

GIVING INVESTORS SHORT SHRIFT: HOW SHORT SALE CONSTRAINTS
DECREASE MARKET EFFICIENCY AND A MODEST PROPOSAL FOR
LETTING MORE SHORTS GO NAKED

Kevin A. Crisp

8 J. BUS. & SEC. L. 135

TABLE OF CONTENTS

INTRODUCTION	136
I. FINANCIAL MARKET PRICING MODELS AND INVESTOR EXPECTATIONS	137
A. The Simplifying and Necessary Assumption of Homogenous Investor Expectations.....	137
B. Debunking Simplicity and Necessity: Heterogeneous Investor Expectations.....	138
C. The Heterogeneous Expectations Model: Difference Drives Trading and Pricing.....	139
II. MARKET EFFICIENCY AND THE ROLE OF SHORT SALES.....	140
A. Average Investor Expectations, Information Efficiency, Fundamental Value Efficiency, and Long-Term Market Stability.....	140
B. Potential Inefficiencies Caused by Short Sale Constraints: Why We Shouldn't Constrain Shorts.....	141
C. Potential Problems: When Might We Want to Limit Short Selling?.....	142
III. THE OFFICIAL PARTY LINE: GOVERNMENT BASED SHORT SALE CONSTRAINTS.....	143
A. Wait Just a Second: The Uptick Rule.....	144
B. Clothing Required: The Not So New Delivery Requirements of Regulation SHO	145
C. Helping the Longs Through the Capital Gains Tax Gap	147
D. Not for the Meek: Mutual Fund Limitations	149
E. Taking It to the States: Utah Takes the Lead in the Fight Against Naked Shorts	150
IV. FIGHTING THE 'GOOD FIGHT': FIRM BASED SHORT SALE CONSTRAINTS	150
A. Technical Restrictions I: Listing, Stock Splits, and Borrowable Share Supply Reduction	151
B. Technical Restrictions II: Direct Trading Restrictions.....	152
C. Legal and Regulatory Threats and Other Non-Technical Bullying.....	153
V. THE HITS JUST KEEP ON COMING: TRADING BASED SHORT SALE CONSTRAINTS.....	154
A. Bears and Bulls Face Asymmetrical Transaction Costs.....	154
B. Asymmetrical Manipulative Risks: Short Squeezes Versus Bear Raids.....	155
CONCLUSION.....	156

INTRODUCTION

Although historically disparaged and subjected to cycles of regulatory constraints, short selling has been afforded many valuable roles in modern financial market modeling. Short sales increase informational efficiency, fundamental value efficiency, and help prevent volatile bubble and crash cycles. Short sales also increase liquidity, facilitate market making, and help to identify corporate fraud. Yet, short sales remain subject to constraints from regulators, issuing firms, and traders. To the extent that these obstacles effectively constrain short sellers, or affect longs and shorts asymmetrically, financial market efficiency decreases.

Part I discusses the role of investor expectations in financial market models. The Capital Asset Pricing Model assumes homogenous investor expectations both as a simplifying tool and as a necessary corollary to perfect demand elasticity. However, reality and empirical evidence debunk this assumption. The heterogeneous expectations model accounts for differences in investor expectations about an asset's future performance. Relative optimists buy while pessimists sell. In fact, this difference in expectations often drives trading.

Part II discusses the role of short sales in efficient markets. Under the heterogeneous expectations model of investing, short sales allow bearish investors to optimize their portfolios. Moreover, they allow pessimists to place their bet in the marketplace. In this way, short sales move market prices towards a more efficient reflection of the average investor expectation. Empirical evidence shows that short sales also increase informational efficiency by increasing the speed of price adjustments to new information. Short sales may also decrease volatility caused by noise traders. Perhaps most importantly, by helping to increase fundamental value efficiency, short sales may help to prevent momentum based bubbles and crashes.

Short sellers may cause inefficiencies, as well. When placed by corporate insiders, short sales may cause dangerous conflicts of interest or pose an increased risk of insider trading. Thus, short sales by corporate insiders are appropriately regulated. Short sales may also be used as part of a market manipulation scheme. However, this risk is not unique to short sales. Market manipulation rules apply appropriately to both longs and shorts. Finally, short sales decrease equity prices. The existing short sale constraints thus act as business subsidy that may be valuable to the national economy. However, inflated equity prices pose their own problems, including inefficient allocation of capital and an increased risk of volatility. Moreover, subsidizing businesses by constraining short sales likely shifts capital to stocks that we least want to subsidize.

Part III discusses and evaluates government based short sale constraints. First, the uptick rule attempts to limit the ability of short sellers to accelerate a downward moving market. The rule prohibits short sales at a price below the last sale price for that security or at the last sale price if that price was itself a downward movement. Empirical evidence shows that sufficient moment-to-moment price volatility allows short sellers to easily avoid the uptick rule. However, the uptick rule may effectively constrain short sellers due to the extra compliance costs relative to longs. The SEC is currently testing a repeal of the uptick rule.

Regulation SHO requires short sellers to make and record, prior to placing the sale, an affirmative determination that the securities can be borrowed. The rule was passed in 2004 amid firm's attempts to scapegoat naked short sellers. The SEC modeled the new rule after the NASD delivery requirements that were in force at the time. The NASD rules had proved difficult to enforce, and brokers can generally rely on standing assurances such as "Easy to Borrow" lists.

However, the rule may effectively constrain short sellers by reinforcing the relatively higher transactional costs faced by short sellers. Allowing widespread naked short selling would essentially turn short sales into futures contracts, in which the parties settled after some date without making physical delivery.

The federal individual income tax structure may constrain some short sellers relative to some long buyers. Gains on securities bought and held by individual investors for one year are generally subject to tax rates 20% below their ordinary income rate. Due to the method of calculating the holding period, short sales do not qualify for the favorable capital gains treatment. Thus, the differential tax treatment between bulls and bears may significantly constrain short sales.

Unfortunately, there is no easy answer for equalizing the tax rates between longs and shorts. Short sales do not fit the rationales behind favorable tax treatment of long-term capital gains. On the other hand, eliminating the favorable rate for longs may disrupt financial markets by eliminating the existing tax subsidy for capital assets. Regardless, the asymmetrical tax rates likely distort allocation of capital by decreasing fundamental value efficiency and inflating equity prices.

Bearish mutual fund managers face short sale limitations from both regulators and shareholders. A pessimistic fund manager is generally forced to hold cash, which prevents portfolio optimization. With almost \$10 trillion in mutual fund assets generally unable to optimize their bearish bets, mutual fund constraints may be causing significant financial market inefficiency.

Part IV discusses and evaluates firm based short sale constraints. Following the theory that short sale constraints inflate prices, many companies have “waged war” against short sellers of their stock. Firms engage in technical transactions that have no purpose or value other than to obstruct short sellers. Some firms even explicitly state that their only motive is to obstruct short sellers. The obstructive tactics include exchange listing, stock splits, conditional dividend payments, and encouraging shareholders to make their shares unavailable for shorts to borrow. These firm based short sale constraints generally do not run afoul of market manipulation rules. Yet, to the extent they work, market efficiency decreases. Unfortunately, drawing clear lines for these undesirable short sale constraints may be difficult because the actions often have otherwise legitimate purposes.

Issuing firms also use courts, regulatory agencies, and public opinion to scare short sellers from their stock. To the extent that firms make frivolous claims, cloud the informational market, or subject short sellers to an asymmetrical risk of regulatory costs, market efficiency decreases.

Part V discusses and evaluates two trading based short sale constraints. First, shorts face higher transactional costs than longs. Second, shorts may face an increased risk of loss from manipulative schemes. This is because short sales tend to be more economically fragile than long buys. Again, allowing widespread naked short selling would help to alleviate both the asymmetrical costs and the asymmetrical trading risks.

I. FINANCIAL MARKET PRICING MODELS AND INVESTOR EXPECTATIONS

A. The Simplifying and Necessary Assumption of Homogenous Investor Expectations

For years the Capital Asset Pricing Model (CAPM) enjoyed wide support from the academic community,¹ especially the legal academic community,² as the best financial market pricing model. Portfolio theory and efficient market theory form the basic building blocks of CAPM.³ Under portfolio theory, investors value assets based on the expected return and the expected variation on that return. Increased variation, or risk, will cause investors to discount an asset relative to its expected return.⁴ Efficient market theory assumes that the velocity of information relevant to an asset's value will generally prevent individual investors from gaining through information arbitrage.⁵

CAPM goes on to predict efficient market equilibriums with perfectly elastic demand functions. When demand is perfectly elastic, buyers will not support any increase in price. Meanwhile, any decrease in price will be immediately consumed by enthusiastic buying until price returns to its equilibrium.⁶ Under CAPM, this occurs because all investors have valued assets identically based on expected return and expected risk, and all investors are trading on identical information. Thus, trading occurs when prices fail to reflect *consensus* expectations.⁷

The assumption of homogeneous investor expectations is both a simplifying assumption⁸ and necessary for CAPM to validate its claim of perfect demand elasticity.⁹ However, both the simplifying assumption and the perfect demand elasticity hypothesis have come under recent academic fire.¹⁰

B. Debunking Simplicity and Necessity: Heterogeneous Investor Expectations

Assuming that all investors agree about an asset's expected return and risk defies common sense and empirical evidence. Earnings estimates from industry analysts, supposed experts on the companies they cover and possessing nearly identical information and skill, frequently differ. Financial media often report on how a conflict between bulls and bears moved the market. Economic experts report widely varying predictions on future economy-wide growth, which heavily impacts the financial prospects of individual economic participants. Further, market participants possess varying levels of relevant information and talent. To assume homogeneous investor expectations for the sake of simplicity ignores the reality of financial markets.

¹ See R. BREALEY & S. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 163 (3d ed. 1988); Gordon & Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. REV. 761, 776 (1985).

² See Gilson & Kraakman, *the Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549-50 (1984).

³ See Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1239 (1990).

⁴ *Id.* at 1239-40.

⁵ *Id.* at 1240-41.

⁶ *Id.* at 1239.

⁷ *Id.* at 1241, 1245.

⁸ *Id.* at 1245.

⁹ *Id.*

¹⁰ See *Id.*; Edward Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151 (1977);

Moreover, current scholarship and empirical evidence also debunk perfect demand elasticity.¹¹ Changes in prices of securities actually cause incremental changes in demand. To purchase larger chunks of a security a buyer must offer higher prices.¹² Thus, assuming homogenous investor expectations oversimplifies and is no longer necessary to support an artificial account of investor demand.

C. The Heterogeneous Expectations Model: Difference Drives Trading and Pricing

The Heterogeneous Expectations (HE) Model assumes that individual investors hold differing beliefs about an asset's future prospects. Subjective disagreement may arise from an investor's inherent optimism or pessimism for a particular stock or segment. Further, unlike CAPM, the HE Model doesn't require perfect information,¹³ perfectly rational actors,¹⁴ homogeneous risk tolerance, or unlimited resources.¹⁵ Thus, investors may hold differing subjective evaluations about an asset's future performance due to a number of factors that were controlled under other models.

Under the HE Model, pessimists sell while optimists buy. Due to a limited supply of outstanding securities, relative optimists buy from relative pessimists until, all other things equal, all outstanding shares are held by only those investors who are the most optimistic about that asset's future performance. This is because those investors who are most optimistic about a security will continue buying until resources, risk aversion, or price satisfies their optimism.¹⁶ After an asset's price reaches a near-term equilibrium, trading will occur mostly due to changes in investor expectations.

Thus, a security's price will be determined in the open market by investor bets that are driven by heterogeneous expectations. Optimists bet by buying long, while pessimists bet by selling. However, with a limited supply held only by those most optimistic about an asset's future performance, the price will likely exceed the average investor's valuation.¹⁷ Moreover, those sufficiently pessimistic to not own the asset will lack the ability to make their bet unless they can place a short sale. Thus, many commentators have noted that legal and practical short sale constraints further inflate asset prices above the average investor expectation by obstructing the ability of relatively pessimistic investors to place their bet in the marketplace.¹⁸

¹¹ Stout, *supra* note 3, at 1252-1258; Miller, *supra* note 10.

¹² Stout, *supra* note 3, at 1247.

¹³ Lynn A. Stout, *Why The Law Hates Speculators: Regulation And Private Ordering In The Market For OTC Derivatives*, 48 DUKE L.J. 701, 741.

¹⁴ *See Id.* at 747.

¹⁵ *See Id.* at 741

¹⁶ Miller, *supra* note 10, at 1153.

¹⁷ Stout, *supra* note 3, at 1248.

¹⁸ *See* Michael R. Powers, David M. Schizer, and Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX L. REV. 233, 238 (2003-2004); Stout, *supra* note 3, at 1248; Stout *supra* note 13, at 757-62. Academics have also used the existence of short sales and short sale constraints to test the validity of the HE Model.

II. MARKET EFFICIENCY AND THE ROLE OF SHORT SALES

A. Average Investor Expectations, Information Efficiency, Fundamental Value Efficiency, and Long-Term Market Stability

A common definition of an efficient financial market is a market where prices “fully reflect available information.”¹⁹ Assuming an even distribution of information and sophistication amongst optimists and pessimists alike, we might take the average investor expectation to be the most efficient valuation. However, it is likely that optimists and pessimists derive their differing opinions based at least in part on differing levels of relevant information and sophistication. Bears may derive their relative pessimism from better access to relevant information or heightened sophistication relative to the investing population as a whole. In such a case, the average bear expectation would most efficiently reflect all available information. Thus, the average investor expectation may not always accurately represent all available information.²⁰

We then look to the how efficiently relevant information disseminates in the marketplace. A market has informational efficiency when traders cannot profit through information arbitrage.²¹ In such a market, relevant information disperses to all investors at a very high, theoretically instantaneous velocity. Thus, prices adjust to relevant information instantaneously because investor expectations adjust instantaneously.

However, Professor Lynn Stout notes that “informational efficiency, alone, does not necessarily imply that market prices are going to respond to information correctly, or even that prices are going to respond at all.”²² Markets exhibit fundamental value efficiency when prices *accurately* reflect the “best possible” expectation of returns and risks based on all relevant information available at the time.²³ Thus, informational efficiency may help to increase fundamental value efficiency, but even markets with informational efficiency will be subject to other misleading biases, such as sophistication bias.

Long-term stability, another concept of market efficiency, in part highlights why we might be interested in maintaining fundamental value efficiency. When prices rise significantly above fundamental values, a market bubble arises that almost inevitably bursts. Such large swings increase perceived risk and decrease investor confidence. Thus, market bubbles may unduly increase the cost of raising capital. Indeed, a significant downswing less related to fundamental economic values than to irrational market overpricing can leave a long-lasting mark on the investing public.²⁴ Thus, from a more general view, efficient national financial markets should be relatively stable over the long-term.

¹⁹ Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639 (2003) (citing Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970)).

²⁰ Stout, *supra* note 3, at 1249.

²¹ Stout, *supra* note 19, at 639-40.

²² *Id.* at 640.

²³ *Id.*

²⁴ *See generally id.*, at 662 (noting a significant risk aversion amongst investors and that the “prospect of intermittent loss is so psychologically painful that investors tend to shun stocks.”)

B. Potential Inefficiencies Caused by Short Sale Constraints: Why We Shouldn't Constrain Shorts

Placing a bet is a major function of trading securities in secondary markets.²⁵ As noted above, market pessimists place their bets primarily through short sales.²⁶ Thus, effective constraints on short sales mute market pessimists so that price inflates above that dictated by the average investor expectation.²⁷ If we assume informational efficiency and perfect sophistication, then a price inflated above the average investor expectations would likely be inflated above the fundamental value. Further, assuming that markets cannot sustain inaccurate prices, such a position would likely lead to undue volatility. However, in a world of imperfect information and uneven investor sophistication, we must look further than average investor expectations.

Short sale constraints also decrease informational efficiency. In particular, empirical evidence shows that short sale constraints decrease the speed of price adjustments to bad news.²⁸ Such inefficiency opens markets to information arbitrage, allowing traders to gain on asymmetric information. Moreover, informational inefficiency decreases price accuracy, since prices would not fully reflect all available information.

While a deviation from an accurate average investor expectation and decreasing informational efficiency may cause price to misrepresent an asset's fundamental value,²⁹ short sale constraints cause fundamental value inefficiency in other ways, too. "Noise traders" trade for reasons generally unrelated to an accurate measure of an asset's fundamental value. For example, noise traders might act on market momentum, misinformation, or poor strategy.³⁰ Powers, Shizer, and Shubik note that "[w]hile noise traders could be either long or short, optimistic noise traders pose a particular threat because... their overly rosy assessment is less

²⁵ See Powers, Schizer, and Shubik, *supra* note 18, at 237 (noting that trading also occurs to optimize liquidity).

²⁶ See *id.* at 238 (also noting that "[s]hort sales enable market pessimists to optimize their portfolios.").

²⁷ Powers, Schizer, and Shubik also note that short sales help investors to effect various bets other than the primarily pessimistic bet. For example, investors use short sales to complete bets on volatility and mergers, as well as to hedge risks. Thus, they argue that "short sales play a valuable role in completing financial markets." *Id.* at 238-39.

²⁸ See Sorin M. Sorensen, *The Effect of Options on Stock Prices*, 55 J. FIN. 487 (1998) (noting that widespread availability of options helps to decrease this effect).

²⁹ *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. of Financial Services*, 106th Cong. 5 (2003), <http://72.14.253.104/search?q=cache:6Y223CS4M9AJ:financialservices.house.gov/media/pdf/052203ol.pdf+%22investment+company+act%22+%22short+sale%22+%22mutual+fund%22&hl=en&gl=us&ct=clnk&cd=20> [hereinafter *Long and Short*] (testimony of Owen A. Lamont) (noting empirical evidence that short sale constraints lead to 24% overvaluation, citing other supporting studies, and reasoning that short sellers frequently function to discover troubled companies, corporate fraud, or otherwise inflated stock prices).

³⁰ Powers, Shizer, and Shubik, *supra* note 18, at 240.

likely to be corrected than an overly pessimistic view.”³¹ Sophisticated short sellers are needed to reign in a stock that noise traders have bid above its fundamental value.³²

In the face of short sale constraints, this is less likely to efficiently occur, which may then lead to our fourth concern, a market bubble. Indeed, as positive momentum increases, volume in noise trading may increase as more traders buy based on relatively unchecked positive momentum.³³ Momentum, or other price factors unrelated to fundamental value, eventually reaches a tipping point and prices return to levels better supported by fundamental value. However, the decrease in stability caused by market bubbles can be detrimental to the health of financial markets. Even without the potential negative externalities associated with significant bubble and crash cycles, equity prices that are out of whack with fundamental values decrease efficiency by causing inefficient allocation of capital.³⁴

Finally, short sales may prove useful for other reasons not directly tied to these concepts of market efficiency. Short sales are generally necessary for market making.³⁵ Short sales may increase liquidity for investors.³⁶ Also, short sellers may help detect corporate fraud.

C. Potential Problems: When Might We Want to Limit Short Selling?

Short sales may cause inappropriate conflicts of interest when placed by officers, directors, or other significant shareholders. Fortunately, this issue involves a generally identifiable class, and is thus ideally suited for short sale specific legislation. Short sales by corporate managers are not completely barred since they may need to sell their company’s stock short for legitimate reasons such as liquidity or hedging. However, since such needs should not be long-term, SEC rules generally prohibit insiders from holding a short position in their own company’s stock for longer than 20 days.³⁷

Similarly, short sales may be a vehicle for improper use of insider information. However, this is also a potential problem for long purchases. Thus, generalized insider trading prohibitions provide a better fit.³⁸

Inflated equity prices subsidize businesses by decreasing the cost of capital.³⁹ Since it has been argued that short sale constraints effectively increase equity prices, such constraints may be valuable to the economy as a whole. However, as noted above, prices inflated above

³¹ *Id.* at 241.

³² Note that this assumes that the short sellers are not noise traders themselves. However, if we assume that noise traders and sophisticated traders are just as likely to be either optimistic and pessimistic, then constraining only the pessimists would tend in the aggregate to pull price away from its fundamental value as determined by sophisticated, informed investors whose sole focus is an asset’s real value. For a discussion of manipulative short sellers, see *infra* text pp. 15-18.

³³ See Stout, *supra* note 19, at 662 (using behavioral finance and the HE model to show how market bubbles can form when short sales are constrained).

³⁴ Floyd Norris, *Time to Bring Share Lending Into the Light*, N.Y. TIMES, Sept. 22, 2006, at C1.

³⁵ See Powers, Shizer, and Shubik, *supra* note 18, at 238. Indeed, market makers are often exempt from some short sale regulations.

³⁶ *Id.* at 236.

³⁷ 15 U.S.C. § 78p(c) (2006).

³⁸ See 15 U.S.C. § 78p (2006) (requiring disclosure of short-swing profits by insiders).

³⁹ Powers, Shizer, and Shubik, *supra* note 18, at 249.

fundamental value tend to be volatile. Thus, any benefits derived from such a business subsidy may be offset by the negative externalities associated with inaccurate market prices and market bubbles.⁴⁰ Moreover, such business subsidies and macroeconomic management would be much more effective if implemented by economic controls other than short sale constraints. Indeed, the firms that benefit most from such a short sale constraint subsidy are likely those whose stock price most exceeds the fundamental value. These stocks that warrant relatively more short sale activity are likely companies that we least want to subsidize. A stronger concern may be the economic costs associated with short sale constraint deregulation. Lifting the burdens faced by short sellers would likely remove the cost of capital subsidy currently held by businesses.⁴¹

Market manipulation has long been a popular concern for short sales.⁴² The general worry is that traders with sufficient resources can intentionally push the price of a security down by placing a significant number of short sales.⁴³ Such concerns tend to be most prevalent for thinly traded assets, for which fewer resources would presumably be needed to create price movements. If the security was previously trading at an accurate price, then such manipulation would decrease fundamental value efficiency. However, these deceptive trading concerns are equally applicable to longs. Thus, generalized market manipulation rules more accurately target such practices than would short specific rules.

Some short sale hawks argue that aggressive short selling can cause “cascading defaults.”⁴⁴ If unchecked short sellers are wrong about their bearish bets, they risk large losses and default. If the defaults are large enough, then entities beyond the primary creditor may be affected. However, since longs also use margin in their transactions, this potential inefficiency is not short sale specific. Indeed, both longs and shorts are subject to margin requirements intended to prevent cascading financial collapse.⁴⁵

III. THE OFFICIAL PARTY LINE: GOVERNMENT BASED SHORT SALE CONSTRAINTS

Popular opinion has long disparaged short sellers. The public often views long purchasers as investing in the national economy for the greater good.⁴⁶ Meanwhile, short sellers have been described as “evil people” and “irrational, even immoral.”⁴⁷ The academic literature frequently summarizes the historical view of short sellers with the now hackneyed 19th century Daniel

⁴⁰ See *id.* at 248 (noting that “[A]ccurate market prices yield significant positive externalities.”).

⁴¹ Further empirical study into this question may be needed before any large-scale short sale bailout. Any social benefits from more efficient or accurate market pricing may be offset to the extent that abruptly removing the existing business subsidy harms the economy. It is likely that gradual implementation and fair warning to investors and firms alike would help to mitigate such harm.

⁴² For discussion on short sale specific rules intended to prevent manipulation, see *infra* text pp. 19-26.

⁴³ For examples of short sales used in manipulative schemes, see *infra* n. 72-74.

⁴⁴ See *e.g.* Powers, Shizer, and Shubik, *supra* note 18, at 246.

⁴⁵ Note that Federal Reserve regulations require short sellers to provide cash collateral with their stock lender. Fed. Res. Bd. Reg. T, 12 C.F.R. 220.12 (2006).

⁴⁶ Powers, Shizer, and Shubik, *supra* note 18, at 248.

⁴⁷ Nick Evans, *Don't Shoot the Short Sellers*, 33 *Euromoney* 20 (2002).

Drew quote, “He who sells what isn’t his’n, Must buy it back or go to prison.”⁴⁸ Due to irrational and misplaced fears about short sellers, this persistently negative view has led to short sale specific regulations promulgated by governments, their agencies, and self-regulated organizations. Some of these effectively constrain short sellers, while one prominent short sale rule appears to be no more than political window dressing.

A. Wait Just a Second: The Uptick Rule

We start with a Depression-era SEC rule designed to limit the ability of short sellers to push down prices. Rule 10a-1 prohibits certain traders from selling short at either a minus tick or a zero-minus tick. A minus tick is a price that is *below* the last sale price for that security. A zero-minus tick is a price that is the *same* as the last sale price when the last sale price is below the immediately preceding sale price.⁴⁹ Thus, traders subject to the uptick rule can only sell short at a price above the last sale price for that security or at the last sale price if the last sale price was itself an uptick.⁵⁰

The SEC stated three objectives for the uptick rule upon adoption: (1) to allow short selling in an advancing market; (2) to prevent short selling from driving prices downward; and (3) to prevent short sellers from accelerating downward price moves.⁵¹ However, the SEC at the same time questioned the efficacy of the uptick rule in meeting these objectives.⁵²

If the uptick rule effectively constrained short sellers, shorts would be unable to efficiently reign in inflated security prices. This occurs when we define efficiency by the speed at which price adjusts to new information, especially bad information. Such informational inefficiency, as noted above, would also contribute to fundamental value inefficiency. Indeed, the SEC has suggested that short selling, even during a declining market, increases efficiency by facilitating price movement towards the market’s perception of the true value.⁵³

However, it is likely that the uptick rule proves to be a very ineffective constraint on short sellers. Although there are many limitations on when the uptick rule applies,⁵⁴ the overarching weakness in the rule as a short sale constraint stems from its structure. Historical data shows that in a declining market, sufficient price volatility exists so that short sellers can comply with the

⁴⁸ Daniel Drew, American Financier, http://www.brainyquote.com/quotes/authors/d/daniel_drew.html. However, Drew himself was a short seller. Christopher Mayer, *In Defense of Shorts*, THE FREE MARKET, Sept. 2000, http://www.mises.org/freemarket_detail.asp?control=321&sortorder=articledate. Thus, it is not entirely clear that Drew was warning against the whole practice of short sales, but rather merely warning that short sellers must eventually cover.

⁴⁹ 17 C.F.R. § 240.10a-1(a)(1)(i)(2006).

⁵⁰ Note that there are other definitional limitations to the Uptick Rule in Rule 10a-1, however, due to the general inability of the rule to constrain short sellers, a complete discussion of the rule would be beyond the scope of this paper.

⁵¹ *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

⁵² *Id.* at Pt. 2, 292-93.

⁵³ Exchange Act Release No. 50103, 83 SEC Docket 1278 (Jul. 28, 2004), 2004 WL 1697019 at *45.

⁵⁴ *See infra* note 50.

uptick rule and yet place substantial short sale volume.⁵⁵ Short sellers need only to wait for a minor uptick to place their sales. Indeed, short sellers might want to do this despite the uptick rule as part of a profit maximizing trade strategy.⁵⁶

In light of both the general inefficacy of the uptick rule and the growing sentiment that short sales in general do not pose unique risks to the market, the SEC adopted a pilot program in 2004 to test repealing of the uptick rule.⁵⁷ Pending the results of the pilot program, short sellers in the future may not be forced to wait to place their trades, or to document that they did so, and markets may become marginally more efficient.

B. Clothing Required: The Not So New Delivery Requirements of Regulation SHO

The SEC adopted Regulation SHO amid the fallout of the millennial market crash in an attempt to update short sale rules. Some investors and corporate managers blamed “naked short sellers” for accelerating and prolonging the down cycle. The SEC defines naked short selling as “selling short without borrowing the necessary securities to make delivery.”⁵⁸

Critics of naked short sellers argued that the practice created an infinitely expandable supply of artificial shares, which then artificially depressed share prices.⁵⁹ However, the SEC explicitly denies that failures to deliver from short sales create a counterfeit or artificial supply.⁶⁰ According to the SEC, the real danger of naked short selling is the increased risk of persistent failures to deliver for a particular security. Thus, the policy rules that govern naked short sales focus on encouraging complete and consistent delivery.⁶¹ Moreover, maintaining pricing efficiency and market liquidity are also important policy goals of the SEC.⁶² Thus, the delivery requirements designed to appease naked short hawks remain flexible and generally allow unintentional naked short selling.⁶³

⁵⁵ Special Study, *supra* note 51, at Pt. 2, 292-93.

⁵⁶ Note, however, that there would still be economic waste in the form of compliance costs.

⁵⁷ The pilot program was adopted as part of Reg. SHO, which included a package of changes intended to update the short sale rules. The program was recently extended until August 6, 2007. *SEC to Extend Test on Short-Sale Rules*, WALL ST. J., Apr. 22, 2006, at B5. The uptick rule was suspended for about one third of stocks traded by volume on American markets. The SEC will gather data and then consider full repeal of the uptick rule. Floyd Norris, *Loosening Up Some Depression-Era Limits On Selling Stocks Short*, N.Y. TIMES, Jun. 24, 2004, at C3.

⁵⁸ Short Sales, Sec. Exch. Rel. No. 34-48709, 2003 WL 22461522 at *6 (SEC Oct. 28, 2003).

⁵⁹ Helen Avery and Peter Koh, *The Curious Incident of the Shares That Didn't Exist*, EUROMONEY, Apr. 2005, at 33 (noting that for some companies subjected to high levels of short selling, the amount of shares in circulation can exceed the available float).

⁶⁰ SEC, Division of Market Regulation, *Key Points About Regulation SHO* (Apr. 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm>; *see also DTCC Responds on Naked Short Selling*, http://www.dtcc.com/ThoughtLeadership/keyissues/naked_short_selling.htm.

⁶¹ Short Sales, *supra* note 58.

⁶² *Id.* at *5.

⁶³ *See* Zachary T. Knepper, *Future-Priced Convertible Securities and the Outlook for “Death Spiral” Securities-Fraud Litigation*, 26 WHITTIER L. REV. 359, 380 (2004).

Regulation SHO essentially created uniform delivery rules by adopting the delivery requirements of former NASD Rule 3370.⁶⁴ To place a short sale, brokers must make and record, prior to placing the sale, an affirmative determination that the securities sold can be borrowed.⁶⁵ Brokers generally rely on standing assurances of availability such as “Easy to Borrow” lists.⁶⁶ However, the affirmative determination on reasonable grounds of certainty that a stock can be borrowed proved hard to enforce under the NASD rules. For certain stocks that incur consistent failures to deliver, brokers must deliver the stock no later than 13 days from the trade.⁶⁷

In theory, the locate requirements place an asymmetrical constraint on short sellers, which would then cause stocks to be overvalued. This would be especially true for stocks that find themselves on the threshold list.⁶⁸ The locate requirements also theoretically limit short sellers to selling only those shares available to be borrowed.⁶⁹ If sophisticated and informed short sellers wish to bet that a stock price is inflated, then the HE model and efficiency concerns support allowing short sellers to help the market set more accurate prices.⁷⁰ Further, there is an increased asymmetrical compliance cost for short sellers.⁷¹

⁶⁴ When Reg. SHO was adopted in 2004, the NASD repealed Rule 3370 to reduce the newly created redundancy. SRO, *Notice of Filing and Immediate Effectiveness of Proposed Rule Change by NASD, Inc. Relating to Repeal of Existing NASD Short Sale Rules in Light of SEC Regulation SHO*, Sec. Exch. Rel. No. 34-50822, 2004 WL 2850982 (SEC Dec. 14, 2004). The New York Stock Exchange also had a very similar rule that required prior assurances of delivery. NYSE Rule 440C.10.

⁶⁵ 17 C.F.R. § 242.203(b) (2006).

⁶⁶ Some commentators note that the delivery requirement has very little bite. See Cynthia Schreiber, *Short-Selling Rules Carry Little Impact*, WALL ST. J., Feb. 9, 2005, at 1. The virtually identical NASD Rule 3370 also provided very little bite. Actual delivery was never really required, and only the failure to make the proper recording gave rise to sanctions. See e.g. *In the Matter of the Application of Ko Securities, Inc.*, Sec. Exch. Rel. No. 34-48550, 2003 WL 22233255 (SEC Sep. 26, 2003) (upholding NASD sanctions for firm’s failure to maintain adequate records under NASD Rule 3370). This essentially made some short sales into futures contracts, whereby the parties merely close out their bets without actual delivery.

⁶⁷ For a stock to be a “threshold stock,” at least 10,000 shares and 0.5% of the company’s outstanding shares must fail to be delivered for five trading days. 17 C.F.R. § 242.203(b)(3) (2006).

⁶⁸ Note that placement on the threshold list, which theoretically would cause a stock’s price to inflate, would then be desirable to corporate managers. Traders have been watching threshold stocks in particular to see if the locate rules create an effective impediment to short selling activity. *Short-Selling Rules Carry Little Impact*, *supra* note 66.

⁶⁹ Especially in conjunction with firm efforts to limit the available pool of borrowable shares, this short sale constraint may be significant. See *infra* text 34-38.

⁷⁰ Note again that the SEC refutes the major argument of critics that naked short selling creates an artificially inflated supply.

⁷¹ This increased compliance cost serves to exacerbate the already increased technical costs associated with short selling. See *infra* text 41-43.

Naked short critics also argue that naked short selling is a vehicle for market manipulation. They point to alleged cases of “toxic funding”,⁷² “the death spiral”,⁷³ and “bear-raids”.⁷⁴ The SEC agrees that manipulative abuses of naked short selling potentially harms long-term investors and leads to market inefficiency.⁷⁵ However, such manipulative practices are not unique to short sellers, and the existing market manipulation rules make a better fit. Targeting all naked short sellers only increases economically wasteful compliance costs with an overbroad rule that has minimal bite.

C. Helping the Longs Through the Capital Gains Tax Gap

Some long buyers earn preferential tax treatment over short sellers. This after-tax return gap may significantly affect the relative economics of taking these respective positions. Individual investors who bet on market increases by buying long and holding for one year generally face a tax rate of 15%.⁷⁶ Because of how the holding period for long-term capital gains is computed, short sellers are ineligible for the favorable rate. The relevant holding period for a short sale begins when a seller makes their covering purchase and ends when that stock is then used to repay the initial stock loan.⁷⁷ Since short sellers generally transfer the covering stock to their stock lender very quickly, short sale profits will be classified short-term even though the short position may have been held for more than year. Thus, short sale profits are taxed at the taxpayer’s ordinary income rate, which varies but is generally 20% higher than the capital gains rate for that taxpayer.⁷⁸

Since market optimists bet by buying long and market pessimists bet by selling short, the differential tax treatment of expected profits inflates market prices above fundamental value. As an effective relative short sale constraint, the capital gains tax gap decreases informational efficiency. Moreover, the tax gap exacerbates the intrinsic technical risk gap that already exists due to the relative economic fragility of short selling.⁷⁹

⁷² See Helen Avery, *SEC Seeks to Curb Naked Ambition*, EUROMONEY, Apr. 2005, at 43 (describing “toxic funding”).

⁷³ See Knepper, *supra* note 63 (describing “death spirals”).

⁷⁴ See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F. 3d 189 (3rd Cir. 2001) (describing “bear-raids”).

⁷⁵ Key Points About Regulation SHO, *supra* note 60, at V.1.

⁷⁶ See I.R.C. § 122(3) (setting out the holding period); I.R.C. § 1(h) (setting out the relevant rates); *but see* I.R.C. § 1221 (setting out limits on capital asset classification, in particular limiting *whom* may claim held securities as a capital asset).

⁷⁷ See I.R.C. § 1223; Treas. Reg. § 1.1233-1(a)(3).

⁷⁸ See I.R.C. § 1 (setting out the relevant tax rates). Note that individual investors not subject to tax liability, whether due to offsetting losses and deductions or tax-exempt status, will pay the same amount of tax on both short sale gains and long-term capital gains: zero. Further note that the gap only exists between long-term short positions and long-term long positions. For a more detailed discussion of the various individual tax permutations that affect the differential treatment of long-term capital gains and short sale profits, see Powers, Shizer, and Shubik, *supra* note 18, at 251-63.

⁷⁹ See *infra* text 41-43.

Unfortunately, closing the long-term capital gains tax gap would be problematic. The policy rationales behind the favorable treatment of capital gains include:⁸⁰ (1) providing an incentive to saving, investment, and economic growth; (2) encouraging capital flows to new and developing industries; (3) indirectly minimizing the double taxation of corporate income; (4) ameliorating the asset “lock-in” effect caused by the tax code’s realization rules;⁸¹ (5) minimizing the potentially harsh “bunching” effect caused by the realization rules;⁸² and (6) mitigating the tax code’s failure to add inflation to basis.⁸³

We might view open short positions as an asset under tax regulation § 1221.⁸⁴ Thus, short positions held open for one year or more would qualify for the favorable tax treatment afforded long-term buyers.⁸⁵ However, long-term short sale positions do not fit further the policy rationales behind the favorable long-term gain treatment. Short sales do not directly encourage economic growth, except to the extent that they encourage more efficient financial markets. Shorts do not provide start-up companies with their necessary capital. The realization requirement for taxing short sales does not cause asset lock-in. Finally, giving shorts preferential tax treatment would not ameliorate the double-taxation of corporate income or the tax code’s failure to incorporate inflation into basis.

If we change the baseline so that both long-term capital gains and short sale profits are taxed at ordinary income rates, then we lose the potential values embodied by the policies that support favorable treatment of long-term capital gains. Further, this favorable treatment indirectly subsidizes businesses and financial markets.⁸⁶ Abrupt removal of this subsidy may cause unwanted economic damage. However, there are policy reasons that support eliminating the

⁸⁰ William A. Klein, Joseph Bankman, & Daniel N. Shaviro, FEDERAL INCOME TAXATION 668-70 (14th ed. 2006).

⁸¹ Paper gains on held assets for both long purchasers and short sellers are not taxed until a realization event occurs, which usually involves selling the asset or closing out the short position.

⁸² Because of the realization requirements, gains that actually accrued over many years will be taxed in one single year, which may move a taxpayer through the progressive tax rates so that most or all of the gain, if taxed at ordinary income rates, would be taxed at a relatively higher rate than that normally faced by the taxpayer.

⁸³ For computing the gain on the sale of an asset or on the closing out of a short position, the tax code does not allow inflation to be added to the basis. Thus, for long-term holders, they might be taxed on large nominal gains that are actually much smaller than the real gains. Note, however, that this actually helps short sellers. If the initial sale price were adjusted upwards for inflation, short sellers would have to report larger gains than under current law.

⁸⁴ I.R.C. § 1221 (defining a capital asset as all “property” with eight exceptions, none of which are applicable per se to open short positions).

⁸⁵ This solution has been endorsed by Powers, Schizer, & Shubik, *supra* note 18, at 251. The authors further noted that short positions held open for one year or more are less likely to be part of a manipulative scheme. *Id.*

⁸⁶ Favorable treatment of long-term capital gains has long been viewed as an indirect business subsidy that increases capital market valuation. Indeed, this subsidy is an obvious policy rationale for the favorable treatment. However, only the emergence of the HE Model allows us to view the favorable long-term capital gains rate as inflating market prices even further by distorting the allocation of resources amongst shorts and longs.

favorable treatment of long-term capital gains, including the current system's distortion of equity pricing and efficient allocation of resources.⁸⁷

Thus, while eliminating the capital gains tax gap between longs and shorts would likely increase market efficiency by lifting a significant short sale constraint, it is not at all clear that the political and economic costs of doing so would be fully offset.

D. Not for the Meek: Mutual Fund Limitations

In step with the traditional disdain for short selling and the view that short sales were too risky for average investors,⁸⁸ the Investment Company Act of 1940 placed severe restrictions on the ability of mutual fund⁸⁹ managers to make short sales. Thus, bearish managers were generally forced to hold cash.⁹⁰ However, for such pessimistic investors, short sales would better optimize their portfolio. Moreover, allowing bearish mutual fund managers to optimize their portfolios through short sales would increase market efficiency, especially considering the relative sophistication of most mutual fund managers.⁹¹

The SEC relaxed short sale restrictions for mutual funds in 1997.⁹² So called "130/30" mutual funds may generally short \$30 for each \$100 invested.⁹³ While the new rules pave the way for bearish mutual fund managers to begin optimizing their portfolios, the availability of these "hedgery" mutual funds has been limited. Many fund companies want to avoid the extra compliance hassles.⁹⁴ Individual investors seeking to optimize their portfolios may instead invest in less regulated hedge funds, which are much more free to employ short sales.⁹⁵ However, the availability of hedge funds are currently limited to individual investors with \$1

⁸⁷ The favorable capital gains rate creates complex tax returns, which increase compliance costs and economic waste. Different tax rates are applied to different assets, distorting allocation of capital. Also, the disparate treatment of income from capital gains and labor distorts the allocation of resources amongst long-term investments and ordinary labor. *See* Klein, Bankman, & Shaviro, *supra* note 80, at 666.

⁸⁸ *Long and Short, supra* note 29, at 8.

⁸⁹ "A mutual fund is a company that pools money from investors and invests the money in stocks, bonds, short-term money-market instruments, and other securities." SEC, Mutual Funds (2006), <http://www.sec.gov/answers/mutfund.htm>.

⁹⁰ In an effort to market mutual funds as potential pieces in an individual investor's overall asset allocation strategy, many mutual funds go even further by limiting the percentage of cash a manager may hold at any time. Such "fully invested" funds would thus further reduce market efficiency by preventing bearish managers from not only short selling, but from selling out of the market altogether.

⁹¹ As of December 1, 2006, mutual funds managed \$9.898 trillion in investor assets. Investment Company Institute, About ICI, (2006), http://www.ici.org/about_ici.html.

⁹² *Long and Short, supra* note 29, at 10.

⁹³ *The Long and Short of 'Hedgery' Mutual Funds*, FINANCIAL ADVISOR, December 2006, http://www.fa-mag.com/news.php?id_content=4&idNews=824. The manager must invest the \$30 proceeds from the short sale in long positions, so that the ratio of short to long ends up 30/130. *Id.*

⁹⁴ *Id.*

⁹⁵ *See Long and Short, supra* note 29, at 9.

million net worth or \$200,000 annual income, which effectively blocks a significant number of individual investors.⁹⁶

E. Taking It to the States: Utah Takes the Lead in the Fight Against Naked Shorts

Utah recently passed a law aimed at naked short sellers that attempts to add teeth to SEC Regulation SHO.⁹⁷ Under the new law, companies domiciled in Utah may collect \$10,000 per business day from Utah brokers who fail to alert authorities about failures to deliver. Also, the new law gives the issuers of such securities a private right of action.⁹⁸

The Utah law, if enforced, may be a more effective short sale constraint than its SEC counterpart. Thus, the potential inefficiencies discussed above for Regulation SHO would hold more weight. In particular, compliance costs of short selling by Utah investors may be significantly distorted. Moreover, if the Utah law stands, a dangerous precedent may be set in which short sale hawks use state governments to decrease market efficiency.

IV. FIGHTING THE ‘GOOD FIGHT’: FIRM BASED SHORT SALE CONSTRAINTS

After discussing active steps that regulators have taken to constrain short sales, we next discuss government inaction against short sale constraints created by issuing firms. Executive salaries and corporate loan covenants are often tied to measures of equity. Also, shorts often provide a useful scapegoat for poor stock price performance. Thus, in accordance with the theory that short sale constraints inflate equity prices, issuing firms often attempt to obstruct short sellers of their stock. Firms use methods that fall into two main categories: technical restrictions and bullying.⁹⁹

Perhaps fittingly and in line with the theory that sophisticated short sellers increase fundamental value efficiency, firms that engage in a “war on the shorts”¹⁰⁰ typically see significantly decreased returns in the following months and years.¹⁰¹ Two reasons drive the decrease in returns. First, the inflated price caused by the firm based short sale constraints lowers the price adjusted return. Second, anti-shortening actions are often a last resort for troubled companies and signal negative inside information.¹⁰² Indeed, market watchers frequently use

⁹⁶ The SEC is currently considering raising these requirements, which were set in 1982 and not indexed to inflation. Kathleen Pender, *Hedge Fund Investing Reforms Considered*, S.F. CHRONICLE, December 10, 2006, at F-1.

⁹⁷ S.B. 3004, 2006 Leg. (Utah 2006).

⁹⁸ Complaint at 6, *Securities Indus. Assoc. v. Klein*, No. 2:06CV00623 (D. Utah 2006). The SIA filed suit to strike the law on federal preemption grounds and the law is currently subject to a temporary injunction.

⁹⁹ Note that firms may also employ a short squeeze, a trading based constraint discussed below that has deterrent effects similar to both firm based technical restrictions and firm based bullying.

¹⁰⁰ Owen A. Lamont, *Go Down Fighting: Short Sellers vs. Firms*, 11, Jan. 9, 2003, <http://www.haas.berkeley.edu/finance/lamontpaper.pdf>.

¹⁰¹ *Id.* at 28.

¹⁰² *Id.* at 28-29.

short sale data, both the volume for a specific stock and signs of a firm based war on shorts, as signals that sophisticated investors smell trouble, fraud, or both.¹⁰³

A. Technical Restrictions I: Listing, Stock Splits, and Borrowable Share Supply Reduction

Issuing firms often make short selling of their shares difficult by engaging in otherwise legal activities. First, stocks may face less short sale restraints when traded over-the-counter (OTC) or on NASDAQ.¹⁰⁴ Thus, while firms often seek listing on AMEX or NYSE for publicity and stature, some firms have explicitly done so to impede short selling of their shares.¹⁰⁵ Due to the expansion and general ineffectiveness of the uptick rule and the increased uniformity of delivery requirements caused by Regulation SHO, such tactics are likely to be less prevalent in the future. Moreover, the effectiveness of listing as a short sale constraint is subject to the limitations discussed above for the uptick rule and the delivery requirements.

In a second tactic, firms engage in stock splits or conditional distributions. Again, while there will often be non-short specific reasons for a stock split, firms have done so apparently for the sole purpose of causing short sellers to close their positions.¹⁰⁶ In one example, a firm forced shareholders to remit physical certificates to receive dividends, which forced the recall of stock loans to short sellers.¹⁰⁷ These technical constraints not only inflate stock prices by forcing short sellers out of the market for a particular stock, even if only temporarily, but also increase technical costs for short sellers and may more permanently deter short sellers.

A third, more elaborate, and potentially more permanent short sale constraint involves decreasing the supply of borrowable shares available to short sellers. Firms have publicly encouraged shareholders to remove their stock from “street name” and from margin accounts.¹⁰⁸ Firms may also move shares into “friendly ownership,” holders who will not lend the stock to short sellers.¹⁰⁹ The effect of these actions is often twofold. First, short sellers become more and more limited in their ability to place a trade as the number of borrowable shares decreases. This effect is often magnified for stocks of thinly capitalized companies. Thus, the price becomes inflated. Second, a short squeeze often occurs as existing shorts find their position too risky, which in turn causes an uptick in price as these investors are forced to buy shares outright in an ever inflated market.¹¹⁰

¹⁰³ See e.g. Peter A. McKay, *Short Selling: Short Interest Rises to Record On the Nasdaq; Bearish Investors' Moves Are Suggesting a Reversal Is in Store for Tech Rally*, WALL ST. J., Sep. 27, 2006, at A14.

¹⁰⁴ Both OTC and NASDAQ traded stocks were formerly not subject to the uptick rule and other delivery requirements.

¹⁰⁵ See Lamont, *supra* note 100, at 14.

¹⁰⁶ *Id.* at 15.

¹⁰⁷ *Id.*

¹⁰⁸ See e.g., *id.* at 14 (noting in particular, Conseco investor Irwin Jacobs' full-page ads).

¹⁰⁹ See e.g., Complaint, *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032 (D. Minn. 2003) (outlining stock loan scheme in which shares were purchased on margin and then sold only to brokers who promised not to loan them short sellers).

¹¹⁰ For more discussion on short squeezes, see *infra* text pp.43-45.

All three of these technical constraints would likely be legal under existing market manipulation rules.¹¹¹ This is true even if the firm engaged in the activity with the clear intent of obstructing short sellers.¹¹² Where there is no bona fide reason for a company to engage in an activity other than disrupting short sellers, market efficiency decreases. First, by obstructing short sales to inflate prices, markets lose fundamental value efficiency and become susceptible to price crashes. This is particularly worrisome for investors of thinly traded stocks, where such tactics are more likely to be employed and have a stronger effect. Second, the costs to firms to engage in the activity and the costs to short sellers to avoid and comply with these antics cause economic waste.

If we prohibited interference of short sellers by firms through these otherwise legitimate activities, firms would likely avoid such rules by claiming otherwise legitimate purposes not related to obstructing short sellers. While drawing the line may be difficult, it would not be unworkable. Factors to determine a legitimate firm purpose could include: 1) statements made by the issuing firm, 2) the realistic expectation at the time of the activity of legitimate, non-short sale obstructing gains,¹¹³ 3) any legitimate gains actually realized by engaging in the activity, and 4) the negative consequences suffered by short sellers.¹¹⁴ Ultimately, we should attempt to prevent wasteful and inefficient short sale “wars” that have little or no business purpose other than to inflate stock prices by disrupting short sellers.

B. Technical Restrictions II: Direct Trading Restrictions

¹¹¹ This assumes that the issuing firm has not failed to disclose material information or made a material misstatement. *See* 17 C.F.R. § 240.10b-5 (2006).

¹¹² All claims under Rule 10b-5 must prove deception, misrepresentation or nondisclosure. *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977). If the defendant’s allegedly manipulative conduct and intent were fully disclosed to the market, there can be no Rule 10b-5 manipulation violation. *Marsh v. Armada Corp.*, 533 F. 2d 978, 983 (6th Cir. 1976) (dismissing a 10b-5 manipulation claim where the defendant corporate manager ceased paying dividends with the announced purpose of lowering the stock price to facilitate a merger). Thus, so long as the issuing firm announces its intent and makes the activity public knowledge, there can be no market manipulation claim. Note, however, that cornering the market into friendly ownership without making the proper disclosures would likely violate market manipulation laws. *See Stephenson*, 282 F. Supp. 2d 1032 (alleging violation for failure to disclose material information about related parties and cornering the market).

¹¹³ Note that it would be hard to imagine legitimate gains to be expected from forcing or encouraging shareholders to turn in stock certificates or to remove them from street name and margin accounts. With current technology, electronic record keeping and trading is likely more efficient than paper methods.

¹¹⁴ This might be best considered as a litmus test for the company’s motives. Thinly traded or potentially troubled stocks with relatively high volumes of short sellers are more likely to have short seller losses caused by firm based constraints. Price movement analysis, similar to that used to determine reliance and damages in market manipulation cases, might be a sub-factor. Also, these are the stocks where the market most needs the voice of sophisticated bears. Perhaps just as importantly, these are the companies most susceptible to firm based constraints engaged in solely to disrupt short selling.

Some firms have adopted explicit trading restrictions on their shares in an attempt to obstruct short sellers. In one method, issuers make transfer of their stock “custody only,” which prevents transfer of the shares to intermediaries that facilitate short selling such as the Depository Trust Company (DTC).¹¹⁵ In 2004, however, the SEC adopted a rule that prohibits public companies from imposing restrictions on transfers to intermediaries.¹¹⁶ In another method, firms have attempted to directly withdraw their company’s shares from the DTC. The SEC stepped in again, stating that issuers may not withdraw shares from intermediaries.¹¹⁷ Thus, attempts to place direct trading restrictions on a firm’s stock in order to obstruct short selling have so far been met with SEC disapproval. However, the threat remains, and it may not always be clear that short sellers are being targeted.

C. Legal and Regulatory Threats and Other Non-Technical Bullying

Firms “waging war” against short sellers frequently seek the aid of courts, regulatory agencies, and public opinion. Such firms intend to create a chilling effect as a deterrent to short sellers of their stock. Firms or shareholders often file lawsuits against short sellers of the company’s stock. Among other claims, these suits frequently allege libel, conspiracy,¹¹⁸ and market manipulation.¹¹⁹ These lawsuits and requests for regulatory investigations often serve not only as short sale deterrents, but also as public relations vehicles.

On the public relations front, firms have publicly announced regulatory investigations into short sellers of their stock or an intention to request a regulatory investigation.¹²⁰ Firms also make “belligerent statements,”¹²¹ which are public statements claiming that short sellers of the company are conspiring against stockholders, manipulating the share price, or spreading misinformation about the company.¹²² Such activities may have a chilling effect on short sales to the extent that public opinion encourages short sale hawks to continue constraining shorts. Also, a chilling effect may occur to the extent that short sellers refrain from shorting a particular stock due to the perceived risk of potential litigation costs. To the extent that such obstacles affect short sellers more than long buyers, these constraints decrease market efficiency.¹²³ Finally, to

¹¹⁵ *Short Sales*, Sec. Exch. Act Rel. No. 34-48709, 2003 WL 22461522 at *7 (SEC Oct. 28, 2003).

¹¹⁶ 5 Hazen, LAW SEC. REG. § 23.5, 555 (5th ed. 2006).

¹¹⁷ *SRO, The DTC, Order Granting Approval of Proposed Rule Change Concerning Requests for Withdrawal of Certificates By Issuers*, Sec. Exch. Act Rel. No. 34-47978, 2003 WL 21288541 (SEC June 4, 2003).

¹¹⁸ See Lamont, *supra* note 100, at 13.

¹¹⁹ See e.g., *Sedona Corp. v. Ladenburg Thalmann*, 2005 WL 2647945 (S.D.N.Y. 2005).

¹²⁰ See Lamont, *supra* note 100, at 12.

¹²¹ This is the term used by Owen Lamont to categorize public statements intended to disparage short sellers or create a scapegoat. *Id.* at 11.

¹²² *Id.*

¹²³ Indeed, it would be very unlikely that a corporate manager would wage a public relations battle against their own shareholders for driving the stock price upward. While regulatory agencies may be unbiased in their investigations against short sellers per se, companies are not likely to publicize investigations into shenanigans that have falsely increased their company’s share price.

the extent that belligerent statements cloud the informational market for a stock, both informational and fundamental value efficiency decrease.

Lawsuits and requests for regulatory investigations that are based on meritorious claims of illegal activity likely do not decrease efficiency. Short sale abuses and spreading misinformation detract from fundamental value and informational efficiency. Further, limitations on frivolous lawsuits should deter and penalize firms that abuse legal remedies. However, to the extent that short sellers are subjected to a higher risk of litigation costs than long buyers due to firms' targeting of short sellers, asymmetrical expected litigation costs for bearish investors decrease market efficiency.

V. THE HITS JUST KEEP ON COMING: TRADING BASED SHORT SALE CONSTRAINTS

In addition to government and firm based constraints, short sellers face asymmetrical trading based constraints. The first of this type, transaction costs, arises from the extra steps required to place a short sale rather than a long purchase. The second trading based constraint, short squeezes, may increase risks asymmetrically for short sellers due to the relative economic fragility of short sales.

A. Bears and Bulls Face Asymmetrical Transaction Costs

To purchase a stock long, an investor needs to place only two transactions: a buy and a sell. Bears, on the other hand, must engage in four transactions to place a short sale: a loan, sale, buy, and repayment of the borrowed asset.¹²⁴ Further, the market for lending shares to short sellers is less centralized and less efficient than the market for buyers looking to purchase long.¹²⁵ Borrowing shares for short sales can be particularly tough for thinly traded, small capitalization stocks that have small institutional ownership.¹²⁶ Thus, short sellers face transaction costs that are asymmetrical to long purchasers.

One solution for equalizing transaction costs between optimists and pessimists would be to allow naked short selling.¹²⁷ This would eliminate the need for short sellers to locate borrowable stock and to replace the borrowed asset. Short sales would essentially become futures contracts, in which the parties settle without demanding actual delivery. As discussed above, critics of naked short selling would argue that allowing widespread naked short sales increases the opportunities for fraudulent manipulation. However, to the extent that the manipulation rules deter and punish abusive short selling, these fears may be overblown. More importantly, the risk of manipulative market cornering may affect short sellers and long buyers equally even if we allowed widespread naked short selling.¹²⁸

¹²⁴ See Stout, *supra* note 13, at 757.

¹²⁵ *Long and Short*, *supra* note 29, at 2.

¹²⁶ *Id.*

¹²⁷ Note that attempts to avoid the extra costs by short sellers would create asymmetrical avoidance costs. Further, such attempts would likely violate other rules, such as the delivery requirements the rule against difference contracts. See *e.g.*, Stout, *supra* note 13, at n. 221.

¹²⁸ Note that Regulation T generally equally limits margin resources for short sellers and long buyers. For nonexempt securities, long buyers can only borrow up to 50% loan-to-value. 12 C.F.R. § 220.18(a) (2006). Thus, the buyer must put down 50% of the share price at the time of

B. Asymmetrical Manipulative Risks: Short Squeezes Versus Bear Raids

Short sellers face a peculiar manipulative risk called a short squeeze. A short squeeze occurs when the price of a security increases to levels at which short sellers can no longer accept the heightened risk of loss, thus forcing short sellers to buy in the open market to cover their position. The short seller is removed from the market and a new buy order is placed on the market, further increasing price and potentially squeezing even more short sellers.¹²⁹ Both investors and firms have been accused of intentionally causing a short squeeze both to temporarily inflate price and to more permanently scare short sellers from a stock.¹³⁰

While long buyers face a similar trading risk from bear raids,¹³¹ the effect on bulls may not be equally strong. The relative economic fragility of short sales may enhance the expected costs associated with the respective manipulative risks.¹³² Because of the relative thinness of the stock borrowing market, especially for thinly traded stocks, shorts may also face more difficulty reacting to a short squeeze than a long faces in reacting to a bear raid.¹³³ Also, long buyers whose expectations remain optimistic can merely hold during a bear raid, waiting for the market to correct and for their expectations to be reflected in the price. Shorts, on the other hand, may be obligated to liquidate their investment either before a specific date or as their stock lender demands.¹³⁴

Thus, to the extent that shorts face a relatively higher expected risk of loss from manipulative trading schemes, short sales may be relatively constrained. While both short squeezes and bear raids may be illegal under market manipulation laws, the asymmetrical risks borne by short sellers remain. Relaxing the technical restrictions on short sales, such as allowing widespread naked short selling, would help to alleviate the risk differential. Short sellers would be less limited in their responses to short squeezes since they would not be subject to stock loan covenants.

the trade. Short sellers of nonexempt securities must down 150% of the share price at the time of the trade. 12 C.F.R. §220.18(b) (2006). However, with the proceeds of the sale, the short seller only needs to put down 50% of their own money. Thus, potential manipulators both on the upside and the downside would still be equally limited in resources.

¹²⁹ *Rocker Mgmt., L.L.C. v. Lernout & Hauspie Speech Prod. N.V.*, 2005 WL 1365465 at *2 (D. N.J. 2005).

¹³⁰ See e.g., *Rocker Mgmt.*, 2005 WL 1365465; *S.E.C. v. Wexler*, 1993 WL 362390 (S.D.N.Y. 1993); *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032 (D. Minn. 2003); *In the Matter of Vladlen "Larry" Vindman*, 2006 WL 985308 (S.E.C. Release 2006).

¹³¹ See *infra* note 74.

¹³² Theoretically, short sellers face the risk of unlimited loss but only limited gains. Long buyers, on the other hand, face unlimited gains but risk only a limited loss. Powers, Schizer, and Shubik, *supra* note 18, at 241. While this observation has been criticized as merely theoretical, it carries more weight in the context of comparing a bear raid to a short squeeze. In a bear raid, the object truly is to move the price to zero, and a short squeeze seeks to inflate price as high as possible. Note further, that manipulative schemes generally target small capitalization stocks. This further lowers the potential total losses risked by long purchasers.

¹³³ See Stout, *supra* note 13, at n. 223. Note again that small capitalization, thinly traded stocks tend to be the targets of manipulative schemes.

¹³⁴ See Stout, *supra* note 3, at n.68.

CONCLUSION

Although firms and shareholders frequently vilify short sellers, short sales are necessary to efficiently functioning markets. Effective short sale constraints likely decrease informational efficiency, fundamental value efficiency, and may lead to increased volatility and market bubbles. Short sellers also increase liquidity, facilitate market making, and help markets to identify corporate fraud. Yet, shorts continue to face public criticism and obstacles not faced by longs.

Some apparent constraints appear upon closer inspection to provide little, if any, obstruction to short sellers. In particular, short sellers can easily avoid both the uptick rule and the delivery requirements. However, repeal of the delivery requirements and allowance of widespread naked short selling may be appealing to alleviate other short sale obstacles.

The capital gains tax gap may substantially constrain shorts relative to longs. Unfortunately, equalizing the tax treatment of shorts and longs would be very problematic. Short sales held open for one year do not further the policy rationales behind the preferential long-term capital gains rate. On the other hand, although there may be some arguments for eliminating the preferential capital gains rate other than eliminating a short sale constraint, doing so would frustrate the policy reasons that support the favorable treatment in the first place. It is not at all clear that the efficiency benefits would outweigh the tax costs.

Finally, allowing issuing firms to “wage war” on short sellers decreases financial market efficiency. Regulators should prevent firms from engaging in technical actions that obstruct short sellers when there is no otherwise bona fide reason for the action. Courts and regulators should also be wary of firms that target and bully short sellers of their stock.