

REVIEW OF THE POLICY DEBATE OVER SHORT SALE REGULATION DURING THE MARKET CRISIS

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I. INTRODUCTION

This article summarizes the recent history of short sale regulation, and academic research on the subject. It then discusses the impact of the market crisis beginning in 2007 on short sale regulation, the current debate over the Securities and Exchange Commission's ("SEC") revisions to Regulation SHO, and a general issue of public perception of risk and regulatory policy in complex financial markets.

II. OVERVIEW OF SHORT SALE REGULATION

Short sales serve three purposes. First, traders use short sales to profit from anticipated declines in stock prices, selling borrowed shares at a high current price and hoping to repay the loan with shares purchased at a subsequent lower price. Second, market makers, responding to incoming buy orders for stocks they do not have in inventory, sell shares that they do not possess but can acquire within designated settlement periods as part of their market-making function. Third, short sales are an important component of complex electronic trading and hedging strategies; for example, to manage overall portfolio risk, participants combine long positions that increase in value as prices increase with short positions increasing in value as prices go down.

Short sales in market making or complex trading and hedging strategies do not target anticipated declines in the price of stocks; they facilitate transactions by others, or are part of a broader technique based on the relative prices of different securities. These now constitute the largest share of short selling, especially as electronic trading comprises such a large share of market activity.

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For example, Credit Suisse notes that only 0.7 percent of hedge funds' short sales are "dedicated shorts," or designed to profit from anticipated declines in specific stock prices.¹

"Dedicated short" selling, however, generates the most attention in regulatory debates. Those defending short selling maintain that short sellers improve markets by investigating and disclosing information about over-valued stocks.² Corporate issuers, holders of particular stocks, or other parties maintain, however, that short sellers, by selling at progressively lower prices, spreading negative rumors about companies, and other manipulative methods, commonly *induce* stock price declines by concerted short selling rather than *correct* inflated prices.

Market declines historically produce calls for tighter controls on short selling. In 1932 J. Edward Meeker reviewed how this debate was an important part of financial crises going back hundreds of years,³ and Charles Jones discussed how the debate played out in the 1930s and in the market declines in 2008.⁴ In 1938 the SEC issued Rule 10a-1 under the Securities Exchange Act, prohibiting short sales of exchange-listed securities at levels below the last sale price, or at the last sale price "unless that price was above the next preceding different price" (a zero-plus tick); the purpose was to prevent short sellers from driving prices down through sales at progressively lower prices.⁵

The Securities and Exchange Commission reviewed recent history of short sale regulatory proposals in a 1999 concept release.⁶ The SEC's *Report of the Special Study of the Securities Markets* in 1963 suggested that short sale regulation "did not prevent the harmful effects of short selling that the rules were designed to prevent," but acknowledged that the data to support such conclusions needed improvement.⁷ In 1976, the SEC proposed temporary suspensions of short sale pricing rules to permit analysis of how the markets

¹ CREDIT SUISSE, WHAT HAPPENED WHEN TRADERS' SHORTS WERE PULLED DOWN 5 (2008).

² DAVID EINHORN, FOOLING *SOME* OF THE PEOPLE *ALL* OF THE TIME: A LONG SHORT STORY 355 (2008).

³ J. EDWARD MEEKER, SHORT SELLING 151 (1932).

⁴ Charles M. Jones, Shorting Restrictions: Revisiting the 1930's 1-2 (Oct. 2008) (unpublished manuscript, on file with Columbia Business School), available at http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3233/JonesShortingRestriction_s4a.pdf.

⁵ 4 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 443 (5th ed. 2005).

⁶ Short Sales, 64 Fed. Reg. 57,996, 57,998 (proposed Oct. 28, 1999) (to be codified at 17 C.F.R. pt. 240).

⁷ *Id.*

would function without them.⁸ Eight of the twelve comments on the proposal, including those by the New York Stock Exchange (“NYSE”) and Amex, opposed the suspensions, arguing that even temporary relaxation of short sale restrictions would damage the markets. The SEC withdrew the proposal in 1980.

The House Committee on Government Operations issued a report on short selling in 1991.⁹ The report said that short selling benefited the equity market, but that short sale regulation through the uptick test should be retained and an equivalent rule applied to the NASDAQ OTC market.¹⁰ The committee report said that many complaints about short selling reflected a poor understanding of how short selling actually operated, but also that there was some evidence of abusive short selling through spreading of rumors.¹¹ The report said that the investing public overestimated short sellers’ manipulative powers, but public misperception itself increased short selling’s effects because investors’ reactions reinforced short sellers’ activities.¹² The committee called for more disclosure of general statistics on short selling and large individual short positions.¹³ Since the 1991 report, the National Association of Securities Dealers (“NASD”) adopted a short sale bid test to restrain short selling, and the NYSE and NASD required members to report additional data on their short positions.¹⁴

The SEC’s 1999 concept release solicited comments on major revisions of short sale regulation.¹⁵ It raised the idea of removing short sale price tests when markets had risen by a large amount; the reasoning was that short sales are most likely to benefit markets by restraining bubbles, and short sellers were least likely to be able to manipulatively drive down prices in rising markets. (The year 1999 was the peak of the internet bubble.)¹⁶ It requested comment on price test exceptions for actively traded securities; focusing short sale regulation on specific events, such as mergers, acquisitions, and tender offers; and exempting hedging transactions

⁸ Short Sales of Securities, 41 Fed. Reg. 56,530, 56,530 (proposed Dec. 28, 1976) (to be codified at 17 C.F.R. pt. 240).

⁹ H.R. REP. NO. 102-414, pt. 1 (1991).

¹⁰ *Id.* at 21–22.

¹¹ *Id.* at 8, 14.

¹² *Id.* at 15.

¹³ *Id.* at 23.

¹⁴ Short Sales, 64 Fed. Reg. 57,996, 57,999 (proposed Oct. 28, 1999) (to be codified at 17 C.F.R. pt. 240).

¹⁵ *Id.* at 57,996.

¹⁶ *Id.* at 58,000.

from short sale regulation.¹⁷ It also discussed modifying short sale regulation given developments such as after-hours trading and decimalization, revising the definitions of short sales, extending short sale regulation to listed securities in the Over-the-Counter (“OTC”) markets, and also eliminating short sale regulation entirely.¹⁸

After receiving 2,778 comment letters on the 1999 concept release, the SEC proposed a major revision of short sale regulation in 2003.¹⁹ The proposed Regulation SHO followed certain SEC enforcement actions related to short selling in 2003 and the SEC staff had alluded to the upcoming revision of short sale regulation in its report on hedge funds in September 2003.²⁰ It noted, in footnote 269 of the hedge fund report, that

[a]mong the most common trading practices used by hedge fund advisers is short selling. The staff makes no recommendations to the Commission regarding short selling at this time, but notes that it is currently considering recommending that the Commission propose rule amendments that would modernize short sale regulation designed to target areas of abuse, including naked short selling. (“Naked” short selling generally refers to a sale of securities when the seller does not own the securities sold and makes no arrangements to borrow the securities in order to make delivery on the sale.) The amendments would also be designed to ease regulatory restrictions where they are unnecessary or inhibit beneficial short selling.²¹

III. REGULATION SHO AND EARLY AMENDMENTS

In 2004 the SEC adopted Regulation SHO, after receiving 462 comment letters on the 2003 proposal. Regulation SHO defined ownership for short sale purposes, clarified rules for determining net aggregate short sale positions, required that sales be marked as long, short, or “short exempt,” and strengthened Regulation M

¹⁷ *Id.*

¹⁸ *Id.* at 57,999, 58,002–03.

¹⁹ Short Sales, 68 Fed. Reg. 62,972, 62,976–78, 63,007–09 (Nov. 6, 2003) (to be codified at 17 C.F.R. pts. 240 & 242).

²⁰ Rachel McTague, *SEC to Consider Staff Proposal to Update Short Sale Regulation*, 35 Sec. Reg. & L. Rep. (BNA), 1750, 1751 (Oct. 20, 2003).

²¹ U.S. SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 79 n.269 (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

governing short selling in connection with securities offerings.²² A new Rule 203 targeted naked short selling by requiring broker-dealers to locate securities available for borrowing prior to effecting short sales.²³ The rule made some exceptions for the locate requirement, including short sales by registered market makers in connection with bona-fide market making.²⁴ The rule also imposed additional requirements on threshold securities, or securities where for five consecutive settlement days there were aggregate fails to deliver of 10,000 shares or more per security, where the level of fails was equal to one-half of one percent of the issuer's total shares outstanding, and the security was included on a list published by an SRO.²⁵ The rule required a participant of a registered clearing agency to close out a fail to deliver that had remained open for thirteen consecutive days by purchasing securities of like kind and quantity, and prohibited the participant and any broker-dealer for which it cleared transactions from effecting further short sales in the threshold security until the failed position was closed out.²⁶ The requirement to close out fail to deliver positions in threshold securities did not apply to positions that were established prior to the security becoming a threshold security.²⁷

Regulation SHO also established a one year pilot that suspended the tick test under Rule 10a-1 for about one third of the stocks in the Russell 3000, for sales in securities in the Russell 1000 index executed after 4:15 P.M., and for sales in all other securities between the closing and the next day opening of the consolidated tape the next day.²⁸ The Regulation SHO announcement said that “[t]he Commission’s Office of Economic Analysis (“OEA”) will gather and analyze data during the pilot period to assess trading behavior in the absence of short sale price restrictions. Additionally, researchers are encouraged to provide the Commission with their

²² Short Sales, 69 Fed. Reg. 48,008, 48,008, 48,009, 48,010, 48,020 (Aug. 6, 2004) (to be codified at 17 C.F.R. pts. 240–42); U.S. Sec. & Exch. Comm’n, Div. of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (last visited Feb. 2, 2010) [hereinafter SEC, Responses].

²³ Short Sales, 69 Fed. Reg. at 48,014; SEC, Responses, *supra* note 23.

²⁴ Short Sales, 69 Fed. Reg. at 48,014.

²⁵ *Id.* at 48,016.

²⁶ *Id.* at 48,016, 48,017–18.

²⁷ *Id.* at 48,018.

²⁸ *Id.* at 48,009, 48,013; Order Suspending the Operation of Short Sale Price Provisions for Designated Securities and Time Periods, 69 Fed. Reg. 48,032, 48,032, 48,033–34 (Aug. 6, 2004).

own empirical analyses of the pilot.”²⁹

In 2007, the OEA’s analysis of the pilot concluded, subject to cautions, that

[w]e find no evidence of “bear raids” associated with the pilot. . . . Our evidence suggests that removing price restrictions for the pilot stocks has had an effect on the mechanics of short selling, order routing decisions, displayed depth, and intraday volatility, but on balance has not had a deleterious impact on market quality or liquidity.³⁰

The academic analyses of the pilot cited by the SEC concluded that “[t]he evidence therefore suggests unambiguously that such tests should be removed”³¹; “this study lends support . . . to the SEC’s recent decision to abolish the uptick rule”³²; “c[an] safely be suspended permanently”³³; and “removal of the uptick rule makes short selling a more effective tool for keeping prices in line with their efficient values.”³⁴ Any adverse effects cited by the studies, such as slight increases in volatility, were not large enough to offset the benefits of removing the price test.³⁵ The SEC then did remove the tick test, with compliance due on July 6, 2007.³⁶

The SEC, on the same day that it voted unanimously to repeal the tick test (August 14, 2007), also tightened Regulation SHO in one key respect. As noted earlier, Regulation SHO’s requirement to close out fail to deliver positions in threshold securities did not apply to positions that were established prior to the security becoming a threshold security.³⁷ The SEC voted unanimously to repeal this “grandfather provision,” extending the closeout

²⁹ Short Sales, 69 Fed. Reg. at 48,009.

³⁰ OFFICE OF ECON. ANALYSIS, U.S. SEC. & EXCH. COMM’N, ECONOMIC ANALYSIS OF THE SHORT SALE PRICE RESTRICTIONS UNDER THE REGULATION SHO PILOT 56 (2007), available at http://www.sec.gov/news/studies/2007/regsho_pilot020607.pdf.

³¹ Gordon J. Alexander & Mark A. Peterson, *The Effect of Price Tests on Trader Behavior and Market Quality: An Analysis of Reg SHO*, 11 J. FIN. MARKETS, 84, 109 (2008).

³² Lynn Bai, *The Uptick Rule of Short Sale Regulation—Can it Alleviate Downward Price Pressure from Negative Earnings Shocks?*, 5 RUTGERS BUS. L.J. 1, 62 (2008).

³³ Karl Diether et al., *It’s SHO Time! Short-Sale Price-Tests and Market Quality*, 64 J. FIN. 37, 72 (2009), available at <http://www.cob.ohiostate.edu/fin/faculty/werner/papers/Its%20SHO%20Time!.pdf>.

³⁴ Ekkehart Boehmer & J. Wu, *Short Selling and the Informational Efficiency of Prices* 14 (Jan. 8, 2009) (unpublished manuscript), available at www.terry.uga.edu/finance/docs/boehmer_short_selling.pdf.

³⁵ Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348, 36,352–53 (July 3, 2007) (to be codified at 17 C.F.R. Parts 240 and 242).

³⁶ *Id.* at 36,348, 36,350.

³⁷ See *supra* note 28 and accompanying text.

requirements to such positions, on the grounds that “large and persistent fails to deliver may have a negative effect on the market in these securities” and because of ongoing concerns about “extended fails to deliver in connection with ‘naked’ short selling.”³⁸ Acknowledging some risks of the change, such as increased volatility, reduced liquidity, and potential manipulation, the SEC argued that “we believe the benefits of requiring that fails to deliver not be allowed to continue indefinitely justify these potential effects. In addition, we believe that such effects, if any, would be minimal.”³⁹ The SEC’s Office of Economic Analysis, after subsequently analyzing this amendment, concluded that it had reduced fails to deliver among non-optionable securities.⁴⁰ Fails to deliver in optionable securities, however, had increased, with one explanation being that

the investors who previously failed to deliver in the equity market have now moved to the options market to establish a synthetic position. Since the option market makers still enjoy an exception to the close-out rule and tend to hedge their positions in the equity markets, the fails may now be coming from the option market makers instead of the equity investors themselves.⁴¹

IV. RESEARCH ON THE EFFECTS OF SHORT SALES AND SHORT SALE REGULATION PRIOR TO THE MARKET CRISIS OF 2008

The vast majority of academic studies of short sale regulation, several of which include as-yet unpublished working papers, have emphasized short selling’s benefits and have been wary of restraints on it. In addition to the papers submitted to the SEC regarding its pilot suspension of the price test, Akbas et al. concluded that “our evidence suggests that short sellers act as specialized monitors who generate value-relevant information in the stock market.”⁴² Balasubramanian and Cyree indicated that short sellers credibly

³⁸ Amendments to Regulation SHO, 72 Fed. Reg. 45,544, 45,544 (proposed Aug. 14, 2007) (to be codified at 17 C.F.R. pt. 242).

³⁹ *Id.* at 45,548.

⁴⁰ Memorandum from Office of Economic Analysis on Impact of Recent SHO Amendment on Fails to Deliver to File 1 (June 9, 2008), *available at* <http://www.sec.gov/comments/s7-19-07/s71907-562.pdf>.

⁴¹ *Id.*

⁴² Ferhat Akbas et al., Why Do Short Interest Levels Predict Stock Returns? (Jan. 31, 2008) (unpublished manuscript), *available at* <http://ssrn.com/paper=1104850>.

monitor banks through their trading behavior.⁴³ Boehme et al. concluded that diverse investor opinion and low restraints on short selling diminish overvaluation of stocks,⁴⁴ and Boehmer et al. stated that “short sellers are important contributors to efficient stock prices.”⁴⁵ Examining broad short sale trends, Lamont and Stein wrote that

aggregate short-selling tends to increase in bear markets, which perhaps makes it all the easier for people to blame the messenger. However, according to our interpretation of this evidence, the problem is not too much short-selling in falling markets . . . but rather, too little in rising markets. If this view is correct, any regulatory efforts to constrain short-selling are likely to be misguided.⁴⁶

Boehmer et al., after studying the effects of repealing the tick test, said that “we do not find any evidence that this more aggressive shorting activity destabilizes stock prices in any way, and in fact short sellers seem to be even more important contributors to efficient share prices after the uptick rule is removed.”⁴⁷ Citing numerous studies, Jones wrote that

[t]he empirical evidence is absolutely uniform. . . . [I]n [the] aggregate short sellers appear to trade based on (and be well-informed about) fundamentals, and they earn excess returns. When short sellers’ information is not incorporated into prices because shorting is costly, difficult, or prohibited, the evidence indicates that stocks can get overvalued.⁴⁸

Other studies of short selling have reached similar conclusions.⁴⁹

⁴³ Bhanu Balasubramanian & Ken B. Cyree, *Market Monitoring of Banks: Do Short Sellers Monitor Banks?* 1 (Jan. 11, 2008) (unpublished manuscript), available at <http://ssrn.com/paper=1089865>.

⁴⁴ Rodney D. Boehme et al., *Short-Sale Constraints, Differences of Opinion, and Overvaluation*, 41 J. FIN. & QUANTITATIVE ANALYSIS 455, 485 (2006).

⁴⁵ Ekkehart Boehmer et al., *Which Shorts Are Informed?*, 63 J. FIN. 491, 491 (2008).

⁴⁶ Owen A. Lamont & Jeremy C. Stein, *Aggregate Short Interest and Market Valuations*, 94 AM. ECON. REV. 29, 31–32 (2004).

⁴⁷ Ekkehart Boehmer et al., *Unshackling Short Sellers: The Repeal of the Uptick Rule* 19 (Dec. 11, 2008) (unpublished manuscript), available at <http://www2.gsb.columbia.edu/faculty/cjones/UptickRepealDec11.pdf>.

⁴⁸ Charles M. Jones, *Shorting Restrictions: Revisiting the 1930’s* 2 (Oct. 2008) (unpublished manuscript), available at <http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3233/JonesShortingRestrictions4a.pdf>.

⁴⁹ Arturo Bris, *Short Selling Activities in Financial Stocks and the SEC July 15th Emergency Order*, (Aug. 12, 2008) (unpublished manuscript), <http://www.imd.ch/news/upload/Report.pdf>; Eric Chang et al., *Short-Sales Constraints and Price Discovery: Evidence from the Hong Kong Market*, 62 J. FIN. 2097, 2097 (2007); Anchada Charoenrook & Hazem Daouk, *A Study of Market-Wide Short-Selling Restrictions* (Jan. 2005) (unpublished manuscript), available at <http://www.ssrn.com/paper=687562>; Asher Curtis &

An article by attorneys that was highly critical of naked short selling nevertheless commented that “[d]espite the risks associated with it, traditional short selling has positive benefits for securities markets. The SEC has documented the market benefits associated with traditional short selling and sanctioned the practice. The two main benefits usually associated with traditional short selling are increased market liquidity and pricing efficiency.”⁵⁰

On the other hand, Shkilko et al. reported that their study “confirms theoretical predictions and anecdotal evidence on price-destabilizing short selling” and “contributes to existing literature by identifying a[n] . . . unexplored class of short sellers, the class that exacerbates market frictions and creates temporary liquidity shortages.”⁵¹ Another analysis of the SEC’s Regulation SHO pilot reported that “lifting the tick-test rule goes beyond correcting stock overvaluation and is associated with stock undervaluation, suggesting that the SEC’s recent decision . . . may not be considered as an optimal policy if such undervaluation is driven by predatory short sellers’ price manipulation.”⁵² Overall, most of the empirical studies, with a small number of exceptions, accent short selling’s benefits to pricing efficiency; the few exceptions suggest that it can destabilize prices and lead stocks to be undervalued under some conditions.

V. THE 2007–2009 MARKET CRISIS AND SHORT SALE REGULATION

The stock market decline beginning in November 2007 and other events connected with the credit crisis intensified the political and economic debate over short selling. As noted above, even those emphasizing short selling’s benefits indicate that it can increase market volatility, so the sharp rise in volatility in 2007 (see the VIX Volatility Index figure below) emerging almost simultaneously with the repeal of the tick test made short selling a target.

Neil Fargher, *Does Short-Selling Amplify Price Declines or Align Stocks with Their Fundamental Values?* 32 (Dec. 2008) (unpublished manuscript), available at <http://ssrn.com/paper=817446>.

⁵⁰ James W. Christian et al., *Naked Short Selling: How Exposed Are Investors?*, 43 HOUS. L. REV. 1033, 1042 (2006).

⁵¹ Andriy Shkilko et al., *Price-Destabilizing Short Selling* 33 (Nov. 2, 2007), available at <http://www.degroot.mcmaster.ca/faculty/rsconference/documents/PredatoryShortSelling.pdf>.

⁵² Min Zhao, *The Tick-Test Rule, Investors’ Opinions Dispersion, and Stock Returns: The Daily Evidence* (Oct. 2007) (unpublished manuscript), available at <http://www.ssrn.com/paper=1026396>.

As in past market downturns, issuing corporations and other parties blamed short sellers for driving down prices of financial and other firms, and especially for the collapse of Bear Stearns and Lehman Brothers. Those defending short selling argued that short sellers exposed financial firms' serious underlying problems, that the market crisis and economic uncertainty had increased volatility, and that any asserted causal link between the repeal of the tick test and increased volatility was spurious.

On July 15, 2008, the SEC voted to require anyone executing a short sale in the securities of nineteen major financial companies to arrange beforehand to borrow the shares; three days later it exempted certain bona fide market makers, certain sales of

restricted securities, and syndicate offerings.⁵³ The SEC extended the rule through August 12 after it would have expired on July 29.⁵⁴ A study from Professor Arturo Bris of IMB in Switzerland, dated August 12, then argued that the order had reduced market quality.⁵⁵

On September 19, the SEC announced a temporary emergency ban of short selling in the securities of 799 financial companies, saying that “[t]his emergency action should prevent short selling from being used to drive down the share prices of issuers even where there is no fundamental basis for a price decline other than general market conditions.”⁵⁶ The order provided a limited exception for bona fide market makers, and, on the same day, the Division of Trading and Markets asked the Commission to exempt “hedging activities by exchange and over-the-counter market makers in derivatives on the securities covered by the order.”⁵⁷ The Financial Services Authority in the United Kingdom announced a similar ban on short selling.⁵⁸ A press release by the SEC said:

The Securities and Exchange Commission today announced a sweeping expansion of its ongoing investigation into possible market manipulation in the securities of certain financial institutions. The expanded investigation will include obtaining statements under oath from market participants.

Hedge fund managers, broker-dealers, and institutional investors with significant trading activity in financial issuers or positions in credit default swaps will be required, under oath, to disclose those positions to the Commission and provide certain other information.

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⁵³ Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166, 93 SEC Docket 2122 (July 15, 2008).

⁵⁴ Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,248, 93 SEC Docket 2389 (July 29, 2008).

⁵⁵ Arturo Bris et al., *Efficiency and the Bear: Short Sales and Markets Around the World*, 62 J. FIN 1029, 1029 (2008).

⁵⁶ Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592, 94 SEC Docket 460 (Aug. 25, 2009).

⁵⁷ Press Release, U.S. Sec. & Exch. Comm'n, Statement of SEC Division of Trading and Markets (Sept. 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-213.htm>.

⁵⁸ Press Release, Fin. Serv. Auth., FSA Statement on Short Positions in Financial Stocks (Sept. 18, 2008), available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml>.

“Investors have a right to know that the rule of law is being enforced and that our capital markets are not being manipulated,” said SEC Chairman Christopher Cox. “We are working together with our regulatory partners at NYSE Regulation and FINRA in order to quickly identify, isolate and aggressively prosecute any violations of the federal securities laws during this period of market turmoil.”

Linda Chatman Thomsen, Director of the SEC’s Division of Enforcement, added, “Abusive short selling, market manipulation and false rumor mongering for profit by any entity cuts to the heart of investor confidence in our markets. Such behavior will not be tolerated. We will root it out, expose it, and subject the guilty parties to the full force of the law.”

The Commission’s actions follow recent reports of trading irregularities and allegations of false rumor mongering, abusive short selling and possible manipulation of financial stocks.⁵⁹

The SEC approved certain technical amendments to the emergency orders two days later, including allowing exchanges to add to the list of companies in which short selling was temporarily banned.⁶⁰ The ban expired on October 8, with other elements of the emergency order set to expire on October 17.⁶¹

As the SEC was temporarily banning short sales, New York State Attorney General Andrew Cuomo announced a “wide ranging” investigation into short selling, saying that “I want the short sellers to know . . . that I am watching.”⁶² He said that he had received a “significant number of complaints,” although not disclosing the origin of the complaints, and that the federal government “has been ineffective when it comes to regulating these markets.”⁶³

In mid-October 2008, the SEC issued several related rules. It adopted an interim final temporary rule, through August 1, 2009, requiring certain institutional investment managers to make non-

⁵⁹ Press Release, U.S. Sec. & Exch. Comm’n, SEC Expands Sweeping Investigation of Market Manipulation (Sept. 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-214.htm>.

⁶⁰ *SEC Amends Emergency Order; Revisions Allow Exchanges to Expand Covered Stocks*, 40 Sec. Reg. L. Rep. (BNA) 1535, 1535 (Sept. 29, 2008).

⁶¹ *SEC Order Banning Short Sales in Financial Company Stocks to End 10/8*, 40 Sec. Reg. L. Rep. (BNA) 1583, 1583 (Oct. 8, 2008).

⁶² *Cuomo Launches Civil, Criminal Probe of Short Sales, Faults Federal Response*, 40 Sec. Reg. L. Rep. (BNA) 1504, 1504 (Sept. 22, 2008).

⁶³ *Id.*

public disclosures to the SEC on their short sales and short positions.⁶⁴ This interim final rule modified an earlier emergency rule by eliminating public disclosure of the information and also expanding the coverage of the reporting requirements.⁶⁵ It issued a final rule eliminating the options market maker exception to the close-out requirement of Regulation SHO, in doing so referring to the Office of Economic Analysis study, discussed above, finding that fails in optionable securities had increased since December 2007.⁶⁶

The SEC issued an interim final temporary rule, effective until July 29, 2009,

that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred. This temporary rule should provide a powerful disincentive to those who might otherwise engage in potentially abusive ‘naked’ short selling.⁶⁷

The SEC also issued a final rule saying explicitly that “short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date” are liable for fraud.⁶⁸

As in previous market downturns, corporate issuers and political officials called for much tighter restrictions on short selling. An NYSE-Euronext-sponsored survey of corporate issuers reported that

[r]esults from the Short Selling study indicate very clearly that a large majority of CEOs, CFOs and IR professionals (75%) favor restrictions on short selling activity during periods of stock price volatility and fully 85% favor re-instituting the ‘tick test’ rule. An even larger percentage (92%) think investment managers should publicly disclose their short selling activity. While there is some variation in results by job title, country and market cap, there is

⁶⁴ Disclosure of Short Sales and Short Positions by Institutional Investment Managers, 73 Fed. Reg. 61,678, 61,678 (Oct. 17, 2008) (to be codified at 17 C.F.R. pts. 240 & 249).

⁶⁵ *Id.*

⁶⁶ Amendments to Regulation SHO, 73 Fed. Reg. 61,690, 61,690, 61,693 (proposed Oct. 17, 2008) (to be codified at 17 C.F.R. pts. 241 & 242).

⁶⁷ *Id.* at 61,706, 61,707.

⁶⁸ “Naked” Short Selling Antifraud Rule, 73 Fed. Reg. 61,666, 61,667 (Oct. 17, 2008) (to be codified at 17 C.F.R. pt. 240).

widespread agreement across the board on these points.⁶⁹

Legislators, including House Financial Services Chair Barney Frank and Senate Banking Committee Chair Christopher Dodd, called for reinstatement of the tick test, and Senator Ted Kaufman of Delaware introduced a law to that effect.⁷⁰ Footnote 55 of the SEC's April 2009 proposed amendments to Regulation SHO, discussed below, referred to having "received over 4,000 requests (including duplicate requests) from individuals regarding reinstating a short sale price test."⁷¹ These included letters from "investors, issuers, academics, trade associations, and members of Congress."⁷²

On April 8, 2009, the SEC unanimously requested comment on alternative amendments to Regulation SHO.⁷³ One alternative would require that trading centers establish procedures to prevent short sales from being executed at less than the current national best bid or, if the current national best bid is less than the previous different national best bid, *at* or less than the current best bid ("a 'down bid'"), when the best bids are being disseminated on a real-time basis.⁷⁴ A second alternative would require that short sales be above the last sale price, or equal to the last sale price if that price were higher than the previous different price ("a 'zero-plus tick'"), again when price information is being disseminated on a real-time basis.⁷⁵ The SEC indicated that it tended to prefer a bid test over the sale price test because of lags in distributing sale price data.⁷⁶

⁶⁹ OPINION RESEARCH CORP., SHORT SELLING STUDY: THE VIEWS OF CORPORATE ISSUERS 3 (2008), available at <http://www.nyse.com/pdfs/ShortSellingStudy10212008.pdf>; OPINION RESEARCH CORP., SHORT SELLING STUDY: THE VIEWS OF CORPORATE ISSUERS, ADDITIONAL COMMENTS 17 (2008), available at <http://www.nyse.com/pdfs/ShortSellingStudyComments10212008.pdf>.

⁷⁰ *Ackerman Renews Call for Uptick Rule; Schwab Encourages Congressional Support*, 41 Sec. Reg. L. Rep. (BNA) 52 (Jan. 12, 2009); *Ackerman Urges SEC's New Leader to Act on Uptick Rule, Citing Cox's Support*, 41 Sec. Reg. L. Rep. (BNA) 198 (Feb. 9, 2009); *SEC's Depression-Era Uptick Rule Said Irrelevant to Modern Marketplace*, 41 Sec. Reg. L. Rep. (BNA) 413 (March 9, 2009); *SEC to Consider, as Early as Next Month, Proposal on Uptick Rule or Other Measures. Securities*, 41 Sec. Reg. L. Rep. (BNA) 448 (March 16, 2009); *Senators Want Tough Action from SEC at Upcoming Meeting on Short Selling Rules*, 41 Sec. Reg. L. Rep. (BNA) 603 (Apr. 6, 2009).

⁷¹ Amendments to Regulation SHO, 74 Fed. Reg. 18,042, 18,046 n.55 (proposed Apr. 20, 2009) (to be codified at C.F.R. pt. 242).

⁷² *Id.*

⁷³ MAYER BROWN, U.S. SECURITIES AND EXCHANGE COMMISSION CONSIDERS NEW SHORT SELLING REGULATION 1 (2009), available at <http://www.mayerbrown.com/publications/article.asp?id=6489>; *SEC Submits Short Sale Proposals For Public Comment; Vote Applauded*, 41 Sec. Reg. L. Rep. (BNA) 649 (Apr. 13, 2009).

⁷⁴ MAYER BROWN, *supra* note 73, at 2.

⁷⁵ *Id.* at 1.

⁷⁶ *Id.*

The third through fifth options were “circuit breaker” approaches targeting conditions in which prices had fallen sharply.⁷⁷ The third option would prohibit short sales in a security for the remainder of the day if it had declined in price by a fixed percentage during the day.⁷⁸ The fourth and fifth options would impose price tests using either the national best bid or last sale, as discussed above, after a designated percentage decline in the security’s price during the day.⁷⁹ Each of the five options contained numerous exemptions, responding to conditions in which short sale restrictions would clash with markets as they had evolved since the original price test was established.

VI. ANALYSES OF THE 2008 REGULATORY ACTIONS

Ekkehart Boehmer et al. studied the impact of the SEC’s temporary banning of short selling in close to one thousand financial stocks in 2008.⁸⁰ Comparing trading in the banned stocks to those in a control group, they tentatively concluded that the ban reduced market quality as measured by spreads, price impacts, and intraday volatility.⁸¹

An “independent analysis” sponsored by the International Securities Lending Association, Alternative Investment Management Association, and London Investment Banking Association examined the effects of restrictions on short selling in 2008 across several jurisdictions.⁸² This study suggested that the short sale restrictions had not changed the behavior of stock returns, either of the restricted stocks over time or of those stocks compared to a control group of unrestricted stocks; that, across jurisdictions, the regulations had not generated the predicted effects; that the regulatory restraints were not detrimental; and that “sector-wide influences” rather than short selling restrictions had affected any changes in key market statistics.⁸³ The study emphasized the tentative nature of the conclusions given the brief

⁷⁷ *Id.* at 2

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Ekkehart Boehmer et al., *Shackling Short Sellers: The 2008 Shorting Ban 1* (Nov. 18, 2008) (unpublished manuscript), *available at* <http://www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf> [hereinafter *Shackling Short Sellers*].

⁸¹ *Id.* at 16.

⁸² Ian W. Marsh & Norman Niemer, *The Impact of Short Sale Restrictions 1, 2* (Nov. 30, 2008) (unpublished manuscript), *available at* <http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf>.

⁸³ *Id.* at 24.

time period examined.⁸⁴

Credit Suisse also analyzed the effects of prohibiting short selling in financial stocks in 2008.⁸⁵ It reported that the stocks' trading volume dropped off substantially, and the spreads of restricted stocks widened more than those not subject to the restriction, increasing the costs of trading them relative to unrestricted stocks.⁸⁶ Hedge funds reduced their trading in the stocks because they commonly combine long positions and short selling in similar securities, and as "hedge funds have been limited from taking the short side in certain securities, they can no longer execute these matched long-short trades. The upshot is a significant reduction in hedge fund participation."⁸⁷ The reduced trading volumes, however, did not entirely explain the widened spreads; after the restrictions were removed, "reduced volumes persisted while spreads of restricted stocks tended back toward pre-restriction levels."⁸⁸ Credit Suisse attributed about a twenty basis point widening of the spreads to the restrictions on short selling.⁸⁹

The price of most stocks had fallen prior to the restrictions. The stocks subject to the restrictions fell somewhat less than others. Credit Suisse suggested that if short sellers had targeted the restricted stocks, they probably would have performed worse than others in the period prior to the ban.⁹⁰ Stocks subject to the restriction fell along with the rest of the market during the restriction period (although, as in the pre-restriction period, fell slightly less than others), and "[t]his selling was caused entirely by people who already owned the stocks and wanted to get out ('long sellers') rather than short sellers."⁹¹

Credit Suisse also maintained that events not related to an ability to sell short, such as the collapse of Bear Stearns, explain the increase in market volatility beginning around July 2007.⁹² The

⁸⁴ *Id.* at 24, 25.

⁸⁵ CREDIT SUISSE, THE BLAME GAME: WHAT CAUSED SPREADS TO WIDEN (2008) [hereinafter CREDIT SUISSE, BLAME GAME]; CREDIT SUISSE, EXAMINING THE WAKE OF THE SHORT SALE RESTRICTION (2008) [hereinafter SHORT SALE RESTRICTION]; CREDIT SUISSE, WHAT HAPPENED WHEN TRADERS' SHORTS WERE PULLED DOWN (2008) [hereinafter CREDIT SUISSE, TRADERS' SHORTS].

⁸⁶ CREDIT SUISSE, TRADERS' SHORTS, *supra* note 85, at 1, 2.

⁸⁷ *Id.* at 3.

⁸⁸ CREDIT SUISSE, BLAME GAME, *supra* note 85, at 3.

⁸⁹ *Id.*

⁹⁰ CREDIT SUISSE, SHORT SALE RESTRICTION, *supra* note 85, at 1.

⁹¹ *Id.*

⁹² CREDIT SUISSE, TICKING OFF THE SHORTS 6 (2009) [hereinafter CREDIT SUISSE, TICKING OFF].

SEC repealed the tick test at that time, but Credit Suisse argued that there was no causal connection between the two conditions.⁹³

The SEC's Office of Economic Analysis issued several memoranda on the effects of the restrictions between December 2008 and April 2009.⁹⁴ On December 16, staff members Daniel Aromi and Cecilia Caglio discussed "the extent to which short selling appeared to drive prices downward" in early September 2008, the period prompting the Commission's emergency orders.⁹⁵ They concluded that long selling, rather than short selling, had accounted for most of the downward price pressure.⁹⁶ Their memorandum on December 17 discussed how restrictive various short sale price tests might be, using six trading days in September 2008 as data.⁹⁷ They suggested that

[a] short sale price test would be more restrictive for lower priced stocks and more active stocks. Counter to the intent of such a rule, we also found that a short sale price test would be most restrictive during periods with little volatility. . . . Finally, our analysis showed that even moderate changes in bid increments can have a big impact on the constraints imposed on short selling activity. . . . These statistics suggest that, for practical purposes, high bid increments, such as five or ten cents, might be equivalent to a ban on short selling in some stocks, especially during periods when prices are not changing rapidly.⁹⁸

On January 14 the OEA distributed within the SEC a study of the effects of the pre-borrow requirement for short selling in nineteen financial companies from July 21 to August 12, 2008.⁹⁹ It reported that the pre-borrow requirement substantially decreased short sale volume, increased stock lending rates, sharply decreased fails to

⁹³ *Id.* at 6, 13.

⁹⁴ Memorandum from Daniel Aromi & Cecilia Caglio to Chairman Christopher Cox, U.S. Sec. & Exch. Comm'n Office of Econ. Analysis (Dec. 16, 2008), <http://www.sec.gov/comments/s7-08-09/s70809-369.pdf> [hereinafter December 16 Memo]; Memorandum from Daniel Aromi & Cecilia Caglio to Chairman Christopher Cox, U.S. Sec. & Exch. Comm'n Office of Econ. Analysis (Dec. 17, 2008), <http://www.sec.gov/comments/s7-08-09/s70809-368.pdf> [hereinafter December 17 Memo]; Memorandum from Office of Econ. Analysis to Distribution List, U.S. Sec. & Exch. Comm'n Office of Econ. Analysis (Jan. 14, 2009), <http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf> [hereinafter January 14 Memo].

⁹⁵ December 16 Memo, *supra* note 94, at 1.

⁹⁶ *Id.* at 2.

⁹⁷ December 17 Memo, *supra* note 94, at 1.

⁹⁸ *Id.* at 1–2.

⁹⁹ January 14 Memo, *supra* note 94, at 1.

deliver, and had little to no significant impacts on other market indicators.¹⁰⁰ The authors also observed that “[o]ur results suggest that imposing a pre-borrow requirement may have had the intended effect of reducing fails but may have resulted in significant costs on all short sellers even those whose actions were not related to fails.”¹⁰¹

On April 16, 2009, the OEA reported its study of the effects of the elimination of the options market maker exemption and the implementation of the T+3 Close-out Rule on fails to deliver, updating previous analyses of November 26, 2008 and March 20, 2009.¹⁰² The report noted that the results were consistent with the earlier memos, and, in fact,

the current memo shows much larger declines in fails measures than the earlier memos. . . .

. . . .

. . . [F]ails to deliver decreased significantly after the elimination of the OMM exception and the implementation of the T+3 Close-out Rule. Fails declined by 56.6% across all securities and 73.5% for threshold stocks. In addition, there is some evidence that optionable stocks experienced larger declines than non-optionable stocks. There has been a large downward trend in fails since July 2008.¹⁰³

By May 2009 there was broad support, across industry and regulators, to make the T+3 Close-out Rule permanent.¹⁰⁴

VII. THEMES IN THE RESEARCH AND DISCUSSIONS OF SHORT SALE REGULATION

As discussed above, numerous countries restricted short selling in response to the market crisis, usually on an interim basis. Many of these interim measures had been removed by May of 2009. On May 25, when Australia lifted its eight-month ban on covered short selling of financial stocks, the Financial Times commented that the action brought the country into line with all major developed markets that had already lifted their temporary bans on the

¹⁰⁰ *Id.* at 1–2.

¹⁰¹ *Id.* at 1.

¹⁰² Memorandum from the Office of Econ. Analysis, U.S. Sec. & Exch. Comm’n, to File 1 (April 16, 2009), available at <http://www.sec.gov/comments/s7-30-08/s73008-121.pdf>.

¹⁰³ *Id.*

¹⁰⁴ Nina Mehta, *SEC Expected to Make Fails Rule Permanent*, TRADERS MAG. May 13, 2009, <http://www.tradersmagazine.com/news/-103750-1.html> (last visited Feb. 28, 2009).

practice.

The Australian Securities & Investments Commission (“ASIC”), however, warned it would “immediately” re-impose the ban if it believed that market conditions warranted such a move. Although the effectiveness of the short selling ban had been questioned with critics arguing that it hit trading volumes but did not necessarily reduce market volatility, analysts said the ASIC’s warning would probably deter future short selling activity in Australia.¹⁰⁵

The International Organization of Securities Commissions (“IOSCO”) set out four draft principles to govern short sale regulation in March 2009.¹⁰⁶ It emphasized the importance of regulatory mechanisms to prevent fails to deliver.¹⁰⁷ IOSCO also called for greater disclosure of information on short sales to regulators and the market, saying that disclosures should balance regulatory, economic, technical, and proprietary considerations.¹⁰⁸ IOSCO stressed that authorities needed to enforce the regulations they had in place, particularly to prevent failed trades and to obtain necessary information, and that “[s]hort selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.”¹⁰⁹ It noted a range of regulatory tools for short selling, such as price restrictions, flagging of short sales, restrictions on types of stocks that can be shorted, and margin requirements, and said these

measures may have different levels of effectiveness depending on specific local market conditions and the nature of the market infrastructure already in place. Also, introducing some of these measures (such as price restriction rules or “flagging” short sales) in some jurisdictions may be operationally difficult and may involve prohibitive costs for the regulators and the market participants.¹¹⁰

The World Federation of Exchanges, commenting on the IOSCO release, wrote,

[e]xchanges strongly support the priority given to imposing

¹⁰⁵ Peter Smith, *Australia Lifts Ban on Short Selling Financials*, FIN. TIMES, May 25, 2009, at 22, available at <http://www.ft.com/cms/s/0/e2f0fcba-48ce-11de-8870-00144feabdc0.html>.

¹⁰⁶ TECHNICAL COMM. OF THE INT’L ORG. OF SECS. COMM’NS, REGULATION OF SHORT SELLING 5 (2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf>.

¹⁰⁷ *Id.* at 10.

¹⁰⁸ *Id.* at 5.

¹⁰⁹ *Id.* at 19.

¹¹⁰ *Id.* at 9–10.

strict settlement rules as a requirement to achieve orderly and efficient functioning of the market processes versus other initiatives, such as price restriction rules. The regulatory framework for short selling should include anti-fraud/anti-manipulation provisions, delivery and closeout requirements. A robust settlement regime, including a short settlement cycle, will go a long way to eliminate short sales being effected without due regard to the need to be able to settle the transaction.¹¹¹

It questioned IOSCO's emphasis on market disclosure of short sale positions:

Reporting regimes should be based on a material benefit to a fair and orderly markets with due consideration being given to the costs, complexity, enforceability and market impact of implementing a reporting regime. The primary objective of any short selling reporting regime should be to supplement efforts to deter market abuse. . . . We would envisage IOSCO still acknowledging that, in some circumstances, making information publicly available may help deter abusive activity. However, data on all, or a majority of short positions is not regarded as a prerequisite of a fair, efficient and orderly market. WFE would note that the primary objectives can be achieved via private disclosure to the regulator rather than public disclosure to the market.

. . . .

IOSCO should make it clear that a regulatory commitment to "fairness" and "transparency" does not equate to giving any participants or investors a free ride on the proprietary information or investment strategies of others. A more realistic expectation of the regulatory framework's contribution to "fairness" and "transparency" is that sufficient information will be available to enable all market users to be confident that prices obtained on the market are a reflection of genuine supply and demand.

IOSCO should emphasize that mandatory reporting is seen by the regulator as an adjunct to policies directed at surveilling for and penalizing abusive short selling and is not

¹¹¹ Letter from William J. Brodsky, WFE Chairman, to Greg Tanzer, IOSCO Secretary General (May 7, 2009), *available at* <http://www.world-exchanges.org/files/file/WFE%20comments%20on%20IOSCO%20march%202009%20consultation%20regarding%20short-selling.pdf>.

intended to provide information to assist other investors' trading decisions.¹¹²

The WFE also commented that

[i]f price restrictions are part of an overall regulatory scheme, they should be limited in scope and targeted to address abusive short selling. These schemes should include appropriate exceptions that ensure efficient and effective functioning of the market, and should include exceptions for market makers in both cash and derivative markets, particularly where there is a significant obligation to maintain continuous two-sided markets.¹¹³

The Financial Services Authority Discussion Paper on short selling in February 2009 also emphasized substantial increases in disclosure both to regulatory authorities and the markets.¹¹⁴ It added, however, that

[w]e do not think any direct constraints on short selling are currently justified. Nevertheless, extreme market conditions could re-emerge where the risks posed by short selling warrant some form of emergency intervention, most likely in the form of a prohibition. So we will continue to monitor markets and stand ready to reintroduce a prohibition should this be warranted, if necessary without consultation.¹¹⁵

The FSA rejected price tests as a regulatory measure:

The UK has no direct experience of tick regimes but the US Securities and Exchange Commission (SEC) carried out a comprehensive study into the impact of its up-tick rule which had been in operation for approximately 70 years. This exercise involved significant debate, consultation and a pilot test and led to the conclusion that the SEC 'should remove price test restrictions because they modestly reduce liquidity and do not appear necessary to prevent manipulation'. Another key finding was that there was no evidence that there was an association between extreme price movements and the absence of a tick regime. So in 2007 the SEC abandoned its up-tick rule. We are aware that the removal of their up-tick rule has subsequently been criticised [sic] by

¹¹² *Id.* at 2–3.

¹¹³ *Id.* at 3–4.

¹¹⁴ FIN. SERV. AUTH., SHORT SELLING: DISCUSSION PAPER 09/1 23, 24 (2009), available at http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf.

¹¹⁵ *Id.* at 22.

some commentators in the light of the turbulent market conditions associated with the credit crunch which started in the middle of 2007. We are also aware that it has been argued that there would have been less volatility had the up-tick rule been kept.

Nevertheless, we share the view that tick rules provide limited protection against the negative effects of short selling, at most acting to temporarily decelerate share price declines. What does seem clear is that tick rules come at substantial cost if none of the necessary infrastructure is already in place. Most significantly, in order to be effective, tick rules require a marking (or flagging) regime to be operated by market participants, exchanges and clearing and settlement houses alike. Without such a regime, individual trades cannot be identified as short sales and, should circumstances require it, be blocked. In addition, they have the potential to eliminate legitimate short selling strategies, making the price formulation process more inefficient and reducing liquidity. Additionally, given the increasing fragmentation of trading venues and the absence of a consolidated tape, the cross-exchange consistent application of such a rule would carry with it substantial compliance costs. Finally, tick rules apply only to the cash markets and, as we have highlighted already, there are many ways of achieving the same effect by use of derivatives.

In conclusion we do not consider a 'tick' rule to be a proportionate measure and do not propose adopting one.¹¹⁶

VIII. DEBATE ON THE SEC'S APRIL 2009 PROPOSAL

The SEC, in its April 2009 short sale proposals, said that it had "received over 4,000 requests (including duplicate requests) from individuals regarding reinstating a short sale price test."¹¹⁷ These included letters from "investors, issuers, academics, trade associations, and members of Congress."¹¹⁸ Sharp market declines historically produce calls for restrictions on short selling, given concerns that short sellers contributed to, or even largely produced, the crises.¹¹⁹ The strong reaction against short selling in 2008 fits

¹¹⁶ *Id.* at 21–22.

¹¹⁷ Amendments to Regulation SHO, 74 Fed. Reg. at 18,046 n.55.

¹¹⁸ *Id.* at 18,046.

¹¹⁹ See Jones, *supra* note 5, at 1; David C. Worley, *The Regulation of Short Sales: The Long*

this pattern.¹²⁰ Four of the SEC's five options in its April 2009 proposal included short sale price tests—two using National Best Bid or last sale price applying in all market conditions, and two applying the NBB or last sale price to specific securities should they decline by certain percentages (the fifth was a halt to short sales in a security for the remainder of the day following a specified percentage price decline).¹²¹

As of June 2, there were 3,019 entries on the SEC's website for comments on its April proposal.¹²² The overwhelming majority of the comments were from individual investors.¹²³ To convey their support for reinstating the uptick rule, below are several entries from the list of comments.

I heartily support the SEC's proposal to re-instate the short sale/ uptick /circuit breaker rules. The removal of these rules has caused havoc in the markets. Placing these rules in effect will level the playing for all participants. I hope that the special interests that will support the status quo will fall on deaf ears at the SEC.¹²⁴

Similarly, one commenter noted:

My great fear is that the SEC may have begun to identify with, and have empathy for the Business Entities it is supposed to regulate. I believe your mandate is to provide security and protection for all investors, and insure an orderly marketplace to raise capital for the Companies offering their stock on the various exchanges. I also believe Hedge Funds, Professional Traders, and the Stock Exchanges do not want any restrictions on Short Selling!

.....

PLEASE—don't approve an ineffective Uptick Rule. That would be the worst of all possible outcomes. The Uptick rule must be capable of doing at least as much as the old uptick rule did. You should also provide transparency for all investors. Short Sales should be reported separately from regular stock purchases. If you effectively resolve these

and *Short of It*, 55 BROOK. L. REV. 1255, 1255 (1990).

¹²⁰ See Jones, *supra* note 5, at 26.

¹²¹ Amendments to Regulation SHO, 74 Fed. Reg. at 18,043.

¹²² U.S. Sec. & Exch. Comm'n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809.shtml> (last visited Feb. 28, 2009).

¹²³ *Id.*

¹²⁴ Comment of C. H. Tseronis, U.S. Sec. & Exch. Comm'n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809-2903.htm> (last visited Feb. 28, 2009).

problems, millions of investors sitting on the sidelines will return, invest, and help get the markets and our economy going again.¹²⁵

Another commentator noted that “[s]hort selling should be backed by equity.”¹²⁶ The final two comments expressed similar sentiments:

We have seen, over the past months, the results of years of laissez-faire regulatory oversight of the capital and stock markets. Perhaps the most egregious of these oversights was the lapsing of the uptick rule, which allows a small handful of large players to virtually set the market with their trades. This leaves many small investors out in the cold, and has resulted in large losses for many who can least afford them. The SEC should immediately reinstate the uptick rule, and begin to reassert some semblance of regulation into a market that has shown the world exactly what can be expected from “unbridled capitalism.”¹²⁷

The Opinion Research Corporation survey completed for the NYSE said that “[r]esults from the Short Selling study indicate very clearly that a large majority of CEOs, CFOs and IR professionals (75%) favor restrictions on short selling activity during periods of stock price volatility and fully 85% favor re-instituting the ‘tick test’ rule.”¹²⁸ As noted above, numerous legislators advocated strongly for a reinstatement of a price test for short selling.¹²⁹ Robert Pozen, chairman of MFS Investment Management, and Yaneer Bar-Yam of the New England Complex Systems Institute wrote in a Wall Street Journal article that the uptick rule should be reinstated because, they maintained, the SEC pilot had detected small but substantively important benefits for pricing from the rule and its

¹²⁵ Comments on Proposed Short Selling Regulations, U.S. Sec. & Exch. Comm’n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809-2797.pdf> (last visited Feb. 28, 2009).

¹²⁶ Comment of George G. Kirby, U.S. Sec. & Exch. Comm’n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809-2686.htm> (last visited Feb. 28, 2009).

¹²⁷ Comment of Tim Flowers, U.S. Sec. & Exch. Comm’n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809-2575.htm> (last visited Feb. 28, 2009); *see also* Comment of John Waclawski, U.S. Sec. & Exch. Comm’n, Amendments to Regulation SHO, <http://www.sec.gov/comments/s7-08-09/s70809-2429.htm> (last visited Feb. 28, 2009) (“Please put the uptick rule in place. Too much Undersight [sic] created phantom stock and allowed a few to trade without any stock or Risk.”).

¹²⁸ OPINION RESEARCH CORP., SHORT SELLING STUDY: THE VIEWS OF CORPORATE ISSUERS 3 (2008), available at <http://www.nyse.com/pdfs/ShortSellingStudy10212008.pdf>.

¹²⁹ *See supra* note 70 and accompanying text.

repeal coincided with the increase in market volatility in 2007.¹³⁰

Yet, the overwhelming majority of professional market participants criticized reinstatement of price tests as strongly as public comments, corporate issuers, and key legislators supported them. Credit Suisse maintained that broad new regulatory controls on short selling would be out of proportion to its actual role in the market decline of 2008.¹³¹ It argued that hedge funds' short selling did not focus on targeting firms, as a trivial share of their short selling was "dedicated short."¹³² It said that

[t]he primary intent of a restriction on short selling is to prevent manipulative attacks from short sellers intent on driving down prices. However, it is important to note that the overwhelming majority of short selling occurring in the market is part of a hedged strategy that seeks to pair a short trade with a similar long position. The goal is not to drive the price of the short stock down, but rather to capture any relative mispricings between the two.

Only a miniscule 0.7% of all hedge funds strategies are reportedly "Dedicated Short," with the balance either long only or long-short strategies.¹³³

Similarly, the Security Traders Association maintained:

Furthermore, the limited nature of the alleged problem, abusive short selling, argues against imposition of trading restrictions market-wide. Bid and tick tests would require all market participants to retool their systems at significant expense. However, the alleged activity that these regulations are attempting to curtail are allegedly undertaken by an extremely small group of well-funded market participants bent on exploiting perceived loopholes in the rules for their own pecuniary interests. A recent study of trading data by Deutsche Bank shows that "as stocks plunged in September (2008), fewer than 8 percent of trades for companies in the S&P 500 Financials Index were done on consecutive downticks." Another recent study of exchange data by Bloomberg reveals, "When Citigroup plunged 26 percent on Nov. 20, (2008) the steepest drop on record for the New York-based bank, downticks represented 7.1 percent of

¹³⁰ Robert C. Pozen & Yaneer Bar-Yam, *There's a Better Way to Prevent 'Bear Raids'*, WALL ST. J., Nov. 18, 2008, at A19.

¹³¹ CREDIT SUISSE, TICKING OFF, *supra* note 92, at 6.

¹³² *Id.*

¹³³ *Id.*

trades.” The STA believes that market-wide trading restrictions aimed at curbing less than 10 percent of trading activity represent burdensome regulations and an unnecessary interference with price discovery mechanisms that, for the most part, are functioning with historical efficiency, especially when other rules and regulations already on the books could be used to curtail this perceived problem (e.g. Rule 203T and strict locate requirements).¹³⁴

Credit Suisse also argued that adopting an uptick rule as outlined in the SEC’s April 20 proposal would be extremely difficult and costly.

Equity markets today are much more complex than they were only a few years ago. In only 2 short years, the total number of trading venues including exchanges, ECNs and ATSS has exploded, from around 10 in 2007 to over 40 today In October 2007, the SEC also fully implemented Regulation NMS to help protect customers in the increasingly fragmented marketplace. Reg NMS requires brokers to provide customers with the best possible execution available at any given time. In order to implement such a rule, brokers and exchanges have had to develop extensive technology capable of surveying all trading venues and evaluating which is most optimal at every point in time.

Complying with an uptick rule in such an environment would require monitoring trades in real-time on every single one of these 40+ venues. It would impose a great cost to implement and maintain the necessary infrastructure and would require tremendous computing capacity to handle all of the messaging. It is not uncommon for exchanges to generate several million messages *per second*.

The heavy implementation demands also mean it would take a very long time before a new tick test is fully operational in today’s markets, much longer than the SEC’s proposed 3 month implementation period. By our estimates, full implementation may take up to a year. This time frame may not be acceptable as there seems to be a need to address

¹³⁴ Letter from Peter J. Driscoll, Chairman, & John C. Giese, President and CEO, Sec. Traders Ass’n to The Honorable Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n 2 (May 4, 2009), *available at* <http://www.sec.gov/comments/s7-08-09/s70809-425.pdf> (quoting Edgar Ortega & Jesse Westbrook, *Uptick Rule May Fail to Lift Stocks, Curb Volatility*, BLOOMBERG NEWS, Dec. 9, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a_g2QOVwVr_dU).

the public's concerns immediately.

Note that Reg NMS was not in place at any time when the previous uptick rule or NASD bid test was active so we have never had to face the scope of these challenges before.¹³⁵

While the modified uptick rule based on the National Best Bid would be slightly easier to implement given that the National Best Bid is already maintained and disseminated to all trading centers, it would still pose similar problems because of latency issues among the myriad venues.

The precise time sequence of quotes is not marked so although a central data feed publishes the national best bid in real time, the trading centers may receive that information at different times. Additionally, the consolidated best bid does not report whether the bid is up or down from the previous quote. It would therefore be necessary for each center to maintain their own records and sequence of the national best bid so they can each verify compliance at the time of their execution.¹³⁶

Credit Suisse commented more favorably on the circuit breaker option which would temporarily prohibit short selling in a security following a specified percentage decline in that security.¹³⁷ It said that prohibition would avoid the costs and complications of implementing price tests, whether separate from or combined with circuit breakers.¹³⁸ The temporary halt of short selling would address the "investor confidence" issues that the SEC had emphasized.¹³⁹ It criticized the circuit breaker options which would require price tests after tripping of the circuit breaker for the same logistical reasons as it opposed short selling price tests in general.¹⁴⁰

Larry Tabb wrote that

reinstating an uptick rule will not be effective, especially in today's electronic, decimalized[,] and fully connected world. . . .

. . . .

¹³⁵ CREDIT SUISSE, TICKING OFF, *supra* note 92, at 8; see Letter from Dan Mathisson, Managing Dir., Credit Suisse Sec. (USA), L.L.C., to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Mar. 30, 2009), available at <http://www.sec.gov/comments/s7-08-09/s70809-276.pdf>.

¹³⁶ CREDIT SUISSE, TICKING OFF, *supra* note 92, at 8.

¹³⁷ *Id.* at 9.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 10–11.

While the furor over short selling is tremendous, let's not ruin the market for some feel-good regulation. If we just want an uptick rule, then let's craft it wisely, so it does little harm. If the real purpose is to clamp down on short sellers, then an uptick rule won't ever be enough. Let's understand the real purpose behind any regulation: to limit negatively correlated transactions and financial products. To the besieged, this may sound wonderful. But to the market as a whole, watch out.¹⁴¹

Executives of options exchanges criticized the SEC proposal to expand short sale regulation in general.¹⁴² Similarly, at a Security Traders Association Conference in April, "[s]everal industry executives argued that reining short selling would not stop downward pressure on stock prices. Instead, they said, it would be counterproductive and would make the markets less efficient, thereby hurting investors."¹⁴³ Richard Lindsey, a former director of the SEC's Division of Market Regulation

called the current outcry against short selling by politicians "political theater". . . . Members of Congress, Lindsey said, are blaming short selling for the rapid price declines last fall in a bid to appeal to investors and corporate boards. . . . The impulse to remove [short selling], he said, should not come from "hand wringing."¹⁴⁴

The strongest defense offered for any version of the SEC proposal at the conference was "a pragmatic one."¹⁴⁵ One exchange executive said that a bid test was

the least bad of many bad alternatives. . . . If we do not put forward an acceptable alternative, we run the risk of Congress, [CNBC commentator James] Cramer, or whoever coming in, lighting a match and burning down a forest. . . . If we are going to have restrictions on short selling, we'd like those restrictions to be as little and light as possible.¹⁴⁶

An executive from a different exchange said that it was "operating

¹⁴¹ Larry Tabb, *The Downside of an Uptick Rule*, ADVANCED TRADING, April 16, 2009, <http://www.advancedtrading.com/regulations/showArticle.jhtml?articleID=216501067>.

¹⁴² Peter Chapman, *Options Industry Lets Out War Cry Over Short-Sale Regulation*, TRADERS MAG. ONLINE NEWS, May 14, 2009, <http://www.tradersmagazine.com/news/-103751-1.html>.

¹⁴³ Nina Mehta, *Trading Execs Sound Off on Prospect of Short-Sale Restrictions*, TRADERS MAG. ONLINE NEWS, Apr. 27, 2009, <http://www.tradermagazine.com/news/-103694-1.html>.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

under the assumption that something is going to be done,” and that under the circumstances the task was to arrive at a rule that was “reasonable and implementable.”¹⁴⁷ When pressed on whether a new rule was needed, one of these officials said that “in certain situations a rule would not hurt,” and the other said “no.”¹⁴⁸

Stephen Nelson said that

[t]he proposed short sales uptick rule, released by the SEC on April 10, is a creature of politics.

While this is more or less true of every rule, in this case footnote 55 of the rule release refers to letters from various politicians urging the SEC to adopt an uptick rule, including such luminaries as Congressman Barney Frank and other members of the House Financial Services Committee that he chairs, and Secretary of State Hillary Rodham Clinton, formerly US Senator. It is safe to say that more than the usual political influence is pressuring the SEC to adopt an uptick rule.”¹⁴⁹

He maintained that the fundamental pressure for the rule came from corporate issuers, who saw it as propping up their stock prices, and suggested that stock exchanges, while being in favor of efficient markets, had difficulty publicly opposing an initiative favored so strongly by the corporations whose listings they wanted to retain.¹⁵⁰ Nelson concluded:

The proposed uptick rule, in all of its variations, is a dumb rule that will not serve the public interest. The uptick rule will increase securities transactions costs for no good purpose.

It is a sop to management that will not lead to the hoped-for higher stock prices. This is a good thing because if the rule were effective, it would lead to poor resource allocation, causing us all to end up poorer.

With so many other things that need to be done to reform our broken financial system, it is shameful that our elected representatives and regulators must devote so much of their time to such a silly enterprise.¹⁵¹

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ Stephen J. Nelson, *Commentary: Politics and Short Sales*, TRADERS MAG. ONLINE NEWS, Apr. 27, 2009, <http://www.tradersmagazine.com/news/-103691-1.html>.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

IX. PUBLIC PERCEPTION OF RISK AND REGULATORY POLICY FOR COMPLEX FINANCIAL MARKETS

Studies of risk perception indicate that the public especially fears risks when (1) the risks are not understood well, (2) the risks potentially bring catastrophes and (3) exposure is involuntary. People fear nuclear power, for instance, far more than technologies that are statistically more dangerous but more familiar and known, like smoking or automobile travel.¹⁵² “Short sales” are not nuclear power plants, but they arguably produce a similar political psychology. Surveys show that levels of public understanding of financial market instruments and operations are not high,¹⁵³ and a large majority of the investing public probably does not have a good understanding of how short selling operates. Still, investors associate it generally with price declines and potential manipulation, especially when corporate issuers, prosecutors, and sometimes regulators point to abusive short selling as an explanation of stock price declines. Given that the original purpose of short selling was to profit from expected price declines, and the public bears the consequence of large market losses, steep market declines produce calls for more restraints on short selling.

There have been, and are, similar situations in other areas of financial market technology. For example, the public associated program trading in the 1980s, and derivatives since the 1990s, with financial crises in ways shaped largely by media coverage rather than direct knowledge or experience with program trading or derivatives.¹⁵⁴ Specialized regulatory organizations operate most effectively when they can credibly buffer themselves against exceptionally strong political pressures while managing complex problems in carefully analyzed ways.¹⁵⁵ The SEC’s performance since the 1930s has varied depending on how well it maintained a

¹⁵² STEPHEN BREYER, *BREAKING THE VICIOUS CIRCLE: TOWARD EFFECTIVE RISK REGULATION* 35–36 (1993).

¹⁵³ See ANGELA A. HUNG ET AL., *INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS* xiv (2008), available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf; see also *Financial Literacy and Education: The Effectiveness of Governmental and Private Sector Initiatives: Hearing Before the H. Comm. On Financial Services*, 110th Cong. 271–82 (2008), available at http://www.house.gov/apps/list/financialsvcs_dem/press041508.shtml (follow link for “Printed Hearing: 110-105”) (surveying economic and personal finance in our nation’s schools in 2007).

¹⁵⁴ DAVID P. MCCAFFREY & DAVID W. HART, *WALL STREET POLICES ITSELF: HOW SECURITIES FIRMS MANAGE THE LEGAL HAZARDS OF COMPETITIVE PRESSURES* 135 (1998).

¹⁵⁵ PETER EVANS, *EMBEDDED AUTONOMY: STATES AND INDUSTRIAL TRANSFORMATION* 75 (1995); JAMES M. LANDIS, *THE ADMINISTRATIVE PROCESS* 78 (1938).

virtuous circle of effective performance, leading to sufficient and well-managed resources, leading to legitimate discretion in dealing with controversial issues, and leading to continued effective performance.¹⁵⁶ The broader political and economic environment, including different levels of presidential support, obviously affected its success in doing this.

An exchange in 1995 between Representative Rick White (R-Washington) and SEC Chair Arthur Levitt illustrates the tension between regulatory judgment and Congressional authority in dealing with politically contentious issues. It concerned Congressional pressure to legislatively define broker-dealers' obligations to consider the suitability of investments for sophisticated institutional investors.

Mr. White. . . . I think it's better for Congress to set these policies rather than a regulatory agency.

And I'd be interested in your thinking why you think we should proceed with rulemaking rather than let Congress make some of these decisions?

Mr. Levitt. Well, I don't know that either of us are going to come to the perfect solution, but I have, since I've been at the Commission, studiously tried to avoid asking Congress for anything.

Mr. White. I can understand that.

Mr. Levitt. With all due respect, I don't know when we're going to get it or what we're going to wind up with. And the Commission, I think, has a more intimate ongoing concern about the issues which deal with our markets and the kinds of dangers that arise sometimes suddenly and unexpectedly that can impact our markets.

A response to those issues sometimes doesn't lend itself to the prolonged process involved in the legislative response. The question of suitability is not a black or white question. I think Congress tends to deal best with black and white issues. And because of that, I urge great caution as we approach this issue.

. . . .

¹⁵⁶ See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 268 (2003); ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE* 11 (1992); Sue R. Faerman et al., *Understanding Interorganizational Cooperation: Public-Private Collaboration in Regulating Financial Market Innovation*, 12 *ORG. SCI.* 372, 375 (2001), available at <http://www.jstor.org/pss/3086014>.

Mr. White. I got the sense from your remarks that you may have the feeling that the Commission, because of its day to day dealings with the market, may have a little better sense of the subtleties and maybe you're better equipped to deal with it in a more rational way than we are. Is that essentially what your thinking is?

Mr. Levitt. I think what I'm saying is the solution to the suitability issue set forward by this bill is one that I have reservations about.¹⁵⁷

Currently the SEC, in dealing with short sales as well as other issues, is in a weaker position than it has been in the past. Over the past year the SEC Inspector General issued critical reports on the SEC's management of the oversight of Bear Stearns and the consolidated supervised entity program in general, its management of complaints relating to naked short selling, and, most recently, controls on potential employee insider trading.¹⁵⁸ In March the Government Accountability Office issued a critical report on the SEC's enforcement program,¹⁵⁹ and not detecting Bernard Madoff's investment fraud despite numerous red flags particularly damaged the agency's credibility.¹⁶⁰ The SEC currently is in a position of

¹⁵⁷ *Capital Markets Deregulation and Liberalization Act of 1995, Hearing on H.R. 2131 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce, 104th Cong. 137-38 (1995)* (testimony of Arthur Levitt, Chairman, Sec. & Exch. Comm'n), available at <http://www.archive.org/details/capitalmarketsde00unit> (follow "PDF" hyperlink).

¹⁵⁸ See OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM viii (2008), available at <http://finance.senate.gov/press/Gpress/2008/prg092608>; OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER ASSESSMENT PROGRAM v (2008), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf>; OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, CASE NO. OIG-481, EMPLOYEE'S SECURITIES TRANSACTIONS RAISE SUSPICIONS OF INSIDER TRADING AND CREATE APPEARANCES OF IMPROPRIETY; VIOLATIONS OF FINANCIAL REPORTING REQUIREMENTS; AND LACK OF SEC EMPLOYEE SECURITIES TRANSACTIONS COMPLIANCE SYSTEM 2-3 (2009), available at <http://www.securitiesdocket.com/wp-content/uploads/2009/05/secigreportinsidertrading.pdf>; OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, REPORT NO. 450, PRACTICES RELATED TO NAKED SHORT SELLING COMPLAINTS AND REFERRALS iii (2009), available at <http://www.sec.oig.gov/Reports/AuditInspections/2009/450.pdf>.

¹⁵⁹ U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 7 (2009), available at <http://www.gao.gov/new.items/d09358.pdf>.

¹⁶⁰ *Id.* at 45; *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises of the Comm. on Financial Services, 111th Cong. 2 (2009)*, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr020409.shtml (follow "Printed Hearing: 111-2" link at the bottom of the page).

having to defend its jurisdiction over investor protection functions given the general push for restructuring of regulation.

Thus, in 2007, when the SEC was weighing whether or not to repeal the tick test after extensive analysis, the agency was in a much stronger position to follow the judgment of its professional staff. Policy dynamics around short selling always have been contentious, as noted above. The especially complex political situation now makes managing regulatory policy around short sales even more difficult than it has been in the past.¹⁶¹

X. POSTSCRIPT: COMMENT ON THE FEBRUARY 2010 FINAL AMENDMENTS TO REGULATION SHO

The text above was completed in June, 2009. This postscript discusses the SEC's final short sale rule, approved by a vote of 3-2 on February 24, 2010.¹⁶² The final rule adopted a circuit breaker approach comparable to the one outlined in April 2009. Short sales in a security listed on a national securities exchange would be restricted when the security's price declined by 10% or more from the previous day's closing price. For the remainder of the day, and the following day, short sale bids in that security would need to be at the permissible increment above the national best bid (the "alternative uptick rule"). The SEC staff found that these price restrictions would have been triggered on an average day for approximately 4% of covered securities between April 9, 2001 and September 30, 2009, and for 1.3% of covered securities in the low volatility period of 2004 through 2006.¹⁶³ Trading centers must establish policies and procedures reasonably designed to enforce the rule. The estimates of costs for trading centers and firms, while varying, were considerable by any reasonable standard.¹⁶⁴

As outlined above, short selling is controversial, especially during market crises, because short sellers benefit from price declines. Defenders of short sales maintain that short sellers identify weaknesses in corporate disclosures, informing the market and restraining inflated prices. Critics argue that short sellers have

¹⁶¹ Phillip Swagel, *The Financial Crisis: An Inside View* 33 (Spring 2009) (unpublished manuscript), available at http://www.brookings.edu/economics/bpea/~media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf.

¹⁶² Amendments to Regulation SHO, 75 Fed. Reg. 11,232, 11,232 (proposed Mar. 10, 2010) (to be codified at 17 C.F.R. pt. 242).

¹⁶³ *Id.* at 11,234.

¹⁶⁴ *Id.* at 11,291–11,313.

incentives to orchestrate the bad news they bear. Their strategic short selling can generate the price declines they predict, and from which they benefit, in ways decoupled from firms' economic conditions. They do so either manipulatively or by intensifying market anxiety about a security. As outlined above, the largest share of empirical research in the debate over short selling concludes that short selling does in fact enhance pricing efficiency. The dominant but not unanimous view of the research is that price tests on short sales are either ineffective and/or harmful.

The overwhelming majority of the over 4,300 comments the SEC received on the final proposal favored new restrictions on short sales. Most favoring new restrictions called for restraints that were tighter than the SEC's final rule. The numerous comments by individual investors, and the demands by legislators for new controls, demonstrated vividly the longstanding suspicion of short selling. Thus, there was a striking gap between the research on the effects of short selling and political sentiment favoring restrictions. While in early 2010 the consensus seemed to be that the SEC was in a better political position than a year earlier, for reasons discussed below, it could not yet resist strong Congressional pressure for new restraints on short selling or other matters. The general expectation of even short sales' defenders was that the SEC "had to do something."

The SEC staff proposal maintained that the final rule would enhance investor confidence in equity markets, the rule would apply only when the alternative uptick rule might prudently restrain downward price momentum, and it would give those actually owning securities the first place in line to sell. SEC Chairman Mary Schapiro¹⁶⁵ and Commissioners Luis Aguilar¹⁶⁶ and Elisse Walter¹⁶⁷ voted for the rule, suggesting that it balanced competing considerations; Commissioner Walter noted the closeness of the decision.¹⁶⁸ Dissenting Commissioners Kathleen Casey and Troy Paredes maintained that no empirical evidence demonstrated likely

¹⁶⁵ Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Short Sale Restrictions (Feb. 24, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch022410mls-shortsales.htm>.

¹⁶⁶ Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Reforming Short Sales: Striking a Balance That Can Work for Investors (Feb. 24, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch022410laa-shortsales.htm>.

¹⁶⁷ Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Opening Remarks Regarding Short Sale Price Restrictions (Feb. 24, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch022410ebw-shortsales.htm>.

¹⁶⁸ *Id.*

improvements in investor confidence or market quality from the rule, that this less costly option still was an expensive burden for firms and market centers without net benefits, and that the rule would as likely damage markets and investor confidence as improve them.¹⁶⁹ The dissenters contrasted the quality of the research underlying the SEC's suspension of the uptick rule in 2007 to the unsubstantiated references to "improved investor confidence" primarily supporting this decision.

The dissenters' criticisms of the justifications for the rule were compelling. As they noted, the proposal itself contained much more than the usual amount of information contradicting an agency's conclusion. The SEC staff's arguments for the alternative uptick rule, even with a circuit breaker, were made in an ambivalent way in comparison to its argument for the 2007 suspension of the uptick rule. The perceived political necessity to establish some type of new restraints, given the stigma around short sales in the market crisis and complaints about short selling by legislators, constrained its options.

The SEC has been one of the most respected public regulatory agencies since it was established in 1934.¹⁷⁰ In the 1980s the Roper Center for Public Opinion reported that 58% of those polled, and over 80% of those with an opinion, viewed the SEC favorably or highly favorably.¹⁷¹ Studies examine the "two way street" of influence between Congress and the SEC, but indicate that the SEC historically has had a higher degree of discretion and latitude in its actions than most other regulatory agencies.¹⁷² Congress has tended to defer to the technical expertise of the SEC in matters that do not involve intense political questions because of its reputation. For example, Anne Khademian's book on *The SEC and Capital Market Regulation*, subtitled *The Politics of Expertise*, discussed how Congress regarded the SEC as managing complex legal and regulatory issues in relatively even-handed and dispassionate

¹⁶⁹ See Kathleen L. Casey, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Short Sale Restrictions (Feb. 24, 2010), available at <http://www.sec.gov/news/speech/2010/spch022410klc-shortsales.htm>; Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Adoption of Amendments to Regulation SHO (the "Alternative Uptick Rule") (Feb. 24, 2010), available at <http://www.sec.gov/news/speech/2010/spch022410tap-shortsales.htm>.

¹⁷⁰ See, e.g., JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (2003).

¹⁷¹ John C. Coates, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 543-44 (2010).

¹⁷² See, e.g., GEORGE A. KRAUSE, *A TWO-WAY STREET: THE INSTITUTIONAL DYNAMICS OF THE MODERN ADMINISTRATIVE STATE* (1999).

ways.¹⁷³ In testimony before the Senate Committee on Banking, Housing, and Urban Affairs in 2008, Arthur Levitt commented that “[f]or the past 75 years, the SEC has been the crown jewel of the financial regulatory infrastructure and the administrative agencies.”¹⁷⁴

As noted above, reports regarding Bernard Madoff’s fraud and other matters related to the financial crisis damaged the SEC’s reputation in 2008-2009, and a reputational survey in 2009 rated the SEC lowest of six federal agencies listed.¹⁷⁵ By the fall of 2009, the agency’s leadership had taken steps conveying widely that the SEC was making good-faith efforts to turn around its recent performance. The agency changed almost completely its senior staff leadership and generated several visible regulatory proposals and enforcement cases. It stated that it would deal with technological complexity in financial markets more adeptly through reorganization and specialized recruitment, bringing on several prominent individuals to head a new Office of Risk Management and Innovation.¹⁷⁶ By December 2009, Congress discussed doubling the SEC’s budget directly or by permitting it to fund itself through retained regulatory fees, and Congress likely would grant it substantial new enforcement and regulatory authority.¹⁷⁷ Its

¹⁷³ See ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE* (1992).

¹⁷⁴ Arthur Levitt, Testimony to United States Senate Committee on Banking, Housing, and Urban Affairs (Oct. 15, 2008), *available at* http://banking.senate.gov/public/_files/LEVITTBankingCommitteeTestimonyFINAL101608.pdf.

¹⁷⁵ OFFICE OF INVESTIGATIONS, U.S. SEC. & EXCH. COMM’N, *INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF’S PONZI SCHEME—PUBLIC VERSION* (2009), *available at* <http://www.sec.gov/news/studies/2009/oig-509.pdf>; OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM’N, *SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM* (2008), *available at* <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf>; OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM’N, *SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM* (2008), *available at* <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf>; Posting of Bruce Carton to Compliance Week, *Public Now Views SEC More Unfavorably Than IRS*, <https://www.complianceweek.com/blog/carton/2009/05/22/public-now-views-sec-more-unfavorably-than-irs/> (May 22, 2009, 13:00 EST).

¹⁷⁶ Press Release, SEC’s New Division of Risk, Strategy, and Financial Innovation Adds Experts to Senior Ranks (Nov. 5, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-238.htm>; Press Release, SEC Announces New Division of Risk, Strategy, and Financial Innovation (Sept. 16, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-199.htm>.

¹⁷⁷ Malini Manickavasagam, *Regulatory Reform: House-Passed Reform Bill Strengthens SEC with More Resources, New Powers*, 41 Sec. Reg. L. Rep. (BNA) 2254, 2254 (Dec. 14, 2009); Roben Farzad & Theo Francis, *The SEC: To Catch a Cheat*, *BUS. WEEK*, Nov. 2, 2009, at 25.

political position, however, probably had not improved enough to enable it to resist key legislators' views on the value of new restrictions on short sales.

One view of this process is that the SEC made the best of a bad situation, choosing the most efficient option available with at least the possibility of some benefits under some circumstances. The decision would enable it to move forward on important regulatory questions without further distraction over a peripheral issue. Thus, the agency balanced effectively the technical and political considerations it had to confront. Another view of this process is that the final rule would legitimate pressures for tighter restrictions on short sales during the next market downturn, and that the agency should not have allowed political considerations to intrude on a technical regulatory decision to this extent. This decision, critics feared, might invite a similar degree of political intrusion on other issues related to technology and equity market structure.¹⁷⁸ How either of these views will play out in the future is both an empirical question and a matter of perspective.

¹⁷⁸ Concept Release on Equity Market Structure, 75 Fed. Reg. 3,594 (Jan. 21, 2010); Regulation of Non-Public Trading Interest, 74 Fed. Reg. 61,208 (proposed Nov. 23, 2009) (to be codified at 17 C.F.R. pt. 242).