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## Going Long on Shorts

Scott Squires

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# Going Long on Shorts

SCOTT SQUIRES<sup>1</sup>

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## I. INTRODUCTION

“[W]hat I really want to do is reach in, rip out their heart, and eat it before they die.”

—Richard S. Fuld, Jr., Lehman Brothers, Chief Executive Officer (1994–2008), in reference to investors short selling Lehman Brothers stock.

Controversy surrounding short selling is not a recent phenomenon. Two firsts came at the turn of the seventeenth century: the first company in modern times to sell shares of its stock to the general public, and with it, the first short-selling dispute.<sup>2</sup> Roughly 400 years before Richard Fuld not so subtly expressed his disfavor towards short sellers, the Dutch East India Company was created as a monopoly to facilitate trade between the Dutch and the East.<sup>3</sup> Seven years later, in 1609, one of the company’s original shareholders considered the share price overvalued

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1. J.D. Candidate 2014, University of Miami School of Law; M.B.A. 2009 University of Miami School of Business; B.A. 2006, University of Pennsylvania. I would like to thank my faculty advisor, Stephen Halpert, for his guidance during my research. Additionally, I am grateful to Jessica Johnson and the *University of Miami Law Review* for their feedback during the editing process. A special thank you to my family and friends for their support. Most importantly, this Comment is dedicated to my wife and best friend, Danielle.

2. Chinmay Jain et al., *A Comparative Analysis of Short Selling Restrictions* 7 (Jan. 2012), available at <http://ssrn.com/abstract=1928730>.

3. Henk Rijkeboer, *History of the Dutch East India Company – The Asian Part*, EUROPEAN-

after learning about the planned incorporation of a competing French trading firm.<sup>4</sup> The shareholder formed an association to short shares of the Dutch East India Company.<sup>5</sup> The company's stock price declined twelve percent over the following year, and the short sellers earned significant profits.<sup>6</sup> The other shareholders, angered upon learning about the short sellers' investment strategy, petitioned the Amsterdam Exchange to address the situation. In 1610, the first short-selling regulations were enacted: short selling was prohibited on the exchange.<sup>7</sup>

Corporate managers contend that short sales depress stock prices; academics argue that short sales play an essential role in the pursuit of efficient markets; and regulators continually grapple with their own conflicting views about short sales. This comment explores existing empirical research and concludes that short sales are an important investment vehicle that benefit the financial markets, primarily by increasing the flow of information and improving market efficiency.

The first Part of this comment provides a short-selling primer. Part II explains some of the risks and uncertainties associated with short sales. Next, Part III details the benefits brokerage firms gain from facilitating short sales. A deeper analysis in Part IV explores empirical data and addresses whether there is a social interest in protecting short sales. Finally, Part V proposes regulatory changes that may promote more informed short selling.

## II. AN INTRODUCTION TO SHORT SALES

A short seller will earn money if the price of the stock in which he invests declines.<sup>8</sup> At the most basic level, a short sale transaction operates as follows: First, an investor borrows from a lender the shares of a stock he intends to short and sells the shares on the open market at point A. When the investor wishes to close out the short sale, he buys back the shares of the stock on the open market at point B and delivers the purchased shares back to the stock lender. Excluding transaction costs, the

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HERITAGE, <http://www.european-heritage.org/netherlands/alkmaar/history-dutch-east-india-company-asian-part> (last visited Feb. 10, 2013).

4. Arturo Bris et al., *Efficiency and the Bear: Short Sales and the Market Around the World 1* (Yale ICF, Working Paper No. 02-45, 2004), available at <http://depot.som.yale.edu/icf/papers/fileuploads/2608/original/02-45.pdf>.

5. *Id.*

6. *Id.*

7. Jain et al., *supra* note 2, at 1.

8. The opposite of going "short" in a stock is to go "long" in a stock. An investor that is long in a stock will earn money if the price of the stock increases. *Long (or Long Position)*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/long.asp#axzz2KUrHCCNA> (last visited Feb. 10, 2013).

investor will earn money if the price of the stock at point B is lower than the price of the stock at point A.

Inserting numbers into the illustration presents us with the following. Assume that the investor wants to short sell 200 shares of Stock XYZ, which is trading at \$50 per share at point A. At point A, the investor will borrow 200 shares of XYZ from a lender and sell those shares on the open market and earn \$10,000 in cash (200 shares multiplied by \$50 per share). Then, the investor will close out his short position at point B. At point B, XYZ has declined in value to \$40 per share. The investor must purchase 200 shares of XYZ and deliver those shares back to the lender. Repurchasing 200 shares of XYZ at point B will cost the investor \$8,000 (200 shares multiplied by \$40 per share). The short seller earns \$2,000 from this investment—\$10,000 at point A when he sells the borrowed shares minus \$8,000 to repurchase the shares at point B.

The illustration above conveys the basic mechanics of a short-sale transaction. In practice, short selling is a strictly regulated investment strategy that involves multiple parties.

Before an individual investor can conduct a short sale, he must open a margin account with a brokerage firm.<sup>9</sup> Margin trading occurs when an investor borrows funds from a broker to complete a transaction.<sup>10</sup> The portion of the purchase price that the investor is required to deposit into the margin account is called “margin.” The margin is the investor’s initial equity in the account.<sup>11</sup> Federal Reserve Board Regulation T mandates that an investor deposit fifty percent of the total purchase price of each new stock in the margin account.<sup>12</sup> In addition to the fifty percent “initial” margin requirement, the margin trading regulations also contain a “maintenance” margin requirement. The Financial Industry Regulatory Authority (“FINRA”)<sup>13</sup> requires that an investor’s equity in the account stay above twenty-five percent “of the current mar-

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9. An alternative type of brokerage account is a “cash” account. An investor funds 100 percent of the cash account with his own capital. Short selling is not permitted in a cash account. *Cash Account*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/c/cashaccount.asp#axzz2KUrHCCNA> (last visited Feb. 10, 2013).

10. *Margin: Borrowing Money To Pay for Stocks*, SEC.GOV, <http://www.sec.gov/investor/pubs/margin.htm> (last visited Feb. 10, 2013).

11. *Purchasing on Margin, Risks Involved With Trading in a Margin Account*, FINRA.ORG, <http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/P005927> (last visited Feb. 10, 2013).

12. 12 CFR § 220.12 (2012).

13. The SEC delegated authority to FINRA, as a Self-Regulatory Organization, to oversee brokerage firms. “FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA’s mission is to protect America’s investors by making sure the securities industry operates fairly and honestly. All told, FINRA oversees about 4,290 brokerage firms, about 161,265 branch offices and approximately 630,390 registered securities

ket value of the securities in the account.”<sup>14</sup> Individual brokerage firms have the right to set maintenance margin requirements above twenty-five percent; and additionally, may raise their maintenance margin requirements for an account at any time.<sup>15</sup>

These regulations are detailed in a margin disclosure agreement provided by the broker to the investor before a margin account can be opened. The margin disclosure agreement explains some of the risks that are involved with margin trading.<sup>16</sup> The following section outlines a number of the risks of short selling and concludes with an in-depth look at one of the major risks a short seller faces: the short squeeze.

### III. SHORT SALE RISKS

#### A. *Market Risks: The Margin Call*

The monetary risk of short selling is theoretically unlimited. There is no upper bound to the price of a stock, and as the stock price rises, the short seller's losses rise with it.<sup>17</sup> Many brokerage firms have margin maintenance requirements between thirty and forty percent.<sup>18</sup> Therefore, as the price of the stock increases, the likelihood of a margin call increases as well. A margin call occurs when the investor's equity in the margin account falls below the margin maintenance requirement. To illustrate this, we can use the same figures as above and assume a margin account with only one security in it, XYZ. The investor wants to short sell 200 shares of XYZ, and XYZ is trading at \$50 per share at point A. Per Regulation T, the investor will be required to deposit \$5,000 of equity into the margin account (50% multiplied by (200 shares multiplied by \$50 per share)). Assuming the brokerage's margin maintenance requirement is forty percent, if the price of XYZ increases from \$50 per share to \$55 per share, the investor will be subject to a margin call. The call is triggered because the cost to cover the short position increases from \$10,000 (200 shares x \$50 per share) to \$11,000 (200 shares x \$55 per share). The \$1,000 increase in the cost to cover the

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representatives.” About the Financial Industry Regulatory Authority, FINRA.ORG, <http://www.finra.org/AboutFINRA/> (last visited Feb. 10, 2013).

14. Purchasing on Margin, Risks Involved With Trading in a Margin Account, FINRA.ORG, <http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/P005927> (last visited Feb. 10, 2013).

15. *Id.*

16. Margin Disclosure Statement, FINRA.ORG, <http://www.finra.org/web/groups/investors/@inv/@smart/@advanc/documents/investors/p005895.pdf> (last visited Feb. 10, 2013).

17. Patricia M. Dechow et al., *Short Sellers, Fundamental Analysis, and Stock Returns* 3 (May 1999), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=167154](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=167154). Conversely, the upside is limited. The price of a stock can only go as far down as \$0.00 per share. *Id.*

18. *Margin: Borrowing Money To Pay for Stocks*, SEC.GOV, <http://www.sec.gov/investor/pubs/margin.htm> (last visited Feb. 10, 2013).

short position adjusts the investor's equity in the account downward by \$1,000 to \$4,000. The adjusted margin percentage would be thirty-six percent (\$4000 equity / \$11,000 cost to cover).

Once the investor falls below the margin maintenance requirement, he will have to satisfy the margin call, which may occur in multiple ways. The investor may be forced to close out the transaction by repurchasing the shares on the open market at the increased price—in the above example, at a \$1,000 loss. Alternatively, the investor may be able to meet the margin call by depositing additional equity into the account to meet the forty percent maintenance margin requirement. Or, the brokerage firm may force the sale of other securities in the margin account to cover the deficiency.<sup>19</sup> As part of the margin disclosure agreement the investor agrees that the brokerage firm has the right to liquidate the securities without ever contacting the investor. The investor does not have the right to select which securities in the margin account are liquidated to meet the margin call.<sup>20</sup> Because the securities in the account act as collateral for the margin loan, the brokerage firm has the right to protect its interest as a lender and choose whichever securities it deems prudent for liquidation.<sup>21</sup> The brokerage firm may also increase its maintenance margin requirement at any time without prior notice to the investor, and the investor does not have a right to a time extension on a margin call.<sup>22</sup>

As demonstrated, margin trading affords an investor greater purchasing power through leverage; however, it also exposes the investor to greater risks. The next section discusses another risk of short selling: recall risk.

### B. Recall Risk

Brokerage firms hold their margin account holders' securities in "street name." This means that the brokerage firm will hold the certificates for any securities purchased and the brokerage firm will appear as the owner of the security on the issuer's books.<sup>23</sup> Although the investor is the "beneficial" owner of the securities, the brokerage firm possesses

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19. Margin Disclosure Statement, FINRA.ORG, <http://www.finra.org/web/groups/investors/@inv/@smart/@advanc/documents/investors/p005895.pdf> (last visited Feb. 10, 2013).

20. *Id.* ("Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.").

21. *Id.*

22. *Id.*

23. *Holding Your Securities – Get the Facts*, SEC.GOV, <http://www.sec.gov/investor/pubs/holdsec.htm> (last visited Feb. 10, 2013).

the right to lend its clients' securities to other investors.<sup>24</sup> Brokerage firms accumulate all the securities of their margin accounts into a fungible mass. Then, when a margin client wants to short a particular stock, the brokerage firm will lend the client the stock from the accumulated mass.<sup>25</sup>

The short seller is exposed to the risk that a margin account holder will request that his shares be delivered back to him in order to close out his long position or to transfer his shares to a cash account.<sup>26</sup> Accordingly, the broker reserves the right to recall the loaned shares at any time.<sup>27</sup> If the shares are recalled and the broker is unable to locate alternative shares to lend to the short seller, the short seller must close out the short position by purchasing the required shares on the open market.<sup>28</sup> This exposes the short seller to the possibility of closing the position at a significant loss.<sup>29</sup>

Section VII examines broker disclosures that may provide short sellers a better opportunity to predict the possibility of recall. Margin call and recall risk are functionally linked with the largest economic risk facing short sellers—the risk of a short squeeze.

### C. Short Squeeze Risk

Less than half a year after the collapse of Lehman Brothers<sup>30</sup> and the government bailout of the insurance giant AIG,<sup>31</sup> financial stocks were languishing and Citigroup was “arguably the weakest of the bunch.”<sup>32</sup> However, over a short period between March and April of 2009, shares of Citigroup increased over three hundred percent.<sup>33</sup>

Months earlier, amidst the collapsing financial sector and the sharp decline of the global markets, one company emerged temporarily as the

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24. E.g., *E\*Trade Securities Brokerage Customer Agreement*, ETRADE, <https://us.etrade.com/e/estation/help?id=1209031000> (last visited Feb. 10, 2013).

25. Robert C. Apfel et al., *Short Sales, Damages, and Class Certification in 10b-5 Cases* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 8618, 2001).

26. See Owen A. Lamont, *Go Down Fighting: Short Sellers vs. Firms* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 10659, 2004).

27. *Id.* at 3.

28. Ekkehart Boehmer, *Which Shorts are Informed?*, 63 J. FINANCE 491, 523 (2008).

29. *Id.*

30. *Lehman Brothers Files for Bankruptcy, Scrambles to Sell Key Businesses*, CNBC (Sep. 15, 2008), <http://www.cnbc.com/id/26708143>.

31. Press Release, Board of Governors of the Federal Reserve System, *Authorizing AIG Bailout* (Sep. 16, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

32. Joe Weisenthal, *Citigroup Higher on Hedge Fund Short Squeeze*, BUSINESSINSIDER (Apr. 14, 2009), <http://www.businessinsider.com/citigroup-higher-on-hedge-fund-short-squeeze-2009-4>.

33. *Id.*

most valuable company in the world.<sup>34</sup> On October 28, 2008, shares of Volkswagen peaked at over £1,005 per share.<sup>35</sup> Volkswagen's shares spiked by one hundred forty-seven percent in one day, and then increased by eighty-two percent the day after.<sup>36</sup>

Although Citigroup was a global banking leader and Volkswagen owned a strong line of automotive brands, these excessive gains could not be explained by the underlying fundamentals of the stocks. These two, not particularly rare,<sup>37</sup> events were classic examples of a short squeeze. A short squeeze is generally triggered by the upward movement of a stock, combined with the effects of margin calls and recalls, or simply the fear of possible margin calls and recalls.

Because a short seller has an outstanding obligation to deliver the shares he borrowed back to the lender, if the price of a shorted stock begins to rise, a few things may happen. First, the short seller may believe the stock will continue its upward momentum and to minimize his losses he will quickly cover his short sale by purchasing shares on the open market and delivering them back to the lender. As short sellers close out their positions, upward pressure is pushed onto the stock price.<sup>38</sup> Second, the short seller may be subject to a margin call, because as the stock price increases, the investor's equity in his margin account and his margin maintenance ratio decrease. A margin call often leads to a forced close out of the short position—the shorted stock faces more upward pressure.<sup>39</sup> Third, long investors interested in purchasing the stock as its price rises will add to the upward pressure on the stock.

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34. *Squeezey Money*, *ECONOMIST* (Oct. 30, 2008), <http://www.economist.com/node/12523898>.

35. *Id.*

36. Wei Xu & Baixiao Liu, *Short Squeezes* 3 (Nov. 2012), available at <http://ssrn.com/abstract=2019361>.

37. Other prominent short squeeze instances include the internet companies Yelp, Overstock and Amazon. On August 29, 2012 shares of Yelp increased by 23% when investors that bet against the company scrambled to close out their short positions when they realized that the end of Yelp's "lockup" period was not going to damage the stock. Steven Russolillo & David Benoit, *Short Sellers Cry Out for Yelp*, *WALL ST. J.*, Aug. 29, 2012, <http://online.wsj.com/article/SB10000872396390444914904577619441077234120.html>. On February 17, 2004, Overstock's CEO spent \$13 million on the open market purchasing 620,000 shares of Overstock's stock. This triggered a short squeeze, causing a 16% increase in Overstock's stock in one day. Justin Lahart, *Outside Audit: Overstock's Short Sellers May Have Overdone It*, *WALL ST. J.*, Mar. 12, 2004, <http://online.wsj.com/article/SB107904533621853135.html>. In June of 1998, Amazon announced a stock split. The share price jumped up in part because short sellers rushed to cover their positions because at the time Amazon's short interest neared its entire float. Dechow et al., *supra* note 17, at 4.

38. Matt Krantz, *Ask Matt: 'Short Squeeze' Can Cause Big Investor Pain*, *USATODAY* (May 27, 2013), <http://www.usatoday.com/story/money/columnist/krantz/2013/05/27/short-squeeze-telsa/2151663/>.

39. Lamont, *supra* note 26, at 26.



Operatively, these three events build upon each other and the result is a sharp rise in prices: a short squeeze.

How did the short sellers of Citigroup and Volkswagen fall victim to their respective short squeezes? In March 2009, Citigroup announced a plan to “convert its publicly listed preferred shares into common stock.”<sup>40</sup> Because Citigroup was offering favorable conversion terms to its preferred shareholders,<sup>41</sup> investors rushed to sell short the common shares,<sup>42</sup> while concurrently purchasing the preferred shares.<sup>43</sup> This arbitrage opportunity backfired on the short sellers. Citigroup delayed filing documents with the SEC outlining its conversion plan,<sup>44</sup> and it became evident that the conversion rate would not be the same for all investors.<sup>45</sup> As a result, many short sellers began to close their position, which put upward pressure on Citigroup’s stock price.<sup>46</sup> At the same time, shares of Citigroup were becoming more difficult to borrow because of the low stock price<sup>47</sup> and the high “short interest,” which represents the number of shares of a company that are sold short and not yet covered.<sup>48,49</sup> These factors led to more short sellers scrambling to cover their positions, perpetuating the short squeeze.

The Volkswagen short squeeze was triggered by the news con-

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40. David Enrich & John Jannarone, *Citi Prolongs ‘Squeeze,’ and NYSE Isn’t Helping*, WALL ST. J., Apr. 15, 2009, <http://online.wsj.com/article/SB123973914621017953.html>.

41. Andrew Bary, *Heavy Short Covering Boosts Citi Shares*, BARRONS (Mar. 18, 2009), <http://online.barrons.com/article/SB123739146137172035.html> (“Citi announced an exchange offer involving some \$25 billion of preferred held by the government under the TARP program, some \$12.5 billion of preferred held by a group of private investors, including Saudi Prince Alaweed, and \$14.9 billion of publicly held preferred.”).

42. Weisenthal, *supra* note 32.

43. Susan Pulliam & Jenny Strasburg, *Citi’s Rally Undermines Hedge Funds’ Trading Tack*, WALL ST. J., Mar. 19, 2009, <http://online.wsj.com/article/SB123741964887878187.html>.

44. *Id.*

45. Weisenthal, *supra* note 32.

46. Pulliam & Strasburg, *supra* note 43.

47. See Harlan D. Platt, *A Fuller Theory of Short Selling*, 5 J. ASSET MGMT. 49, 53 (2004) (“When a security’s price falls below a certain threshold, the brokerage firm may restrict future short sales, even if the security is held at the firm, because the firm reclassifies the security as nonmarginable. Some brokerage firms, depending on the individual firm’s policy, remove from their marginable-security list equities whose prices have fallen below either \$5 dollars or \$2 dollars per share. Moreover, some securities firms require investors to repurchase shares previously sold short if the price falls below their marginable level. Both rules make it difficult to short sell shares of low-priced securities.” Shares of Citigroup were trading below \$5.00 at the time.).

48. *Id.*

49. *Definition of “Short Interest”*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/s/shortinterest.asp#axzz2IiaLzAnA>, (last visited Feb. 10, 2013) (“Short interest is a market-sentiment indicator that tells whether investors think a stock’s price is likely to fall. Short interest can also be compared over time to examine changes in investor sentiment. Investors use short interest to make predictions about the direction a particular stock is headed, and to measure the bullishness or bearishness of investors’ sentiment towards the market as a whole.”).

tained in a press release entitled, “Porsche Heads for Domination Agreement.” Porsche announced that it had accumulated 74.1% of the shares of Volkswagen.<sup>50</sup> The German state Lower Saxony owned twenty percent of the shares of Volkswagen and indicated that they were not willing to sell their shares.<sup>51</sup> Therefore, the amount of Volkswagen’s shares available for trading—the “float”—was only six percent.<sup>52</sup> At that point in time, the percentage of tradable shares outstanding was 12.8%, more than double the float.<sup>53</sup> Porsche’s announcement caused the stock price to increase and short sellers scrambled to cover their positions. The result was an extreme short squeeze that made Volkswagen the most valuable company in the world for a short period of time. As a result, multiple hedge funds that had short positions with Volkswagen are currently in litigation with Porsche for alleged stock manipulation.<sup>54</sup> The plaintiffs allege that while Porsche was secretly accumulating shares, it publicly concealed its Volkswagen takeover plans, as well as directly assured the funds that it was only looking for a “slight, simple majority” of Volkswagen shares.<sup>55</sup> It was reported that Porsche earned over £30 billion from the short squeeze.<sup>56</sup>

After a short squeeze, the stock price often moves back down closer to its fundamental value. For example, Volkswagen’s stock price declined forty-five percent after it hit its peak.<sup>57</sup> However, for a short seller that is often too late. Brokerage firms mark to market the value of their clients’ margin accounts on a daily basis, so many clients will face a margin call long before the stock price reverts closer to its pre-short squeeze level, losing large amounts of money in a matter of minutes. The mechanics of margin trading is why a short squeeze poses such a high risk to short sellers.

Section VII proposes ways the SEC and other regulatory bodies can mitigate some of the risks of short sales. These proposals focus on the

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50. Press Release, Porsche SE, Porsche Heads for Domination Agreement (Oct. 26, 2008), available at <http://www.porsche-se.com/pho/en/press/newsarchive2008/?pool=pho%20%20&id=2008-10-26> (stating additionally, “Porsche has decided to make this announcement after it became clear that there are by far more short positions in the market than expected. The disclosure should give so called short sellers - meaning financial institutions which have betted or are still betting on a falling share price in Volkswagen - the opportunity to settle their relevant positions without rush and without facing major risks”).

51. Floyd Norris, *Reinventing the Short Squeeze*, INT’L HERALD TRIB., Oct. 31, 2008, at 11.

52. Xu & Liu, *supra* note 36, at 3.

53. *Id.*

54. Elliott Assocs. v. Porsche Automobil Holding, 759 F. Supp. 2d 469 (S.D.N.Y. 2010).

55. Julie Friedman, *In Morrison’s Wake, Hedge Funds Battle to Maintain Case Against Porsche*, THE AMERICAN LAWYER (ONLINE), Nov. 29, 2012, <http://www.litigationdaily.com/id=1202579853221>.

56. *Supra* note 34.

57. Xu & Liu, *supra* note 36, at 3.

regulations of issuing firms and brokerage firms. The following section focuses on the benefits that brokerage firms receive from facilitating short sales.

#### IV. BENEFITS TO THE BROKERAGE FIRM

Short-sale investments carry risk not only for the investor, but also for the brokerage firm. As such, brokerage firms require compensation in return for facilitating short sales. Of relevance to this article, the compensation takes the form of trading commissions, margin interest, and securities lending revenue. These are significant profit centers for brokerage firms.

Short sellers, on a per investor basis, are larger clients to brokerage firms than long-only investors.<sup>58</sup> According to a 2012 report, short sellers executed over four times as many stock trades over a six-year period than long-only investors.<sup>59</sup> Brokerage firms classify their traders as active or non-active traders. While twenty-six percent of retail short sellers are classified as active traders, only five percent of long-only investors are classified as active traders.<sup>60</sup> Additionally, the average market value of short sellers' accounts is more than double that of long-only investors.<sup>61</sup> Likewise, the average trade size of short sellers is also larger than the average trade size of long-only investors.<sup>62</sup>

Brokerages benefit greatly from active traders. The more trades a client makes, the more revenue the brokerage firm earns in the form of commissions. The ten largest discount brokerage firms earned, on average, a \$7.96 per-trade commission in 2012.<sup>63</sup> The reported commission per trade<sup>64</sup> ranged from \$4.95 to \$9.99.<sup>65</sup> Commissions and other per-trade transaction fees make up a significant portion of discount brokerage firms' annual revenues. For example, TD Ameritrade, E\*Trade, and Charles Schwab's commissions as a percentage of total net revenue were forty-five, twenty-one, and twenty percent respectively in 2011.<sup>66</sup>

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58. Keith Jacks Gamble & Wei Xu, *Informed Retail Investors: Evidence from Retail Shorts* 8 (Oct. 29, 2012), available at <http://ssrn.com/abstract=1919885>.

59. *Id.*

60. *Id.*

61. *Id.* ("The average value of short sellers' stock holdings is \$95,967 while the average value of the long-only investors' stock holdings is \$43,286.")

62. *Id.*

63. J. Alex Tarquinio, *Best and Worst Brokers of 2012*, SMARTMONEY (May 16, 2012), <http://www.smartmoney.com/invest/markets/smartmoneys-annual-broker-survey-23119/>. This is down from \$8.27 per trade in 2011.

64. Commission on a 100-share trade at \$20 per share. *Id.*

65. *Id.*

66. TD Ameritrade 2012 Form 10-K, available at [http://www.sec.gov/Archives/edgar/data/1173431/000119312512480655/d413018d10k.htm#toc413018\\_12](http://www.sec.gov/Archives/edgar/data/1173431/000119312512480655/d413018d10k.htm#toc413018_12); E\*Trade Fin. Corp. 2012 Form 10-K, available at <http://www.sec.gov/Archives/edgar/data/1015780/000119312512075584/>

Because short sellers, on average, are more active traders than long-only investors, their accounts generate more income for brokerage firms. Additionally, short sellers tend to close out their transactions at a rapid pace, which allows brokerage firms to earn in a short timeframe commissions on both the original sale of the borrowed shares and the subsequent repurchase of the shares.

Another significant profit source for brokerage firms is interest revenue. Interest revenue derives from both margin lending and securities lending—two activities made possible by margin account holders. A short seller must pay margin interest on the value of the funds he borrows to execute his trade. The average margin interest rate is approximately 7.15%.<sup>67</sup> This is not a cheap source of financing for the investor; by comparison, this rate is roughly 350 basis points higher than current thirty-year fixed mortgage rates.<sup>68</sup> Margin interest is based on the debit balance in the margin account and is calculated and compounded daily and charged monthly.<sup>69</sup>

Brokerage firms also generate income by participating in the securities lending market, acting as both securities lenders and securities borrowers. When an investor opens a margin account, he agrees that the brokerage firm may lend his shares to third parties.<sup>70</sup> Also, if a short seller's brokerage firm does not possess lendable shares of a security that the short seller wants to borrow, the brokerage firm will attempt to locate and borrow the shares from a third-party lender. When the brokerage firm lends its clients' securities, the borrower deposits cash collateral with the lender.<sup>71</sup> The lender is able to reinvest this collateral and generate income for the firm.<sup>72</sup> The lender will also pay a "rebate" to the securities borrower. The borrower can be thought of as a lender of

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d283628d10k.htm#toc283628\_39; The Charles Schwab Corp. 2012 Form 10-K, available at <http://www.sec.gov/Archives/edgar/data/316709/000119312512077926/d264447d10k.htm>.

67. Based on a survey of five discount brokers, as reported on Feb. 10, 2013. E\*Trade, available at <https://us.etrade.com/e/t/estation/pricing?id=1206010000>; TD Ameritrade, available at <https://www.tdameritrade.com/pricing/margin-and-interest-rates.page>; Scottrade, available at <https://advisor.scottrade.com/brokerage-services/margin-rates.aspx>; Charles Schwab, available at [http://www.schwab.com/public/schwab/investing/accounts\\_products/investment/margin\\_accounts](http://www.schwab.com/public/schwab/investing/accounts_products/investment/margin_accounts); Fidelity, available at <https://www.fidelity.com/trading/commissions-margin-rates>.

68. 30 Year Fixed Rate Mortgage, Overnight Average as of Feb. 10, 2013, BANKRATE.COM, <http://www.bankrate.com/>.

69. *Trade on Margin*, ETRADE.COM, <https://us.etrade.com/e/t/estation/help?id=1302000000#Understand3> (last visited Feb. 10, 2013).

70. E.g., TD Ameritrade Margin Handbook, at 14, available at [https://www.tdameritrade.com/retail-en\\_us/resources/pdf/AMTD086.pdf](https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD086.pdf) (last visited Feb. 10, 2013).

71. Normally equal to 102% of the market value of the securities. Christopher Geczy et al., *Stocks are Special Too: An Analysis of the Equity Lending Market*, 66 J. FIN. ECON. 241, 244 (2002).

72. E.g., *supra*, note 69. Individual investors are not entitled to any return on this investment. *Id.*

cash,<sup>73</sup> and the rebate is the interest he earns on his loan.<sup>74</sup> The rebate rate will be below the market rate for cash, so this spread is considered the “loan fee.” The rebate rate is negatively correlated with the degree of difficulty of locating the shares to borrow. If an investor seeks to borrow “hard-to-borrow” shares he may receive “little or no rebate, or even a negative rebate. In that instance, the borrower essentially pays the lender a rental fee for the privilege of borrowing the scarce security.”<sup>75</sup> Typically, “hard to borrow” shares have smaller capitalizations, smaller floats, smaller institutional ownership, and are in higher demand for borrowing.<sup>76</sup> These factors are important to keep in mind while examining regulations related to short sales because “hard-to-borrow” stocks pose higher recall and short squeeze risks to short sellers. Brokerage firms earn a significant portion of their income from margin lending and the related securities lending business. For example, in 2012, TD Ameritrade reported that it generated seventeen percent of its total net revenue by these activities.<sup>77</sup>

#### V. IS THERE A SOCIAL INTEREST IN PROTECTING SHORT SALES?

Short sellers bet against the market. At an instinctual level, something seems wrong, even unpatriotic, about this practice. These instinctually adverse feelings are reflected in the treatment of short sales throughout history—ranging from criminalization,<sup>78</sup> to outright bans,<sup>79</sup> to partial bans,<sup>80</sup> and consistently throughout, strict regulations. Despite these seemingly hostile views towards short sales, the bans are always eventually lifted. Moreover, regulators, political leaders, and industry

73. Geczy et al., *supra* note 71.

74. *Id.*

75. Karin LaBarge, *Securities Lending: Still No Free Lunch*, VANGUARD (July 2011), <https://institutional.vanguard.com/iam/pdf/ICRSL.pdf>.

76. Lamont, *supra* note 26, at 4.

77. TD Ameritrade 2012 Form 10K, available at [http://www.sec.gov/Archives/edgar/data/1173431/000119312512480655/d413018d10k.htm#toc413018\\_12](http://www.sec.gov/Archives/edgar/data/1173431/000119312512480655/d413018d10k.htm#toc413018_12).

78. Napoleon Bonaparte considered short sales treasons and had short sellers imprisoned. As recently as 1995, the Finance Ministry of Malaysia suggested that short sellers be punished by caning. *Short Selling: Marking the Ban*, INVESTOPEDIA (July 11, 2009), available at <http://www.investopedia.com/articles/stocks/09/short-selling-ban.asp#axzz2JqrIaU00>.

79. For example, Great Britain banned short selling in 1733 after the South Sea Company collapsed. America banned short selling during the War of 1812. *Id.* Recently, Spain implemented a ban on all short sales from July 2012 through January 2013. Sarah Jones, *Spanish Stocks Drop as Regulator Lifts Short-Selling Ban*, BLOOMBERG (Feb. 1, 2013), <http://www.bloomberg.com/news/2013-02-01/spanish-stocks-drop-as-regulator-lifts-short-selling-ban.html>.

80. The SEC banned short sales of financial stocks on September 19, 2008. Press Release, SEC, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets, (Sep. 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-211.htm>. The ban was lifted on October 3, 2008. Press Release, SEC, SEC Statement Lifting the Ban (Oct. 3, 2008), available at <http://www.sec.gov/news/press/2008/2008-238.htm>.

insiders, whether in favor of or against short sales, all agree that there is some role in the market for short sales. The question this comment attempts to answer is what role short sales play in the market and whether there is a social interest in providing greater protection for short sales.

In response to a question about the SEC's temporary ban of short sales of financial stocks in 2008, then-SEC Chairman Christopher Cox stated, "[k]nowing what we know now, I believe on balance the commission would not do it again. The costs [of the short-selling ban on financials] appear to outweigh the benefits."<sup>81</sup> Chairman Cox's statement is overwhelmingly supported by the academic research on short sales.<sup>82</sup> The section below examines the empirical data surrounding short sales. Research shows that short selling improves the market by promoting the flow of information and improving market efficiency.

#### A. *Increased Flow of Information*

The following case study exemplifies how short sales can increase the flow of socially beneficial information. On August 23, 2000, Enron's stock price reached its record high of \$90 per share.<sup>83</sup> In February 2001, Fortune Magazine named Enron the "Most Innovative Company in America" for the sixth consecutive year.<sup>84</sup> However, less than a year later, on December 2, 2001, Enron filed for Chapter 11 bankruptcy.<sup>85</sup> At the height of Enron's market success, James Chanos, a professional short seller, began scrutinizing Enron in October 2000,<sup>86</sup> and he helped bring to the forefront information that was instrumental in exposing one of Wall Street's biggest scandals.

Chanos' interest in Enron first began when he learned that the firm was using a "gain-on-sale" accounting method for its long-term energy trades.<sup>87</sup> As Chanos explained it, this accounting method "allows a com-

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81. Alessandro Beber & Marco Pagano, *Short Selling Bans Around the World* 31 (Aug. 2011), available at <http://ssrn.com/abstract=1502184>.

82. See, e.g., Jap Efendi et al., *Can Short Sellers Anticipate Accounting Restatements?* 4 (July 20, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=591361](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=591361); Pedro Saffi & Kari Sigurdsson, *Price Efficiency and Short Selling*, 24 REV. OF FIN. STUDIES 629, 822 (2011).

83. *Enron Timeline*, Hous. Chron., Jan. 8, 2004, <http://www.chron.com/business/enron/article/Enron-timeline-1983775.php>.

84. Bethany McClean, *Why Enron Went Bust Start with Arrogance. Add Greed, Deceit, and Financial Chicanery. What do you get? A company that wasn't what it was cracked up to be.*, CNNMONEY (Dec. 4, 2001), [http://money.cnn.com/magazines/fortune/fortune\\_archive/2001/12/24/315319/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2001/12/24/315319/index.htm).

85. *Supra* note 83.

86. *Developments Related to Enron Corp.: Hearing Before the House Comm. on Energy and Commerce*, (Feb. 6, 2002) (prepared statement of James S. Chanos), available at <http://www.actwin.com/kalostrader/EnronTestimony.htm>.

87. *Id.*

pany to estimate the future profitability of a trade made today, and book a profit today based on the present value of those estimated future profits.”<sup>88</sup> This is a concerning practice because aggressive managers can fabricate “earnings” by using advantageous assumptions about the trades.<sup>89</sup> However, if these projections do not pan out, the company using this accounting method would either have to adjust the previously reported earnings downward, or simply do another deal with more aggressive “earnings” assumptions to offset the downward adjustments.<sup>90</sup>

Chanos began short selling Enron stock in November 2000 after analyzing Enron’s 1999 Form 10-K filing.<sup>91</sup> Chanos noticed that Enron’s return on capital, before taxes, was only seven percent. He assumed that Enron’s cost of capital was around nine percent; therefore, despite reporting “profits,” Enron was likely losing money.<sup>92</sup> Chanos’ concerns about Enron continued to grow. In a sworn statement to the House Committee on Energy and Commerce, Chanos remarked:

We were also troubled by Enron’s cryptic disclosure regarding various “related party transactions” described in its 1999 Form 10-K as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June and September quarters. We read the footnotes in Enron’s financial statements about these transactions over and over again but could not decipher what impact they had on Enron’s overall financial condition. It did seem strange to us, however, that Enron had organized these entities for the apparent purpose of trading with their parent company, and that they were run by an Enron executive. Another disturbing factor in our review of Enron’s situation was what we perceived to be the large amount of insider selling of Enron stock by Enron’s senior executives. While not damning by itself, such selling in conjunction with our other financial concerns added to our conviction.<sup>93</sup>

Over the next few months, unsettling information continued to flow out of Enron. Multiple senior executives left the company, there was significant insider selling of Enron stock, the 2000 Form 10-K showed continued low return on capital and also reflected a number of large one-time gains that propped up Enron’s earnings.<sup>94</sup>

Chanos’ concerns were well founded. In October 2001, Enron

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88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

reported its first quarterly loss in four years—a loss of \$618 million.<sup>95</sup> The SEC began an investigation into the “related party transactions” and found that they were “a complex web of partnerships . . . designed to hide Enron’s debt.”<sup>96</sup> On December 2, 2001, Enron declared bankruptcy. Enron’s stock became valueless, about 5,600 Enron employees lost their jobs,<sup>97</sup> and investors lost billions of dollars. Chanos concluded his testimony by stating, “[w]hile short sellers probably will never be popular on Wall Street, they often are the ones wearing the white hats when it comes to looking for and identifying the bad guys.”<sup>98</sup>

Short selling provides an outlet for investors to express a pessimistic view. Short interest data can serve as a proxy for negative sentiment about a company. It is unrealistic to think that short selling can single-handedly prevent corporate fraud, but short selling data is essential information for the market. It is information that can help prevent investors from allocating their capital to unwise investments at inflated prices. Additionally, it is information that regulators can use as a proverbial canary in the coal of mine of corporate misconduct.

Although the Enron collapse was a front-page scandal, the fundamental mechanics that triggered the collapse were not unique. On a daily basis, the information gleaned from short selling data plays an essential role in the efficient functioning of the market. The usefulness of short selling data does not stop with its ability to help root out corporate fraud—a number of studies show that short sellers’ holdings are predictive of news announcements, unanticipated earning statements, and stock returns.

In one study, researchers analyzed 565 firms that announced financial statement restatements due to “accounting irregularities” from 1995 to 2002. The study found that there was a “statistically significant” level of short interest in the restating firms starting as far back as nineteen months before the announcements.<sup>99</sup> In the six months preceding the announcements, the short interest level increased significantly and peaked the month before the announcement.<sup>100</sup> Of particular interest, the researchers separated the firms into three different categories based upon the severity of the accounting irregularities. The results showed that the

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95. *The Rise and Fall of Enron: A Brief History*, CBCNEWS (May 25, 2006), <http://www.cbc.ca/news/business/story/2006/05/25/enron-bkgd.html>.

96. *Id.*

97. *Id.*

98. *Id.*

99. Efendi et al., *supra* note 82, at 4.

100. *Id.* at 21.



more severe the accounting irregularity, the greater the short interest level was.<sup>101</sup>

The authors of the study point out that this correlation between short interest levels and accounting restatements can be particularly useful to regulators in light of Section 404 of the Sarbanes-Oxley Act of 2002.<sup>102</sup> Section 404 “requires management and the external auditors to report on the adequacy of the company’s internal control over financial reporting.”<sup>103</sup> In a Staff Statement about Section 404, the SEC wrote:

An overall purpose of internal control over financial reporting is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, a central purpose of the assessment of internal control over financial reporting is to identify material weaknesses that have, as indicated by their very definition, more than a remote likelihood of leading to a material misstatement in the financial statements. While identifying control deficiencies and significant deficiencies represents an important component of management’s assessment, the overall focus of internal control reporting should be on those items that could result in material errors in the financial statements.<sup>104</sup>

Because short sale levels are predicative of accounting restatements, and accounting restatements provide evidence of weak financial reporting controls,<sup>105</sup> the SEC can use this information as a useful tool. A study by Jap Efendi and others recommends that auditors conduct more stringent examinations of companies’ accounting practices when short selling levels are high.<sup>106</sup>

Short sellers’ ability to make money is dependent on discovering overpriced stocks. As discussed, they often achieve this by scrutinizing financial statements and accounting reports to find mispricing.<sup>107</sup> In this respect, a short seller’s incentives are aligned with the incentives of financial regulators. Other industry players, upon whom the market relies to illuminate information about public companies, may not possess the same incentives. For example, financial analysts may hesitate to release negative news out of fear that corporate management will restrict

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101. For example, the most severe accounting irregularities prompted SEC investigations. *Id.* at 24.

102. *Id.* at 6.

103. Jiamin Wang, *Sarbanes-Oxley Section 404 Places Disproportionate Burden on Smaller Public Companies 1* (Aug. 2008), available at [http://www.heritage.org/about/staff/departments/center-for-data-analysis/~media/CDA/CDA\\_features/SOXCDAAedited3.ashx](http://www.heritage.org/about/staff/departments/center-for-data-analysis/~media/CDA/CDA_features/SOXCDAAedited3.ashx).

104. SEC Staff Statement on Management’s Report on Internal Control Over Financial Reporting (May 16, 2005), available at <http://www.sec.gov/info/accountants/stafficreporting.htm>.

105. Efendi et al., *supra* note 82, at 6.

106. *Id.*

107. *Id.* at 4.

information access to them in the future.<sup>108</sup> Additionally, analysts are supposed to report objective, unbiased analysis; however, many analysts work for large institutions with investment banking and brokerage departments that generally thrive on positive news.<sup>109</sup>

Paul Griffin of University of California Davis researched analyst behavior surrounding corrective earnings disclosures that led to allegations of securities fraud.<sup>110</sup> Griffin found that most analysts are reactive to bad news, rather than able to predict bad news.<sup>111</sup> The majority of analyst downgrades come after a firm releases a corrective disclosure.<sup>112</sup> Additionally, in the months following a corrective disclosure, the number of analysts covering those firms declines “significantly.” Griffin contends that this is because “analysts are less interested in following companies with bad news.”<sup>113</sup> Interestingly, the study finds that short sellers are “unusually active” in the months prior to a corrective disclosure.<sup>114</sup> Analysts, despite this public information coming from short sellers, “on average continue to issue optimistic forecasts until the event and/or the price change apparently trigger an adjustment.”<sup>115</sup> James Chanos understood the moral hazard that may drive the analyst behavior studied by Griffin. Chanos stated in his testimony about Enron to the House Committee on Energy and Commerce,

One analyst, while admitting that Enron was a “black box” regarding profits, said that, as long as Enron delivered, who was he to argue! It was clear to us that most of these analysts were hopelessly conflicted over the investment banking and advisory fees that Enron was paying to their firms. We took their “buy” recommendations, both current and future, with a very large grain of salt!<sup>116</sup>

The information contained in short sales is undoubtedly important to the market.

### B. Market Efficiency

In his 1975 book, *The Citizens and the State, Essays on Regulation*, Nobel Prize-winning economist George Stigler stated, “[s]o far as the efficiency and growth of the American economy are concerned, efficient

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108. Paul A. Griffin, *A League of Their Own? Financial Analysts' Responses to Restatements and Corrective Disclosures* 4 (Aug. 15, 2002), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=326581](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=326581).

109. *Id.*

110. *Id.* at 2.

111. *Id.* at 4.

112. *Id.*

113. *Id.* at ii.

114. *Id.* at 4.

115. *Id.* at 5.

116. *Supra* note 86.

capital markets are even more important than the protection of investors—in fact efficient capital markets *are* the major protection of investors.”<sup>117</sup> Extensive empirical literature concludes that short sales improve market efficiency. Efficiency is a broad term, but in the context of this comment efficiency refers to price efficiency and lower transaction costs.

Price efficiency can be defined as “the degree to which prices reflect all . . . available information.”<sup>118</sup> The primary measure of price efficiency is the speed at which prices reflect the available information.<sup>119</sup> Arturo Bris and Ning Zhu studied the effects of short sales on the speed of price discovery across forty-six different countries.<sup>120</sup> Bris and Zhu grouped the countries into four categories: countries where short selling was allowed before and throughout their research; countries where short sales were prohibited throughout their research; countries where short selling was allowed, but rarely used; and countries where short-sale regulations and practices changed during the course of their research.<sup>121</sup> Their cross-market research showed that constraints to short sales decreased the speed at which information is incorporated into stock prices. They concluded, “[m]arkets where short sales are allowed are more efficient because bad news appears to be more rapidly impounded into prices.”<sup>122</sup>

In a similar multi-country study, Pedro Saffi and Kari Sigurdsson also examined the effects of short sale constraints on the speed at which prices reflect available information.<sup>123</sup> Saffi’s and Sigurdsson’s dataset consisted of stocks from thirty-one different countries.<sup>124</sup> The researchers used the supply of lendable shares and loan fees as proxies for short sale constraints.<sup>125</sup> The lower the lending supply and the higher the loan fees, the greater the constraints on the short sale.<sup>126</sup> Saffi and Sigurdsson concluded that stocks with greater short sale constraints possessed diminished price efficiency.<sup>127</sup> A result of inefficient price discovery is that current market information only gradually flows into prices of the short sale-constrained stocks.<sup>128</sup>

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117. GEORGE STIGLER, *THE CITIZENS AND THE STATE, ESSAYS ON REGULATION* 88 (1975).

118. Saffi & Sigurdsson, *supra* note 82, at 822.

119. *Id.*

120. Bris et al., *supra* note 4, at 10.

121. *Id.* at 13–14.

122. *Id.* at 28.

123. Saffi & Sigurdsson, *supra* note 82, at 822.

124. *Id.* at 829.

125. *Id.* at 824.

126. *Id.* at 829.

127. *Id.* at 849.

128. *Id.* at 827.

Consistent with the findings above, additional research has shown that short sales help move share prices to levels in congruence with the underlying fundamentals of the stock.<sup>129</sup> By doing so, this decreases the number of investors that buy or sell at prices “not in accord with underlying economic realities.”<sup>130</sup> For example, research shows that when short sales are constrained, pessimistic investors are unable to participate in the market.<sup>131</sup> This leads share prices to be “biased upward” because the only valuations that are reflected are those of the more optimistic, unconstrained, long investors.<sup>132</sup> Former SEC Chairman Christopher Cox stated in July 2008, “we need the shorts in the market for balance so that we don’t have bubbles.”<sup>133</sup>

Some economists have theorized that the overpricing of Internet stocks in the late 1990s was due in part to short-sale constraints.<sup>134</sup> In a 2001 article for the National Bureau of Economic Research, two New York University economists studied 400 Internet stocks and their characteristics during the period of January 1, 1998 to February 29, 2000.<sup>135</sup> Unsurprisingly, given the highly publicized nature of the Internet “bubble” and subsequent crash, the economists found that the Internet stocks were trading at prices that exceeded their fundamentals. The weighted average price-to-earnings ratio of the 400 companies was 605.<sup>136</sup> In comparison, the price to earnings ratios of Google and eBay—two Internet stocks—at the end of 2012 were 21.89 and 25.63, respectively.<sup>137</sup> One could argue that the price-to-earnings ratio is a misleading metric because investors during the dotcom boom were investing based on potential future earnings of startup companies, not current earnings. However, to impute a price-to-earnings ratio of 20, “the internet sector would need to generate 40.6% excess returns for a 10-year period.”<sup>138</sup> In

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129. Douglas M. Branson, *Nibbling at the Edges – Regulation of Short Selling: Policing Failures to Deliver and Restoration of an Uptick Rule* 11 (Legal Studies Research Paper Series Working Paper No. 2009-23), available at <http://ssrn.com/abstract=1456440>.

130. *Id.*

131. Edward M. Miller, *Risk Uncertainty, and Divergence of Opinion*, 32 J. OF FIN. 1151, 1161 (1977).

132. *Id.*

133. Bradley Ziff & Carey Hsu, *The Effects Of Short Selling Public Disclosure Of Individual Positions On Equity Markets* 25 (Feb. 2011), available at [http://www.oliverwyman.com/pdf\\_files/OW\\_EN\\_FS\\_Publ\\_2011\\_Short\\_Selling\\_Public\\_Disclosure\\_Equity\\_Markets.pdf](http://www.oliverwyman.com/pdf_files/OW_EN_FS_Publ_2011_Short_Selling_Public_Disclosure_Equity_Markets.pdf).

134. See, e.g., Geczy et al., *supra* note 71, at 242; Eli Ofek & Matthew Richardson, *DotCom Mania: The Rise and Fall of Internet Stocks* 10 (Nat’l Bureau of Econ. Research, Working Paper 8630, 2001), available at <http://www.nber.org/papers/w8630>.

135. Ofek & Richardson, *supra* note 134, at 9.

136. *Id.* at 14.

137. Google PE Ratio, YCHARTS, [http://ycharts.com/companies/GOOG/pe\\_ratio](http://ycharts.com/companies/GOOG/pe_ratio) (last visited Feb. 10, 2013); EBay PE Ratio, YCHARTS, [http://ycharts.com/companies/EBAY/pe\\_ratio](http://ycharts.com/companies/EBAY/pe_ratio) (last visited Feb. 10, 2013).

138. Ofek and Richardson, *supra* note 134, at 14.

support of their theory that short-sale constraints played a role in the Internet bubble, Ofek's and Richardson's research showed that Internet stocks were more difficult to short because of high loan fees and low lending supply.<sup>139</sup>

An article published by the Federal Reserve Bank of New York points out that as we saw with the Internet bubble, market forces will likely correct the mispricing of stocks in the long run, but in the short-term, capital will continue to flow into overpriced stocks and their underlying corporations.<sup>140</sup> This misallocation generates social costs that extend beyond simply diminished shareholder equity.<sup>141</sup> The parties involved with these corporations—the “employees, customers, suppliers, and lenders”—were directly affected by the market correction and the subsequent failures of many of the corporations.<sup>142</sup> These consequences trickled down into the overall economy.

Another factor used to determine whether a market is efficient is the transaction costs associated with trading in that market. Academic literature suggests that when constraints to short sales are reduced, transaction costs decrease.<sup>143</sup> One reason for this is that short selling increases the number of potential sellers in the market.<sup>144</sup> As a result, this makes the completion of trades more likely because there is more liquidity in the market.<sup>145</sup> As liquidity increases, the transaction costs of trading decreases, which leads to increased efficiency.<sup>146</sup>

Researchers have been able to use short sale bans from around the world as a natural experiment to test this hypothesis. From September 19, 2008 to October 8, 2008, the SEC banned short selling in financial companies.<sup>147</sup> In the same article published by the Federal Reserve Bank of New York previously discussed, the authors studied the empirical data related to this ban.<sup>148</sup> They estimated that during the period of the ban, transaction costs in the equities option market increased by \$500 million.<sup>149</sup>

A similar study from 2009 found that the relative bid-ask spreads of

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139. *Id.* at 26–27.

140. Robert Battalio et al., *Market Declines: What is Accomplished by Banning Short Selling?* 18 *CURRENT ISSUES IN ECONS. & FIN.* 1, 2 (2012).

141. *Id.*

142. *Id.*

143. Seraina Gruenewal, *Short Selling Regulation After the Financial Crisis—First Principles Revisited*, 7 *INT'L J. OF DISCLOSURE AND REG.* 108, 134 (2010).

144. *Id.*

145. *Id.*

146. *Id.*

147. Battalio et al., *supra* note 140, at 1.

148. *Id.*

149. *Id.*

the banned stocks increased by thirty-two basis points, on average.<sup>150</sup> The economists that conducted the study estimated that the increase in bid-ask spreads caused an increase in transaction costs in the equity market of more than \$600 million.<sup>151</sup> Additionally, these actual costs do not account for the costs of “mutually beneficial trades that did not occur because of the inflated liquidity costs.”<sup>152</sup>

From 2007 to 2009, regulators around the world implemented some form of constraints or bans on short selling.<sup>153</sup> Beber and Pagano examined the effects of these bans on liquidity in thirty countries.<sup>154</sup> Using bid-ask spreads as a proxy for liquidity, the researchers found that the constraints and bans led to “statistically significant” increases in bid-ask spreads—negatively affecting liquidity.<sup>155</sup> This in turn, slowed down price discovery.<sup>156</sup> The negative consequences of short-sale bans were not limited to the United States. On September 18, 2008, the Financial Services Authority—Britain’s equivalent of the SEC—initiated a ban on short selling of financial stocks.<sup>157</sup> Ian Marsh and Richard Payne examined the effects. The results of their research were consistent to what was observed in the United States. They concluded:

Once the ban was enacted differences become very apparent: liquidity drains from the order book for financials to a much larger extent than for non-financials; transactions costs for small and large trades increase much more dramatically and trading volumes fall much more dramatically for financials than non-financials; and our measures suggest that market quality deteriorated much more for financials than non-financials. None of these moves would appear to be in line with the objectives of regulators.<sup>158</sup>

## VI. REGULATORY ISSUES

In a 2010 Final Rule the SEC wrote, “we recognize the benefits to the market of legitimate short selling, such as the provision of liquidity and price efficiency.” Regulators currently agree with the empirical data that short sales are a critical component of the financial markets. The question, therefore, is what regulatory changes can be implemented to reduce some of the risks and uncertainties that are associated with short

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150. The bid-ask spread often serves as a proxy for liquidity. *Id.* at 6.

151. *Id.* at 1.

152. *Id.* at 6.

153. Beber & Pagano, *supra* note 81, at 3.

154. *Id.*

155. *Id.* at 21.

156. *Id.* at 4.

157. Ian Marsh & Richard Payne, *Banning Short Sales and Market Quality: The UK’s Experience 2* (July 2010), available at <http://ssrn.com/abstract=1645847>.

158. *Id.* at 4.

sales? In answering this question, this comment focuses on regulations of both issuers and brokerage firms. There is evidence of issuers using manipulative corporate strategies to battle short sellers. The next section details these strategies and suggests ways regulators can minimize these corporate tactics. The section thereafter suggests additional information brokerage firms can disclose to investors to help reduce some of the uncertainty associated with short sales.<sup>159</sup>

### A. *Issuer Share Repurchases*

Like short sales, issuer-share repurchases is a controversial practice. Share repurchases, or stock buybacks, is when a public company uses its cash to buy back its own shares.<sup>160</sup> Generally, the company repurchases the shares on the open market. To facilitate the discussion of why repurchases pose a risk to short sales and whether they should be more closely regulated to ensure market efficiency, it is necessary to take a brief look at the data surrounding the efficacy and the social costs and benefits of share repurchases.

In a letter to Berkshire Hathaway shareholders in 2000, Warren Buffett wrote,

There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds—cash plus sensible borrowing capacity—beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively-calculated.<sup>161</sup>

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159. There are currently two primary regulatory constraints to short selling: the ban on “naked” short selling and the “alternative uptick rule.” This Comment does not propose any changes to these regulations, but they are briefly described here. When a short seller does not borrow, or arrange to borrow, the shares he plans to short sell in time to make delivery to the buyer within the required settlement period of three days this is considered a naked short sale. Naked short selling is a violation of Rule 203 of Regulation SHO and can result in disgorgement and penalties. SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, SEC.gov (Apr. 10, 2012), <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>; See Press Release, SEC, Short Selling Brothers Agree to Pay \$14.5 Million to Settle SEC Charges (Jul. 17, 2012), available at <http://www.sec.gov/news/press/2012/2012-137.htm>. In 2010, the SEC amended Rule 201 of Regulation SHO to include what is known as the “alternative uptick rule.” Final Rule Amending Rule 201 of Regulation SHO, Release No. 34-61595, available at <http://www.sec.gov/rules/final/2010/34-61595.pdf>. Under the rule, if a stock price declines by ten percent or more in a single day a circuit breaker kicks in and short sales of that stock are prohibited until the following trading day. *Id.* at 1. The SEC’s stated purpose for this rule is to “prevent short sellers from using short selling as a tool to exacerbate a declining market in a security.” *Id.* at 45.

160. Definition of “Share Repurchase,” INVESTOPEDIA, <http://www.investopedia.com/terms/s/sharerepurchase.asp#axzz2Je3ZaGBh> (last visited Feb. 10, 2013).

161. Letter from Warren Buffett, Chairman of the Board of Berkshire Hathaway, to Berkshire Hathaway Shareholders (Mar. 1, 2000), available at <http://www.berkshirehathaway.com/letters/1999htm.html>.

Optimized capital allocation is essential for efficient markets. Capital is optimally allocated when investors purchase stocks that are trading at prices close to their fundamental value and when corporate managers make investment decisions that promote the long-term growth of their companies. Empirical data suggests that share repurchase programs fail to meet either of these two objectives.<sup>162</sup>

Share repurchases has been a growing practice in recent years. From 2003 to 2007, the average repurchases per S&P 500 company grew by more than four times—from \$300 million on average in 2003 to \$1.2 billion in 2007.<sup>163</sup> From 1997 through 2008, 438 companies on the S&P 500 spent a total of \$2.4 trillion on stock buybacks.<sup>164</sup>

Issuers buy back their shares for a number of reasons, some of which are positive, and some arguably not so positive for the overall efficiency of the market. One positive reason behind buybacks is if a company truly believes that its shares are undervalued and that the expected returns on the buyback investment exceeds the expected returns on an alternative investment. For example, in September 2011, Berkshire Hathaway announced that it would buy back its own shares for the first time in over forty years.<sup>165</sup> The company released the following statement: “In the opinion of our board and management, the underlying businesses of Berkshire are worth considerably more than this amount, though any such estimate is necessarily imprecise. . . . If we are correct in our opinion, repurchases will enhance the per-share intrinsic value of Berkshire shares.”<sup>166</sup> The share price of Berkshire Hathaway surged by eight percent on the day the announcement was made.<sup>167</sup>

Berkshire Hathaway’s experience demonstrates that share repurchases often lead to a short-term increase in stock price. Access to this tool by corporate managers can lead to moral hazard problems and deci-

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162. Nelson D. Schwartz, *As Layoffs Rise, Stock Buybacks Consume Cash*, N.Y. TIMES, Nov. 22, 2011, at A1.

163. William Lazonick, *How Stock Buybacks Strangle Innovation and Job Creation*, NEXT NEW DEAL: THE BLOG OF THE ROOSEVELT INSTITUTE (Jun. 30, 2011), <http://www.nextnewdeal.net/how-stock-buybacks-strangle-innovation-and-job-creation>.

164. The Buyback Boondoggle, BUSINESSWEEK (Aug. 13, 2009), [http://www.businessweek.com/magazine/content/09\\_34/b4144096907029.htm](http://www.businessweek.com/magazine/content/09_34/b4144096907029.htm).

165. Jason Zweig & Jonathan Cheng, *Buffett Spots Fresh Bargain: Shares in His Own Company*, WALL ST. J., Sep. 27, 2011, <http://online.wsj.com/article/SB10001424052970204831304576594582853871222.html>. Berkshire Hathaway repurchased shares valued at over \$1.2 billion. Kelly Scott, *Warren Buffett Completes Buyback and Finds Berkshire Share Valuation Attractive*, CHAPWOOD FINANCE (Dec. 13, 2012), <http://www.chapwoodfinance.com/warren-buffett-completes-buyback-and-finds-berkshire-share-valuation-attractive/>.

166. Andrew Frye, *Berkshire to Buyback Shares as Cash Tops \$40B*, BLOOMBERG (Sept. 26, 2011), <http://www.bloomberg.com/news/2011-09-26/berkshire-to-repurchase-shares-saying-stock-is-undervalued.html>.

167. Zweig & Cheng, *supra* note 165.



sions that are suboptimal from a long-term growth and market efficiency perspective. In the same 2000 letter to Berkshire Hathaway investors, Buffett went on to state, “repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price.”<sup>168</sup> As the evidence below indicates, this can be an effective way to combat short sales. Before exploring the effects buybacks may have on short sales, however, it is important to understand how buybacks can affect the performance of a stock’s price and metrics and the market as a whole.

Managers can use buyback programs to improve the metrics of a stock that investors and analysts use to evaluate a firm. For example, if an issuer buys back any of its shares, its “earnings per share” will automatically increase. Earnings per share, calculated by dividing a company’s net income by the average number of outstanding shares, is a metric used to measure a company’s profitability. By repurchasing shares on the open market, the company is decreasing the number of tradable shares, thereby increasing the earnings per share.<sup>169</sup> Analysts often use the earnings per share metric when evaluating a stock and may make “buy” recommendations when a company’s earnings per share improves. Additionally, earnings per share is sometimes a metric upon which an executive’s bonus is based. Charles Elson, the director of the John L. Weinberg Center for Corporate Governance at the University of Delaware remarks that this kind of bonus structure is a “clear . . . conflict of interest” because “unless earnings per share are adjusted to reflect the buyback, [the bonus] does not purely reflect performance.”

In addition to improving earnings per share figures, when a company buys back its shares, it often causes the share price to increase for multiple reasons. First, it “signals” to the market that the company believes its share price is undervalued. Second, it decreases the supply of tradable shares in the market. If demand stays constant, a decrease in supply will lead to an increase in share price. Corporate managers have a strong interest in keeping their stock price high. Over the past thirty years, executive compensation in the form of stock options has risen precipitously. In 1980, the average CEO received less than twenty percent of her annual compensation in the form of stock options.<sup>170</sup> Today, the average value of annual stock options granted exceeds the average CEO’s salary and bonus combined.<sup>171</sup> Volumes can be written about the

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168. Buffett, *supra* note 161.

169. *Earnings Per Share – EPS*, INVESTOPEDIA, <http://www.investopedia.com/terms/e/eps.asp#axzz2Kch00Ehg> (last visited Feb. 11, 2013).

170. Andrew Balls, *Executive Stock Options*, NAT’L BUREAU OF ECON. RESEARCH, <http://www.nber.org/digest/dec98/w6674.html> (last visited Feb. 10, 2013).

171. *Id.*

efficacy of performance-based compensation, but for the purposes of this comment, it is important to simply understand that corporate executives have personal incentives to keep their company's stock price high.

At first blush, an inflated stock price seems beneficial to shareholders. But data shows that in the long run stock repurchases have detrimental effects on the value of a company.<sup>172</sup> By using cash on hand to purchase their own stock, companies are making the choice not to allocate capital to improving their business. Harvard Business School professor, and former Medtronic CEO, William W. George stated, "it's a symptom of a deeper problem, which is a lack of investment in the long term. If we're not investing in research, innovation and entrepreneurship, we're going to be a slow-growth country for a decade."<sup>173</sup> There is clear evidence of major companies investing in their own stock, rather than the future of their own employees. In 2011, Pfizer laid off 1,100 employees and cut its research budget.<sup>174</sup> In November of the same year, Pfizer announced that it estimated to spend between \$7 billion and \$9 billion on stock buybacks that year.<sup>175</sup> In June 2011, Campbell Soup announced plans to lay off 770 employees. Five days earlier, it announced plans to repurchase \$1 billion in stock.<sup>176</sup> Similarly, less than three months after announcing a \$10 billion share repurchase plan, Hewlett Packard eliminated 500 jobs in 2011.<sup>177</sup> The outlook for the longer-term success of companies that make these kinds of capital allocation decisions is questionable. Research by Fortuna Advisors reinforces this trend, showing that from 2001 through 2011 "companies that spent the most on repurchases had a total shareholder return of 37% versus 127% for companies that spent the least."<sup>178</sup>

Any market activity that may lead to increased share prices will have a detrimental effect on short sales. On a daily basis, short sales are tangentially affected by the decisions corporate managers make. The relevant question for the purposes of this article is whether there is more than just a tangential relationship between share repurchases and short sales. A 2011 study by Texas A&M researchers Harrison Liu and Edward P. Swanson suggests that there is.<sup>179</sup>

Liu and Swanson examined data on 4,081 firms from 2003 to 2009

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172. Schwartz, *supra* note 162.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.*

179. Harrison Liu et al., *Do Corporate Managers Trade Against Short Sellers* (Sept. 1, 2011), available at <http://ssrn.com/abstract=1899354>.

to determine “whether managers increase the amount of capital allocated to repurchasing stock in order to counteract an increase in short interest.”<sup>180</sup> The authors used publicly reported monthly short interest data and quarterly share repurchase data.<sup>181</sup> They compared the change in quarterly share repurchases to the change in quarterly short interest.<sup>182</sup> The authors found that “changes in corporate share repurchases are strongly positively associated with contemporaneous changes in short interest.”<sup>183</sup> The data showed that for each one percent increase in short interest, the quarterly share repurchases increased by \$1,140,000.<sup>184</sup> The correlation between short interest and repurchases was shown to be as strongly, and sometimes more strongly, correlated than a number of factors typically associated with repurchases, including stock performance, available cash, and debt levels.<sup>185</sup>

One can infer that corporate managers use the short-term share price increase that typically follows buybacks to squeeze short sellers. This tactic may help the company’s stock price in the short-term, but the results seem to be negative in the long run. Research from the University of Chicago’s Owen Lamont shows that “when firms take anti-shortening actions, their stock returns are extraordinarily low over the subsequent months and years.”<sup>186</sup> Corporate managers might be aware of this correlation, as evidenced by additional research Liu and Swanson conducted on corporate managers’ personal trades. Liu and Swanson analyzed the relationship between corporate managers’ personal insider trades and short interest and share repurchase data. While presenting the paper to American Accounting Association’s annual meeting in 2011, Swanson pointed out:

Managers may act in opposition to short-sellers with the company’s money, but, when their own money is at stake, their trades typically are a reflection of short interest; in other words, at the same time that they’re buying shares with the company’s money, they’ll be selling shares on their own account. . . . The dirty little secret that our study uncovers is that corporate managers commonly use company money

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180. *Id.* at 2.

181. *Id.* at 13.

182. *Id.* (“One advantage of this design is that actions by managers and shorts that occur within a relatively narrow time period (i.e., a quarter) are more likely to be causally related.”).

183. *Id.* at 4.

184. *Id.* at 5 (“This trading is unlikely to result from reverse causation whereby short sellers react to corporate repurchases (i.e., endogeneity) because (1) short sellers have no incentive to increase their position when a company is buying back its shares, and (2) information about corporate share repurchases is reported quarterly, so it is not available to shorts in a timely manner.”).

185. Ben Haimowitz, Recap of Corporate Stock Repurchases Paper, AM. ACCOUNTING ASS’N, [http://aaahq.org/newsroom/CorporateStockRepurchases\\_10\\_9\\_11.htm](http://aaahq.org/newsroom/CorporateStockRepurchases_10_9_11.htm) (last visited Feb. 10, 2013).

186. Lamont, *supra* note 26, at 28.

to fight short-sellers but are perfectly content to trade in concert with them when the money comes out of their own pockets.<sup>187</sup>

The results of Liu's and Swanson's research suggest that corporate managers use the short-term increase in stock price that typically follows a stock buyback to squeeze short sellers.

### B. *Other Potentially Manipulative Issuer Actions*

In addition to share repurchase programs, issuers use other potentially manipulative practices to fight short sales. The primary practice this comment addresses is when issuers manipulate the securities lending market for their shares. The following case study provides a good illustration of this practice. Engineer John Rendall, founder of the company Solv-Ex, boasted in an advertisement for his company in the Wall Street Journal: "You've probably never heard of us. You soon will because our technology will reduce American dependence on Middle East Oil."<sup>188</sup> Rendall founded Solv-Ex in 1980 "on the idea of developing a new technology to extract a tarlike-substance called bitumen from tar sands."<sup>189</sup> The idea was to further refine the bitumen into crude oil.<sup>190</sup> Solv-Ex raised "several million dollars" through a number of private offerings and an initial public offering.<sup>191</sup>

Solv-Ex claimed in 1995 that the technology it created had allowed it to develop "about four billion barrels of oil and one billion tons of aluminum."<sup>192</sup> Naturally, based on analysts' buy recommendations, Solv-Ex's stock price began to rise. One of London's oldest investment banks, Morgan Grenfell predicted, "Solv-Ex, between now [1995] and 2008, will be the fastest-growing oil company in the world."<sup>193</sup>

Some short sellers, however, did not believe the hype. Well-known short seller, Manuel Asensio scrutinized the company. He went as far as conducting interviews with employees and performing "aerial reconnaissance."<sup>194</sup> Asensio's conclusion: Solv-Ex was "perhaps the greatest blizzard of way-over-the-top pumpery I have ever witnessed."<sup>195</sup>

The analysts at Morgan Grenfell were wrong, and Asensio was correct. Solv-Ex's technology had never actually left the research and

187. Haimowitz, *supra* note 185.

188. FRANÇOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 100 (2007).

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

195. MANUEL ASENSIO & JACK BARTH, SOLD SHORT: UNCOVERING DECEPTION IN THE MARKETS 81 (2001).

development stage.<sup>196</sup> Solv-Ex had never produced any commercially viable crude oil.<sup>197</sup> In July 1997, Solv-Ex was removed from the New York Stock Exchange and filed for Chapter 11 bankruptcy.<sup>198</sup>

Solv-Ex successfully defrauded its long investors by using shareholder letters. Solv-Ex also employed a letter to shareholders to manipulate the lending market for its shares to trigger a short squeeze.<sup>199</sup> On February 5, 1996, Solv-Ex faxed a letter to its shareholders and their brokers that stated, "To help you control the value of your investment . . . we suggest that you request delivery of the Solv-Ex certificates from your broker as soon as possible."<sup>200</sup> The goal, which Solv-Ex achieved, was to convince shareholders to remove their shares from the stock-lending market. As previously discussed, when lenders recall their shares, short sellers are obligated to deliver their borrowed shares back to the lender, or alternatively, find new shares to borrow. In less than twenty days, Solv-Ex's stock price surged by forty-two percent.<sup>201</sup> By constraining short sales, Solv-Ex had artificially inflated its stock price above its fundamental value. But these fraudulent actions intended to squeeze out shorts are not unique to Solv-Ex.

A similar event occurred in 2001, when the CEO of GenesisIntermedia sent a letter to shareholders suggesting that they reach out to their brokers and request that they move their shares of GenesisIntermedia stock from their margin accounts to their cash accounts.<sup>202</sup> In part, the letter read, "if enough stock is taken out of street name and margin accounts, short sellers will have difficulty maintaining the current volume of short sales."<sup>203</sup> In an interview with the L.A. Times, GenesisIntermedia's CFO stated:

I think that after our chairman sent out his letter, our shareholders started to take possession of some of their shares, forcing the shorts to cover their positions. . . . There also may be upward pressure on the stock from people seeing the letter and then buying in anticipation that the short squeeze will get more dramatic.<sup>204</sup>

In the thirty days following the letter, GenesisIntermedia's stock price

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196. *Id.*

197. *Id.*

198. Lamont, *supra* note 26, at 2.

199. *Id.*

200. *Id.*

201. \$24.875 on Feb. 2, 1996 to 35.375 on Feb. 21, 1996. *Id.*

202. *Id.* at 25.

203. Jerry Hirsch, *Genesis Puts Squeeze on Stock Bears*, L.A. TIMES, May 11, 2001, <http://articles.latimes.com/2001/may/11/business/fi-62068>.

204. *Id.*

rose by thirty-nine percent, squeezing out numerous investors with short positions in the process.<sup>205</sup>

## VII. PROPOSED REGULATORY CHANGES

### A. Regulation of Issuers

The SEC must take a harder look at corporations when they repurchase shares or take actions that influence the lending market for their shares. According to the SEC,

A fundamental goal of the federal securities laws is the prevention of manipulation. Manipulation impedes the securities markets from functioning as independent pricing mechanisms, and undermines the integrity and fairness of those markets. Congress granted the Commission broad rulemaking authority to combat manipulative abuses in whatever form they might take.<sup>206</sup>

Recognizing the potential for “manipulative abuses” through share repurchases, the SEC in 1982 adopted Rule 10b-18, which “provides a voluntary ‘safe harbor’ from liability for manipulation” under Sections 9(a)(2),<sup>207</sup> 10(b), and Rule 10b-5 of the Securities Exchange Act of 1934 (“Exchange Act”).<sup>208</sup>

Rule 10b-18 provides four conditions the repurchases must meet in order to fall within the safe harbor.<sup>209</sup> First, the purchases must be conducted through a single broker each day.<sup>210</sup> Second, the purchase must not be the opening transaction of the day, nor may the purchase take place less than thirty minutes before the markets close.<sup>211</sup> Third, the purchases must be at a price that “does not exceed the highest independent bid or the last independent transaction price, whichever is higher, quoted or reported . . . at the time the Rule 10b-18 purchase is effected.”<sup>212</sup> Fourth, an issuer may only purchase up to twenty-five percent of the average daily trading volume of its shares.<sup>213</sup>

The SEC notes that even if an issuer’s repurchases “technically sat-

205. Lamont, *supra* note 26, at 25.

206. SEC Final Rule Amending Regulation M, Release Nos. 33-7375; 34-38067, available at <http://www.sec.gov/rules/final/34-38067.txt>.

207. 14 Fletcher Cyc. Corp. § 6852 (“Section 9(a) of the Securities Exchange Act of 1934 prohibits the manipulation of security prices through various sham transactions intended to induce the purchase or sale of any registered security.”)

208. SEC Division of Market Regulation, *Answers to Frequently Asked Questions Concerning Rule 10b-18 (“Safe Harbor” for Issuer Repurchases)*, SEC.gov (Nov. 17, 2004), <http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm>.

209. 17 CFR § 240.10b-18 (2012).

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

isfy” the Rule 10b-18 safe harbor conditions, the issuer may still violate the anti-fraud and anti-manipulation provisions of the Exchange Act. The safe harbor is not available if “the repurchases are made as part of a manipulative scheme to influence the closing price of a company’s securities, or are done to mask other motives, such as inflating or manipulating short-term earnings.”<sup>214</sup> When an issuer repurchases its shares with the primary intent to prop up its stock price and squeeze short sellers, it impedes the “securities markets from functioning as independent price mechanisms.” In its 2010 proposed rule to amend Rule 10b-18,<sup>215</sup> the SEC wrote, “Rule 10b-18’s safe-harbor conditions are designed to minimize the market impact of the issuer’s repurchases, thereby allowing the market to establish a security’s price based on independent market forces without undue influence by the issuer.”<sup>216</sup> It is critical that the SEC abides by its words. When an issuer repurchases its shares with the primary intent to combat short sales, it hinders the market’s ability to establish security prices in line with underlying fundamental values. Likewise, when an issuer artificially causes the lending supply of its shares to be constrained, independent market forces are unable to fairly affect share prices. The SEC’s stated mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”<sup>217</sup> In pursuit of its mission, the SEC should more closely scrutinize these manipulative practices.

### B. *Regulation of Brokerage Firms*

The educated investor understands that a short sale is a risky investment. He understands that there is chance that the market might move against him, that his borrowed shares may be recalled at any time, and relatedly, that he may get caught in a short squeeze. Before he decides to initiate the transaction, he will attempt to calculate the risk-adjusted return of the short sale and compare it to available alternative investments. There are countless moving variables involved in the stock market, and there is no way to account for all of them. However, the lending supply of particular stocks is one important variable that short sellers can use to better calculate the riskiness of their potential investments. Brokerage firms have access to this information, but are not currently

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214. *Supra* note 208.

215. The amendments were promulgated to clarify and modernize the safe harbor provisions. Proposed Rule Amending Rule 10b-18, Release No. 34-61414, 2010, available at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.

216. *Id.*

217. SEC, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC.gov, <http://www.sec.gov/about/whatwedo.shtml> (last visited Feb. 10, 2013).

required to disclose it. This information will not reduce the “risks” associated with short sales, but it will reduce some of the “uncertainty.” The likely result will be an increase in the number of informed short sales in the market.

University of Chicago economist Frank Knight<sup>218</sup> is best known for his 1921 book, *Risk, Uncertainty, and Profit*, in which he theorizes about the distinction between “risk” and “uncertainty.”<sup>219</sup> According to Knight, risk applies to situations where the ultimate outcome is unknown, but one can accurately measure the odds of an outcome occurring. Uncertainty, on the other hand, applies to situations where one does not possess sufficient information to accurately predict the odds to begin with.<sup>220</sup>

The relevance of this distinction to short sales is that Knightian uncertainty may lead to non-participation. An uncertainty-averse investor will allocate more of his capital into an investment that possesses a “distribution of returns he is more confident” about.<sup>221</sup> Peter Dizikes of MIT News explains this theory in the context of financial firms:

Investment banks that in recent years regarded their own apparently precise risk assessments as trustworthy may have thought they were operating in conditions of Knightian risk, where they could judge the odds of future outcomes. Once the banks recognized those assessments were inadequate, however, they understood that they were operating in conditions of Knightian uncertainty—and may have held back from making trades or providing capital, further slowing the economy as a result.<sup>222</sup>

Empirical evidence shows that short sales play an important role in the market. To reduce the number of informed short sellers that choose not to participate in the market, this comment recommends requiring brokerage firms to disclose information that will mitigate some of the uncertainty that surrounds share recalls.

FINRA should require that brokerage firms disclose to their clients, on a dynamic basis, the number of lendable shares the firm has available of a particular security. In a survey of five online brokerage firms, only

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218. Frank Knight served as George Stigler’s thesis advisor at University of Chicago. George Stigler, *Autobiography*, NOBELPRIZE.ORG, [http://www.nobelprize.org/nobel\\_prizes/economics/laureates/1982/stigler-bio.html](http://www.nobelprize.org/nobel_prizes/economics/laureates/1982/stigler-bio.html) (last visited Feb. 10, 2013).

219. Peter Dizikes, *Explained: Knightian Uncertainty*, MITNEWS (June 1, 2010), <http://web.mit.edu/newsoffice/2010/explained-knightian-0602.html>.

220. *Id.*

221. Astrid V. Schornick, *Irrelevance of Short Sale Constraints Under Ambiguity Aversion 3* (Aug. 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=676648](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=676648).

222. Dizikes, *supra* note 219.



one firm discloses this information to its clients.<sup>223</sup> The four surveyed firms that do not disclose this information<sup>224</sup> are the four largest online brokerage firms by number of clients.<sup>225</sup> This is important information for an investor because recall risk is negatively correlated with loan supply.

Along similar lines, if a brokerage firm does not have in its own supply shares available to lend, the firm will often borrow the shares from a third-party securities lender. As discussed in Section IV, if there is limited lending supply, the security is considered “hard to borrow.” Brokerage firms should be required to disclose to their clients whether the shares they deliver to the short seller come from their own supply or a third party and whether the shares were considered “hard to borrow.” This information will reduce the uncertainty associated with short sales and hopefully encourage informed investors to participate in the short sale market.

### VIII. CONCLUSION

Short sales have remained controversial since the formation of the first publicly traded company over 400 years ago. However, there should be no debate over the importance of short sales. Short sales play a critical role in the market because, as the empirical data concludes, they bring valuable information to the market, drive prices closer to fundamental reality, and lower the costs of trading. Regulators should take steps to better protect short sales by actively scrutinizing potential manipulative practices of issuers, and by requiring brokerage firms to increase informational disclosures.

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223. Interactive Brokers discloses this information via its “Short Stocks Availability Tool.” Telephone interview with Interactive Brokers Broker (Feb. 8, 2013).

224. TD Ameritrade, Charles Schwab, E\*Trade, and Scottrade. Telephone Interviews with Brokers from TD Ameritrade, Charles Schwab, E\*Trade, and Scottrade (Feb. 8, 2013).

225. Largest Online Brokerage Firms in US. Biggest Stock Broker Companies in 2013, *BROKERAGEREVIEW*, <http://www.brokerage-review.com/stock-brokers/largest-brokerage-firms.aspx> (last visited Feb. 10, 2013).