Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States

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Katherine McGavin*

I. INTRODUCTION

In a well-regulated market with minimal risk of abuse, the liquidity and information efficiency benefits of short selling far outweigh its potential harm. Contrary to the recent hostility short sellers face from market regulators and the popular press, short sellers in aggregate are neither market villains nor agents of destruction. While a small minority of short sellers have exploited lax regulation and inattentive enforcement of anti-abuse rules to manipulate stock prices and earn substantial fees, these rare episodes suggest that the world’s major capital markets need better enforcement of existing rules and not new rules per se. The failure of market regulators to prevent abuse and manipulation of stock prices by

* J.D. Candidate, 2010, Northwestern University School of Law. I would like to thank Professor Olufunmilayo Arowo for her insightful comments and research support and Joanna Rubin for her valuable editorial assistance.

† Owen Lamont describes this hostility:

Regulations and procedures administered by the SEC, the Federal Reserve, the various stock exchanges, underwriters, and individual brokerage firms can mechanically impede short selling. Legal and institutional constraints inhibit or prevent investors from selling short... We have many institutions set up to encourage individuals to buy stocks, but few institutions set up to encourage them to short...

In addition to regulations, short sellers face hostility from society at large. Policy makers and the general public seem to have an instinctive reaction that short selling is morally wrong... usually in times of crisis or following major price declines... short sellers are blamed.

short sellers and curb naked short selling reflects a failure of enforcement, not bad underlying policy.

In 2008, market regulators, including the United States Securities and Exchange Commission ("SEC") and the United Kingdom Financial Services Authority ("FSA"), attempted to restore investor confidence in public capital markets and to protect financial institutions from rapid devaluation of their stock by temporarily banning short positions in certain securities. Less than one year later, the SEC and FSA bans have lapsed and there is no clear evidence that these emergency restrictions protected the markets or the underlying financial institutions from harm and volatility. Indeed, one published study argues that the SEC's initial ban on naked short selling in certain financial stocks caused market quality and market efficiency to deteriorate.\(^2\) Today, market regulators seek to rebuild a short selling policy that allows covered short selling while reducing the risk of market abuse and bear raids (instances in which short sellers force down stock prices by shorting stocks in very high volumes). The reinforced framework must include rules and regulations that increase market efficiency, enhance visibility of short selling to regulators and to investors, improve regulators' responsiveness to market failures and periods of extreme volatility, and enforce anti-abuse laws consistently and judiciously. While short selling increases efficiency and liquidity in capital markets, short selling is a flawed market efficiency mechanism that will not work without the supportive architecture of an effective regulatory system and the vigilant enforcement of anti-abuse laws by market regulators.

In the past several years, the various approaches to short selling regulation adopted by regulators of the world's largest capital market have attracted tremendous attention. The debate escalated after the SEC changed U.S. securities law to allow so-called "naked" short sales in July 2007.\(^3\) After a short quiet period, the debate resurfaced when the FSA, SEC, and other regulators temporarily banned short selling of certain securities in 2008. Although no empirical evidence proves that the 2007 SEC decision to allow naked short selling caused the market volatility of 2008, the global financial crisis provoked public demand for increased regulation and government control over securities transactions. As investors lost faith in the regulations of the last century, governments responded with new and, in some cases, austere measures to reduce opportunistic and manipulative investor behavior and restore public confidence.


Today's headlines, however urgent, are not unfamiliar to securities market historians. The debate about the merits of short selling has been ongoing in securities and commodities exchanges for close to 300 years. Historically, the debate has captured public attention in the midst of financial crises and bear markets, and ebbed as the rush of a bull market draws attention to other concerns—and restores faith in market efficiency.

Today, hedge funds are the largest investors short selling securities. Some critics believe that hedge funds, acting deliberately and with the intent to manipulate securities prices, affect the value of securities by shorting them in high volumes. While hedge funds (and the broker-dealers they use to execute their transactions) are certainly a primary target of the current regulations regarding short sales, the SEC and FSA have adopted policies that regulate investment behavior rather than policies that target certain types of investors. This approach suggests that exchange regulators are willing to accommodate the changing character of major investors in their regulatory regimes. However, future regulatory decisions must prioritize the nature of accommodation and focus on the impact on securities markets of consolidated investment and large-scale arbitrage investment by hedge funds.

This comment outlines past attempts to regulate short selling, explains the emergency regulations enacted in 2008 in response to the financial crisis, and offers a series of recommendations for policymakers as they contemplate a new era of short sale regulation designed to match the pace of modern capital markets and the character of modern investors. Section II provides a definition of terms to orient readers to the subject of the paper and explains the perceived risk in unregulated short selling. Section III describes historical examples of regulation and the resurgence of short selling. Section IV reviews regulation of short selling in the United Kingdom, and Section V reviews regulation of short selling in the United States. Section VI explains the contemporary debate, makes policy recommendations for future reform, and criticizes the new reactive regulations' departure from the dominant theory that short selling is good for capital markets. The comment concludes by promoting reform to encourage liquidity and restore confidence in capital markets, and by advocating a steadier course to follow in the next market decline.

II. DEFINITION OF TERMS

Rule 200(a) of SEC Regulation S10 (f/k/a Rule 3b-3 of the Securities

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* See infra Part III.

Exchange Act) defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." In a covered short sale, the short seller, believing that the price of a stock will fall, borrows that stock from its true owner and sells it. If the price does fall, the short seller will buy back the stock in the open market (thereby "covering" his position) and return the stock to its owner. Meanwhile, the short seller will earn the difference between the original price of the stock at the time he borrowed it and the price of the stock when he returned it to the owner.

So-called "naked" short sales are short positions for which no underlying security has been borrowed. The SEC explains:

In a ‘naked’ short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a ‘failure to deliver’ or ‘fail.’

The number of fails reported per quarter is an indication of the persistence of naked short selling, often in spite of regulations in place to bar the practice. For example, the SEC noted that Regulation SHO, adopted to prevent investors from using naked short sales, curbed the number of fails but did not reduce the number to zero. In response, the SEC proposed amendments to Regulation SHO to eliminate loopholes in the closeout rules. Even these amendments, however, did not eliminate naked short selling. Likewise, the FSA has noted that while settlement discipline rules require exchanges and clearing houses to “secure the timely discharge of the rights and liabilities of the parties to transactions,” settlement performance is not perfect, especially for less liquid stocks.

Regardless of the initial market price of the underlying stock, short selling can cause temporary reductions in the value of shorted stock. When investors take short positions, they create an excess market supply of the shorted stock by selling borrowed shares. This sell-off causes the price of the stock to decline—even if the actual market demand for the stock does not change. In a covered short sale, the excess market supply of the

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9 FIN. SERVS. AUTH. [FSA], DISCUSSION PAPER 17: SHORT SELLING 13 19 (2002), available at http://www.fsa.gov.uk/pubs/discussion/dp17.pdf [hereinafter DP17] (citing a case in which "there was short selling in the shares of a company to such an extent that the short sales outstripped the shares in issuance. The result was that many purchasers did not get delivery of their shares and were unable to vote at an [Extraordinary General Meeting].
10 Christopher L. Culp & J.B. Heaton, The Economics of Naked Short Selling, Reg.,
shorted stock will be recouped when the short seller covers his position and repurchases the available “extra” stock. At this point, if the underlying market demand curve has not shifted, the stock price will return to its original market value. If the market demand curve has shifted down, short sellers will profit because the value of the shares will be below their initial price even when the volume of available shares normalizes. In this way, short selling can be extremely lucrative for short sellers who successfully identify falling stocks. Reciprocally, short sellers who misgauge stock performance and have to re-purchase securities at market prices above the original sales prices will lose money. Shorting securities is an effective way to hedge positions (by taking both a long and a short position in a certain security) and is a common arbitrage tactic.

In an economic analysis of short selling, Christopher Culp and J.B. Heaton explained that a “short position is profitable only because the demand curve [for the underlying stock] shifts down for reasons unrelated to [the investor’s] short selling, not because short selling forces it down . . . Speculative short selling, by itself, does not cause the downward shift.” Therefore, short sellers who have to cover their positions will not short a stock unless they believe the demand curve or market value of the stock will decline. Culp and Heaton also explain how short selling can increase stock market pricing efficiency.

The potential social benefit of short selling is that it forces prices today closer to the amount that reflects the intersection of supply and demand later, if we assume that the current demand is excessively optimistic and will shift to a more rational (i.e., lower) level. Indeed, short sellers will have an incentive to pursue their strategy until there is no more profit available from the strategy. This will force prices today to move toward what they should be in the future.

Proponents of short selling often point to this efficiency argument and the increased liquidity provided by short sales to support their position. Critics of short selling point to the temporary price reductions and heightened market volatility induced by short sellers to advocate prohibiting the practice.

While temporary price reductions will rebound quickly in covered short sales, this correction will not occur promptly in a naked short sale. Securities market regulators believe that market manipulators use naked short selling to force prices below values that would be possible in covered short selling by creating relatively long-term excess supplies of a stock.

13 Id.
14 Id. at 47–48.
disproportionate to the number of shareholders willing to lend shares.\textsuperscript{15} Moreover, when naked short sellers must cover their positions, they create excess demand for stocks. Thus, naked short selling creates more volatility than covered short selling because naked short sellers can push stock prices down and pay inflated prices to cover their positions.\textsuperscript{16} For these reasons, the SEC has sought to control naked short selling, while taking a relatively lenient position towards covered short selling. Other regulators, including the FSA, have elected to allow naked and covered short selling, although they may take a stricter position in the future.

\textbf{III. HISTORICAL OVERVIEW OF THE SHORT SELLING DEBATE: REGULATION AND RESURGENCE}

In the past several hundred years, proponents and opponents of speculation and arbitrage in securities markets have clashed on numerous occasions, often in the context of severe market volatility or decline. Early, and somewhat anecdotal, examples of the debate over the merits of short selling attracted public attention in the eighteenth century.

A well-known early example of attempted regulation of short selling occurred in England in the 1730s. In 1710, the British Parliament incorporated the South Sea Company, a trading company that traded in South America.\textsuperscript{17} Parliament first sought to use the capital raised by the South Sea Company to finance the British Navy's war debt.\textsuperscript{18} In 1720, Parliament granted the South Sea Company the exclusive right to trade in the South Seas—an act that required the company “to do for territories in what were vaguely known as the South Seas what the East India Company

\textsuperscript{15}\textit{Christopher Cox, What the SEC Really Did on Short Selling, Wall St. J., July 24, 2008, at A15.}

\textsuperscript{16} The sudden and dramatic increase in the price of Volkswagen shares in October 2008 in a real-world example of this effect (called a “short scramble” or “short squeeze”). Believing that Volkswagen shares were overpriced in the market and would soon fall, hedge funds sold Volkswagen shares short in high volumes. In mid-October, Porsche disclosed that it had amassed a 74.1% ownership stake in Volkswagen. Because the German government owned roughly twenty percent of Volkswagen, short sellers realized that Volkswagen’s free float was less than six percent of its outstanding shares and that they had been borrowing shares from Porsche to take their short positions. When markets opened after Porsche disclosed its holdings in Volkswagen, Volkswagen's share price increased eighty-five percent (to 391 Euros) as short sellers scrambled to cover their positions. Porsche made billions of Euros from the rampant speculation in the overpricing of Volkswagen stock. \textit{Paul Murphy, The Disreputable Market in Volkswagen, Fin. Times Alphaville, Oct. 27, 2008, http://alphaville.ft.com/blog/2008/10/27/17465/the-disreputable-market-in-volkswagen/}\textsuperscript{17} \textit{Paul Murphy, Porsche LLC? – the VW Fruit Machine Explained, Fin. Times Alphaville, Oct. 17, 2008, http://alphaville.ft.com/blog/2008/10/17/17150/porsche-llc-the-vw-fruit-machine-explained/}\textsuperscript{18} Culp & Heaton, supra note 10, at 51.

\textsuperscript{17} \textit{Charles Dubos, The Story of the Stock Exchange: Its History and Position 36 (1901).}

\textsuperscript{18} \textit{Id.}
Speculation in the company's stock and wild rumors about the company's "vast potential wealth" drove the price well-above a sustainable value:

[(In the first list published, six years previously [in 1724], the price was given as 1 to 1 1/2. By the middle of May 1720, the price had risen by leaps and bounds to 500, on 21st May it was 600, on 23rd May 650, on 25th May 710 . . . . On 2nd August the price was 1000, on the 7th 1100, on the 9th 1200. Then the bubble burst)]

By the end of August 1720, the South Sea Company's stock price declined precipitously to 700 pounds per share. The price fell to eighty-six by October. A few speculators and short sellers who had anticipated the declines profited in the bubble, while many other investors lost fortunes. In 1733, in the wake of what is now known as the South Sea Bubble, the House of Commons ratified a law banning naked short selling. The law, which was in place for 150 years, was largely ignored by investors and was not rigorously enforced.

Similarly, in 1792, the New York state legislature ratified a ban on short selling. Five weeks later, a group of stockbrokers in New York City created the New York Stock Exchange ("NYSE") in the Buttonwood Agreement to circumvent the law. NYSE rules allowed short selling in direct contravention of the statute.

Public debate again arose in Chicago among investors in the Chicago Board of Trade and Mercantile Exchange in the 1920s. Responding to the

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19 Id. at 36–37.
20 Id. at 37–38.
21 Id. at 38.
22 Id. at 44.
23 DUGUID, supra note 17, at 38, 42–43 ("Ruin and desolation were soon amongst thousands of families throughout the land.").
24 Id. at 42.
26 Id.
27 Id.
28 Id.
29 Id.
30 See James C. McMath, Futures and Options: The Chicago Board of Trade, Short Selling and Hedging, 98 CENT. L.J. 367 (1925) [hereinafter McMath, Futures and Options]; James C. McMath, Speculation in Grain for Future Delivery: What is Legal and What is Illegal, 98 CENT. L.J. 365 (1923).
imposition by Congress of a tax on options contracts, prominent Chicago lawyer James McMath wrote:

There is a widespread notion that selling short is wrong. It is neither wrong nor illegal and has not been held illegal. Every short seller must eventually become a buyer, just as every buyer long must eventually become a seller, either before the month for delivery arrives, or if he takes the grain he must sell it unless he has some use for it.

... If the market was a one-sided affair, it would be very injurious to both the producer and the consumer.\textsuperscript{31}

McMath argued that speculation could benefit the farmers and consumers, whose produce and raw materials were traded in the Chicago exchange, and should not be prohibited.\textsuperscript{32}

Less than a decade later, in 1932, Richard Whitney, President of the NYSE, gave a series of eloquent speeches in defense of short selling to the House of Representatives and the Chambers of Commerce of Connecticut and New York.\textsuperscript{33} Opposing his advocacy was William Perkins, a New York attorney who fiercely criticized short selling and called on Congress to regulate the practice.\textsuperscript{34} Whitney and Perkins publically debated the benefits and harms of short selling as Congress was considering legislation that would control short selling and give the Federal Trade Commission broad power to regulate it.\textsuperscript{35} Their debates resonated with the American public, which was still suffering in the aftermath of the stock market crash of 1929 and the bear market of the 1930s, and influenced the drafting of the Securities Exchange Act of 1934.

Whitney emphasized the market stabilizing effects of short selling. He explained that "[s]hort selling is also regularly employed as a 'hedge,' not at all for the purpose of making speculative profits, but for insuring against losses due to price fluctuations."\textsuperscript{36} Further, he argued that "[t]he decline in security prices has not been due to short selling, but has been due to our unsatisfactory business conditions and to the liquidation of securities owned outright or held on margin."\textsuperscript{37} Whitney went on to explain that economic recessions force institutional investors, entities that would otherwise hold securities for long periods of time, and individual investors to sell securities

\textsuperscript{21} McMath, \textit{Futures and Options}, supra note 30, at 368.
\textsuperscript{31} Id. at 367–68.
\textsuperscript{32} See generally \textit{SHORT SELLING, FOR AND AGAINST} (Richard Whitney & William R. Perkins eds., 1932).
\textsuperscript{33} See generally \textit{id.}
\textsuperscript{34} See \textit{id.} at 99–100, 167–76.
\textsuperscript{35} Richard Whitney, \textit{Short Selling, in SHORT SELLING, FOR AND AGAINST 1, 6} (1932).
\textsuperscript{36} Id. at 7.
(a relatively liquid asset) to raise cash. According to Whitney, this widespread liquidation, an outgrowth of the Depression, and not bear raiding as critics contended, was a main driver of the NYSE’s decline. Whitney also argued that short sellers help create a market for other investors’ declining securities. Whitney’s arguments parallel closely the arguments of contemporary defenders of short selling.

Perkins, who decried short selling as a tool of market manipulators and as a cause of market volatility, responded to Whitney’s arguments with a series of proposals for legislative reform. First, he suggested an “exhaustive inquiry into short selling” that would analyze the effects of short selling on the market. Perkins next recommended that the stock exchanges be brought under the authority of the Federal Trade Commission and that brokers be brought under banking laws. Perkins’ most draconian proposal was that Congress impose a separate income tax on profits earned in connection with short sales, with no offsetting losses allowed. Finally, he recommended that banks and trust companies be prohibited from dealing in securities.

The contemporary debate echoes sentiments expressed in each of these controversies—the public despair and outlash against traders and speculators of the South Sea Bubble, McMath’s reasoned critique of seemingly punitive regulation, Whitney’s financial economics perspective, and Perkins’ call for government intervention. While several policy makers, publicly-traded corporations, and many nervous individual investors fear the harms caused by manipulative short selling tactics employed by large investors, many financial experts and industry leaders have defended short selling as a critical means of stabilizing market prices.

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38 Id. at 9–10.
39 Id. at 19–20.
40 Id. at 20.
41 For example, Whitney wrote:

Stock market prices . . . are not prosperity itself, but simply an index to it. The stock market reflects business conditions. It is not their cause. It is wrong to say that a ban on short selling could halt our business depression. When economic equilibrium in the world’s affairs is again reestablished . . . liquidation of securities will stop, buyers will regain confidence, and prices will rise. The prohibition of short selling would delay and cannot hasten this process. Neither our governmental authorities by means of legislation, nor the New York Stock Exchange by means of its regulations, can by any magic stroke perform economic miracles.

Id. at 22.
43 Id. at 38–39.
44 Id. at 39.
45 Id.
and maintaining market efficiency. Indeed, the consensus among many financial experts (including former SEC Chairman Christopher Cox) and hedge fund managers is that the benefits of legalized short selling far outweigh the harm it might cause. However, even proponents of legitimate short selling acknowledge the harm that naked short selling can cause and support efforts to monitor naked short selling. By looking closely at the status of short sale regulation in the United Kingdom and the United States, this comment will outline the current state of the short sale debate.

IV. THE UNITED KINGDOM: CENTRALIZED AUTHORITY AND CONCILIATORY REGULATION

The FSA is an integrated regulator with broad powers to regulate and supervise "almost all financial services businesses in the U.K., including banking, securities, and insurance, on a prudential basis and as regards conduct-of-business activities." The FSA also has broad powers to enforce financial regulation and to investigate and prosecute violations. The FSA’s integrated approach to regulation is a product of major financial reform in the United Kingdom in the past ten years.

While the FSA is a highly centralized financial regulator, the FSA takes a "conciliatory" approach to market regulation by involving stakeholders in policy debate and development. As it did when considering regulation of the hedge fund industry, the FSA reached out to short sellers and other investors before regulating short sales in 2002 and 2003 and discussed with them the merits of regulating or deregulating short selling. The recommendations and insight gathered by the FSA in these discussions informed regulation until mid-2008.

The FSA’s conciliatory approach is an outgrowth of the organization’s first incarnation as a system of “practitioner-based regulation in a statutory framework.” Following a series of highly publicized financial scandals in the 1970s, Parliament ratified the Financial Services Act in November 1986. The Act imposed a series of costly regulatory systems and

40 See Cox, supra note 15.
41 Id.
43 Id. at 29.
45 Id. at 373.
46 See generally DP17, supra note 9.
47 Henry Laurence, Spawning the SEC, 6 Ind. J. Global Legal Stud. 647, 662 (1999)
48 Id. at 661.
compliance requirements on financial institutions and was gradually watered down over the next fifteen years.\textsuperscript{53} The costs imposed on financial institutions made the Act unpopular in the City of London, and the apparent failure of the practitioner-regulators empowered by the Act to end fraud and protect small investors turned public opinion against the regime.\textsuperscript{54} The practitioner-regulators were unable to regulate effectively, and the Securities and Investment Board (“SIB”), a quasi-governmental organization meant to oversee the practitioner-regulators, did little to improve the system.\textsuperscript{55}

In 1997, the Chancellor of the Exchequer initiated reform of the U.K. financial sector regulatory regime.\textsuperscript{56} The reform consolidated regulation and oversight of investment services in a restructured agency, the FSA, which replaced the SIB in October 1997.\textsuperscript{57} The Financial Services and Markets Act of 2000 gave the FSA broad statutory powers to regulate the securities markets.\textsuperscript{58} The FSA’s concentration of power moved regulatory authority from fragmented private practitioner-regulators into the hands of a single independent body.\textsuperscript{59} In spite of this concentration of authority, the FSA remains committed to incorporating practitioners’ interests into its policies. The following discussion of short selling regulation illustrates this point.

A. Discussion Paper 17

In 2002 and 2003, in the midst of a bear market that had exacerbated concern about short selling among market participants, the FSA conducted a thorough investigation of the nature and extent of short selling in the U.K. financial markets. The study evaluated short selling and considered several regulatory proposals. The FSA ultimately adopted the least costly and most conservative of the proposals it considered.\textsuperscript{60}

During the summer of 2002, the FSA hosted over twenty small meetings with investors and other market participants and hosted a

\textsuperscript{53} Id. at 661–66.
\textsuperscript{54} Id. at 664–68.
\textsuperscript{55} Id. at 665, 668.
\textsuperscript{57} Id.
\textsuperscript{58} Id. ("The Financial Services and Markets Act... transferred to the FSA the responsibilities of several other organisations: Building Societies Commission; Friendly Societies Commission; Investment Management Regulatory Organisation; Personal Investment Authority; Register of Friendly Societies; Securities and Futures Authority.").
\textsuperscript{59} FSA, Who Are We, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Dec. 28, 2009).
roundtable discussion that hedge funds, prime brokers, securities lenders, and corporate stakeholders attended. In his opening remarks at the roundtable, FSA Chairman Howard Davies expressed the FSA’s generally positive view of short selling as an instrument of market efficiency and encouraged participants in the roundtable to articulate their views of the risks and benefits of short selling. The options for new regulation and improved transparency of short positions in financial markets discussed at the roundtable closely coincide with the recommendations and proposals the FSA published in Discussion Paper 17: Short Selling (“DP17”) in October 2002.

The purpose of DP17 was to “review how short selling is currently practiced in U.K. equity markets, the role that it plays in the market, and issues of regulatory concern in the context of market confidence and investor protection.” DP17 first considered the changes in U.K. financial markets since SIB’s last review of short selling in 1996-1997 (which took a positive view of short selling, did not adopt new proposals, and concluded that short selling “should be controlled through general measures to prevent disorderly markets rather than specific limits on the ability to sell short”). DP17 noted the “significant growth in funds using short selling” since 1996, the increased use of derivatives in financial markets, and the new equity trading rules and concluded that these new market features created need for a new review of short selling.

While acknowledging the risks associated with short selling (such as settlement disruption and market manipulation), the FSA rejected banning or imposing constraints on short selling—this meant that investors in the United Kingdom could continue to use short sales and naked short sales as legitimate hedging and arbitrage strategies. The FSA explained that anti-abuse rules, such as the Code of Market Conduct, already in place banned and punished manipulative trading and bear raid tactics and concluded that these measures sufficiently controlled the risk of market manipulation by short sellers. Instead of imposing direct limitations on short selling, the FSA evaluated ways to increase disclosure of short positions at the highest utility and lowest cost and ways to reduce the risk of settlement disruption

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65 Id. at 6-7.
66 Id. at 7.
67 Id. at 15.
68 Id. at 18.
due to naked short sales.\textsuperscript{71}

The FSA outlined three options for improving transparency of short selling in DP17:

Option 1: Marking and reporting short sales for cash equities

Option 2: Full disclosure of short positions in both cash and derivatives markets

Option 3: Publishing data on securities lending as a proxy for data on short selling\textsuperscript{72}

Of these options, Option 3 was the least costly because it simply required CRESTCo, the existing U.K. securities settlement system, to publish the data collected in its records on a monthly basis—no new reporting standards or significant data compilation efforts would be required.\textsuperscript{73} Perhaps not surprisingly in light of this cost efficiency and because institutional investors opposed Options 1 and 2 which would have been onerous to comply with and would have risked exposing their investment strategies to competitors, 75\% of respondents to DP17 endorsed Option 3.\textsuperscript{74} Even though the FSA and DP17 respondents acknowledged the imperfection of settlement data as a proxy for short selling data, they agreed that Option 3 was the best of the proposed options.\textsuperscript{75}

In its Feedback Statement to DP17 (the “DP17 Feedback Statement”), the FSA rejected new regulation of short sales and adopted only Option 3.\textsuperscript{76} The FSA explained:

We believe that publication of stock borrowing data is a cost-effective way of improving market transparency. While the data may not be a good proxy for short selling, we believe the information is useful enough of itself to warrant publication. Provided sufficient customer confidentiality protections are in place, publication should not harm legitimate commercial interests. We also believe that regular publication can, over time, provide a broad indication of

\textsuperscript{71} \textit{Id. at} 15.
\textsuperscript{72} \textit{Id. at} 21–25.
\textsuperscript{73} \textit{Id. at} 24.
\textsuperscript{75} \textit{DP17 Feedback Statement, supra note} 62, at 16–18.
\textsuperscript{76} \textit{Id.}
short selling trends.\textsuperscript{71}

The FSA likewise rejected targeted disclosure requirements (namely disclosure of short sales beyond certain established thresholds, disclosure of naked short sales, and disclosure of directors' short sales) that would have increased visibility of short positions.\textsuperscript{78} The FSA also rejected "tick regimes" such as Rule 10a-1 formerly in place in the United States.\textsuperscript{79} Tick regimes, discussed in the following section, prohibit short sales at prices below the last traded price and aim to curb market abuse and bear raids.\textsuperscript{80} In DP17, the FSA explained that the U.K. exchanges prefer "general rules and processes to safeguard against excessive price volatility" over price limit tests.\textsuperscript{81} Moreover, the FSA explained it had "not seen a strong case showing that tick rules curb share price volatility or soften market declines . . . at least as far as this year is concerned, countries operating tick rules . . . have not seen less steep market falls or significantly reduced volatility than the [United Kingdom]."\textsuperscript{82}

Addressing the risks of fails caused by naked short sales but deciding not to prohibit or directly limit them, the FSA adopted a "package of measures" to reduce settlement risk and improve delivery in short sales of illiquid securities.\textsuperscript{83} The measures were: (1) CRESTCo will publish data on settlement failures for securities with the highest ratio of fails to issued securities, (2) the London Stock Exchange and virt-x will notify their members about securities with a high ratio of fails to issued securities, (3) the London Stock Exchange might reduce the buy-in timeframe for illiquid securities experiencing a high settlement failure rate, and (4) the exchanges will keep penalties for buy-in under review.\textsuperscript{84} The FSA acknowledged that naked short selling posed a risk to markets and attempted to form a solution that was a "proportionate response" to the settlement disruption problems posed by naked short selling.\textsuperscript{85} However, the Feedback Statement suggests that the FSA was unwilling to impose significant changes to the regulatory system already in place.

Both DP17 and the DP17 Feedback Statement reveal that in 2002 and 2003, the FSA was unwilling to curb short sales in U.K. financial markets and believed that the utility of short selling outweighed the potential benefit of regulating, or of requiring complete and explicit disclosure of, short

\textsuperscript{71} Id. at 17–18.
\textsuperscript{78} Id. at 18–21.
\textsuperscript{79} Id. at 4.
\textsuperscript{80} DP17, supra note 9, at 17.
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} DP17 FEEDBACK STATEMENT, supra note 62, at 22–24.
\textsuperscript{84} Id. at 23–24.
\textsuperscript{85} Id. at 24.
selling. In the first half of the decade, the FSA, hedge funds, investment banks, and other institutional investors regarded full disclosure as onerous and costly. The solid consensus among the FSA and respondents to DP17 broke down suddenly in 2008 when markets tumbled and the FSA adopted draconian measures to curtail practices it once endorsed.

B. The FSA's Intervention in the 2008 Market Crisis

In the wake of the Northern Rock and Lehman Brothers collapses, the FSA banned short sales of U.K. financial sector companies' securities and imposed a set of new daily disclosure rules for net short positions in U.K. financial sector companies. Short Selling (No. 2) Instrument 2008, which became effective on September 19, 2008, and which remained in place until January 16, 2009, stated:

A person who enters into a transaction that (whether by itself or in conjunction with other transactions) has the effect of: creating a net short position in a [U.K.] financial sector company; or increasing any net short position in a [U.K.] financial sector company that the person had immediately before 19 September 2008; is, in the opinion of the FSA, engaging in behaviour that is market abuse (misleading behaviour).

The statute revision also instructed: "Failure by a person who has a discloseable short position in a [U.K.] financial sector company to provide adequate ongoing disclosure of their position is behaviour which, in the opinion of the FSA, is market abuse (misleading behaviour)."

The FSA made the changes suddenly, just days after Lehman Brothers filed for bankruptcy, and the FSA ratified the new rules without consultation. The deterioration of the financial markets and the precipitous fall of Bear Stearns, Lehman Brothers, AIG, and Northern Rock had put the FSA on alert that the markets needed emergency intervention—and that hedge funds and institutional investors, whose unregulated arbitrage tactics had been viewed in 2002 as the markets' highest-octane fuel, might be partially responsible for the rapid decline. In January 2009, when the short sale ban lapsed, the FSA left the heightened disclosure rules in place. In February 2009, after a comprehensive review of short selling during the 2008-2009 market crisis, the FSA proposed permanent disclosure requirements and advocated international cooperation and

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88 Id.
89 HANDBOOK NOTICE 81, supra note 86, at 18.
consensus with respect to short sale regulation. Section VI reviews the FSA's current proposals in depth.

V. THE UNITED STATES: REGULATION OF SHORT SALES

Unlike the centralized and streamlined regulatory structure in the United Kingdom, regulation in the U.S. is complex, fragmented and duplicative. For example, securities and banking regulations have state and federal components, while state authorities regulate insurance companies and federal authorities regulate futures markets. While banking regulators are primarily prudential regulators, the SEC is primarily an enforcement authority. The apparent disarray of U.S. financial regulation reflects the fragmented nature of the financial industry when Congress put in place the foundation of the regulatory system.

The Securities Exchange Act of 1934, enacted while the shock of the market crash of 1929 still burned in the collective memory of Congress and the investing public, gave the SEC power to regulate short sales. In spite of vigorous debates between proponents and opponents of short selling (such as the debate between Whitney and Perkins captured above), Congress elected not to impose direct statutory regulations and did not take a firm position about the permissibility of short selling in the Exchange Act. Section 10 of the Exchange Act delegated the power to regulate short sales (or to leave short sales unregulated) to the SEC:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce or of the mails, or of any facility of any national securities exchange [t]o effect a short sale... of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

A. Rule 10a-1

Shortly after the ratification of the Exchange Act and after studying

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91 GROUP OF THIRTY, supra note 48, at 32–33.
92 Id. at 33.
93 Id. at 32.
short selling volumes in the bear market of 1937, the SEC adopted a rule to curb the market manipulation risk of short selling.97 In January 1938, the SEC adopted Rule 10a-1, a rule designed "to prohibit short selling in a declining market" and to supplement the national securities exchanges' short selling rules which the SEC believed had failed to curb market abuse.98 The SEC concurrently adopted a statutory definition of "short sale" in Rule 3b-3 (now Rule 200(a) of SEC Regulation SHO), quoted in Section II.99

Rule 10a-1, which remained in place largely unmodified until 2007, stated that any security registered on a national securities exchange may be sold short at either (1) a price above the price at which the immediately preceding sale was effected (a "plus tick"), or (2) a price equal to the last sale price if it was higher than the last different price (a "zero-plus tick").100 With only narrow exceptions, Rule 10a-1 prohibited short sales on "minus ticks" or "zero-minus ticks."101 Rule 10a-1, commonly referred to as the "tick test" or the "Uptick Rule," had three objectives: first, to allow short selling in bull markets; second, to prevent market manipulators from using short selling as a tool to drive market prices down; and, third, to prevent short sellers from exhausting all remaining bids at one price level.102 Contemporary critics of the tick test claim that while it "barred short sellers from selling shares unless the stock price was rising, which had the impact of cushioning the market impact of such selling," it was only "a symbolic barrier against the kind of short selling that could cause stocks to fall precipitously."103 Indeed, in a world of electronic trading and real-time stock price adjustments, Rule 10a-1’s requirements were modest impediments to determined short sellers.

In 1963 and 1976, the SEC considered revising Rule 10a-1 after SEC studies concluded that the short sale rules did not prevent the harm they were designed to address.104 The SEC’s 1963 Special Study concluded that the proportion of short sales in the total market volume of sales increased in a declining market, suggesting that Rule 10a-1 did not curb short selling in

98 Id.; see also Christopher M. Salter & Christopher F. Chase, Short Selling and Naked Shorts in the Regulation SHO Environment, 40 Rev. Sec. & Commodities Reg. 231 (2007), available at http://www.omm.com/files/News/3c966dce-5908-4718-961d-125ca60c2435/Presentation/NewsAttachment/3a3b00aa-0317-437a-8f6b_13231e70c5/Nakedshortselling.pdf
100 Release No. 34-42037, supra note 95.
101 Id.
102 Id.
104 Salter & Chase, supra note 98, at 231–32.
a bear market. In 1976, the SEC proposed a temporary suspension of Rule 10a-1 to investigate market operation without short sale price limitation rules in place. The SEC believed the availability of data with respect to short selling continues to be inadequate to establish meaningful conclusions regarding the general effects of short selling or the efficacy of short sale regulation. Moreover, the SEC "believed that it was possible that no conclusive statistical evidence regarding the short or long-term effects of short selling could be gathered while Rule 10a-1 limited short selling activity, and that some type of suspension of the existing short sale rules might be necessary." The SEC's proposal elicited a strong reaction from its respondents, 75% of whom opposed any suspension of short sale rules. Respondents, including the NYSE and Amex, believed that a suspension would have damaging consequences for investors, including greater day-to-day price variability, accelerated price declines, and higher volatility in stock markets. Interestingly, only one issuer, AT&T, responded to the proposal. AT&T condemned the proposal, citing a risk of increased volatility and speculation in its stock. In 1980, the SEC withdrew its proposal. The SEC did not attempt suspension of Rule 10a-1 for another twenty-five years.

In 1988, the SEC also withdrew its Proposed Rule 10b-11 which would have imposed borrowing requirements on short sellers and, therefore, prohibited naked short selling. The rule would have required short sellers to borrow the security or to have "reasonable grounds to believe that he, or the person for whose account the short sale is effected, can borrow the security, so that... he or the person for whose account the short sale is effected, will be capable of delivering the security on the date delivery is due." When the SEC first drafted Proposed Rule 10b-11 in 1976, it was "part of a comprehensive public fact-finding and rulemaking proceeding on short sales to determine whether short sale regulation

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105 Release No. 34-42037, supra note 95.
106 Id.
108 Id.
109 Id.
110 Id.
111 Id.
112 Release No. 34-42037, supra note 95.
113 Salter & Chase, supra note 98, at 232. 33.
continued to be necessary.”116 Additionally, “[t]he Commission recognized that the proposed rule in all likelihood reflected industry practice, but believed that an express obligation with respect to a short seller’s ability to meet delivery requirements was appropriate should short sale rules be rescinded.”117

Once the SEC rejected terminating Rule 10a-1, it likewise dismissed Proposed Rule 10b-11.118 Furthermore, the SEC recognized that the national exchanges had imposed their own rules to control naked short selling and was willing to allow the Self-Regulatory Organizations (“SROs”) to self-regulate—at least for a while.119 The principles outlined in Proposed Rule 10b-11, which gave the SEC a greater role in the regulation of settlements and short sales, and preempted some SRO rules, reappeared in 2004 when the SEC adopted Regulation SHO.

B. Regulation SHO: A New Approach to Short Sale Regulation

The SEC promulgated new rules regulating short sales in 2004. These rules, codified as Regulation SHO, mark an important shift in the SEC’s approach to short sale regulation. In its proposal of Regulation SHO, the SEC concluded that the SROs’ existing rules had “not fully addressed the problems of naked short selling and extended fails to deliver” and that a “uniform” rule would be a more effective regulation.120

Regulation SHO consists of three rules, Rule 200, Rule 202T, and Rule 203, and largely replaced the short sales rules in place prior to 2004.121 Regulation SHO expanded the SEC’s regulation of short sales. Rule 200 revised and replaced Rule 3b-3.122 It revised definitions of terms including “short sale” and ownership of a security.123 It also created requirements that sell orders in all equity securities be marked “long,” “short,” or “short exempt.”124

Rule 202T was a temporary rule that gave the SEC authority to suspend Rule 10a-1 and parallel sale price limitation rules of the SROs to

116 Withdrawal of Proposed Rules, supra note 114.
117 Id.
118 Id.
119 Id.
121 Id.
124 Id.
investigate the effect of short sale price tests on the market. In Rule 202T, the SEC explained that it had "stated [its] belief that temporary suspension of Commission and SRO price tests is an essential component of evaluating the overall effectiveness of such restrictions, and would permit the collection of data on the impact of short selling in the absence of a price test." The SEC considered implementing Rule 201 in 2004, which would have removed Rule 10a-1 and parallel SRO rules, but deferred the proposal until after the Rule 2021 Pilot Test (the "Pilot").

The SEC conducted the Pilot as authorized under Rule 202T from 2005 to 2007. The Pilot removed price tests from one thousand stocks and analyzed data about price movement, trade volume, and trading transaction type. The Pilot's main findings included: (1) elimination of price test restrictions resulted in a balanced use of up ticks and down ticks during the trading process; (2) price restrictions distort liquidity by impeding the trading process; (3) eliminating price tests did not affect fundamental volatility across days; and (4) the inconsistencies in price tests among the SROs distorted their competitive advantages for investors. The SEC Office of Economic Analysis' review of the Pilot's short sale data suggested that Rule 10a-1 did not effectively regulate short selling and created inefficient opportunities for regulatory arbitrage. The SEC Office of Economic Analysis concluded that that the SEC and the SROs should remove rules that limit the execution price of short sales.

The SEC's and other academic researchers' analysis of the Pilot's data led to the removal of price tests and adoption of Rule 201 in 2007. The SEC removed Rule 10a-1 and, in Rule 201, prohibited the SROs from implementing their own price tests for short sales. Although applauded in 2007, the decision to remove price tests came under fire in 2008.

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126 Regulation SHO, supra note 121.
129 Id.
131 Id., O'Melveny & Meyers, supra note 130.
132 Id.
Rule 203, the third rule enacted in Regulation S10, created new uniform borrowing and delivery requirements. Rule 203(a) requires broker-dealers to make delivery in a sale of equity securities marked "long" when due and prohibits them from using borrowed securities in such transactions.\textsuperscript{134} Rule 203(b) closely echoes Proposed Rule 10b-11. The SEC explained:

Rule 203(b) creates a uniform Commission rule requiring a broker-dealer, prior to effecting a short sale in any equity security, to "locate" securities available for borrowing.\textsuperscript{135} Rule 203 supplants current overlapping SRO rules. Specifically, the rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.\textsuperscript{136}

To comply with Rule 203(b), broker dealers must document a "locate" for each short sale transaction.\textsuperscript{136} Broker-dealers also must use their discretion to determine whether "reasonable grounds" exist to believe that the security will be delivered—although the rule specifies safe harbors including reasonable reliance on a customer's assurances that the security can be borrowed and reasonable reliance on "Easy to Borrow" lists maintained by the exchanges.\textsuperscript{137}

The necessity of Regulation S10 grew out of "longstanding problems involving failures to deliver stock by the end of the standard three-day settlement period for trades, some of which were symptoms of abusive 'naked' short selling."\textsuperscript{138} Rule 203(b) was the SEC's most direct attempt to curtail naked short sales. The 2007 amendments also enforced strict close-out rules on broker-dealers:

\textbf{Rule 203 of Regulation SHO} imposes "close out" requirements on broker-dealers. Rule 203(b)(3) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for 13 consecutive settlement days, the participant must take immediate action to close out the fail to deliver position.\textsuperscript{139} Until the participant fulfills the close-out requirement, the participant . . . [is] prohibited from accepting a short sale order in the threshold security from any person, or effecting a short sale in the threshold security for its own account, without

\textsuperscript{134} Regulation SHO, supra note 121.
\textsuperscript{135} Id. (emphasis added).
\textsuperscript{136} Id.
\textsuperscript{137} Id.
\textsuperscript{138} Barbash, supra note 8, at 136.
borrowing the security or entering into a bona fide arrangement to
borrow the security.\footnote{Memorandum from Willkie Farr & Gallagher LLP to its clients, SEC Adopts
Amendments to Short Sale Rules (June 15, 2007), available at

Even while it removed Rule 10a-1’s tick regime, Regulation SHO and
its 2007 amendments represented an expansion of the SEC’s regulatory and
rule-making authority with respect to short sales, and a reciprocal
diminution of the SRO’s independent authority.

Multiple claims and settlements expose the shortfalls of Regulation
SHO as an adequate mechanism to regulate naked short selling.\footnote{See, e.g., Class Action Complaint, Electronic Trading Group LLC v. Banc of America Securities LLC (In re Short Sale Antitrust Litigation), No. 06-CV-2859 (S.D.N.Y. 2006); Amended Class Action Complaint, Electronic Trading Group LLC v. Banc of America Securities LLC, No. 06 CV 2859 (S.D.N.Y. 2006).} For example, in 2006, the NYSE Board found that Daiwa Securities America, Inc. had violated Rule 203(b) by effecting short sales without borrowing or
making arrangements to borrow securities, and without reasonable grounds
to believe that securities could be borrowed for delivery when due.\footnote{NYSE Hearing Board Decision 06-113, Daiwa Securities America Inc. (June 28, 2006), available at http://www.nysel.com/pdfs/06-113.pdf.} In
2007, the SEC determined that Goldman Sachs Execution & Clearing (“Goldman Clearing”) had violated Rule 200 by failing to label transactions
in civil damages in this case.\footnote{Id.} In spite of its failures, Regulation SHO
evidenced the SEC’s commitment to implementing a manageable and
comprehensive system to monitor naked short selling and highlighted the
SEC’s sensitivity to the potential harm abusive short selling can cause
capital markets.

C. SEC Emergency Rules and the 2008 Market Crisis

In 2008, a series of bank failures and extreme market volatility
undermined investor confidence and seemed to challenge the wisdom in the
SEC’s recent short sale regulation amendments. While it is clear that lax
short sale regulation was not the principal driver behind the widespread
market failure, many critics argued (and the SEC conceded to some extent)
that insufficient short sale constraints facilitated the speculation in and
ultimate failure of Bear Stearns and Lehman Brothers. In an Emergency
Order issued on July 15, 2008, which banned naked short sales of seventeen
major financial firms and Fannie Mae and Freddie Mac, the SEC wrote:
False rumors can lead to a loss of confidence in our markets. Such loss of confidence can lead to panic selling, which may be further exacerbated by "naked" short selling. As a result, the prices of securities may artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, this chain of events can threaten disruption of our markets.

The events preceding the sale of The Bear Stearns Companies Inc. are illustrative of the market impact of rumors. During the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. As Bear Stearns’ stock price fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms. In light of the potentially systemic consequences of a failure of Bear Stearns, the Federal Reserve took emergency action.144

In additional emergency orders issued in September 2008, the SEC temporarily prohibited short selling of the stocks of approximately 800 financial firms, required institutional money managers to report short sales and short positions in certain securities, and eased restrictions on the ability of issuers to repurchase their securities.145 Interim Rule 10a-3T, adopted in October 2008, required certain investment managers to disclose short sales on Form SH, a new form adopted to increase transparency during the term of the emergency order. Interim Rule 10a-3T also required asset managers to file Form SH with the SEC on a weekly basis and to disclose their short positions privately to the SEC in this fashion.146 As in the United Kingdom, the suddenly stringent SEC rules controlling short selling in 2008 represented a move away from the relatively lenient rules of the past.

As the FSA extended its disclosure rules, the SEC extended the Form SH reporting requirements after the short sale ban expired on October 16,

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2008. On July 27, 2009, the SEC announced that it would develop a new public disclosure system in collaboration with the SROs after the expiration of Rule 10a-3T. The primary objectives of the new public disclosure system will be to make the following information available on the SROs' websites:

**Daily Publication of Short Sale Volume Information.** The SROs will publish the aggregate short selling volume in each individual equity security on a daily basis.

**Disclosure of Short Sale Transaction Information.** The SROs will publish information regarding individual short sale transactions in all exchange-listed equity securities on a one-month delayed basis.

**Twice Monthly Disclosure of Fails Data.** The SEC will publish data regarding the numbers of fails to deliver for all equity securities twice per month.

Section VI will consider the wisdom of extending the disclosure rules and other policy options available to financial market regulators.

**VI. THE CONTEMPORARY DEBATE**

Even before the temporary short sale bans in the United States and United Kingdom expired, financial economists and asset managers who use short sale strategies in their investments lined up to make a case against limits on short selling and to argue that banning short selling would only exacerbate market inefficiencies. Indeed, as soon as the SEC implemented the short sale bans, speculation grew that the emergency rules either had no impact on market volatility or increased market volatility. Criticism of the FSA rules likewise appeared in the British press shortly after the FSA

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150 Id.

151 E.g., Arturo Bris, *Shorting Financial Stocks Should Resume*, WALL ST. J., Sept. 29, 2008, at A25 (calling on the SEC to "Stop the folly - End the ban").
announced its new short sale restrictions.152

Arturo Bris, a professor of finance at the Institute for Management Development in Switzerland, argues that a close examination of trades on the NYSE in July and August 2008 suggests that the ban on naked short selling exacerbated fluctuations in the affected securities’ prices and further disrupted the functioning of fair, orderly equity markets.153 In an article written in August 2008, Bris compared the performance of the nineteen U.S. financial institution stocks targeted by the July SEC Emergency Order to pools of fifty-nine U.S. financial firms not affected by the July Emergency Order and seventy-three non-U.S. financial firms not affected by the July Emergency Order.154 He analyzed trade-by-trade NYSE data before the July Emergency Order and found that, although the market quality of the nineteen stocks affected by the July Emergency Order was worse than comparable U.S. financial stocks, the lower market quality was not a product of short selling activities.155 He also found that after July 21, when the Emergency Order became effective, the nineteen targeted stocks “suffered a significant reduction in intra-day return volatility and an increase in spreads, which suggests a deterioration of market quality.”156 Bris’ research suggests that market efficiency deteriorated after the July Emergency Order went into effect:

In more efficient markets, individual stock returns co-move less with the market, and are less correlated with past market returns as information is impounded into prices immediately. Applying this technique to the sample of financial stocks shows that overall market efficiency has declined overall after the EO has become effective. Additionally, the efficiency of G19 stocks has deteriorated more than

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153 Bris, supra note 2.

154 Id. at 7.

155 Id. at 5–6.

156 Bris further stated:

For example, from the pre-[Emergency Order] period to the post-[Emergency Order] period, relative quoted spreads for G19 stocks have increased from 18 percent to 48 percent, but they have increased only from 11 percent to 29 percent for comparable U.S. financial stocks. There has been no significant change in the relative quoted spreads for non-U.S. financial institutions.

Id. at 6.
the efficiency of comparable U.S. Financial stocks.\textsuperscript{157}

Bris' data suggests that proponents of short selling were right to question and condemn the SEC and FSA's emergency regulations and short sale bans—but preliminary results are weak authority to resolve an ongoing policy debate in the midst of a financial crisis. Moreover, while Bris' analysis looked at a ban on naked short selling, policymakers must consider additional empirical research on other short sale constraints as they develop a future regulatory regime. For example, a study published by the Cass Business School (and discussed in detail in the following section) found that the short sale bans did not curb market volatility.\textsuperscript{158} Like Bris' research, the Cass report is necessarily preliminary. Financial economists have extensively investigated the effects of short sale constraints on market efficiency and their research—remarkable for its consistent conclusion that short selling increases market efficiency\textsuperscript{179}—should be the basis and underlying authority for the SEC's future regulation of short sales.

Several financial economists endorse the "Overpricing Hypothesis," a theory that short sale constraints can cause stock prices to become overpriced by limiting short-sellers' ability to correct inflated prices and by slowing down the market's reaction to negative information about the

\textsuperscript{157} Id.


\textsuperscript{159} See, e.g., Douglas W. Diamond & Robert E. Verrecchia, \textit{Constraints on Short-Selling and Asset Price Adjustment to Private Information}, 18 J. FIN. ECON. 277 (1987) (arguing that prohibitions on short sales reduce the adjustment speed of stock prices to private information and that imposing constraints on market pessimists (short-sellers) undermines market efficiency and causes an optimists' bias); Naoto Isaka, \textit{On the Informational Effect of Short-Sales Constraints: Evidence from the Tokyo Stock Exchange}, 30 J. FIN. RES. 455 (2007) (arguing that constraints reduce the informational efficiency of stock prices and demonstrating that short sale constraints reduce the adjustment speed of stock prices to negative information about the financial performance of the underlying institution); Charles M. Jones & Owen A. Lamont, \textit{Short-Sale Constraints and Stock Returns}, 66 J. FIN. ECON. 207, 208-209 (2002) (arguing that the presence of short sale constraints can cause stocks to become overpriced in otherwise efficient markets and showing that "stocks that are expensive to short have low subsequent returns, consistent with the hypothesis that they are overpriced"); Owen Lamont, \textit{Short Sale Constraints and Overpricing}, NBER REPORTER, Winter 2003, at 16, available at http://www.nber.org/reporter/winter03/winter03.pdf (outlining the "Overpricing Hypothesis" which explains that "in extreme cases where short sellers want to short a stock but find it difficult to do so, overpricing can be very large" and identifying SEC regulations as one constraint that impedes short selling in U.S. equity markets). But see, e.g., Jørgen Vitting Andersen, \textit{Could Short Selling Make Financial Markets Tumble?}, 8 INT'L. J. THEORETICAL & APPLIED FIN. 509, 519 (2005) (arguing that higher volumes of short sales correlate with lower stock market returns and bear markets, and suggesting that "[t]he real danger is instead when a downwards spiral of the markets has begun, in which case an increase in short trading activity will only increase the downward trend").
The Overpricing Hypothesis and the various empirical studies that evaluate and confirm it are evidence that market regulators, in the interest of preserving and promoting market efficiency, should not prohibit short selling. Market research also highlights a liquidity benefit of short selling that supports regulations allowing safe short selling. The Overpricing Hypothesis and supporting empirical research of financial economists suggest that the most important question regulators should seek to answer as they build a new regulatory system is not whether to allow short selling, but rather how to allow short selling while controlling the risks of abuse. Short selling is not a flawless market efficiency mechanism and will not work without effective regulation and vigilant market monitoring to detect and deter abuse.

A. Regulatory Options

Although stock markets remain volatile and well below their 2007 performance, the SEC and FSA have allowed their short sale bans to lapse. Short selling regulation remains a primary policy concern for both regulators, but the SEC and FSA seem to have adopted a more measured tone in their policy discussions in the first quarters of 2009. Additionally, both regulators seem to have acknowledged that short sale bans are not good long-term policy and were not strong enough medicines to offer financial institutions the protection they needed to weather the financial crisis. In 2008, policymakers were hopeful that short sale bans, while perhaps suboptimal policy, were a less costly alternative to government bailouts of the financial sector. One year after several of the largest bailouts of major international banks in history, regulators are embracing disclosure regimes and transparency as a means of regulating short selling and tracking abuse in real time, and are abandoning reactionary prohibitions and rules ill-fitted for modern capital markets.

Several regulatory approaches that have been used in the past no longer seem to be effective. Ineffective rules and regulations that should be removed from regulators’ arsenals include short-term reactionary bans on all short selling in the midst of market crisis and Tick Tests such as Rule 10a-1 (retired by the SEC in 2007). Measures that should be part of future regulation include strict close out and settlement rules that ban naked short positions that last more than a set number of days, circuit breaker rules, and enhanced disclosure rules. Current SEC and FSA policy discussions emphasize disclosure, a prudent priority in spite of protests by asset managers.

160 E.g., Jones & Lamont, supra note 159; Isaka, supra note 159.
1. Short-Term Bans on All Short Selling

Some economists believe that aggressive short selling in bear markets can exacerbate market volatility and decline.\(^{162}\) However, preliminary observation of market performance in 2008 after short selling bans were in place suggests that banning short selling in the midst of a market crisis will neither prevent a market’s decline nor mitigate volatility.\(^{163}\) While the short sale bans aimed to protect financial institutions, they do not seem to have been effective and do seem to have shaken investor confidence in market efficiency.\(^{164}\) Moreover, neither the FSA nor any other regulator has found evidence that short selling caused financial stocks to tumble.\(^{165}\)

A study produced by researchers at the Cass Business School in London and commissioned by the International Securities Lending Association, the Alternative Investment Management Association and the London Investment Banking Association evaluated the performance of U.K., U.S., Italian, French and German stocks before and after regulators in each country implemented short sale bans.\(^{166}\) The study compared the daily returns of stocks that were subject to the restrictions to returns of stocks that were not.\(^{167}\) The study found that the short sale bans did not change the behavior of stock returns. Its principle findings were:

1. No strong evidence that restrictions on short selling changed the behaviour of stock returns. Stocks subject to the restrictions behaved very similarly both in how they behaved before their imposition and to how stocks not subject to the restrictions behaved.

2. Comparing behaviour across countries where the nature of the restrictions differed, the authors found no systematic patterns consistent with the expected effect of the new regulations, i.e. no evidence of a reduced probability of large price falls.

\(^{162}\) E.g., Andersen, supra note 159; Culp & Heaton, supra note 10.

\(^{163}\) Simon Nixon, Short Ban was Short-Lived, WALL ST J., Jan 6, 2009, at C.10 ("[T]here is no evidence that short-selling bans served any useful purpose. Bank shares continued to tumble after the ban. A study by Cass Business School, comparing bank shares across various markets, found no differences that could be explained by the ban. A better explanation is simply the rush by investors to dump bank stocks.").

\(^{164}\) Id

\(^{165}\) Id.


\(^{167}\) Marsh & Niemer, supra note 166, at 4.
The authors also found no sign of any detrimental impact of the constraints in terms of reduced efficiency of pricing. . . . \footnote{188}{Press Release, Cass Business School, supra note 158.}

The results of the Cass Business School study support an argument that short-term emergency orders to suspend short selling are not effective measures to restore normalcy to markets in crisis. The study, published in late November 2008, should be re-evaluated after more time has passed since the bans and the markets have moved closer to a normal state. As markets normalize, researchers will have a more extensive data set to analyze.

Owen Lamont and Jeremy Stein analyzed the apparent market anomaly that aggregate short interest tends to be relatively low in a bull market (when, by definition, many stocks are overpriced). \footnote{169}{Owen A. Lamont & Jeremy C. Stein, Aggregate Short Interest and Market Valuations, AM. ECON. REV., May 2004, at 29.} Their research looked specifically at the Dot-Com Bubble. They argue that open-ended hedge funds, which allow investors to withdraw their funds at any time, mute the market correcting potential of rational arbitrageurs who would take short positions in bull markets. \footnote{170}{Id. at 31.} When the market rises, Lamont and Stein explain, rational arbitrageurs who had taken short positions in overvalued companies will lose money. \footnote{171}{Id.} Investors in these rational arbitrage funds will redeem their investments and the funds will have to scale back their positions. Consequently, Lamont and Stein argue, aggregate short interest remains small in a bull market. Lamont and Stein conclude that "the problem is not too much short-selling in falling markets . . . but rather, too little in rising markets." \footnote{172}{Id.} Their research, coupled with Arturo Bris' evidence that aggregate short interest does not markedly increase during a bear market, suggests that the best policy in periods of market growth and contraction is to allow short selling.

While additional empirical research should be conducted to determine the efficacy of the short-term bans of 2008, preliminary research suggests that the bans were not effective regulation and did not calm markets or protect the stocks subject to the ban from volatility. Preliminary research seems to confirm the notion that short sale bans will not calm market volatility, and that investors' sentiment and confidence level dictate market performance to a greater extent than short sale volume. Therefore, in future market crashes, regulators should rely on real-time surveillance and aggressive anti-fraud and anti-abuse regulation instead of drastic emergency rules that prohibit normal market operation and erode investor confidence.
2. Tick Tests

Several memoranda published by Wachtell, Lipton, Rosen & Katz ("Wachtell") call on the SEC to reinstate Rule 10a-1.\textsuperscript{173} Wachtell criticized not only the SEC's decision to remove Rule 10a-1 but also the Pilot Program that informed the SEC's decision. In its condemnation, Wachtell argues that the SEC conducted its Pilot Program in a bull market in which the need for regulation and risk of market manipulation was relatively low and that the Uptick Rule is an important market safety measure.\textsuperscript{174} In January 2009, Representative Gary Ackerman, a member of the House Financial Services Committee, introduced legislation to reinstate the Uptick Rule.\textsuperscript{175} In April 2009, the SEC released new proposals for short sale regulation, including proposals to reinstate a tick test.\textsuperscript{176} The SEC continues to weigh proposals and plans a roundtable meeting to discuss them on September 30, 2009.\textsuperscript{177} Ackerman's proposal and the SEC proposals highlight the ongoing debate among policymakers about the impact of short selling—and the uncertainty about which anti-abuse measures to adopt.

Former SEC Chairman David Ruder argues that the Uptick Rule is no longer effective in markets in which investors follow and make trade decisions based on fraction-of-a-penny price adjustments.\textsuperscript{178} Indeed, decimal pricing is often cited as a reason Rule 10a-1 and other sale price limitations are no longer effective ways to curb abusive selling.

In its February 2009 Discussion Paper on short selling, the FSA evaluated a tick test as a possible means of regulating short selling and limiting market abuse by short sellers. The FSA drew lessons from the SEC's experience with Rule 10a-1 and referenced the conclusions of the SEC Pilot Test that "the SEC 'should remove price test restrictions because they modestly reduce liquidity and do not appear necessary to prevent

\textsuperscript{173} See Memorandum from Herlihy & Levine, supra note 133; Memorandum from Edward D. Herlihy & Theodore A. Levine, Wachtell, Lipton, Rosen & Katz, to the firm's clients, today the SEC Must Step Up (Sept. 16, 2008), available at http://amlawdaily.typepad.com/amlawdaily/files/today_the_sec_must_step_up.pdf;

\textsuperscript{174} Memorandum from Herlihy & Levine, supra note 133.

\textsuperscript{175} Alistair Barr, Crisis on Wall Street: As Some 'Shorts' Thrive, More Calls for Regulation, WALL ST. J., Jan. 10, 2009, at B3.


\textsuperscript{177} See Press Release, SEC, supra note 176.

\textsuperscript{178} David Ruder, Former SEC Chairman, Remarks at Northwestern University School of Law (Oct. 9, 2008).
manipulation. The FSA noted, "[a]nother key finding was that there was no evidence that there was an association between extreme price movements and the absence of a tick regime." The FSA rejected a tick test as a means of controlling short sale risks, citing the high costs of implementing a regime to apply the rule and the risk of eliminating legitimate short selling strategies. While compliance with a reinstated tick regime might be easier in the United States where infrastructure is in place and the exchanges would be able to re-establish their enforcement mechanisms, the reasoning of the 2007 decision to revoke Rule 10a-1 and the FSA's analysis of the net negative effects of a tick test should discourage the SEC and Congress from reinstating a tick rule in the United States. Tick tests are costly and ineffective risk reduction measures not appropriate for modern markets.

3. Close-out and Settlement Rules

Arturo Bris evaluated the impact of the SEC's ban on naked short selling in July and August 2008 and discovered that the ban had negative effects on market quality and market efficiency. Financial economists and regulators regard naked short selling as a cause of market volatility and a tactic of market abuse by manipulative short sellers. These concerns are supported by economic models and by real-world scandals and exposed abusive strategies. However, there is also evidence that naked short selling can benefit markets:


180 Id.

181 The FSA stated:

[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. Id.

182 Bris, supra note 2.

183 E.g., Culp & Henton, supra note 10 (providing an economic analysis of how naked short selling can increase market volatility when short sellers buy stock to cover their positions and the price subsequently falls down to an equilibrium value); Cox, supra note 15 (describing the effect of short selling on Bear Stearns).
Naked short selling creates competition in the market for security lending by allowing a new buyer to provide the service of being owed the share rather than allowing only the current owner to do so. To the extent that competition in the securities lending market is desirable—and it is difficult to argue that it is not desirable if the underlying market itself is valuable then naked short selling, far from being detrimental, may be valuable in facilitating the gains from short selling.\textsuperscript{184}

Indeed, one of the most often cited benefits of short selling is its liquidity benefit, and naked short selling increases market liquidity by expanding the market for stock lending.

In its February 2009 Discussion Paper, the FSA determined that a prohibition on naked short selling or a requirement that all short selling be covered would have a net negative effect.\textsuperscript{185} The FSA reviewed the mechanisms in place in the United Kingdom to reduce the risk of settlement failure, namely the U.K. Recognised Investment Exchanges and Recognised Clearing Houses, and the stock exchanges’ regimes to punish repeated fails. The FSA concluded, “[t]o the extent that non-delivery remains an issue, it is probably more proportionate to address that through tightening of settlement rules rather than by introducing a blanket ban on naked shorting.”\textsuperscript{186} While the FSA noted the higher risk of market abuse and volatility if naked short sales are not regulated, and noted that a requirement that all short sales be covered would curb aggressive short selling, it rejected a blanket prohibition.\textsuperscript{187}

The Discussion Paper evaluated several disadvantages to a ban on naked short sales and proposed that a ban would “prevent legitimate behaviour which can provide beneficial market impacts”:\textsuperscript{188}

For example, a naked short selling prohibition would stop intraday naked short selling (e.g. by day traders), an activity generally

\textsuperscript{184} Culp & Hanton, supra note 10, at 51.
\textsuperscript{185} DP09/1, supra note 179, at 18.
\textsuperscript{186} Id. at 17.
\textsuperscript{187} The FSA stated:

\textsuperscript{188} [A naked short sale ban] limits the speed and the extent to which a short selling strategy can be executed and thus can act as a brake on more aggressive short selling (which would normally carry commensurate risks). This is because the short seller will have to expend time and resources locating and borrowing the stock and there will always be a cap on the amount of stock that can be borrowed, namely the amount of issued share capital. Neither of these limitations applies to naked short sellers who can, in theory, short more that 100% of the shares in issue. However, it is not clear to what extent naked shorting is used to take significant positions. Our contacts with market participants suggest that those wishing to take big positions do so on a covered basis. Id.
accepted to be legitimate trading that provides valuable liquidity to the system and does not pose a significant risk of settlement disruption. In particular, such a prohibition would significantly impair the ability of market makers to function properly, as it is often a necessary part of their role to short sell to meet client demand for a stock (where their own inventories are exhausted). 188

Evidence of the liquidity benefits of naked short selling should not prompt policymakers to allow naked short selling without oversight or regulation. While naked short selling may be economically similar to covered short selling, it is an easy tool of market manipulators and can be used to create a large surplus of borrowed shares, which does not represent shareholder’s willingness to lend. Some countries, like Australia, have long-standing prohibitions on naked short selling while others, like the United States and United Kingdom, allow naked short selling but have regulatory systems in place to oversee prompt settlement and close-out. 189

The FSA Discussion Paper makes the important argument that the harm that can result from naked short sales and persistent fails can be controlled by strong regulation of the settlement process, shortened settlement periods, and strict close-out rules. These objectives, which were the primary objectives underlying Regulation SHO, continue to be the bases of naked short sale regulation in the United States. The SEC adopted Rule 204 in July 2009 which made permanent Rule 204T, an interim temporary rule adopted in 2008. Rule 204 aims to curb naked short selling by strengthening close-out rules and requiring broker-dealers to “immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position.” 190

188 Id.
189 In October 2008, the SEC installed Rule 10b-21, a new naked short selling antifraud rule, that reinforces the existing settlement and close-out rules of Regulation SHO:

Rule 10b-21 takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer’s securities. Rule 10b-21 will also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. In addition, Rule 10b-21 could help reduce manipulative schemes involving “naked” short selling.


Since adopting Rule 204, the SEC has actively enforced its requirements. Settlement problems and high instances of failure to deliver do not call for new regulation. Rather, they call for better enforcement of existing regulation. The FSA and SEC are wise to highlight certain advantages of naked short selling with regulated and closely monitored settlement periods, and other regulators should follow their lead.

4. Circuit Breaker Rules

"Circuit breaker" rules, such as the regime enforced by the London Stock Exchange ("LSE"), which prohibit short sales after a defined decline in the price of a security, are one alternate means of regulating abusive short selling and protecting underlying issuers from manipulation of their stock price. For example, under a circuit breaker rule, an exchange would suspend short selling of a certain stock if the price fell more than 10% (or any defined threshold) in a single day. Similarly, a regulator could suspend all trading in a stock if the stock price fell below the threshold.

While the SROs could implement their own rules and considered doing so in 2008, the SEC could also issue a uniform rule. The proposed short sale regulations currently under review by the SEC include three circuit breaker proposals. A uniform rule issued by the SEC would create consistency across exchanges and could be drafted to give the SEC a direct and active oversight position—perhaps filling gaps in what has been regarded as insufficient oversight in 2008. Moreover, a uniform rule would avoid discrepancies in the SRO's rules, which would invite regulatory arbitrage by investors, and prevent a race to the bottom among SROs eager to attract investors.

In its February 2009 Discussion Paper, the FSA considered and rejected implementing circuit breaker rules. The FSA detailed the LSE's automatic execution suspension periods (AESPs) and concluded that current regulations were sufficient to mitigate risk and prevent abuse. The FSA's disinclination to adopt circuit breaker rules reflects the regulator's decision to leave control of circuit breakers to the exchanges. The similar relationship between the SEC and the SROs in the United States suggests that both regulators must weigh the costs and benefits of centralized regulation as they build new short sale rules. Indeed, as the SEC considers circuit breaker rule proposals, it will give careful attention to the costs and regulatory burden a new regime would impose on SROs and

193 Amendments No. 34-59748, supra note 176.
194 DP09/1, supra note 179, at 21.

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the SEC. The FSA’s decision to leave circuit breaker rules to the LSE might not be the optimal strategy because it will encourage investors to migrate towards markets with favorable regulation, and risk creating a race to the bottom among market regulators.

5. Enhanced Disclosure Requirements

While temporary short sale bans have lapsed, enhanced disclosure requirements remain in place, albeit in a different form than the rules first implemented in Fall 2008. In spite of protest from hedge fund managers and fund associations, proposals for enhanced disclosure have the most support among policymakers. Hedge fund managers oppose disclosure requirements because they believe that if their short positions are made public, other investors will match their trading positions and thereby undermine their strategies. Richard Gilbert, chief executive of the Investment and Financial Services Association in Australia, collaborated with hedge fund industry associations in the United States and the United Kingdom to warn regulators about the harmful effects of public disclosure of short positions and call for a consistent international approach to short sale regulation. Gilbert suggested that short positions should be made known to regulators in close-to-real-time, but that positions should not be made public for at least two weeks after the transactions.

As of March 6, 2009, the FSA has heightened disclosure requirements in place. The temporary FSA rules require asset managers to publicly disclose short positions in specified financial stocks worth 2.5% of a company’s total outstanding stock. These temporary heightened rules, unpopular with asset managers, are likely to give way to an even more onerous regime under the FSA’s new regulatory proposal.

The FSA’s February 2009 Discussion Paper on Short Selling (“DP09/1”) proposed a more rigorous and comprehensive disclosure requirement. Asset managers would have to disclose short positions worth 5% of a company’s issued share capital, and would have to disclose changes in short positions if the change interval exceeded 1% of a company’s issued share capital. The proposed disclosure requirements would apply to all stocks traded on UK exchanges. Shortly after the FSA

195 Amendments No. 34, supra note 176.
196 Peter Smith & Tom Mitchell, Fund Heads Voice Short Selling Fears, FIN TIMES, Jan. 8, 2009, at 27.
197 Id.
198 Id.
200 Id.; DP09/1, supra note 179, at 31.
201 DP09/1, supra note 179, at 32.
released DP09/1, Sally Dewar, managing director of wholesale and institutional markets at the FSA said, "We believe that enhanced disclosure is the right way forward. . . . We also consider it to be important that we align our proposals with those being developed on an international basis and we are working towards this." 797 In DP09/1, the FSA weighed the market benefits of public disclosure (including detection of market abuse and visibility of unusual short selling activity that would otherwise cause an over-reaction) against the harm to asset managers of public disclosure and the costs to asset managers of compliance. The FSA concluded:

"The question is therefore whether the indirect costs of requiring public disclosures outweigh the benefits. We acknowledge that some market participants would prefer for any disclosures to be done privately to the FSA, arguing that public disclosure might have potentially harmful commercial effects. They are concerned that disclosures might make themselves vulnerable to being squeezed by competitors when it comes time to cover their short position. Against this, without any form of public disclosure, much of the benefit of disclosure as a potential constraint on aggressive large-scale short selling leading to disorderly markets would be lost. In addition, the informational benefits to the wider market of having transparency on significant short positions would also be lost. . . . On balance, we consider that the benefits of having public disclosure of significant short positions outweigh the costs and that the short selling disclosure regime should be on this basis." 798

Hedge fund managers have reacted to the FSA proposal with criticism. Condemning the FSA proposal, Andrew Baker, chief executive of the Alternative Investment Management Association, an international hedge fund association, said "[i]t is short selling is a good thing, because of price discovery and supplying liquidity to the marketplace [as the FSA said] then you have got to provide the conditions in which it thrives: it needs water, oxygen and food and not much light." 799 Baker called for disclosure of aggregate positions, showing the total short holdings in each company rather than the specific holding of each investor. 800 The FSA rejected this proposal in DP09/1. 801

797 Hughes, supra note 199.
798 DP09/1, supra note 179, at 29.
800 Id.
801 DP09/1, supra note 179, at 29.

For the sake of completeness we should also note that we see little value in a regime which required disclosure of individual positions to the regulator and then U.S. publishing aggregate information about those positions. It would only give
Current U.S. regulation of short sales also focuses on disclosure. However, the SEC initially opposed daily public disclosure of short positions held by asset managers. Interim Rule 10a-3T required disclosure only to the SEC and on a weekly basis. When it adopted Rule 10a-3T, the SEC commented: "we are concerned that publicly available Form SH data could give rise to additional, imitative short selling. Accordingly Rule 10a-3T states that all forms SH filed with the Commission will be nonpublic to the extent permitted by law." This rule expired on August 1, 2009, at which time the SEC announced plans to collaborate with SROs to make short sale volume and transaction data publicly available on the internet. The SEC-SRO disclosure plan suggests that the SEC's position with respect to public disclosure has moved closer to that of the FSA.

Both the SEC and the FSA believe that a permanent disclosure requirement will improve regulators' ability to monitor abusive short selling. However, the debates on the relative merits of public and nonpublic disclosure and the relative merits of real time and periodic disclosure are likely to continue, with hedge funds lobbying aggressively for nonpublic and periodic disclosure only. While disclosure to regulators should be sufficient to allow regulators to police market manipulation, the FSA's argument that public disclosure will temper speculation and over-reaction by investors to short selling-induced volatility is compelling. Carefully investigating and evaluating the impact of new disclosure requirements will be the most important step for regulators and policymakers to take before implementing a new regime, and involving hedge funds in the dialogue will be an important way to make sure that the regime works. However, including disclosure in future long-term policy will be a crucial element of monitoring manipulation and abuse and will help preempt emergency regulations (like the 2008 bans) in the midst of the next market crisis. Transparency—at least for financial market regulators—will reduce the information asymmetries that encourage market manipulators to exploit lax regulation and cause regulators to over-react to periods of market decline and volatility.

H. Calls for International Cooperation

Another important feature of the growing consensus regarding short sale regulation is the sensitivity of national market regulators to the global impact of their rules and regulations. The SEC and FSA, in addition to SROs and industry associations, are collaborating to develop a short sale regulatory system that minimizes opportunity for regulatory arbitrage and

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297 Disclosure of Short Sales and Short Positions by Institutional Investment Managers, supra note 146.
helps to avoid abuse by international short-sellers. Without international cooperation, short sale regulation could turn into a "race to the bottom" in which market regulators reduce restrictions and relax enforcement in an attempt to attract capital to their markets. Additionally, the growth of sophisticated investors using increasingly complex and sophisticated short sale strategies and the increasing incidence of fraud and abuse by these investors have alerted regulators to the need for better protection to guard their capital markets from systemic risk.

The integrated and global character of financial markets and national economies caused many regulators to apply their own short sale bans in 2008 after the SEC and FSA announced theirs. Without parallel protections, small market regulators feared, smaller or secondary capital markets would be exposed to "attack by short sellers." In addition to the United States and United Kingdom, Australia, Belgium, France, Germany, Switzerland, and several Asian countries announced short sale bans in 2008. Australia, Belgium, France, Germany, and Switzerland extended their short sales bans into 2009. Current attention to international coordination about new policy and the domino effect of short selling bans in the summer and fall of 2008 suggest that regulators are sensitive to the risk of regulatory arbitrage—and wisely sensitive to the need for a global strategy to curb capital market manipulation.

VII. CONCLUSION

Even though most regulators have allowed their short sale bans to lapse and seem to be thinking constructively about the form of future regulation, the dust has notsettled on the short sale debate. As the events of the past year outline, short selling regulations tend to mirror the capital markets they oversee. In years of market growth, the risk of market manipulation by abusive short sellers seems low. Regulation becomes unpopular because it imposes costs on investors and investment managers and because it reduces market liquidity and undermines the price stabilization benefit of short selling. In bull markets, as the SEC Pilot suggested, the call for regulation decreases. However, in periods of market decline and financial crisis, greater regulation seems necessary to curb the impact of pessimistic rumors and doomsday speculation. In these conditions, greater regulation or suspension of short selling looks like a quick tonic for an ailing market. The challenges regulators face are finding the right balance of oversight and interference and building a regulatory system that responds effectively to market fluctuation. The very low level of investor confidence in 2009 reveals that sudden, stringent regulation

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208 Hughes, supra note 199.
209 Id.
210 Pauline Skypain, Need to Make Clear Views on Short Selling, FIN TIMES, Jan. 12, 2009, at 6.
calms neither markets nor nerves—and that market regulators must answer calls for emergency regulation with prudence and restraint.

Increased disclosure of short positions will increase the visibility of short sale transactions and make the market for borrowed stock transparent. This comment argues that transparency will help regulators understand what factors drive stock price volatility and cause market crashes. It also posits that strictly enforced settlement and close-out rules that curb naked short selling and make short sale transactions predictable and consistent will deter market manipulation. Strict settlement and close-out rules will also reduce the threat of abuse and bear raids that drive down the stock price of otherwise healthy issuers. With better understanding of the role short sellers play in a bear market and the relationship between market disruption and short sale volume, regulators will be able to punish abuse selectively and will avoid punishing the entire market with onerous and inefficient restrictions.

As markets normalize, regulations should follow suit and regulators should once again allow short selling and naked short selling with careful settlement requirements. Evidence that restriction of short selling causes overpricing of stock and higher levels of market inefficiency even in a bear market suggests that regulators should allow short selling while carefully monitoring the short positions of aggressive traders. Allowing controlled short selling will increase liquidity and allow hedge funds and other institutional short sellers to continue to move markets towards efficient prices, thereby restoring faith in markets over time.