sharp declines in the wake of England's transition.[50] Nonetheless, the ban was labeled an "emergency measure."[51] Richard Whitney, president of the NYSE, noted a visible decrease in liquidity as a result of the ban, commenting that "[w]ithin two hours after short selling was forbidden, the governing committee found there was a real danger of technical corners and of crazy and dangerous price advances."[52] In other words, there was an impact on price volatility and stock concentration such that parties might be able to "corner"—or, control the price of—a given security over which they had obtained sufficient control.[53]

Despite negative conclusions regarding the ban among NYSE officials, there existed intense political pressure for reform.[54] This led the NYSE to prohibit short-sale orders on a "downtick," i.e., a price lower than the last sale.[55] The purpose of the rule was to prohibit manipulative raids and aggressive coordinated selling, without impeding liquidity aids, such as market-makers.[56] The SEC

47. Jones, *supra* note 15, at 6. R

48. *Id.* at 6, 26–27.

49. *Financial Markets: Stocks Unexpectedly Steady, Despite England's Action—Heavy Sterling Discount*, N.Y. TIMES, Sept. 22, 1931, at 22; *Stocks Here Rally After Violent Drop: With Short Sales Barred, Most Issues Recover with Some Gains at the Close*, N.Y. TIMES, Sept. 22, 1931, at 1.

50. This turned out to be either premature or brilliant from a price support perspective. The market saw only a modest decline of .93% on the first day and .75% on the second day. Jones, *supra* note 15, at 6. R

51. Jones, *supra* note 15, at 7. R

52. *Stock Exchange Practices: Hearing on S. Res. 84 Before the S. Comm. on Banking and Currency*, 72nd Cong. 186 (1932) (speech of Richard Whitney, President, New York Stock Exchange), *available at* http://fraser.stlouisfed.org/publications/sensep/issue/3912/download/64809/19320411_sensep_pt01.pdf.

53. SCOTT, *supra* note 43, at 83 (definition of "corner"). R

54. Jones, *supra* note 15, at 7. R

55. *Id.*

56. *Id.* Market makers are persons or firms who buy and sell a particular security on their own account on a continuing basis. SCOTT, *supra* note 43, at 225. R

eventually passed a regulation restricting short-sale orders to "upticks"—prices higher than the previous sale.[57] This meant that a group of short sellers could not drive down the price of a security on their own, since each short seller would have to sell at a price higher than the last sale price.[58]

The introduction of the rule generated a sharp rise in stock prices with little effect on volume or price volatility, similar to other short-sale restrictions imposed during the period.[59] However, imposition of the uptick rule also resulted in a slight increase in liquidity, as measured by bid-ask spreads.[60] Interestingly, the market response did not distinguish between stocks with heavy short interests and all other stocks; that is, the market responded favorably to the uptick rule in general, without regard for whether the rule was likely to have an impact on a particular stock.[61]

The experience of the Great Depression is useful in considering the desirability of short sale restraints, particularly in the context of a panic. First, the experience highlights the potential threat to liquidity engendered by a ban on short selling—dangerous price advances and corners came on quickly. Imposing a similar restriction would necessitate balancing a likely sacrifice in liquidity against the objectives of the ban. Second, the experience also suggests that there may be alternatives to an outright ban, like a tick rule, which could be preferable in a panic context, where liquidity is especially important.[62] Third, the market response to the imposition of the

57. Jones, *supra* note 15, at 20–24; Rule 10-a for the Regulation of Short Selling, 3 Fed. Reg. 247 (Jan. 26, 1938) (formerly 17 C.F.R. § 240.10a-1) (adopting Rule 10-a-1, prohibiting short sales on a downtick), *amended by* Amendments to Short Selling Rules, 4 Fed. Reg. 1,209 (Mar. 14, 1939) (allowing zero-tick or uptick short sales), *removed by* Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348 (July 3, 2007). **R**

58. Later developments cut back on the effectiveness of the rule. *See infra* notes 74–80 and accompanying text. **R**

59. Jones, *supra* note 15, at 21–23. Other events functionally restricting short selling included a requirement for written authorization for lending shares, SEC investigations, and release of a "list of shame" (top fifty short sellers). *Id.* **R**

60. *Id.* The bid-ask spread is the difference between the bid (the price the buyer is willing to pay) and the ask (the price that the seller is willing to accept). SCOTT, *supra* note 43, at 18, 30, 355 (definitions of "ask," "bid," and "spread"). **R** One explanation for the rise in liquidity hypothesizes that it is due to the fact that the tick restrictions force shorts to use less aggressive limit orders as opposed to market orders, thereby providing more liquidity than otherwise. Jones, *supra* note 15, at 26. **R**

61. Jones, *supra* note 15, at 10, 24.

62. Of course, the imposition of the uptick rule was (supposed to be) a one-time occurrence; the rule is a prophylactic, not an emergency measure. This suggests that the two options (bans and tick tests) are not true alternatives for dealing

uptick rule demonstrates that the fear of short selling can be very strong—so strong that its prohibition might raise the price of stocks without regard to whether they will be affected by a ban. The implication of this phenomenon may be that the public generally overestimates the downward impact of short selling. Thus if a regulatory objective is the prevention of price collapse of an entire market, the sheer price support engendered by a short selling ban could be perceived as a convenient side effect. Unfortunately, as discussed below, some of these lessons were borne out for the worse in the 2008 crisis. Some had to be learned again.

C. The State of the Law

Despite the fruitlessness of Hoover's investigation, the experience of the market crashes of the Great Depression seemed only to reinforce the stereotypes of short sellers. This was demonstrated by the anti-shorting social pressure that drove the NYSE to introduce the tick test, which persisted until only recently.[63] In recent years, there existed two major regulatory restraints on short selling: "naked short" rules that impose borrowing requirements on short sellers prior to sale; and "price tests" or "tick tests," which regulate the price at which shorts may sell.[64] Recent developments in these restraints played a crucial role in the lead up to the 2008 ban.

"Naked shorts" are short sales undertaken without having borrowed the stock first.[65] There are several fears associated with naked short selling. First, if short sellers are not required to borrow a particular stock, short sales can flood the market more quickly because the added step of formally borrowing from a broker would be eliminated.[66] This would be of particular concern in the event of a

with panics and need not be traded off. However, as will be mentioned below, the uptick rule had been repealed, *see infra* note 75 and surrounding text, thus it (or a version of it) was one possible emergency option during the 2008 crisis. **R**

63. *See infra* note 75 and accompanying text. **R**

64. A third is unfavorable taxation relative to long sales. *See* Powers, *supra* note 20, at 249–63.

65. The colloquial definition includes all sales where no stock was borrowed beforehand. However, the SEC defines a "naked" short sale as one in which "the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period." SEC, Naked Short Sales, http://www.sec.gov/answers/nakedshortsale.htm (last visited June 12, 2010).

66. Borrowing a stock is a formal transaction requiring collateral, *see* KATHRYN F. STALEY, THE ART OF SHORT SELLING 13–14 (1997), which could otherwise be sourced from the proceeds of the short sale. Thus, to require borrowing prior to sale would prohibit or delay short sales where collateral was not available.

panic, where dramatic price drops are exacerbated by the speed with which sales can take place.

Second, "naked shorts" could result in a "failure to deliver" the stock, wherein the seller does not actually provide a stock to the purchaser within the allotted time, which is currently three days.[67] If the seller cannot find a stock to borrow within three days, the seller will be unable to deliver the stock to the buyer.[68] Failures to deliver may be unintentional. For example, if the price of the stock goes up, short sellers may race to borrow stock in order to make delivery. Demand for stocks to borrow may exceed supply, leading to a failure to secure a stock to borrow, and thus a failure to deliver the stock.[69]

Failures to deliver can also be intentional. They might create the illusion that there is high demand for borrowed stocks due to heavy short interest, thereby indicating negative market sentiment about the quality of the stock, leading to price decline.[70] In this way, short sellers can manipulate the price to their profit. The SEC responded to this problem in 2004 with Regulation SHO, which requires that sellers "locate securities to borrow before selling"[71]

67. *See* SEC, Naked Short Sales, *supra* note 65.

68. *Id.*

69. *See* Powers, *supra* note 20, at 266–69.

70. There is much debate about how serious this concern is, and whether, aside from manipulation, short selling exerts excessive downward pressure on price. Some think the Depository Trust & Clearing Corp. and its subsidiary the National Securities Clearing Corp. execute borrows in a way such that shares may be loaned multiple times, creating "counterfeit shares." *See* John R. Emschwiller & Kara Scannell, *Blame the 'Stock Vault'?*, WALL ST. J., July 5, 2007, at C1. The SEC denies this, and the DTC has addressed the Emschwiller article almost line by line. *See, e.g.*, SEC, Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (last visited Apr. 6, 2010) (explaining that DTC and NSCC systems do not allow lender to relend shares, and explaining that confusion arises from broker-dealers' practices of crediting buyer's account with a share and crediting lender's account with a right to a share, but the obligation of seller to deliver persists). Thus, while a failure to deliver does not create additional shares, it does allow for the possibility that the number of tradable shares could exceed float during the period that the failure to deliver is open. The DTC notes that one tenth of 1% of the daily number of trades fail, and 80% of total failed positions are resolved within two business weeks. DTCC, DTCC Responds to The Wall Street Journal Article, "Blame the 'Stock Vault?'" (July 6, 2007), http://www.dtcc.com/news/press/releases/2007/wsj_response.php (last visited Apr. 6, 2010).

71. The requirement to "locate" does not require it to be borrowed. The rule allows short sellers to use the proceeds from a sale to finance a borrow, but increases the likelihood the stock will be available to borrow and thus deliver.

and imposes delivery requirements "for securities in which a substantial number of failures to deliver have occurred."[72]

The "tick test," prohibiting short sales that are not at or above the sale price of the last sale, was in effect with minimal change from the Great Depression.[73] However, significant changes in the logistics of trading, including the use of complex trade-executing systems and the switch to decimal pricing increments, prompted the SEC to study the effectiveness of the test by conducting a "pilot" temporarily suspending the rule for a set of securities.[74] The results of the pilot, as well as analysis performed both inside and outside the agency, convinced the SEC to remove all price tests and prohibit their imposition by self-regulatory organizations, such as the NYSE.[75]

The SEC release accompanying the repeal of the price tests responded to comments submitted after the publication of the proposed amendments.[76] In response to a comment regarding manipulation, the release stated that improvements in transparency and regulatory surveillance of modern markets have greatly reduced the risk of undetected manipulation.[77] In response to a comment regarding panic, or "unusually rapid and large market declines," the release only stated that to adopt special rules to deal with panic circumstances would undermine the uniformity objective of abolishing the tick test.[78]

The concern for manipulation, evident in the regulation of naked short sales, is curious compared to the approach to the tick tests, which explicitly declined to accommodate manipulation and

72. Regulation SHO, 69 Fed. Reg. 48008, 48008 (Aug. 6, 2004) (codified at 17 C.F.R. 240–42). The locate requirement is met where the broker-dealer has "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due." *Id.* at 48014. Therefore, collateral need not necessarily be paid before the short sale. There are also even more benign reasons for failures to deliver (e.g., mechanical error, legitimate market making).

73. Amendments to Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348, 36,348 (July 3, 2007).

74. *See* Order Suspending the Operation of Short Sale Price Provisions (July 28, 2004), 69 Fed. Reg. 48,032 (Aug. 6, 2004); Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions (Nov. 29, 2004), 69 Fed. Reg. 70,480 (Dec. 6, 2004); Order Extending Term of Short Sale Pilot (April 20, 2006), 71 Fed. Reg. 24,765 (April 26, 2006).

75. Amendments to Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36348 (July 3, 2007).

76. *Id.* at 36,348.

77. *Id.* at 36,351–52.

78. *Id.* at 36,352.

panics.[79] This may be explained by the absence of serious backlash to deregulatory activity where there is empirical data demonstrating that the regulation was ineffective in its then-current form.[80] Additionally, the fact that the pilot was conducted during a period of general stock price incline likely contributed to its lack of public salience. Unsurprisingly, this issue resurfaced after the events of Fall 2008.

D. *Identifying Relevant Interests*

The interests affected by restraints on short selling can be divided into three categories: 1) those who use short selling as part of their portfolio and benefit from less restriction, 2) those holding net-long positions or equivalent interests who benefit from restriction, and 3) society in general, which benefits from market efficiency and its superior allocation of societal resources. Each category of interests puts pressure on regulatory behavior and affects regulatory action or inaction.

Setting aside concerns regarding manipulation, short sellers' interests are the most straightforward. Prior to undertaking any given investment strategy, an investor benefits from the freedom to devise any tools she can imagine to enable more nuanced investment strategies. A paramount interest for such an investor is flexibility. This means that the investor would likely favor a regulatory landscape of minimal restrictions and open markets, without prejudice to either long or short sales.[81]

Those who restrict themselves to long positions, on the other hand, only profit when prices go up. Thus they prefer heavy restriction of short sales, which exert downward pressure on market prices.[82] This category includes many unsophisticated investors. After all, any individual who simply buys shares on her own account becomes a shareholder with a long position, which improves when prices rise. Complicating this calculus, companies themselves have an equivalent position: because their cost of capital depends in part

79. *See supra* notes 76–78 and accompanying text. **R**

80. *See* Amendments to Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348, 36,349 & n.20 (July 3, 2007).

81. Of course, based on any given chosen strategy, there may be reasons why a short seller may resist regulation of one type of investment strategy more than another, due to the market dynamics and logistical elements of the various strategies. Furthermore, various Pareto-optimal regulations may be desirable to all investors, for example rules forbidding fraud.

82. *See supra* note 32 and accompanying text. **R**

on their stock price, companies benefit from higher stock prices.[83] Additionally, executive compensation often consists of stock or stock options, or is aligned with, stock prices.[84] Companies, their executives, and their shareholders thus have interests directly contrary to those of short sellers in this regard—restrictions on short selling mean relief from some amount of downward pressure on stock price.

Society generally has an interest in an efficiently priced stock market.[85] Because stock prices play a role in determining how capital will be allocated, stock prices that accurately reflect business health will ensure that capital resources flow to operations that will most productively use them. Therefore, society in general should welcome the role played by short sales in incorporating negative information into stock prices to more accurately reflect business health.[86] The mission of the SEC—to ensure efficient markets for investors—reflects this societal interest.[87] Assuming that mission is respected by the governing administration, SEC regulators also have a personal interest in promoting efficiency: such action will preserve their places in the agency, and continue their capacity to exercise power.[88]

However, the societal interest is obscured by political complexities. The reality is that the capitalization of the stock market is regarded as an important indicator of the country's economic health.[89] The political implication of this fact is that the government is continually faced with the temptation of an over-valuation bias. Furthermore, the ratio of parties whose interests are aligned

83. *See* Powers *supra* note 20, at 249. **R**

84. *See* Crisp, *supra* note 20, at 150. **R**

85. *See also supra* notes 30–38, 46 and accompanying text. **R**

86. This extends to potential shareholders in the ex ante position, who will likely prefer that a stock price accurately reflect its value. Of course, once the shareholder owns a stock, she will prefer that its value go up regardless of its worth.

87. SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://sec.gov/about/whatwedo.shtml (last visited Apr. 6, 2010) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

88. *See* Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 169 (1990). They'll also have an interest in later employment. *Id.*

89. *See, e.g.*, Javier C. Hernandez, *Dow Industrials Close Below 10,000*, N.Y. TIMES, Feb. 9, 2010, at B9 ("The Dow Jones industrial average, a closely watched barometer of the economy's health, dipped below the 10,000 threshold on Monday, delivering a psychological setback as investors braced for more market volatility.").

with stock market increases—shareholders, companies, and employees—may outnumber those who utilize short sales to benefit from stock price decline.[90] Thus, in addition to the general political interest in projecting a healthy economy, the government may face a more concrete over-valuation bias if it hopes to respond to the dominant voices of those constituents who benefit from high prices. There is little political gain from the diffuse social interest in efficiency.

Setting aside the political aspects of determining the public interest, complexities persist in assessing substantive metrics of the public interest. In particular, market efficiency is still a work in progress in the banking sector, which was at the heart of the 2008 crisis and resulting ban. Capital markets are essential to the economy. And public confidence is crucial to the continuing viability of the banking system, and is thus a focus of regulatory efforts to protect that system.[91] When a bank's stock price falls, this may indicate to investors that their money is not safe in that bank. If investors race to withdraw their investments from a bank—a "run"—the bank may be unable to meet all its withdrawal demands, leading to its failure.[92] The possible resulting loss of confidence in the market, coupled with the financial interdependence of banks, may lead to the failure of other banks as well.[93] Unlike companies with hard assets, which cannot necessarily be recalled by investors during a panic, a bank has no time for its stock price to bounce back and instill public confidence before a run can destroy it.[94] As a result, the public interest with respect to short selling policy may be different in the financial sector, where the risks associated with stock price decline are greater.

In sum, there are powerful private interests exerting pressure on regulatory action. The public interest that the regulator may be seeking to vindicate is nebulous and, particularly in the area of

90. Brokers charge for lending shares, and would therefore seem to be a potential force on the other side of the debate, aligned with short sellers. However, brokers have not played a large role in public debate about short selling.

91. HENNIE VAN GREUNING & SONJA BRAJOVIC BATANOVIC, ANALYZING AND MANAGING BANKING RISK 34 (2003).

92. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 199 (2008).

93. *Id.*

94. This is why there is a special resolution process for banks through the FDIC, which does not disclose which banks are in trouble, as such disclosure would only make matters worse for the bank and have fallout throughout the economy. *See* Tami Luhby, *Problem banks: What you need to know*, CNNMONEY.COM, July 26, 2008, http://money.cnn.com/2008/07/26/news/economy/fdic_list_what_it_means/index.htm.

banking, of great consequence. In addition, the matters themselves—high-level trading strategies and their impact on trading markets in the financial sector—are objectively complex.[95] Furthermore, agency regulation is opaque relative to publicly broadcasted congressional sessions. Thus, monitoring and information costs of public supervision of regulatory action related to short selling are very high[96]—another factor which contributed to the ultimate regulatory action in 2008.

In general, restrictions are bad for short sellers. They are good for companies, their executives, and their shareholders. And while they are good for the public's interest in market efficiency, they are potentially bad for the interests of many members of the public as individual investors. Finally, the impacts of short-sale restrictions may be somewhat unclear in the context of a struggling financial industry.

II. THE 20 DAY SHORT-SELLING BAN DURING THE 2008 CRISIS

This Part examines the twenty day short-selling ban during the 2008 crisis in light of the history, the law and the relevant interests discussed in Part I. After establishing the timeline of the relevant events, this Part examines three narratives: the role of the rhetoric of short sellers and companies, the experience and behavior of the regulators, and the international influences on regulatory behavior.

A. Timeline

On July 13, 2008, four months after the government orchestrated the merger of Bear Stearns into JPMorgan Chase and two days after IndyMac collapsed, the SEC announced that it would be conducting examinations aimed to prevent "intentional spreading of false information intended to manipulate securities prices."[97] Two days later, the SEC announced that it was exercising its authority under the "Emergency Provision" of the Securities Exchange Act to temporarily ban naked short sales on the securities of nineteen

95. *See infra* Part II.C.

96. For discussion of the importance of monitoring and information costs for regulatory decision-making, see Levine & Forrence, *supra* note 88, at 170. R

97. Press Release, SEC, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008), http://www.sec.gov/news/press/2008/2008-140.htm (to be conducted together with Financial Industry Regulatory Authority, Inc. and New York Stock Exchange Regulation, Inc.).

"substantial financial firms," including Fannie Mae, Freddie Mac, and Lehman Brothers.[98] On September 17, 2008, two days after the collapse of Lehman Brothers and the day following the AIG bailout, the SEC announced another emergency order to 1) impose new penalties on clearing agencies and broker dealers with a "fail to deliver" position, and 2) effect a "naked" short-selling antifraud rule making it illegal to deceive as to "intention or ability to deliver a security."[99] The next day, September 18, the SEC used its emergency power to temporarily ban short sales of securities of 799 financial firms.[100]

B. *Public Companies vs. Short Sellers*

Because public companies and their executives have an interest in high stock prices—for cost of capital, executive compensation, and, in the case of a bank, investor confidence reasons[101]—short sellers are convenient targets to blame for poor stock performance.[102]

98. Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,166 (July 15, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58166.pdf (citing Bear Stearns failure as example of effects of false rumors and naked short selling, and saying that "[t]his emergency requirement will eliminate any possibility that naked short selling may contribute to the disruption of markets in these securities"). The order was to be effective on July 21 and to terminate on July 29, 2008 but was later amended to extend for the full period authorized by the SEC emergency power (30 days), to August 12, 2008. Order Extending Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,248 (July 29, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58248.pdf.

99. Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,572 (Sept. 17, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58572. The order also revoked the market-maker exception to the close out requirements for "naked" short selling. *Id.*

100. Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,592 (Sept. 18, 2008) (effective immediately and terminating Oct. 2, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58592. The order was later extended to terminate earlier than the thirty-day maximum (Oct. 17, 2008) or 3 days after the President's signing of the Emergency Economic Stabilization Act. Order Extending Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,723 (Oct. 2, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58723. Also on September 18, the SEC temporarily required certain institutional investment managers to report information concerning daily short sales of securities. Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,591 (Sept. 18, 2008) (to be in effect Sept. 29 to Oct. 2, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58591.

101. *See infra* text accompanying notes 82–84, 91–93. R

102. Shorts can also contribute to stock price increase in the event of a short squeeze whereby short sellers are forced to cover their open positions due to increases in a stock price, and the rush to cover actually accelerates the increasing

Firms use many strategies to hinder short sellers or to make their transactions more costly: trading over the counter or on NASDAQ, where short-sale constraints are heavier than on AMEX or NYSE; using stock splits to force short sellers to close their positions; conditioning dividend distributions on remitting physical stock certificates; publicly encouraging shareholders to remove their stock from street name and margin accounts; and moving stock into "friendly ownership" that will not lend, thereby decreasing shares available for borrowing and potentially causing a squeeze.[103] Firms also use litigation, calls for regulatory investigation, and public accusations of market manipulation to chill short selling and gain public support for government action.[104]

In the 2008 story, the companies' perspective won over the media long before they convinced the government of the imminent danger posed by short sellers. Lehman Brothers publicly fought the short sellers, accusing them of spreading false rumors, and taking deliberate acts to beat them. For example, a large preferred-shares issue was intended to combat speculation regarding its capital position.[105] The SEC had opened investigations in July as to whether investors spread misinformation to profit from stock declines, particularly those of Bear Stearns and Lehman Brothers, and sent subpoenas to over fifty hedge funds.[106] In April, Representative Barney Frank asked Cox and the SEC to broaden the inquiry to include trading in all major banks.[107]

The days leading up to the twenty-day ban were characterized by intense lobbying by companies whose stocks had fallen. The companies lobbied the public, stock lenders, and government officials, who in turn lobbied the SEC. John Mack, the chief executive officer of Morgan Stanley, and Lloyd Blankfein, the chief executive officer of Goldman Sachs, spoke with many government officials and made several public statements about "the abuses of short sell-

stock price. However, this is unlikely to cause net benefit since the initial short sale depressed the price, and the later increase must be stimulated by some force. The magnitude of a net increase in price is likely very small relative to other upward forces at work.

103. Firms have also tried to impose explicit trading restrictions and even withdraw shares from DTC, but the SEC stepped in to prohibit such actions. For discussion of these issues, see Crisp, *supra* note 20, at 150–54.

104. *Id.*

105. Susanne Craig, *Lehman Wants To Short-Circuit Short Sellers*, WALL ST. J., Apr. 1, 2008, at C1.

106. Scannell & Strasburg, *supra* note 15. R

107. *SEC Rumour Probe Should Examine Banks, U.S. House Committee Says*, NAT'L POST, Apr. 5, 2008, at F6.

ers" in the days leading up to the ban.[108] As justification for its decision to stop lending shares of Goldman Sachs, Morgan Stanley and Wachovia, Eric Baggesen of CalPERS (the California Public Employees' Retirement System), the largest American public pension fund, noted its "degree of concern about volatility in financials."[109] Amid this campaign against short selling came the first regulator: Andrew Cuomo, New York's attorney general, opened investigations into the stock price slides "aggravated by illegal short selling."[110] New York Senators Charles Schumer and Hillary Clinton, worried about their Wall Street constituents, called Cox directly and urged a ban on short sales.[111]

Efforts to demonize short sellers did not stop with the implementation of the ban. On the Monday following the Friday ban, the exchanges added seventy-one companies to the list of firms whose stock could not be shorted, including IBM, GE, and GM.[112] Some saw this as part of "an attempt to remediate a failure to consider carefully what was going to happen"[113] and questioned the necessity of adding such firms to the list, which had reached over 900 companies, about one seventh of the total listed on American exchanges.[114] Of course, many of these firms lobbied NYSE to be added.[115] As Keith Bliss, director of sales at Cuttone & Co., said, "What company would not want to get on the list if they could?"[116]

As a matter of fact, some companies did ask to be removed from the list.[117] "Short-selling is an important activity in terms of providing information to market participants," said Rob Dillon, the chief executive of Diamond Hill Investment Group, Inc., a company which utilizes short selling as part of its investment strategy.[118]

108. Kara Scannell et al., *SEC Is Set To Issue Temporary Ban Against Short Selling*, WALL ST. J., Sept. 19, 2008, at A1.

109. *Id.*

110. *Id.*

111. *Id.*

112. Kara Scannell, *The Financial Crisis: SEC Quickly Revises Short-Selling Rules; Shift on Financials, Hedge Funds Sends Traders Scrambling*, WALL ST. J., Sept. 23, 2008, at A3.

113. *Id.* (quoting Lawrence Harris, former chief economist at the SEC from 2002 to 2004).

114. *No-Short List Keeps Getting Longer*, N.Y. TIMES DEALBOOK, Sept. 25, 2008, http://dealbook.blogs.nytimes.com/2008/09/25/short-selling-shield-now-covers-drug-stores/ (last visited June 14, 2010); Kara Scannell & Serena Ng, *SEC's Ban on Short Selling Is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C1.

115. Scannell & Ng, *supra* note 114. R

116. *Id.*

117. *Id.*

118. *No-Short List Keeps Getting Longer*, *supra* note 114. R

Some firms that asked to be removed cited concerns about liquidity in the marketplace.[119] Others focused on information effects with respect to their own stock and the market generally. "For the economy and markets to efficiently allocate capital, you need to have information," Mr. Dillon noted.[120] When a medical malpractice insurer opted out, its CEO declared, "We also believe in free and fair markets."[121] Greenlight Capital, the Cayman Islands-based reinsurer headed by David Einhorn, famous for his early short positions against Allied Capital and Lehman Brothers, said, "We believe it is in the long-term interest of our company to have the market set an appropriate price for our shares. We also do not want investors to feel our stock is the beneficiary of any artificial price support."[122]

A firm might also opt out to maintain a convertible bond market for its stock. In the early part of 2008, these half-stock, half-bond hybrids were an extremely important source of liquidity for financial firms—indeed, many investors would not buy convertible bonds without a short sale to hedge their position.[123] Without an exception for hedging, the SEC was "literally shutting the market down."[124]

Both short sellers and public company representatives framed their message in public-interest language to garner the public support that would turn out to be crucial. The endangered companies focused on morally charged language to excite the public's already heightened distrust of the secretive side of banking, using words like "abuse," variations on "illegal" behaviors, and "false" rumor spreading.[125] Even the word "naked" came to be accusatory, despite the fact that "naked" short selling is not illegal provided that certain conditions are met, and the practice was not heavily regulated prior to these events.[126] In the media, "naked" came to be equivalent to deceptive, manipulative, and "illegal."

Short sellers, on the other hand, framed their arguments in terms of truth-finding, focusing on informational aspects of efficient markets and the preservation of "free and fair markets."[127] By

119. Scannell & Ng, *supra* note 114. **R**
120. *Id.*
121. *Id.*
122. *Id.*
123. Tom Lauricella, *The Crisis On Wall Street: Short-Sale Ban Wallops Convertible-Bond Market*, WALL ST. J., Sept. 26, 2008, at C2.
124. *Id.* (quoting Adam Stern, chief executive at hedge-fund manager AM Investment Partners).
125. *See supra* notes 108 (abuse), 110 (illegal), 105 (false). **R**
126. *See supra* notes 71–72. **R**
127. *See* Scannell & Ng, *supra* note 114.

claiming to reject the appearance of "artificial price support," they implicitly accused the public companies of deception and framed themselves as protectors of truth.[128] Bloggers had picked up the arguments on their own, with references to the role of short sellers in revealing fraud in public companies.[129] In addition, both sides appealed to the "un-American" or unpatriotic nature of the other's behavior, though this seemed to be used against short sellers.[130]

Others who participated in the SEC calls on the day of the ban expressed concerns for liquidity and for the potentiality that net-long investors would sell their stock if they could not use short sales to hedge their positions.[131] Some also noted a likely increase in the use of options to make bearish bets.[132] In hindsight, the statements of James Chanos, the short seller famous for revealing the Enron corporate scandal and chairman of a hedge fund lobbyist group, were very telling: "While this is all politically pleasing to the regulatory powers that be, the fact of the matter is that there has been no evidence presented of short sellers circulating false market rumors to drive down the price of stocks."[133] He made a second point that trading in credit default swaps—unregulated insurance contracts for off-exchange debt instruments—"dwarf[ ] the trading in equities in financial firms[, and u]ntil the SEC . . . gets their hands around that, the banning of the short selling is meaningless."[134] He also expressed concern that requiring short sellers to publish their

128. *See id.*

129. *See, e.g.*, Gray Galles, Don't Sell Short Selling Short, Ludwig Von Mises Institute (Apr. 6, 2007), http://www.mises.org/story/2527 (last visited June 18, 2010).

130. A clip of Jim Cramer discussing the issue demonstrates just how purposeful the use of rhetoric is. The goal of both Cramer and the anchor seems to be using the language of patriotism and terrorism, rather than expressing any particular point. *See Stop Trading with Jim Cramer* (CNBC television broadcast Sept. 18, 2008), *available at* http://www.youtube.com/watch?v=zj0Vwnt1CLs. This language was around long before the events of this episode. *See The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk, H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, H. Comm. on Financial Services*, 108th Cong. 6 (2003) (testimony by Professor Owen A. Lamont) ("There is a natural tendency to feel that short selling is somehow inherently malevolent or un-American. To the contrary, it is quite positive for our economy to correct overpricing and detect fraud. And nothing could be more American than free speech, free markets, and a healthy competition among ideas and firms.").

131. Scannell et al., *supra* note 108. **R**

132. *Id.*

133. *Id.*

134. *Id.*

positions could allow chief executives to bring frivolous lawsuits against those who short their stock.[135]

As it turned out, these results-oriented arguments by short sellers did not carry the day. One of the United Kingdom's largest hedge fund managers thought that "the hedge funds would have lost the debate anyway[,] but given that no one turned up[,] there was no chance."[136] The CEOs won the public relations battle due to months of rumors about the impact of short selling, converting what would have been a *special* interest into a *general* interest by convincing the public that its interests were more accurately aligned with those of companies rather than with short sellers. The mudslinging was interesting enough to spark intense media attention: from January 1, 2006 to the day of the ban, over 7144 newspaper articles were published mentioning short selling.[137] Three quarters of those were published since January 1, 2007 and almost half were published in the eight months of 2008 preceding the ban—almost 3300 articles, not including blog postings, television news and interviews, nor public statements from government or private players.[138]

The issue was squarely on the public agenda and thus limited the policy discretion on the part of regulators. Michael Levine and Jennifer Forrence describe this discretion as "slack" that gives agencies room to maneuver in the grey areas that the public does not understand.[139] Because the issues are complex, there is a high cost to gathering and sorting the information relevant to determining what the best action is, and monitoring the actions of regulators is very difficult. A gap in the principal-agent relationship is thus created. However, where "slack" is reduced due to high levels of media attention, as with short selling, the regulator's decision whether to act will not be shielded from the public's view.[140] At the same time, with respect to short selling, the public may not have fully internalized the complexity of the issues necessary to determine an objectively "best" course of action. As a result, the likelihood of an

135. *Regulators Move to Stop Some Short Selling*, N.Y. TIMES (Online), Sept. 19, 2008, http://www.nytimes.com/2008/09/19/business/worldbusiness/19iht-sell.4.16317673.html.

136. James Mackintosh, *Short Shrift*, FIN. TIMES, Oct. 6, 2008, at 8.

137. Figures were generated using "Proquest Newspapers" database with confined date parameters (search: "short-selling or short-sale or 'short selling' or 'short sale' or 'short seller'").

138. *Id.*

139. *See* Levine & Forrence, *supra* note 88, at 176 & n.15. R

140. *Id.* at 179.

outcome in the "general interest"—supported by the polity[141]—was high, as was the risk of unintended consequences.

C. Agency Dynamics: the SEC, the Treasury, and the Federal Reserve

As the chairman of the SEC, Cox was faced with balancing public demand for action with concern for unintended consequences. As for unintended consequences: "You can sort it out later!" Henry Paulson exclaimed to Cox over the phone. "You have to save [the banks] now or they'll be gone while you're still thinking about it."[142]

The "supremely self-confident" Paulson, former chairman of Goldman Sachs and then-current Treasury Secretary, had spent the week in meetings with Ben Bernanke, the quiet Great Depression scholar and then-chairman of the Federal Reserve System; Timothy Geithner, the young gun and then-president of the Federal Reserve Bank of New York; and the CEOs of the major banks, scrambling as they spiraled downward.[143] The bailouts and government-sponsored deals of the preceding six months had brought a heap of public criticism upon Paulson and Bernanke.[144] As known pragmatists, both were willing to do what was necessary to save the system; they had been acting with the interests of the system front and center, and they had little left to lose in terms of their political reputations, especially amongst Republicans. If successful, weathering the financial crisis was sure to be their legacies; no doubt ends would be more important than means. Judging by Paulson's response to Cox's concerns regarding unintended consequences, Cox was likely feeling pressured to adopt a similar outlook.

141. *Id.* at 176. I use "general interest" in the Levine-Forrence sense, based on its likelihood of being ratified by an informed polity. However, as will be evident below, I believe this particular "general interest" to be flawed from an efficiency standpoint and objectively inferior. This does not conflict with the "informed" nature of the polity; its constituents are simply irrational in the aggregate. Explanations I would suggest for this are behavioral irrationalities (including endowment and prospect theory applications) and/or a prisoner's dilemma. Unfortunately, exploration of such theories is outside the scope of this Note.

142. Stewart, *supra* note 1, at 79. **R**

143. *Id.* at 60.

144. Steven R. Weisman & Jenny Anderson, *Can Hank Paulson Defuse this Crisis?,* N.Y. TIMES, July 27, 2008, at B1; Steven R. Weisman, *U.S. Lawmakers Set to Question Bernanke on Bear Stearns Bailout*, N.Y. TIMES (Online), Apr. 2, 2008, http://www.nytimes.com/2008/04/02/business/worldbusiness/02iht-fed.1.11616448.html?pagewanted=1&sq=bernanke%20bailout&st=cse&scp=77; Michael M. Grynbaum, *Plan to Aid Borrowers Is Greeted by Criticism*, N.Y. TIMES, Feb. 13, 2008, at C4.

Those days were replete with the influence of company leadership, pleading for their solvency.[145] Paulson had close ties to many of the bank heads,[146] and had likely been influenced by the one-sided nature of the discussions held in the board room at the Federal Reserve during that week. John Mack of Morgan Stanley, in particular, publicly lambasted short sellers for allegedly spreading false rumors to drive the company's stock price down and secure profits for themselves.[147] In light of sharp stock declines and the urgency in the air, Paulson was sufficiently persuaded to push Cox to act against short sellers.[148] Moreover, this approach was supported by Bernanke's general stance, which, informed by experiences from the Great Depression, advocated for over-intervention rather than insufficient action.[149]

The SEC, Treasury, and the Federal Reserve do not necessarily have the same goals, nor should they necessarily err in the same direction. The Treasury mission includes "promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems."[150] The Federal Reserve Board mission is "to ensure the safety and soundness of the nation's banking and financial system."[151] The mission of the SEC, on the other hand, is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[152] Based on these roles, it is not clear that the SEC should place the same weight as the Treasury and the Federal Reserve on the survival of the banks.

However, looking closely at its mission statement does not provide a clear picture of how the SEC should approach the problem of short sales in the context of panic. There exist investors with conflicting interests: those who want to invest in the stock and those, like short sellers, who invest by moving stock from those who

145. *See generally* Stewart, *supra* note 1. **R**

146. *Id.* at 62, 63, 65, 75.

147. Susan Pulliam et al., *Anatomy of the Morgan Stanley Panic—Trading Records Tell Tale of How Rivals' Bearish Bets Pounded Stock in September*, WALL ST. J., Nov. 24, 2008, at A1. An interesting twist is that records show that while those CEOs were sitting in the Federal Reserve board room, their companies were placing bets against each other in the credit default swap market. *Id.*

148. Stewart, *supra* note 1, at 79. **R**

149. *Id.* at 61.

150. Dep't of the Treasury, Duties & Functions, http://www.ustreas.gov/education/duties/ (last visited Apr. 7, 2010).

151. Bd. of Governors of the Fed. Reserve Sys., Mission, http://www.federalreserve.gov/aboutthefed/mission.htm (last visited Apr. 7, 2010).

152. SEC, The Investor's Advocate, *supra* note 87.

value it less to those who value it more (in reverse chronological order). It is hard to say whether the SEC's mission statement contemplates protecting one group of investors from the other. The statement focuses on macro-type mechanisms to protect investors, such as efficiency and order in the markets, which could suggest that the first goal, protection of investors, is to be achieved by pursuing the latter goals.[153] Ex ante short selling constraints designed to enhance price continuity could be desirable,[154] but, the SEC had to make this tradeoff in the context of a crisis, when there is no time for ex ante constraints. Considering that a significant cost of short selling constraints is decreased liquidity, the choice may appear to tip away from a ban. However, the conflicts do not end there—the SEC must still tradeoff the need for capital formation with the hit to the convertible bond market that will result from restraints on short sales.

Even if these tradeoffs are properly balanced, conflicts between the SEC and the Treasury or the Federal Reserve will surely arise. For example, if banks are insolvent, it could potentially be the SEC's obligation to let the market achieve efficiency by accurately reflecting the dismal reality of a failing bank's balance sheet. Though it is unlikely that the SEC's obligations require the collapse of the banking system, it is unclear how aligned its duties are with the primary concerns of the agencies whose subjects of regulation are threatened.

The SEC sidesteps these problems by focusing on the fairness aspect of its mission: it must protect investors from unfairness in the market.[155] The agency could justify its action to intervene by blaming the undesirable stock declines on *unfair* and *illegal* behavior. In that way, if the intervention does not work, the failure can be explained by new and unpredictable unfair activities to circumvent the prohibited mechanisms for achieving the same undesirable outcome. In other words, if the activity that led to the negative outcome was prohibited, it is easy to shift blame to human error; thus, one can achieve political cover by prohibiting any behavior that cannot be controlled.

153. But, even a focus on "efficiency" does not provide a clear solution; general investors may prefer *continuous* market efficiency while traders may prefer *immediate* market efficiency. *See* Douglas M. Branson, *Nibbling at the Edges—Regulation of Short Selling: Policing Failures to Deliver and Restoration of an Uptick Rule* 38–39 (U. of Pitt. Sch. of L. Legal Studies Research Paper Series, Working Paper No. 2009-10, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364475.

154. *Id.* at 8–10.

155. *See supra* note 152 and accompanying text.

The shift in blame was achievable in 2008 because slack was reduced sufficiently to generate action; but the complexity of the matters, the dominance of the CEOs' voices, and the plethora of issues on the table were such that slack was not enough to ensure that action truly in the public interest was taken. If there had been slack, Cox could have ignored the public demand for a ban based on the belief that it was not in the best interest of the public. Levine and Forrence refer to this type of regulatory behavior as that of a "Burkean Independent," one who acts in an "other-regarding" as opposed to self-interested manner to bring about an outcome that he believes to be best for society, but that would not be ratified by the polity if provided with all the relevant information.[156] However, here there was no slack, and thus if Cox ignored public demand and declined to implement the ban, he would have made himself into what Levine and Forrence termed a "failed ideologue"—one who exercises Burkean-style independent judgment as to what is in the public interest, but who does so in the absence of slack and thus has no chance of hiding her action or avoiding public criticism.[157] Instead, Cox accommodated the public demand for action, though it is unclear whether he did so simply to avoid public criticism, or because he too had been convinced of the urgent threat posed by short sellers.

Paulson certainly served as an additional source of pressure, but he was facing his own complex set of influences. He may have been acting with "Burkean" motives—those consistent with his own, personal notion of society's best interests[158]—with respect to the bank bailouts, a topic about which public opinion was mixed.[159] However, he was captured on the short selling issue. Because he was not the primary regulator—the decision to ban short selling was technically not his to make—Paulson had some slack; his actions to influence the decision were not as easily accountable to the public. However, he did need the banks to cooperate with his efforts to save the banks through forced mergers. Therefore Paulson was able to invest the slack he did have to support the short-selling ban and appease the bank heads, in order to serve his primary interest in preserving the banking system by other means. Furthermore, as between Paulson and Cox, there appeared to be zero

156. Levine & Forrence, *supra* note 88, at 179. **R**

157. *Id.*

158. *Id.* at 174.

159. *See, e.g.*, Floyd Norris, *How Voters See the Bailout*, N. Y. TIMES, Oct. 18, 2008, at B3.

slack—Cox had virtually no discretion, and no space, to act independently outside the scrutiny of Paulson.

In going ahead with the ban, the SEC used public interest language, borrowed from the CEOs, to assure the public that it was acting in their general interest. Beginning with its investigations into hedge fund activity and the imposition of less dramatic restraints on short selling following Bear Stearns and IndyMac, the SEC emphasized in releases the impact of unfair behavior on the orderliness of the market, thus providing the justification for its activities. For example, the release regarding the ban on naked short selling of nineteen stocks in July of 2008 starts off strong, stating that "false rumors can lead to a loss of confidence in our markets," citing recent charges against a trader for market manipulation.[160] It goes on to promise that "this emergency requirement will eliminate any possibility that naked short selling may contribute to the disruption of markets in these securities."[161] Of course, that was neither the first nor the last attempt to restrict the naked short selling that the agency and much of the public blame for the drastic declines.[162] The press release regarding the outright ban on short selling of 799 stocks quotes Cox: "The Commission is committed to using every weapon in its arsenal to combat market manipulation that threatens investors and capital markets."[163] He claims the order "will restore equilibrium to markets."[164]

However, by the time the SEC extended the ban on October 2, 2008, the S&P Banking Index had dropped 11% and the S&P Insurance Index dropped 12%.[165] Washington Mutual's stock fell so dramatically that it had to be seized by the FDIC and sold at an incredible price to JPMorgan Chase.[166] And Wachovia stock plunged almost 50% to be eventually seized by the FDIC and sold to Citigroup.[167] With these numbers, many wondered why the SEC

160. Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release No. 58,166, at 1–2 (July 15, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58166.pdf.

161. *Id.* at 3.

162. *See infra* Part II.A.

163. *See* Press Release, SEC, SEC Halts Short Selling of Financial Stocks, *supra* note 3.

164. *Id.*

165. Paul R. La Monica, Commentary, *The SEC's Crusade Against Shorts is a Joke*, CNNMONEY.COM, Oct. 2, 2008, http://money.cnn.com/2008/10/02/markets/thebuzz/index.htm.

166. *Id.*

167. *Id.*

extended the ban at all.[168] But a clue emerged from a comparison of the extension order to previous orders. All previous orders referenced the dangers to the orderly functioning of markets posed by false rumors.[169] However, the order extending the ban did not mention rumors, and instead stated only that it "intend[ed] the prohibition to restore investor and market confidence by preventing short selling from being used to drive down the prices of securities in financial institutions even where there is no fundamental basis for a price decline other than general market conditions."[170] The language shifted from abusive conduct to information problems—the actions that the emergency orders restrain are not justified from the perspective of an accurate representation of the market.

By 2008, the SEC seemed to have abandoned its attempt to exclusively frame its actions as a response to illegal behavior, and did little to ward off the potential inference that it was simply trying to prevent an exceedingly unpleasant outcome. The agency ultimately ended up helping the Treasury and the Federal Reserve achieve their objectives and neglected its own mission—in particular, concerns for efficiency and liquidity.

D. International Context

Another factor contributing to the ultimate decision to institute the ban was the international response to the crisis. The United States did not act alone that week in 2008; the United Kingdom was on a similar schedule reacting to the Lehman disaster, and, in implementing its ban one day before the United States, was the first nation to institute emergency short-selling restrictions.[171] However, the international instinct to blame and heavily restrict short sellers put the issue on the global public agenda in the weeks and months prior, and as a result, inaction became even less of a politically feasible option for United States regulators.

While this did contribute to the push to regulate, it also created some slack for American regulators in their choice of what regulation to use, because United States regulators could count on other developed countries to impose market regulations in even

168. *See, e.g.*, *id.*

169. *See, e.g.*, *supra* notes 160–63 and accompanying text.

170. Order Extending Emergency Order Pursuant to Section 12(k)(2), Exchange Act Release 58,723 (Oct. 2 2008), *available at* http://www.sec.gov/rules/other/2008/34-54723.

171. Peter Thal Larsen, *UK Ban on Short Selling of Financials*, FIN. TIMES, Sept. 19, 2008, at 2.

more controversial ways. To the extent that the international responses appeared harsh, rash, and unprincipled, American regulators were given slack to continue or adjust their strategy without public outcry.

Indeed, generally, during the period following the Lehman collapse, short sellers were met with more and harsher restrictions abroad than in the United States.[172] There was sharper rhetoric and even more accusatory language. Italian Prime Minister Silvio Berlusconi banned what he called "speculative attacks" on Italian banks, and Peer Steinbrück, Germany's then-finance minister, was pushing for a global ban on "purely speculative short selling."[173] John Sentamu, archbishop of York, referred to short sellers as "bank robbers and asset strippers."[174]

The entire crisis was acknowledged to be a global affair, and future systemic risk and crisis management had been determined to be dependent on coordinated strategies.[175] Thus international pressure to act against short sellers was significant, and countries reacted in substantive ways.[176] Some countries implemented bans similar to that in the United States but lasting longer. The United Kingdom, for example, maintained its ban on short selling of financial firms until January of 2009.[177] In Canada and Switzerland, there were short selling bans on financial stocks beginning on the same day as the United States, lasting until early October of 2008 in Canada and until December of 2008 in Switzerland.[178] The Netherlands imposed a similar ban lasting eight months.[179] Denmark and Ireland have bans still outstanding.[180]

Other countries instituted broader bans that lasted longer than that in the United States. In contrast to the United States and United Kingdom, many Asian countries and Australia have applied

172. However, the initial implementation of the UK ban was more nuanced than that of the US, including both a convertible-bond hedge exemption and market-maker exemption. *See* Mackintosh, *supra* note 136. R

173. *Id.*

174. *Id.*

175. Gerald F. Seib, *The Financial Crisis; Capital Journal: Global Crisis Coordination Takes Shape—Slowly*, WALL ST. J., Oct. 11, 2008, at A2.

176. *See, e.g.*, Sheryl Gay Stolberg & Mark Landler, *Bush Calls 20 Nations To Meeting On Markets*, N.Y. TIMES, Oct. 23, 2008, at B1.

177. Seraina Gruenewald et al., *Emergency Short Selling Restrictions in the Course of the Financial Crisis* 14 (unpublished working paper, Jan. 21, 2010), *available at* http://ssrn.com/abstract=1441236. The status of such bans reflects information available as of January, 2010, except where otherwise noted.

178. *Id.* at 8 (Canada), 14 (Switzerland).

179. *Id.* at 12.

180. *Id.* at 8 (Denmark), 10 (Ireland).

emergency measures to all listed firms.[181] Iceland also instituted a ban on short selling of financials for four months that included "any instrument with the same purpose and the same economic exposure."[182] Greece and Russia had outright short-selling bans for around eight months in late 2008 and early 2009.[183] India banned short selling of non-financial companies, and South Korea banned short selling for all listed firms, measures which are both still outstanding.[184] Italy had a ban on short selling all listed firms, but later limited it to financial firms, and it now restricts only short selling of firms increasing their capital.[185] France and Germany instituted bans only on naked short selling, but the former included spot and options contracts.[186] France's measure is still in force.[187] On January 29, 2010, Germany declined to extend its original ban,[188] but has since instituted a new ban on some naked short selling and is considering a market-wide ban.[189]

Even if a prediction as to the likelihood of other countries' following the lead of the United States was never explicitly made, the general characterization of the United States as a more lenient and predictable forum for trading generates a kind of feedback loop. To their constituents, European countries cannot be seen to

181. *Id.* at 4.

182. *Id.* at 10.

183. *Id.* at 9 (Greece), 13 (Russia). Greece recently instituted a new ban, scheduled to expire June 28, 2010. *Greek SEC Watchdog Bans Short Selling in Stocks*, REUTERS, Apr. 28, 2010, http://www.reuters.com/article/idUSATH00541520100428.

184. *Id.* at 10 (India), 13 (South Korea).

185. *Id.* at 11.

186. *Id.* at 9.

187. *See* Press Release, Autorité des Marchés Financiers [AMF, Financial Markets Authority], AMF Prolongs Exceptional Measures on Short Selling of Financial Stocks Pending a Permanent Europe-Wide Regime (Jan. 27, 2010), http://www.amf-france.org/documents/general/9297_1.pdf.

188. *See* Press Release, Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin, Federal Financial Supervisory Authority], General Decrees on the Ban of Short Sales Expire (Jan. 29, 2010), http://www.bafin.de/cln_161/nn_720494/SharedDocs/Artikel/EN/Service/Meldungen/meldung__100129__leerv__aufhebung__en.html?__nnn=true. BaFin recently adopted a requirement that investors holding a net-short position above a certain threshold in specified stocks notify BaFin by the end of the following day. Press Release, Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin, Federal Financial Supervisory Authority], BaFin Introduces Transparency System for Net Short-Selling Positions (Mar. 4, 2010), http://www.bafin.de/cln_161/nn_720494/SharedDocs/Mitteilungen/EN/2010/pm__100304__leerverk__transparenz__en.html?__nnn=true.

189. Patrick McGroarty & Andreas Kissler, *Germany Proposes Wider Ban on Naked Short Selling*, WALL ST. J. (Online), May 25, 2010, http://online.wsj.com/article/SB10001424052748704026204575266212488296850.html.

respond only as much as the notoriously under-regulated United States, and the United States can count on more populist reactions abroad. While it may not help to quell the immediate backlash following implementation of restrictions, the relatively harsh international responses certainly help to downplay, in hindsight, the seriousness of the restrictions imposed by the United States if media attention turns negative. It also provided some room to maneuver when the SEC was considering whether to extend the ban in early October 2008. The international scramble to push through their own restrictions kept the issue on the global public agenda and urged an extension. Yet, the international response had so much momentum that it prevented the factual realities of the market response (or lack thereof) to the ban in the United States to generate more skepticism about the nuances of the ban and its propriety. This is especially important to the extent regulators were concerned about the move of investors to more lenient regimes, a concern which continues to be salient as regulators debate long-term rules on short selling.[190]

III.
WHAT WE LEARNED

> People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain.[191]

Speculative behaviors can be damaging, but are not always worth the trouble of trying to control. Of course, Holmes may not have envisioned in 1905 the kind of impact such behaviors could

190. *See, e.g.*, Jill Lawless & Aoife White, *Hedge Funds Mull Ditching UK for Switzerland, Asia*, ASSOC. PRESS, Nov. 27, 2009, http://abcnews.go.com/Business/wireStory?id=9188318 (last visited June 16, 2010).

191. Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 247–48 (1905) (Holmes, J.) ("This court has upheld sales of stock for future delivery . . . .").

exert given the speed and breadth of the modern market. In other words, maybe this time was different. Looking to how great the waste incident to this social function truly was or could have been, was it right to attempt to control it in this way, and will it be right next time?

A. In Hindsight

In hindsight, the 2008 decision to ban short sales appears to have been a bad one on its own terms. Immediately following its implementation, volumes of trades on American exchanges fell 41%, at least in part due to reluctance to take long positions that could not be hedged with shorts.[192] As a result, the cost of trading on such stocks rose as bid-offer spreads "widened substantially."[193]

Frank Hatheway, Nasdaq's chief economist, echoed Richard Whitney, president of NYSE during the two-day ban in 1931.[194] The SEC had not met its goals: "The ban did not restore stability to the market. It did not support prices," and "I would not advocate a return to a short-selling ban."[195] Emerging empirical research concludes that the ban was detrimental for liquidity, slowed price discovery, and failed to support prices.[196] There was more volatility in the "protected" stocks, and liquidity in those stocks had decreased by half.[197] The results paralleled those of the naked short-sale ban on nineteen stocks over the summer of 2008, identified by Arturo Bris and neglected by the SEC at the imposition of the September ban and its extension.[198]

192. Mackintosh, *supra* note 136.

193. *Id.*

194. For Whitney's statement, see *supra* note 52 and accompanying text. R

195. David Greising, *Short-Selling Ban Leaves SEC with Little to Show*, CHI. TRIB., Oct. 10, 2008, at 37.

196. Alessandro Beber & Marco Pagano, *Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis* 3–4 (Centre for Studies in Econ. and Fin., Working Paper No. 241, updated Jan. 2010), *available at* http://www.csef.it/WP/wp241.pdf. The data showed a positive stock price correlation in the United States. However, based on the declines in other countries, the authors believe it is probably due to other policy measures announced at the time, *id.* at 26, namely the bailout. "[T]he overall evidence indicates that short-selling bans have at best left stock prices unaffected, and at worst may have contributed to their decline." *Id.* at 4.

197. Greising, *supra* note 195. R

198. *Id.*; Arturo Bris, Op-Ed, *Shorting Financial Stocks Should Resume*, WALL ST. J., Sept. 29, 2008, at A25.

B. Means and Ends

Cox has acknowledged the undesirable results of the ban, but it is unclear whether he perceives the failure to have been one of degree or one of kind.[199] It is not possible to determine what would have happened if the ban were not pushed on Cox after Lehman fell, but it is clear that five commissioners who would not have supported a ban on Wednesday voted unanimously to implement one on Thursday after calls from Treasury, the Federal Reserve, Blankfein, and Mack, and after the United Kingdom had already announced its ban.[200] Perhaps after a few weeks Cox would have made a reasoned determination that the threat of unfair activity to the orderliness of the market was real enough to warrant a tradeoff for disorderliness resulting from decreased liquidity that would certainly accompany a ban. Indeed, a few weeks after the ban was lifted, markets were dropping, and, again, banks were begging for bans and market shut down, citing examples of rule of law violations such as Lincoln's suspension of habeas corpus and Roosevelt's forcible internment of Japanese Americans.[201] The SEC rejected that advice and exchanges stayed open.[202]

The fact that even the banks conjured such extreme analogies suggests private actors recognized the situation for what it was: a major deviation from established process. The emergency powers possessed by the SEC are meant to be used sometimes, and it is possible they were warranted in 2008. However, the SEC had no evidence of illegal behavior, at least none they touted then, or since. The SEC spent all of one day debating the merits of the ban, and essentially rested their decision on pressure from another agency with different objectives and obligations under the cover of public misunderstandings and international media chaos.[203] At the end of the day, Cox had no solid explanation for these acts beyond sheer price support, which is evidenced by the evolving language of the public and of the SEC's own releases from "manipulative," "abusive," and "illegal" behavior, to simply detrimental short sales.[204]

199. Younglai, *supra* note 6 ("[K]nowing what we know now, I believe on balance the commission would not do it again. . . . The costs appear to outweigh the benefits,") (quoting Cox).

200. Stewart, *supra* note 1, at 78.

201. Younglai, *supra* note 6.

202. *Id.*

203. *See generally* Stewart, *supra* note 1, at 79.

204. *See infra* notes 160–70 and accompanying text.

C. Political Correctness

Some still blame abusive short sellers for the demise of the major banks with colorful language and outright conspiracy theories.[205] Much of the media attention characterizes the past two years' events as a secret slaughter of banks by short sellers, despite that while only eighty-nine banks had failed by September 2009, nearly 1900 hedge funds had gone out of business by March 2009.[206] On the other hand, emerging empirical research found no evidence of price decline resulting from naked short selling of the hardest hit financial institutions, and has concluded that naked short sellers have responded to public news, with their activity intensifying after the price has already declined rather than triggering such price declines.[207] A majority of the scholars and economists at the SEC's recent short selling roundtable noted the benefits of the practice and indicated that the events of the financial crisis were more global in nature, thus justifying a regulatory approach that did not focus solely on short selling.[208]

The enduring factual debate is important because of its political implications. From the perspective of history, the public's perception of the appropriateness of the SEC's acts will turn not on their efficacy, but on the perceived factual truth of the role played by short sellers in the collapse of the banks, which is more easily distorted. Though the SEC investigations are apparently ongoing, no results have been publicized. If culprits are found, and especially if they are convicted of crimes, history will say that the SEC action was proper and that drastic restrictions will be warranted in the future.

This raises two issues. The fact remains that the ban did not achieve its objective to restore equilibrium, presumably not demonstrated by the falling stock prices, the deep hit to liquidity, and the increased volatility that occurred despite the ban. To the extent that the companies continue to dominate in the media war, this

205. For colorful language, see Matt Taibbi, *Wall Street's Naked Swindle*, ROLLING STONE, Oct. 15, 2009, at 50, and for conspiracy theories, see MARK MITCHELL, THE STORY OF DEEP CAPTURE (2009), http://www.deepcapture.com/wp-content/uploads/2009/08/deepcapture-the-story-v1.pdf.

206. Stewart, *supra* note 1, at 79. **R**

207. *See generally* Veljko Fotak et al., *Naked Short Selling: The Emperor's New Clothes?* (May 22, 2009) (unpublished working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1408493&rec=1&srcabs=1264939.

208. *See* SEC, Roundtable to Discuss Short Sale Price Tests and Short Sale Circuit Breakers (May 5, 2009), at 111–33, http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf.

aspect of our experience will not be preserved, just as it was not preserved following the Great Depression. For the public, the crucial question in their minds going forward will be whether there exists manipulative activity in the marketplace, and whether the likelihood of such activity is great enough to warrant intervention. On this flawed theory past failures become irrelevant, and we continue to allow our fear of manipulative practices to determine the tools we use to regulate markets, as opposed to the efficacy of those tools.

Another issue is the possibility that no manipulative behavior will ever be "found," at least not in any conclusive way. This Note has suggested that the SEC should consider and focus on the remote likelihood of successful implementation of such a ban in the future. However, if the SEC continues to frame the legitimacy of its actions in terms of unfair behavior, the lack of evidence could constrain behavior in the future. This could allow for more appreciation of the observation that a short sale ban does not achieve objectives that rely on liquidity and reduced volatility. The possibility of unfair behavior does not change that fact.

The remaining question is whether the SEC, or even the Treasury or the Federal Reserve, is willing to go as far as pursuing price support without a justificatory hook, such as manipulative behavior. This Note has suggested that the lack of findings of illegal behavior would undercut that justification for the future. Yet, it is still undesirable for the regulatory agencies to acknowledge a plan to support prices temporarily. To prevent migration, the regulatory regime still has an interest in appearing to be the most capitalist and predictably efficiency-based, and thus its regulators will strive to reduce the appearance of deviation from those principles as much as possible. If the SEC wants to continue to use strategies based on public perception, its hope should be that some illegal behavior is discovered, in order to preserve the strategy for future use. The narrative will certainly take an even more aggressive turn against short selling if they do, despite lack of any evidence that they contributed to the harms suffered by those who oppose them. Regardless of whether one agrees that a price support goal is desirable or justified, intentionally obscuring the true causes of the harms we hope to prevent can only be counter-productive.

IV. EPILOGUE: THE NEW UPTICK RULE

In response to continuing public and political pressure, on October 17, 2008, the SEC permanently adopted the antifraud rule it implemented with its emergency powers on September 17, focusing on shorts effected by sellers "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."[209] Even in the release, the SEC acknowledged that such behavior was already illegal under the general antifraud provisions of federal securities laws.[210] More recently, the SEC voted 3–2 to adopt a new rule that restricts short sales on stocks that have fallen 10% in a day.[211] The rule requires that short sales in such circumstances be executed only at a price above the current national best bid.[212] The restriction applies until the close of the following day.[213] Chairman Mary L. Schapiro said that while short selling can be beneficial, "[w]e also are concerned that excessive downward price pressure on individual securities, accompanied by the fear of unconstrained short selling, can destabilize our markets and undermine investor confidence in our markets."[214] The rule

209. "Abusive" shorts are defined as those for which the seller intends to fail to deliver within the settlement cycle. "Naked" Short Selling Antifraud Rule, 73 Fed. Reg. 61,666, 61,667 (Oct. 17, 2008). On May 4, 2010, Goldman Sachs Execution & Clearing settled an SEC administrative action for violations of this rule in December 2008 and January 2009. *See* Goldman Sachs Execution & Clearing, L.P., Exchange Act Release No. 62,025 (May 4, 2010), *available at* http://www.sec.gov/litigation/admin/2010/34-62025.pdf; Marcy Gordon, *Goldman Sachs Settles Short-Sales Allegations*, ASSOC. PRESS, May 4, 2010, http://abcnews.go.com/Business/wireStory?id=10553721 (last visited June 19, 2010). However, this is unrelated to the SEC's fraud allegations against Goldman Sachs & Co. and Fabrice Tourre relating to synthetic collateralized debt obligations tied to subprime residential mortgage-backed securities, which they marketed in early 2007. *See* SEC Litigation Release No. 21,489, SEC v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y.) (Apr. 15, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21489.pdf; *see also* Gordon, *supra* note 208.

210. SEC Litigation Release No. 21,489, SEC v Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y.) (Apr. 15, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21489.pdf; *see* Rule 10b-5, 17 C.F.R. § 242.203(b)(1) (2009).

211. Fawn Johnson, *In 3-2 Vote, SEC Limits Short Sales*, WALL ST. J., Feb. 25, 2010, at C1. For the rule, see Amendments to Regulation SHO, Exchange Act Release No. 61,595 (Feb. 26, 2010) (effective May 10, 2010), *available at* www.sec.gov/rules/final/2010/34-61595.pdf.

212. Press Release, SEC, SEC Approves Short Selling Restrictions (Feb. 24, 2010), http://sec.gov/news/press/2010/2010-26.htm.

213. *Id.*

214. Mary L. Schapiro, Chairman, SEC, Statement at SEC Open Meeting—Short Sale Restrictions (Feb. 24, 2010), http://sec.gov/news/speech/2010/spch022410mls-shortsales.htm.

will "enable long sellers to stand in the front of the line and sell their shares before any short sellers."[215]

The two dissenting commissioners felt that the rule lacked empirical support, noting that the release itself states, with respect to the 2008 crisis: "[W]e are not aware . . . of any empirical evidence that the elimination of short sale price tests contributed to the increased volatility in the U.S. markets."[216] At the time of the rule's initial proposal, Commissioner Casey expressed that the relationship of the repeal of the uptick rule in 2007 to the increased market volatility was essential to the justification for the proposed rule.[217] The lack of such relationship, admitted by all commissioners, resulted in her harsh dissent:

> The focus of the Commission should be on rulemaking that furthers the mission of the agency: to protect investors, maintain fair, orderly and efficient markets, and promote capital formation.
>
> In the 330 pages of the rule release, there is no evidence that this proposed rule advances any of these goals, even the inchoate promise of the "promotion of investor confidence."
>
> . . . .
>
> . . . [T]his is regulation by placebo; we are hopeful that the pill we've just had the patient take, although lacking potency, will convince him that everything is all right.[218]

Commissioner Paredes agreed that there was insubstantial evidence supporting the rule and felt that the claim that it would bolster investor confidence was "conjecture and too speculative."[219] His long dissent also touched on another issue, which he refers to as "ratcheting."[220] Commissioner Paredes worried that when the new rule inevitably does not work—i.e., the price of a stock declines even after the 10% threshold is met and shorts are restrained—there will be calls for more restrictive rules, which "would harm

215. *Id.*

216. Amendments to Regulation SHO, Exchange Act Release No. 61,595, (Feb. 26, 2010), at 21–22, *available at* www.sec.gov/rules/final/2010/34-61595.pdf; Troy A. Paredes, Comm'r, SEC, Statement at Open Meeting and Dissent Regarding the Adoption of Amendments to Regulation SHO (the "Alternative Uptick Rule") (Feb. 24, 2010), http://www.sec.gov/news/speech/2010/spch022410tap-shortsales.htm; Kathleen L. Casey, Commissioner, Securities Exchange Commission, Statement at Open Meeting Short Sale Restrictions (Feb. 24, 2010), http://www.sec.gov/news/speech/2010/spch022410klc-shortsales.htm.

217. Casey, *supra* note 216.

218. *Id.*

219. Paredes, *supra* note 216.

220. *Id.*

market quality even more."[221] "[B]y claiming more than the alternative uptick rule can deliver, [the SEC] will have fostered expectations among investors that the price test cannot meet," and demand will follow for "ratcheting" up the restrictiveness of the short-sale rules.[222]

A foundation for this scenario has already been laid by proponents of short-sale rules. Senator Ted Kaufman, Democrat of Delaware, expressed his disappointment with the rule.[223] "I am frankly surprised that the S.E.C. didn't go further on the uptick rule, so now I got to go around and talk to my colleagues and see what is available."[224] A joint statement with Senator Johnny Isakson, Republican of Georgia, criticized the rule as of "limited use, helping only in the worst-case scenarios that could occur during a terrorist attack or financial crisis."[225]

Thus, when the rule does not prevent rapid price decline, two groups will be validated: those ready to claim that weak regulation was the cause and those who see the rule as simply another "costly political directive that has nothing to do with preventing the next financial crisis."[226] Note one shift in regulatory behavior—instead of responding to emergency pressures as played out in the media, this rule-making episode brought the debate in-house. It occurred within the government agency itself, providing opportunity for a higher level of both dialogue and analysis. Also, the discussion took place in advance of the next emergency, and thus had the benefit of more thoughtful deliberation and might prevent later accusations of inaction. However, parallels in the regulatory method abound: both SEC actions proceeded based on a misdiagnosed threat, both neglected empirical history, and both sets of relevant actors ultimately declined to take up the complex questions surrounding efforts to prevent price decline. Furthermore, the operation of the recent rule mimics the most negative framing of short sellers themselves—while short sellers can benefit from fear-driven sales, so too can the SEC buoy the market by acknowledging and

221. *Id.*
222. *Id.*
223. *See* Cyrus Sanati, *Lawmakers Find S.E.C.'s Short-Sale Rule Lacking*, N.Y. TIMES DEALBOOK, Feb. 24, 2010, http://dealbook.blogs.nytimes.com/2010/02/24/lawmakers-find-s-e-c-s-short-sale-rule-lacking/ (last visited June 16, 2010).
224. *Id.*
225. Johnson, *supra* note 211. **R**
226. *Selling Investors Short; The SEC Refutes Its Own Short-Sale Ban*, WALL ST. J., Feb. 26, 2010, at A14. The SEC has estimated that costs will be approximately $1 billion to implement the rule and $1 billion annually to maintain it. *See* Johnson, *supra* note 211. **R**

thereby legitimizing fears. The SEC is not merely responding to the reality of irrational fears; it is incorporating the irrational fear into its policy.[227]

CONCLUSION

Implementing a new and effective price test and dedicating significant resources to investigation and prosecution of manipulation would hopefully go far to prevent manipulative behavior. However, where volatility is sufficient to allow circumvention of a price test, or where herding behavior simply drives prices down sharply in the absence of manipulative naked short selling, the SEC will find itself in the same situation as it was before the 2008 ban.[228] Executives will likely continue to dominate the public debate on short selling. Furthermore, the failure of investigations to provide specific scapegoats may not be sufficient to mitigate the historically vibrant perception of short sellers as generally immoral and untrustworthy. The legitimacy granted by the newest SEC rule to the cycle of elevation of public pressure over empirical experience ensures the cycle will continue.

The history has demonstrated this pattern over and over—regulators responding to some public notion of the general interest that requires short sale restraints, particularly in the context of panic—either during the panic or in anticipation of it. Yet, the empirical experience of history has been lost. Efforts to determine the public interest appear to have been set aside in favor of public pressure, resulting in an approach that threatens to neglect root causes.

In the case of the twenty day short-sale ban, regulators were presented with significant pressure, both inside and outside the government, to respond to a perceived threat of manipulation.

227. Another implication of the non-empirical approach to the operation of this rule is that its efficacy will be difficult to assess. If the rule is aimed to curb destabilization based on "fear of unconstrained short selling," it's work is mostly done the moment it goes into effect. If comfort taken from the rule is incorporated into all sales, perhaps we should be looking for less volatility overall.

228. An incident occurring just prior to this Note's going to press forced SEC Chairman Schapiro to acknowledge a limitation of the rule. On May 6, 2010, the Dow Jones Industrial Average dropped nearly 1,000 points in one half hour. *Fawn Johnson, SEC: 'Uptick Rule' Wouldn't Have Made Difference When Market Fell*, Dow Jones Newswires, May 11, 2010, http://www.nasdaq.com/aspx/stockmarketnews storyprint.aspx?storyid=201005111702dowjonesdjonline000579 (last visited Apr. 6, 2010). The rule was not yet in effect, but the event prompted questions regarding its anticipated efficacy in such a scenario. *Id.* Chairman Schapiro replied that "[t]o the extent the sales we saw were long sales, the uptick rule would not have made a difference." *Id.*

Even if one agrees that these efforts were "silly but harmless,"[229] there is reason to resist this style of regulatory behavior. By indulging public pressures for what will predictably be ineffective efforts, regulators fail to foster the appropriate appreciation of marketplace forces. This is not a deregulatory thesis. An appropriate appreciation of marketplace forces would acknowledge the fragile and interconnected nature of financial markets in particular[230]—a sphere which has been historically shaped and facilitated by regulatory entities and activities. However, in deciding whether to restrain investor behavior, the degree to which action will be effective in bringing about efficiency and stability is critical, as is the degree to which these values are traded off or sacrificed.

By folding these fears into regulatory policy, the SEC further complicates investors' calculus, thereby adding additional uncertainty. As a matter of regulatory behavior, we can expect this approach to continue, since public dialogue continues to place short selling in the context of manipulation and destruction, and regulators continue to face incentives that favor action over inaction. The recent uptick rule may temper some fears, but it cannot prevent rapid price decline in all but a few narrow circumstances. If another crisis occurred, there may indeed be pressure to institute another short selling ban, despite the rule; and such a ban will likely not achieve its goals.

229. Scannell & Strasburg, *supra* note 15 (quoting short-selling expert Owen A. Lamont).
230. *See supra* Part I.D.