

See discussions, stats, and author profiles for this publication at: <https://www.researchgate.net/publication/228273907>

In Pursuit of the Naked Short

Article · February 2011

CITATIONS

6

READS

227

1 author:



Alexis Stokes

Texas State University

4 PUBLICATIONS 20 CITATIONS

SEE PROFILE

NEW YORK UNIVERSITY
JOURNAL OF LAW AND BUSINESS

VOL. 5

Spring 2009

No. 1

IN PURSUIT OF THE NAKED SHORT

ALEXIS BROWN STOKES*

Recent lawsuits claiming market manipulation through naked short-selling have failed to produce remedies for the alleged injured parties; no private plaintiff yet has won a final judgment, with damages, based on allegations of naked short-selling. Despite this poor track record, naked short-selling litigation has proliferated in the post-Enron era, as struggling small-cap companies blame naked short-sellers for their sagging stock prices, and with the plaintiffs' bar pursuing the naked short as a Holy Grail because of the potentially huge damage awards.

This article explores the origins of naked short-selling litigation; considers the failures of significant naked short-selling lawsuits in federal court; surveys the obstacles erected collectively by constitutional standing requirements, the Federal Rules of Civil Procedure, the Private Securities Litigation Reform Act, brokerage firms, death spiral financiers, and the Depository Trust and Clearing Corporation; examines the efficacy of Regulation SHO, SEC rule 10b-21, and new FINRA rules; discusses recent state legislation and state court litigation; and identifies non-litigation options to curb naked short-selling. Ultimately, this article seeks to answer the question: If manipulative naked short-selling is more than a mythological scapegoat for small cap failure, what remedies are, or should be, available?

* J.D., Harvard Law School; B.A., Rice University. The author thanks both Peter Stokes and participants at the University of Florida's Huber Hurst Research Seminar, co-sponsored by and held at The University of Pennsylvania's Wharton School of Business in February 2007, for their comments and support. An earlier version of this paper was also presented at The Academy of Legal Studies in Business Annual Conference in August 2007. The author also notes that although, as a junior associate, she formerly served among the many defense co-counsel in one of the cases, *Jag Media Holdings v. A.G. Edwards & Sons, Inc.*, 387 F.Supp.2d 691 (S.D.Tex. 2004), cited herein, the views expressed are solely the author's and do not necessarily reflect those of her former law firm or clients.

INTRODUCTION

*“The court was not astonished to learn from counsel that the practice of selling short naked is rather less fun than might be imagined.”*¹

Recent lawsuits claiming market manipulation through naked short-selling have failed to produce remedies for the alleged injured parties; no private plaintiff yet has won a final judgment, with damages, based on allegations of naked short-selling. Despite this poor track record, naked short-selling litigation has proliferated in the post-Enron era as struggling small-cap companies blame naked short-sellers for their sagging stock prices and the plaintiffs’ bar continues to pursue these claims because of the potentially huge damage awards.

This article explores the origins of naked short-selling litigation; considers the failures of significant naked short-selling lawsuits in federal court; surveys the obstacles erected collectively by constitutional standing requirements, the Federal Rules of Civil Procedure, the Private Securities Litigation Reform Act, brokerage firms, death spiral financiers, and the Depository Trust and Clearing Corporation; examines the efficacy of Regulation SHO, SEC rule 10b-21, and FINRA rules; discusses recent state legislation and state court litigation; and identifies non-litigation options to curb naked short-selling. Ultimately, this article seeks to answer the question: If manipulative naked short-selling is more than a mythological scapegoat for small-cap failure, what remedies are, or should be, available?

Part I of this article provides context for understanding the naked short-selling phenomenon. Part II examines the popularization of the naked short as a scapegoat for corporate failures. Part III explores the proliferation of lawsuits alleging naked short-selling and focuses on the injusticiability of market manipulation through naked short-selling claims. Part IV previews trends in naked short-selling litigation. Part V considers current and proposed regulatory and legislative solutions to the naked short-selling problem.

1. *Miller v. Asensio*, 101 F. Supp. 2d 395, 398 (D.S.C. 2000).

I.

NAKED SHORT-SELLING, DEFINED

In a typical securities transaction, an investor purchases a stock, waits for the stock price to increase, and then sells the stock at a profit. In securities lingo, this “buy low, sell high” behavior is called “selling long.” The investor’s risk is limited to the purchase price of the stock.

Sometimes an investor adopts a “sell high, buy low” strategy through a “short sale” instead. The investor, suspecting that a stock is overvalued and will decrease, borrows the stock (usually from a broker or institutional investor), sells it, waits for the price to decline, purchases the stock at the lower price to return to the lender, and pockets the difference in price as profit.² For example, an investor believes that Company ABC, which is currently trading at \$50 a share, is overvalued and that the stock price will decline. The investor borrows 100 shares of ABC stock at \$50 a share from his broker³ and immediately sells them for \$5000. The investor waits, and when ABC’s stock declines to \$30 a share, he buys 100 shares on the open market for \$3000 and returns them to his broker. The investor reaps a profit of \$2000 on this short sale. The risk, of course, is that if Company ABC’s stock price increases instead of decreases, the investor’s loss is potentially infinite.⁴

2. See, e.g., Deborah Solomon, *SEC Is Set to Approve Plan to Ease Short-Selling Curbs for One Year*, WALL ST. J., June 23, 2004, at C3.

3. Brokers, in turn, borrow the necessary security from custody banks, fund management companies, and other customers who own long positions in the stock. When borrowing from customers who have fully paid for their long positions, the broker must obtain their permission, provide collateral, and pay them a fee. Brokers then charge the short-seller a fee of approximately five-to-ten base points to cover these transaction costs. In fewer cases, brokers may borrow shares from other brokers, although this practice is usually reserved for their large institutional customers.

4. See Symposium, *Tax Issues Raised by Financial Products: Shorts Against The Box, Collars and Equity Derivatives*, 13 ST. JOHN’S J. LEGAL COMMENT. 1, 14 (1998); Michelle Celarier, *Weekend Reading: Profile of a Short Seller: Rocker’s Passion for Shorting*, N.Y.Times.com, Apr. 14, 2006, <http://dealbook.blogs.nytimes.com/2006/04/14/weekend-reading-profile-of-a-short-seller/>; Zachary T. Knepper, *Future-Priced Convertible Securities and the Outlook for “Death Spiral” Securities-Fraud Litigation*, 26 WHITTIER L. REV. 359, 369 (2004).

As long as the short sale is not used to manipulate the price of a stock,⁵ it is generally considered a legal, non-fraudulent market tool in the United States.⁶ As Judge Richard Posner has noted:

For every short seller—a pessimist about the value of the stock that he’s selling short—there is, on the other side of the transaction, an optimist, who thinks the stock worth more than the short-sale price. Unless the shorts are trading on insider information, all that a large volume of short selling proves is a diversity of opinions about the company’s future. . . . Of course, if there were more pessimists, all wanting to sell short, than there were optimists, the price of a stock would plunge; but the important thing would not be the short selling, but the price plunge, and we made clear in our previous opinion that a price plunge, without more, is not a reasonable basis for suspecting fraud.⁷

Moreover, most American market watchers claim that short selling can be a beneficial market correction device in that it “weeds weak and fraudulent companies from the field,”⁸ and that by identifying “companies and industries that are overvalued by investors in the grip of irrational exuberance. . . . [and] by bringing such valuations down to earth, short selling can prevent economically wasteful over-allocation of resources.”⁹ Further, “selling the stock of a badly managed company to a less-thoughtful investor is [a] fair—if brutal—

5. U.S. Securities and Exchange Commission Division of Market Regulation, *Key Points About Regulation SHO* (modified Apr. 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm>.

6. *See, e.g.*, *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 194-95 (3d Cir. 2001); *Sullivan & Long v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995). Note, however, that other countries treat short-selling differently. Canada, for example, has more liberal short-selling rules than does the United States, whereas China bans short-selling outright. *See, e.g.*, Anchada Charoenrook & Hazem Daouk, *Market-Wide Short-Selling Restrictions*, Aug. 2005, available at <http://mba.vanderbilt.edu/vanderbilt/data/research/1017full.pdf>.

7. *LAW V. MEDCO RESEARCH, INC.*, 113 F.3d 781, 784 (7TH CIR. 1997).

8. Kevin Kelleher, *Naked Before Byrne*, *TheStreet.com*, Aug. 18, 2005, <http://www.thestreet.com/tech/kevinkelleher/10238633.html>.

9. MARK JICKLING, CRS REPORT FOR CONGRESS: REGULATION OF NAKED SHORT SELLING, CONG. RES. SERVICE, Mar. 30, 2005 at 1.

game in a market where stupidity is a sin.”¹⁰ Short selling may also help provide liquidity when shares of securities are needed in rapid supply.¹¹ Finally, short-selling may act as a necessary “counterweight” to fraudulent run-ups aimed at artificially inflating stock prices.¹² However, controversy arises when the short sales are “naked”—when the investor makes no effort to cover the stock he has sold¹³ and instead essentially creates phantom shares.¹⁴

In a naked short sale, the investor identifies a stock that is overvalued and likely to decline in price. Unlike a typical short sale, however, the investor then sells shares of that stock that he does not own or borrow and does not intend to own or borrow.¹⁵ One commentator characterizes naked short-selling as “make believe short-selling. In the same way kids play doctor without the medical equipment, naked shorters sell unbor-

10. Kelleher, *supra* note 8; *see also* Celarier, *supra* note 4 (profiling short-seller David Rucker, who claims that he gets “the bad guys off the street” and sanitizes the markets from “frauds, fads, and failures” through short-selling).

11. Knepper, *supra* note 4, at 369; *see also* *FSA Cracks Down on Short Selling*, BBC NEWS, June 13, 2008, <http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/7452312.stm>; Arturo Bris, William N. Goetzmann, & Ning Zhu, *Efficiency and the Bear: Short Sales and Markets around the World*, January 2003, available at <http://www.sec.gov/spotlight/hedgefunds/hedge-efficiency.pdf>.

12. Jickling, *supra* note 9, at CRS-5. *See also* Rajesh Aggarwal & Guojun Wu, *Stock Market Manipulation: Theory and Evidence*, AFA 2004 San Diego Meetings (March 11, 2003), available at http://groups.haas.berkeley.edu/afa/UPDF/P306_Asset_Pricing.pdf (arguing that 84.51% of market manipulation cases involve the inflation of stock process while less than 1% of cases involve deflation of stock prices).

13. *See* Amendments to Regulation SHO, Exchange Act Release No. 54,154, 2006 WL 2712000, at *1 (proposed July 14, 2006), available at <http://www.sec.gov/rules/proposed/2006/34-54154.pdf>.

14. *See, e.g.*, Alistair Barr, ‘Naked’ Short Selling Is Center of Looming Legal Battle, MARKETWATCH, June 14, 2006, available at <http://www.marketwatch.com/news/story/naked-short-selling-center-looming/story.aspx?guid=%B4B3FE0D6-1EFF-4986-83B3-54F21475CA1C%7D>.

But see Depository Trust & Clearing Corp., oration, DTCC’s Updated Critique of Section 4.1 of Prof. Finnerty’s Paper, “Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation” (January 24, 2006), available at www.dtcc.com/news/press/releases/2006/finnerty.php (arguing that “phantom shares” is a “pejorative expression” that mischaracterizes the role of the DTCC).

15. U.S. Securities and Exchange Commission, *Naked Short Sales*, (modified Apr. 18, 2005) <<http://www.sec.gov/answers/nakedshortsale.htm>>.

rowed stocks—stocks that no one has borrowed and possibly never will.”¹⁶

So how can an investor sell stock he does not possess? Enter the role of the Depository Trust & Clearing Corporation (“DTCC”), a financial services company that clears and settles securities trades and provides custody of securities.¹⁷ The DTCC processes most of the securities transactions in the United States, which amounted to over \$1.86 quadrillion in 2007.¹⁸ The DTCC’s mission is to provide an efficient and safe mechanism for buyers and sellers to make their exchanges without the burden of exchanging paper certificates every time a stock is traded.¹⁹ The DTCC is not a regulatory body, however; instead it is overseen by the Securities and Exchange Commission (“SEC”).²⁰

The SEC requires that investors complete, or settle, their securities transactions within three business days of the sale.²¹ If the seller does not deliver the stock certificates to the brokerage firm within this “T+3” (trade date plus three days) period,²² the DTCC issues a “fails to deliver” (“FTD”), which is the securities equivalent of an “IOU.”²³ Although they are not “perfect substitutes for real shares of the issuer’s stock,”²⁴ these

16. Kelleher, *supra* note 8.

17. Depository Trust & Clearing Corporation, *Our Business: An Overview*, <http://www.dtcc.com/about/business/index.php>.

18. *Id.*

19. *Id.*

20. Depository trust & clearing corp., *Media Statement on Robert Shapiro’s Report on Naked Short Sales*, www.dtcc.com/news/press/releases/2006/shapiro.php.

21. U.S. Securities and Exchange Commission, *Settling Securities Transactions, T+3*, <http://www.sec.gov/answers/tplus3.htm>. Note that this three-day settlement date applies to stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. *Id.* Also, the import of this rule is that for the three-day period, even a normal short sale temporarily creates multiple beneficial owners and thus deflates stock price because while the short position is open, there is essentially an extra, phantom share.

22. *See id.*

23. See BOB O’BRIEN, *SYMPHONY OF GREED: FINANCIAL TERRORISM AND SUPER-CRIME ON WALL STREET 26* (2006), <http://thesanitycheck.com/Portals/0/Symphony.pdf>.

24. Depository Trust and Clearing Corp., *DTCC’s Updated Critique of Section 4.1 of Prof. Finnerty’s Paper, “Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation,”* <http://www.dtcc.com/news/press/re>

FTDs have economic value²⁵ to the buyer whose account is credited with a long position.

The naked short sale thus takes advantage of a system that allows a transaction to occur, and all moneys to be paid, before delivery occurs.²⁶ A stock sale can be processed and affect the share price, but the delivery portion of the transaction may never occur.²⁷ Market players merely trade the FTD and in the short term, at least, the paper shares are not missed by anyone except, perhaps, the DTCC, which maintains records of delivery obligations.

Meanwhile, broker-dealers and banks credit customer accounts prior to the delivery of the securities, which may never arrive.²⁸ The result is that a share of stock can be figuratively duplicated, sometimes multiple times, and can be owned by multiple investors,²⁹ creating an artificial oversupply of the stock.³⁰ With the oversupply, the stock price usually falls.³¹ For small- and micro-cap companies, especially, these stock price plunges can affect their ability to attract investors, raise capital, and negotiate financing.³²

leases/2006/finnerty.php (last visited Jan. 21, 2009). <http://www.dtcc.com/ThoughtLeadership/keyissues/finnerty.htm?shell=false> (last accessed Dec. 11, 2006).

25. See BOB O'BRIEN, *SYMPHONY OF GREED: FINANCIAL TERRORISM AND SUPER-CRIME ON WALL STREET* 26 (2006), <http://thesanitycheck.com/Portals/0/Symphony.pdf>.

26. See *id.* at 26-27.

27. See *id.*

28. See SEC Appendix § 7.1, <http://sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (updated May 6, 2005).

29. Kelleher, *supra* note 8 (citing Alan Newman).

30. While the aggregate number of positions reflected in customer accounts at brokerages may be greater than the number of securities issued and outstanding, thus creating this "artificial" supply, naked short-selling does not affect the issuer's total shares outstanding. See United States Securities and Exchange Commission, *Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO*, <http://sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (last visited Jan. 29, 2009). However, when multiple investors have claims to the same share of stock, this can create problems regarding shareholders' rights to vote and to dividends.

31. See, e.g., Philip Dickerson, *Regulation SHO*, 24 ANN. REV. BANKING & FIN. L. 181, 181 (2005).

32. See, e.g., Daniel Kadlec, *Watch Out, They Bite!*, TIME, Nov. 9, 2005, <http://www.time.com/insidebiz/printout/0,8816,1126706,00.html>.

Allegedly, this is often the destiny of small-cap, thinly-traded, financially-challenged companies that utilize floorless, future-priced convertible financing, also known as “toxic” or “death spiral” financing, in which they accept money on unfavorable terms.³³ The lender acquires the right to convert debt to stock at variable, below-market prices, and the lower the stock price, the more shares the lender gets on conversion.³⁴ If the lender can manipulate the stock price downward, it can convert the debt to more stock and gain a greater share of control in the company.³⁵ The original shareholders stand to lose most or all of their stake in the company if the lenders short as many shares as possible, take their profit, and then wait as the stock price continues to fall with the aim of acquiring enough shares upon conversion to cover the shorts.³⁶ Thus, the lender has an incentive to encourage or participate in naked shorting of the company’s stock, which could theoretically drive down the stock price to the point where the company loses viability and collapses.³⁷

That’s the theory. In reality, Wall Street players and the DTCC dispute both the extent to which naked short selling actually occurs and the extent to which it is harmful.³⁸ For example, although Robert Shapiro, former Under Secretary of Commerce and currently a plaintiff’s consultant in naked short-selling litigation, contends that there are now about a half-billion shares in the United States that have been sold but

33. For a thorough discussion of such future-priced convertible securities, see Knepper, *supra* note 4, at 364-65, 367.

34. *Id.* at 367.

35. *Id.*

36. Karl Thiel, *Who’s Behind Naked Shorting?*, THE MOTLEY FOOL, Mar. 30, 2005, <http://www.fool.com/news/commentary/2005/commentary05033008.htm>.

37. See, e.g., Barr, *supra* note 14; Dickerson, *supra* note 31, at 181; Knepper, *supra* note 4, at 367.

38. See Ellen Simon, “Wall Street: Overstock.com’s Naked Short Selling Problem,” PITTSBURGH POST-GAZETTE, Feb. 4, 2006, available at <http://www.post-gazette.com/pg/06035/649757-28.stm>; Depository Trust & Clearing Corp., *Naked Short Selling and the Stock Borrow Program*, http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked_short_selling.php (last visited Feb. 9, 2009); Depository Trust & Clearing Corp., *Regulators Say Reg SHO Is Working*, <http://www.dtcc.com/news/press/releases/2006/sho.php> (last visited Feb. 9, 2009). But see, e.g., Barr, *supra* note 14.

not delivered for settlement in the required three days³⁹ and that short selling has cost investors \$100 billion and caused 1,000 companies to collapse.⁴⁰ Meanwhile, another market commentator notes that “Wall Street’s best connected investors say naked shorting is as uncommon as an investment bank managing director who drives a Kia.”⁴¹ Still others note that if naked short-selling were really prevalent, “somewhere along the chain, people would be hurting. For example, brokers, having to make their clients whole, would be kicking up a tremendous fuss. Since this does not seem to be the case, it is hard to believe naked shorting is the bogeyman.”⁴² Another commentator points out that “an obvious check on naked short selling is the unwillingness of Wall Street firms to blow themselves up by advancing large sums against undeliverable shares.”⁴³ A vice-president of the New York Stock Exchange (“NYSE”) once claimed that talk of unregulated naked short-selling is “fear mongering,”⁴⁴ while a vice-president of the National Association of Securities Dealers (“NASD”; now the Financial Industry Regulatory Authority or “FINRA”) contended he had “seen not one instance of naked short selling or any abusive short activity.”⁴⁵ For their part, hedge funds—often accused of participating in or facilitating naked shorting schemes—contend that naked short-selling is a “straw man” because most FTDs result from options trading and not a manipulative effort to drive down stock prices.⁴⁶ And skeptics, re-

39. Barr, *supra* note 14. *But see* Depository Trust & Clearing Corp., *Media Statement on Robert Shapiro’s Report on Naked Short Sales*, <http://www.dtcc.com/news/press/releases/2006/shapiro.php> (last visited Feb. 11, 2009) (alleging that “Robert Shapiro’s report is replete with errors, baseless numbers (e.g., estimated fails), faulty analysis.”).

40. Kadlec, *supra* note 32. For a detailed summary of the plaintiff bar’s perspective on naked shorting, *see* James W. Christian, Robert Shapiro, & John-Paul Whalen, *Naked Short Selling: How Exposed are Investors?*, 43 HOUS. L. REV. 1033 (2006).

41. Simon, *supra* note 38.

42. *Naked Short Selling*, THE FINANCIAL TIMES, July 6, 2006.

43. Holman W. Jenkins, Jr., *Do Nudists Run Wall Street?*, WALL ST. J. ONLINE, Apr. 12, 2006, <http://online.wsj.com/article/SB114480254610823574.html>.

44. Cameron Funkhouser, Remarks at the NASAA Conference on Naked Short Selling, Nov. 30, 2005 at 9.

45. Cameron Funkhouser, Remarks at the NASAA Conference on Naked Short Selling, Nov. 30, 2005.

46. Kelleher, *supra* note 8.

sponding to complaints from the alleged victims of death spiral financiers, claim that in such deals, the corporate officers are fully aware of the ramifications for themselves and their companies and thus no fraud is being committed.⁴⁷ With liability and credibility on the line, none of these commentators is an objective or independently reliable source.

If naked shorting does occur, its effects on the aggregate market are arguable, with some contending that “if naked short-selling had not taken place during the micro-cap crime wave of the 1990s, such stocks would have climbed even higher before they crashed”⁴⁸ and that naked shorting is “the only market force against over-hyped, or even fraudulent, small-cap and micro-cap stocks.”⁴⁹ Even Warren Buffett suggests that he does not “have a great problem” with naked short-selling because “companies with a large short interest very often have been revealed as frauds or semi-frauds.”⁵⁰ The stocks most affected by naked short-selling are “penny” stocks—those sold over-the-counter or listed on the NASDAQ bulletin-board.⁵¹

Although this article does not debate the economic ramifications of naked short-selling,⁵² in its focus on the attempt to plead and prove naked short-selling as a justiciable claim in a court of law, the article presumes for the sake of argument that naked short-selling does occur to some extent; that when used as a market manipulation tool, it is illegal;⁵³

47. See, e.g., Matthew McClearn, *Predator or Prey: The Mysterious World of Death-Spiral Finance*, TORONTO STAR, Oct. 15, 2002, at B1, available at <http://www.rgm.com/articles/predatororprey.html>.

48. Investopedia, *Naked Shorting*, <http://www.investopedia.com/terms/n/nakedshorting.asp> (last visited March 20, 2009).

49. *Id.*

50. Interview by Rick Casterline with Warren Buffett, CEO, Berkshire Hathaway, (May 6, 2006), <http://www.fool.com/investing/value/2006/06/01/berkshire-behind-the-scenes-part-5.aspx>.

51. CRS Report for Congress, *Regulation of Naked Short Selling*, Mar. 30, 2005, at CRS-3.

52. For perspective on naked shorting's economic and financial impact, see Christopher L. Culp & J.B. Heaton, *Naked Shorting*, available at <http://ssrn.com/abstract=982898>; John D. Finnerty, *Short Selling, Death Spiral Convertibles, and The Profitability of Stock Manipulation*, available at <http://www.fma.org/Chicago/Papers/ShortSellingManipulationPaper0926.pdf>.

53. See, e.g., Securities and Exchange Commission, *Division of Market Regulation: Key Points About Regulation SHO*, Apr. 11, 2005, available at <http://www.sec.gov/spotlight/keyregshoissues.htm> (“Fraudsters may use naked short selling as a tool to manipulate the market. Market manipulation is illegal.”).

and that parties injured by naked short-selling schemes deserve a remedy.

II.

NAKED SHORT-SELLING, SCAPEGOAT

In the past seven years, naked short-selling has graduated from an anecdote to a scapegoat. Generally, small- and micro-cap companies⁵⁴ are the quickest to blame naked shorting for their financial woes, but now even some of America's largest corporations contend that naked shorters—rather than their own management or balance sheets—caused their stock prices to decline, consequently preventing the companies from raising capital.⁵⁵ For example, Enron's former officers assigned partial responsibility for Enron's stock price plummet to manipulative short-sellers.⁵⁶ Furthermore, in July, 2008, the SEC imposed a temporary, emergency rule barring naked shorting of Fannie Mae, Freddie Mac, and seventeen other financial institution securities in response to concerns that naked shorting might exacerbate the subprime mortgage crisis.⁵⁷

Overstock.com, Inc., an internet retailer, has become the poster child for the media and legal wars against naked short-selling. Patrick Byrne, Overstock's CEO, claims that a naked short-selling "conspiracy orchestrated by a Sith Lord"⁵⁸ drove

54. For purposes of this article, small-cap companies are defined as having less than \$1 billion in approximate market capitalization; micro-caps, a subset of small-caps, are companies with an approximate market capitalization value of less than \$100 million. Market capitalization is the measurement of corporate size based on the current stock price multiplied by the number of outstanding shares.

55. See, e.g., Gary Matsumoto, *Naked Short Sales Hint Fraud in Bringing Down Lehman*, Bloomberg.com, Mar. 19, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aB1j1qmFOTCA&refer>.

56. See Gregory M. Drahuschak, *Selling Stock Short Shouldn't Get Blame for a Precipitous Decline*, PITTSBURGH TRIBUNE-REVIEW, Apr. 30, 2006, available at http://www.pittsburghlive.com/x/pittsburghtrib/business/columnists/drahuschak/s_448984.html; John R. Emshwiller and Gary McWilliams, *Skillful Testimony Leaves Room for Prosecutors*, WALL ST. J., Apr. 14, 2006.

57. SEC Release No. 58166, available at www.sec.gov/rules/other/2008/34-58166.pdf.

58. Ellen Simon, *Overstock.com's "Naked Short Sellers" Target Overstock*, Feb. 5, 2006, available at http://www.usatoday.com/tech/news/2006-02-05-overstock-stock_x.htm. Byrne also "likened the conspiracy to an organization structured like al Qaeda" and claimed that naked short-sellers have ties to Italian, Russian, and Israeli mafia. *Id.*

Overstock's share price down 77% in less than two years.⁵⁹ However, observers note that this decline was more likely a result of the company's poor cash flow, annual net losses, lack of inventory, and a problematic transition to an expensive new information technology system—issues that scared away investors—rather than a naked short-selling conspiracy.⁶⁰ But Byrne remains convinced, having observed four to five times his company's float traded in a single day,⁶¹ and points to Overstock's daily inclusion on the SEC's threshold security list (discussed *infra*) as evidence of the persistent FTDs plaguing the company's stock.⁶²

In the wake of the Enron, Tyco, and WorldCom scandals, the media has jumped on Overstock's bandwagon, in part, perhaps, because "There's something about those two words [naked shorts] that begs for sensational coverage."⁶³ News outlets ranging from Bloomberg Television to Al Jazeera have profiled the naked shorting controversy.⁶⁴ The Case of Robert Simpson's Sock Drawer only fueled the media fire.⁶⁵ According to an SEC filing, Robert Simpson, a Michigan resident, acquired 1,158,209 shares in Global Links Corporation, which constituted 100% of the company's issued and outstanding common stock.⁶⁶ Simpson claims he placed all of the shares in his sock drawer and then watched as over sixty million Global Links shares traded over the next two days, the equivalent of

59. Liz Moyer, *Naked Short Victim Strikes Back*, FORBES.COM, Feb. 2, 2007, available at http://www.forbes.com/business/2007/02/02/naked-short-suit-overstock-biz-cx_lm_0202naked.html.

60. Simon, *supra* note 58.

61. Thiel, *supra* note 36.

62. Simon, *supra* note 58.

63. Kelleher, *supra* note 8; see also Karl Thiel, *The Naked Truth on Illegal Shorting*, THE MOTLEY FOOL, Mar. 24, 2005, <http://www.fool.com/news/commentary/2005/commentary05032407.htm>.

64. E.g., *Phantom Shares* (Bloomberg Television Mar. 12, 2007) (transcript available at <http://www.bloomberg.com/apps/news?pid=conewsstory&refer=conews&tkr=OSTK:US&sid=aEOpTqmLZB7A>); *People & Power: Rigged Markets* (Al Jazeera Network May 20, 2007).

65. See, e.g., Jonathan Fowler, *Ripley: Believe It Or Not: 70M Shares Trade After Michigan Man Puts Them All in Sock Drawer*, FINANCIALWIRE, Mar. 4, 2005, http://www.accessmylibrary.com/coms2/summary_0286-18988950_ITM; Thiel, *Who's Behind Naked Shorting?*, *supra* note 36.

66. Global Links Corp., Schedule 13D, at 3-4 (Feb. 3, 2005), available at <http://www.sec.gov/Archives/edgar/data/949728/000101540205000967/doc1.txt>.

every share in his sock drawer changing hands approximately sixty times, a physical impossibility suggesting that the shares being traded were phantoms created by naked short sellers.⁶⁷ Although the DTCC investigated Simpson's claims and determined that at least some of the delivery failures likely resulted from information about a reverse stock split not yet having reached the marketplace and not from naked short-selling,⁶⁸ Simpson's story is frequently told by naked short-selling opponents.⁶⁹

Other small-cap companies also contend that they are the targets of naked short-sellers. For example, Pegasus Wireless claims that naked short-sellers have created thirty million phantom shares and launched a negative email and media campaign against the company, causing the stock to fall from \$18.90 to about \$0.61 and the company to de-list from the NASDAQ.⁷⁰ Similarly, Tidelands Oil & Gas executives claim that naked shorters orchestrated the company's share price decline from \$4.00 to \$0.12 in 2003, even as the company completed a major pipeline project that should have boosted the stock.⁷¹ Meanwhile, Hyperdynamics, an oil seismology firm, sued a hedge fund and other investment funds, alleging that a naked short-selling conspiracy is responsible for a loss of \$67 million in market value in less than one year after the company's stock price fell from \$6.00 per share to less than \$0.50.⁷²

Naked short-sellers may well be targeting these struggling companies, but declining stock prices must be considered in

67. Thiel, *supra* note 36.

68. Depository Trust & Clearing Corp., *Media Statement on Global Links*, (Aug. 31, 2006), available at <http://www.dtcc.com/ThoughtLeadership/keyissues/global_links.htm?shell=false>. See also Thiel, *supra* note 36 (noting that factors besides naked shorting could have caused the trading volume in Global Links; for example, the company has a "huge overhang of preferred shares convertible to common stock").

69. See, e.g., James W. Christian, et al., *Naked Short Selling: How Exposed Are Investors?*, 43 HOUS. L. REV. 1033, 1035 (2006).

70. Liz Moyer, *Attack on Pegasus*, FORBES.COM, Oct. 3, 2006, http://www.forbes.com/2006/10/02/pegasus-attacks-shorts-biz-cx_lm_1003pegasus_print.html.

71. Mike W. Thomas, *Two San Antonio Firms Claim Fraud Stinging Stock*, SAN ANTONIO BUS. J., Feb. 2, 2004.

72. See *Hyperdynamics Corp. v. Southridge Capital Mgmt.*, No. 05-CV-1953, 2005 WL 1861231 (S.D. Tex. filed June 3, 2005).

context. As Bethany McLean has noted, “there are two old maxims on the Street: One, you can’t destroy a fundamentally healthy company through market manipulation—push the stock low enough, and someone will step in and buy it. And two, if a company begins to complain about short-sellers, watch out, because something else is very wrong.”⁷³ As discussed below, the federal judiciary shares Wall Street’s skepticism about the existence and effects of naked shorting.

III.

NAKED SHORT-SELLING, CAUSE OF ACTION

Although seasoned market watchers may downplay the issue, the plaintiffs’ bar claims that naked short-selling “is killing young Corporate America, costing jobs, and cheating people out of hundreds of millions of dollars with fake shares.”⁷⁴ With “hundreds of millions of dollars” in potential damages, lawsuits alleging naked short-selling have proliferated in the past five years;⁷⁵ plaintiffs are seeking remedies in both the federal and state courts. This section focuses on federal court litigation.

A. *Legal Framework*

American jurisprudence first recognized the naked shorting phenomenon in *The Anderson Co. v. John P. Chase, Inc.*,⁷⁶ a 1975 securities fraud case in which the district court determined that an investment advisor had no duty to prevent its client from short selling. Today, plaintiffs alleging injuries caused by naked short-selling rely on both section 10(b) of the 1934 Securities Exchange Act⁷⁷ and SEC rule 10b-5⁷⁸ in argu-

73. Bethany McLean, *Overstock’s Phantom Menace*, FORTUNE, Nov. 1, 2005, available at http://money.cnn.com/2005/11/01/news/midcaps/overstock_fortune_111405/.

74. See, e.g., Barr, *supra* note 14 (quoting Wes Christian).

75. Three Houston-based class-action firms, for example, expect to file approximately fifty naked short-selling lawsuits in 2007. See *id.*

76. 1975 WL 359 at *6 (S.D.N.Y. Mar. 12, 1975).

77. Section 10(b) of the Exchange Act makes it unlawful for any person “[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j (b).

ing that naked short-selling is fraudulent and thus illegal. In conjunction, these broad provisions establish a framework for two types of securities fraud claims: misrepresentation and market manipulation. A plaintiff bringing a misrepresentation claim under section 10(b) and rule 10b-5 must demonstrate that the defendant made a false statement or omitted a material fact, in connection with the purchase or sale of a security by the plaintiff, with scienter, and that plaintiff's reliance on defendant's action caused plaintiff injury.⁷⁹ While not easy to pursue, naked-shorting-as-misrepresentation claims are common and consistently adjudicated by the courts.⁸⁰

Many naked short-selling lawsuits also allege market manipulation. Market manipulation is a term of art that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."⁸¹ However, the legal standard for market manipulation is less lucid than that for misrepresentation and differs substantially among the circuits. The uncertainty of what constitutes market manipulation and how a market manipulation claim should be pled and litigated thus animates the remainder of this section's discussion.

The Second Circuit, which hears most market manipulation claims because of its jurisdiction over New York, requires plaintiffs to prove that they suffered damages, in reliance on the defendants' material misrepresentations, omissions, or scheme to defraud; that the defendants acted with scienter;

78. Rule 10b-5 states, "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

79. *E.g.*, *Halperin v. eBankerUSA.com, Inc.*, 295 F.3d 352, 356-57 (2d Cir. 2002); *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 173 (3d Cir. 2001).

80. *E.g.*, *ATSI Communications, Inc. v. Shaar Fund Ltd.*, 493 F.3d 87, 105-06 (2d Cir. 2007).

81. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

that this occurred in connection with plaintiffs' purchase or sale of a security; and that this was furthered by the defendants' use of the mails or a national securities exchange.⁸² The Ninth Circuit requires a plaintiff to allege the use or employment of a manipulative or deceptive device or contrivance; scienter; a connection with the purchase or sale of a security; reliance or transaction causation; economic loss; and loss causation, i.e., a causal connection between the manipulative or deceptive device or contrivance and the loss.⁸³ The Third Circuit offers a more specific standard in requiring plaintiffs to prove that the defendant engaged in deceptive or manipulative conduct by injecting inaccurate information into the marketplace or by creating a false impression of supply and demand for a security; in connection with the plaintiff's purchase or sale of the security; that the defendant had the purpose (scienter) of artificially depressing or inflating the price of the security; and that the plaintiff suffered damages in reliance on the defendant's conduct.⁸⁴ Under this standard, the Third Circuit holds that short selling could only form a basis for a section 10(b) market manipulation claim if done "in conjunction with some other deceptive practice that either injected inaccurate information into the market or otherwise artificially affected the price of the stock."⁸⁵ So can the "naked" part of short selling constitute "some other deceptive practice"?

In the seminal case on point, *Sullivan & Long, Inc. v. Scattered Corporation*,⁸⁶ the Seventh Circuit said no, unequivocally holding that naked short selling is not intrinsically manipulative under section 10(b). While one scholar suggests that *Sullivan & Long* can be distinguished from other naked short-selling cases where the naked short seller violates a market rule or equitable trading principle,⁸⁷ this argument does not help

82. See *Schnell v. Conseco, Inc.*, 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999); *Global Intellicom v. Thomson Kernaghan & Co.*, 1999 WL 544708, *7 (S.D.N.Y. July 27, 1999).

83. See *Simpson v. AOL Time Warner*, 452 F.3d 1040, 1047 (9th Cir. 2006); *Verona Partners, LLC v. Tenet Capital Partners Convertible Opportunities Fund, LP*, 2006 WL 2669035 (N.D.Cal. Sept. 18, 2006).

84. See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 206-11 (3d Cir. 2001).

85. *Id.* at 207.

86. 47 F.3d 857, 864-65 (7th Cir. 1995).

87. See *Knepper*, *supra* note 4, at 414.

plaintiffs' suits about over-the-counter/bulletin-board stocks for which, traditionally, there have been no locate or delivery rules. Instead, scholars and litigators attempt to distinguish the type of naked shorting in *Sullivan & Long* from the type of naked shorting allegedly targeting small-cap companies now. Unlike in *Sullivan & Long*, most targets of death spiral financing and corresponding naked shorting are "universally small, financial weak companies that trade in inefficient, illiquid markets lacking adequate regulatory protections."⁸⁸ While the courts might tolerate naked short selling for securities of large, established issuers trading on exchanges, it is harder to justify the naked short selling of small issuers trading in the less-regulated securities markets.⁸⁹

Assuming plaintiffs can distinguish *Sullivan & Long* and convince a court that naked shorting constitutes market manipulation, ultimately, plaintiffs alleging section 10(b) claims must meet constitutional standing requirements, the particularity requirements of Federal Rule of Civil Procedure 9(b),⁹⁰ and the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), all discussed *infra*. Together, these rules impose a heavy burden on plaintiffs, one that is rarely met. And even if plaintiffs surpass these hurdles, there still remains the fundamental question of whom they can viably sue.

B. *Problems with Naked Short-Selling As Market Manipulation Cases*

If naked short selling exists, and is more than an anecdote-supported myth chased by counsel for small cap companies, can it be effectively pleaded and proved as market manipulation by private plaintiffs in court? The answer, thus far, is no, at least in federal court. Although naked short-selling violates black-letter trading rules on the exchanges,⁹¹ to date, no naked short-selling claim has succeeded to final judgment on

88. *Id.* at 416.

89. *Id.*

90. *See, e.g.*, *In re Daou Sys. Inc. Sec. Litig.*, 411 F.3d 1006, 1014 (9th Cir. 2005).

91. *E.g.*, NYSE Rule 440C.10; NASD Rule 3370. Note that as of July 2007, FINRA rules include both the NASD rules and certain incorporated NYSE rules. *See* <http://www.finra.org/RulesRegulation/FINRARules/index.htm>.

market manipulation grounds, and only a few suits have progressed beyond a defendant's motion to dismiss. Collectively, standing requirements, the Federal Rules of Civil Procedure, and the Private Securities Litigation Reform Act pose high hurdles for plaintiffs. In addition, the lack of viable, attractive defendants, as well as brokerage industry and DTCC resistance to any allegation of manipulative naked shorting, make such lawsuits difficult to pursue.

1. *Standing Requirements*

Standing is the first obstacle for prospective plaintiffs in naked short-selling lawsuits. To meet the constitutional standard,⁹² plaintiffs must show that they have suffered a legal injury, that the injury can be traced to the challenged action, and that the injury is likely to be redressed by a favorable decision of the court.⁹³ In the context of securities litigation, courts limit standing to "persons who are defrauded in connection with the purchase or sale of securities. This limitation is satisfied by showing 'a nexus between the defendant's actions and plaintiff's purchase or sale.'"⁹⁴ The problem with a naked short-selling claim is that is difficult to determine who is actually defrauded or injured by the alleged action, and thus, who has standing to sue.⁹⁵

Issuers are the most frequent private litigants in naked short-selling lawsuits, but unless the issuer was also a purchaser or seller of its stock, the issuer lacks standing to sue.⁹⁶ Merely issuing treasury stock does not necessarily constitute a "sale" of securities, nor does honoring conversion notices, for purposes of conferring standing to assert a market manipulation claim.⁹⁷ Even if issuers can meet the standing requirements, as

92. U.S. CONST. art. III, §2.

93. *E.g.*, *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992).

94. *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405, 407 (5th Cir. 1993).

95. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

96. Section 10(b) protects corporations as well as individuals who are sellers of a security, but the corporation must have been an "active market participant." *E.g.*, *Endovasc, Ltd., v. J.P. Turner & Co.*, 2004 WL 634171 at *12 (S.D.N.Y. Mar. 30, 2004). *See also Log On America, Inc. v. Promethean Asset Mgmt. L.L.C.*, 223 F. Supp. 2d 435, 446 (S.D.N.Y. 2001).

97. *Endovasc Ltd., v. J.P. Turner & Co.*, 2004 WL 634171 at *12 (S.D.N.Y. Mar. 30, 2004) (citing *Global Intellicom*, 1999 U.S. Dist. LEXIS 11378 at *26;

in situations where the issuers sell future-priced convertible securities to death spiral financiers, the risk of suing short sellers may outweigh the benefits to shareholders. A study of 266 public companies that sued or publicly accused short sellers of wrongdoing from 1977 to 2002 found that the companies' stock returns suffered, falling an average of 2% per month in the year following the action.⁹⁸ This is possibly because once a company publicly admits that it is vulnerable to naked short-selling schemes, investors may lose confidence in the company's long-term viability; or perhaps instead, investors shy away from litigious companies. In any case, from the issuer's perspective, the negative financial ramifications of a lawsuit may undermine any successful judgments.

Investors may have a legitimate cause of action, but they face difficulties in proving damages. As per the Supreme Court's standard in *Dura Pharmaceuticals, Inc. v. Broudo*, an investor would need to prove "loss causation," *i.e.*, that the defendants' naked short-selling activities proximately caused the investor's economic loss.⁹⁹ In situations where the companies targeted by naked short-sellers face additional financial difficulties, it is difficult, without inadmissible speculation, to quantify the effects of naked shorting as distinguished from other contributors to a lower stock price.¹⁰⁰

Although it dealt with misrepresentation, and not manipulation claims, *Miller v. Asensio & Co, Inc.*¹⁰¹ illustrates this dilemma. In *Miller*, stockholders in Chromatics Color Sciences International, Inc. ("CCSI") sued Asensio, an investment advising company, alleging that Asensio employees made material misstatements about CCSI, causing CCSI stock to drop and the stockholders to lose money.¹⁰² A jury found that the defen-

Log On America v. Promethean Asset Management, LLC, 223 F. Supp. 2d 435, 446 (S.D.N.Y. 2001)).

98. Celarier, *supra* note 4 (citing analysis by Owen Lamont, financial professor at the Yale School of Management).

99. *See Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (April 19, 2005) (requiring plaintiffs in securities fraud cases to show a direct link between a company's alleged misrepresentations and a subsequent loss in stock value).

100. *See, e.g., Culp & Heaton, supra* note 52, at Part III.

101. 363 F.3d 223 (4th Cir. 2004) (affirming 101 F. Supp. 2d 395 (D.S.C. 2000)).

102. *Id.* at 225.

dant's employees had made material misstatements, and the defendant was liable under rule 10b-5, but that the plaintiff was entitled to zero damages.¹⁰³ The Fourth Circuit affirmed the verdict, determining that the jury could have reasonably concluded that the plaintiffs proved that defendant's fraudulent misrepresentations constituted a substantial cause of plaintiffs' loss and so find the defendant liable; the court also concluded that the plaintiffs failed to show that their loss was solely caused by defendant's fraud, and therefore, the jury could refuse to award any damages.¹⁰⁴ The Fourth Circuit thus recognized that while many factors, including natural corrections of overinflated value, reports of financial mismanagement, scandal, and a bad business model, unrelated to rule 10b-5 and section 10(b) violations, can cause a decline in a company's stock, such factors do not absolve a perpetrator of fraud from liability,¹⁰⁵ and do not, by implication, undermine the standing of the plaintiff. However, a plaintiff who seeks damages—and not merely a judgment of liability—has a difficult battle in calculating and proving recoverable damages.¹⁰⁶

CompuDyne Corporation v. Shane may bolster a prospective plaintiff's damages and standing arguments, however. In *CompuDyne*, a PIPE ("private investment in public equity") related action, the court held that:

But for Defendants' insider trading and illegal short selling, Plaintiffs . . . would have received a price higher than \$12 per share for the shares sold in the PIPE. Plaintiffs allege that the first part of Defendants' scheme to illegally sell short CompuDyne stock artificially depressed and/or increased the volatility of CompuDyne's stock price. . . . Plaintiffs also allege that the price of shares issued in connection with a PIPE was 'discounted from the prevailing market price.' Thus, the lower the market price of CompuDyne stock prior to the pricing of the PIPE, the lower the shares to be issued in connection with PIPE would be priced, and the less money Plaintiffs would

103. *Id.* at 227.

104. *Id.* at 233.

105. *Id.* at 234-35.

106. *See id.* at 230-31 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975)).

receive from the PIPE. Plaintiffs' allegations fulfill the [*Dura Pharmaceuticals*] standard for pleading loss causation."¹⁰⁷

The *CompuDyne* court further explained the Supreme Court held that pleading loss causation based on an allegation that the plaintiff sold his stock for less than it was worth because its price was artificially depressed is not the same as pleading loss causation based on an allegation that the plaintiff purchased a stock whose price was merely artificially inflated.¹⁰⁸ A plaintiff who sells a stock at an artificially depressed price no longer possesses the shares and thus has realized an economic loss.¹⁰⁹ *CompuDyne* thus represents the most sympathetic judicial view yet of naked short-selling plaintiffs.

However, unless the investor requested that the brokerage firm close out the sale and produce paper stock certificates, and unless the brokerage firm was unable to do so, the investor is arguably a participant—however unwitting—in the naked shorting scheme; if he never demanded a close-out or presentation of physical stock certificates, the investor cannot complain that he was sold phantom shares. Because even phantom shares show up as legitimate long positions in the investor's account, the investor faces an uphill battle in proving he was injured by naked short-selling. Without provable, redressable injury, an investor lacks standing to sue.

In addition to the standing-based barriers, litigation is financially impracticable for the average individual investor. Class actions are no more appealing in the wake of the Securities Litigation Uniform Standards Act of 1998 (SLUSA)¹¹⁰ and the Supreme Court's decisions in *Dura Pharmaceuticals*¹¹¹ and *Tellabs v. Makor Issues & Rights, Ltd.*,¹¹² discussed *infra*. The result: With the investors themselves unwilling or unable to sue, and standing requirements precluding the targeted corpora-

107. 453 F. Supp. 2d 807, 827 (S.D.N.Y. 2006).

108. *Id.* (citing *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346-48 (2005)).

109. *Id.* n.8.

110. 15 U.S.C. § 78bb(f)(1)-(2) (2006); *see also* *Anderson v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 521 F.3d 1278, 1287-88 (10th Cir. 2008) (affirming dismissal, on SLUSA grounds, of a class action suit claiming naked shorting as market manipulation).

111. 544 U.S. 336.

112. 551 U.S. 308 (June 21, 2007).

tions from litigating, would-be lawsuits against naked short-sellers lack viable plaintiffs.

2. *Federal Rules of Civil Procedure*

Assuming that the plaintiff meets the standing requirement, the Federal Rules of Civil Procedure pose the next hurdle. Federal Rule of Civil Procedure 12(b)(6) allows for dismissal of a lawsuit if a plaintiff fails “to state a claim upon which relief can be granted.” Such dismissals are to be viewed with disfavor and are granted only where “it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.”¹¹³ If the plaintiff is entitled to relief under any set of facts or any possible legal theory that could consistently be proven with the allegations in the complaint, the court may not grant dismissal.¹¹⁴ In determining whether dismissal should be granted, the Court accepts as true all allegations contained in the plaintiff’s complaint and views the facts in the light most favorable to the plaintiff.¹¹⁵ However, conclusory allegations or legal conclusions will not suffice to prevent a motion to dismiss,¹¹⁶ and it is this standard over which most plaintiffs in naked short-selling suits have stumbled.

Courts treat a dismissal for failure to plead fraud with particularity as required by Federal Rule of Civil Procedure 9(b) as a dismissal for failure to state a claim upon which relief may be granted.¹¹⁷ Under rule 9(b), “in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other conditions of mind of a person may be averred generally.”¹¹⁸ The purpose of rule 9(b)’s particularity requirement is to ensure that defendants can effectively respond to plaintiffs’ allegations, to prevent the filing of baseless complaints for purposes of obtaining discovery on unknown wrongs, and to protect defendants from unfounded allegations of wrongdoing

113. *Jag Media Holdings, Inc. v. A.G. Edwards & Sons*, 387 F. Supp. 2d 691, 703 (S.D. Tex. 2004) (citations omitted).

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. FED. R. CIV. P. 9(b).

which might injure their reputations.¹¹⁹ Although rule 9(b) is “relaxed” with respect to market manipulation claims,¹²⁰ thus far many courts have interpreted rule 9(b) inconsistently and stringently in naked short cases, particularly in conjunction with the heightened pleading requirements of the PSLRA, discussed below.

3. *Private Securities Litigation Reform Act (“PSLRA”)*

Through the PSLRA, enacted in 1995, Congress imposed stringent requirements for pleading federal securities fraud claims. The complaint must plead fraud or manipulation with particularity and specific facts supporting strong inference of scienter. For example, PSLRA Paragraph (b)(1), which applies to securities claims alleging misstatements or omissions of material facts, requires that “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”¹²¹

Paragraph (b)(2) applies to securities claims “in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind,” and requires that the complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹²²

The PSLRA prohibits discovery until these pleading requirements are met.¹²³ This means that would-be plaintiffs often lack access to information and documents that might bolster their naked short-selling claims, especially because there is a lack of public hard data on stocks that fail to deliver.¹²⁴ Although it reports to regulators, the DTCC does not publicly disclose information on fails, because, as the DTCC argues, releasing that information might jeopardize SEC inves-

119. *Jag Media Holdings, Inc.*, 387 F. Supp. 2d at 703 (citing *Hernandez v. Ciba-Geigy Corp. USA*, 200 F.R.D. 285, 290 (S.D. Tex. 2001)).

120. *E.g.*, *Internet Law Library, Inc. v. Southridge Capital Mgmt.*, 223 F. Supp. 2d 474, 486 (S.D.N.Y. 2002).

121. 15 U.S.C. § 78u-4(b)(1).

122. 15 U.S.C. § 78u-4 (b)(2).

123. 15 U.S.C. § 78u-4(b)(3)(B).

124. *See, e.g.*, Kelleher, *supra* note 8.

tigations into such fails, and because “[National Securities Clearing Corporation] rules prohibit release of trading data, or any reports based on the trading data, to anyone other than participating firms, regulators, or self-regulatory bodies such as the NYSE or NASDAQ. We do that for the obvious reason that the trading data we receive could be used to manipulate the market, as well as reveal trading patterns of individual firms.”¹²⁵ Would-be plaintiffs are thus left with no “official” calculations of delivery fails. The SEC, with the DTCC’s support, is currently considering releasing two-month-old, aggregated delivery failure data on a quarterly basis,¹²⁶ but even that data may be too opaque and only suggest naked short-selling, not prove it.¹²⁷

Thus, to meet the PSLRA pleading requirements, the plaintiff would have to show that the most plausible explanation for why the disputed trading practices occurred is market manipulation. Given the lack of accessible data, this sometimes may require the equivalent of a *res ipsa loquitur* argument—let the available facts point toward the obvious, common-sense explanation. In addition, confidential sources, such as former brokerage firm employees, who could testify to the occurrence of naked short-selling and the knowledge of the participants might help plaintiffs plead their claims.¹²⁸ The high attrition rate at brokerage firms suggests availability of such witnesses.¹²⁹ Notably, however, under the Seventh Circuit’s ruling in *Higginbotham v. Baxter International, Inc.*,¹³⁰ anonymous witnesses are suspect and should be “discounted.”¹³¹ The Hig-

125. *Naked Short Selling and the Stock Borrow Program*, Depository Trust and Clearing Corp., Mar. 2005, at 6, 7, 11, available at <http://www.dtcc.com/news/newsletters/dtcc/2005/mar/mar05@dtcc.pdf>.

126. Press Release, DTCC Supports SEC Initiative to Make Trade Failure Data Publicly Available (June 19, 2007), http://www.dtcc.com/news/press/releases/2007/trade_failure_data.php.

127. See Kevin Kelleher, *Naked Before Byrne*, THESTREET.COM, Aug. 18, 2005, <http://www.thestreet.com/tech/kevinkelleher/10238633.html>.

128. *E.g.*, *In re Cabletron Sys., Inc.*, 311 F.3d 11, 24 n.6, 28-31 (1st Cir. 2002).

129. Some experts suggest employee attrition rates of up to 85% within four years of hiring. See, e.g., Michelle Leder, *Training Brokers Not to Flunk Out*, REGISTERED REP., Nov. 1, 2002, http://registeredrep.com/certification/finance_training_brokers_not/.

130. 495 F.3d 753 (7th Cir. 2007).

131. *Id.* at 757.

ginbotham plaintiffs' complaint relied heavily on statements from anonymous confidential witnesses, including unnamed former employees of the defendant, in pleading scienter in support of their securities fraud claims.¹³² The Seventh Circuit determined that "confidential witness" allegations are insufficient because such witnesses' motives cannot be discerned or their information objectively corroborated.¹³³ Higginbotham thus poses another obstacle for plaintiffs seeking remedies for already difficult-to-prove naked shorting claims.

Alternatively, because market manipulation claims require the showing of a pattern of behavior, plaintiffs could gather evidence charting a pattern of black-letter rule-breaking by short-sellers and thus create a strong inference of intent.¹³⁴ Because FINRA rules expressly prohibit naked short-selling, illustrating repeated violations of these rules should be sufficient for pleading purposes. But again, the problem for plaintiffs is in gathering compelling evidence of these rule violations, given that the brokerages, the DTCC, and the SEC are not forthcoming with specific information about delivery failures. In addition, as discussed *infra*, the FINRA rules do not apply to all market players; if the alleged naked shorter is not bound by FINRA rules, then violations of those rules do not support evidence of intent.

Ultimately, to meet the PSLRA's heightened pleading requirements, plaintiffs need to prove scienter. The exact degree of scienter—recklessness?¹³⁵ actual knowledge? conscious misbehavior?—required is unclear,¹³⁶ although increasingly, some courts suggest leniency. As noted in *CompuDyne*.

132. *Id.* 756-57.

133. *Id.* at 757 ("Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist.")

134. See Barr, *supra* note 14 (citing Georgetown University Professor James Angel).

135. Every circuit court of appeals that has considered the issue of whether reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5 has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 2507 n.3. The degree of recklessness required, however, differs among the circuits, and the Supreme Court has not yet addressed the issue. *Id.*

136. In crafting the PSLRA, Congress did not clarify what facts suffice to create a strong inference of scienter, thus leaving this issue to the courts. *Id.* at 2509.

Allegations of scienter are not subject to the same exacting scrutiny applied to the other components of fraud, such as direct participation. Scienter can be alleged by conclusory allegations if they are supported by facts giving rise to a strong inference of fraudulent intent. The inference may be established either “(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”¹³⁷

In *CompuDyne*, for example, the court determined that allegations the defendant engaged in unlawful short sales based on confidential non-public information was highly probative of scienter.¹³⁸ However, generalized assertions of financial motive, without more, are insufficient to meet the PSLRA’s pleading standards.¹³⁹

The Supreme Court recently tightened the meaning of the PSLRA’s “strong inference” requirement in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*¹⁴⁰ The Court held that in determining whether a securities fraud complaint gives rise to a “strong inference” of scienter, a court “must engage in a comparative evaluation” and consider “competing inferences.”¹⁴¹ As the Court noted, “[a]n inference of fraudulent intent may be plausible, yet less cogent than other, non-culpable explanations for the defendant’s conduct.”¹⁴² Thus, to qualify as “strong” under the PSLRA’s pleading requirement, the “inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”¹⁴³ The Court further defined “strong” as meaning “powerful,” “persuasive,” and “effective,” underscoring its conclusion that plaintiffs must present a compelling

137. *CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807, 819-20 (S.D.N.Y. 2006) (citing *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 329 (S.D.N.Y. 1999)).

138. *Id.* (citing *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003)).

139. *E.g., In re Syncor Int’l Corp. Sec. Litig.*, 327 F. Supp. 2d 1149, 1166-67 (C.D. Cal. 2004).

140. 127 S. Ct. at 2504-05.

141. *Id.* at 2504.

142. *Id.*

143. *Id.* at 2504-05.

inference, not just a possibility, of scienter.¹⁴⁴ Although *Tellabs* does not break dramatic new legal ground, it does emphasize how difficult the scienter burden is, as further illustrated in the following cases, which all consider whether and how plaintiffs meet the pleading requirements for claims of market manipulation through naked short-selling.

In *Jag Media Holdings, Inc. v. A.G. Edwards & Sons, Inc.*,¹⁴⁵ investors sued over 100 brokerage firms, investment banks, and financial institutions, alleging a naked short-selling conspiracy.¹⁴⁶ Jag Media Holdings (“Jag”), a small dotcom that provides financial and market-related information to Internet subscribers, had accepted “convertible debenture” financing from three named defendants.¹⁴⁷ After the deal was signed, the stock price tanked to five cents a share.¹⁴⁸ Jag claimed that the financier, with the help of brokerage firms, had manipulated the market via naked short sales to drive down the stock price.¹⁴⁹ In support of its naked short-selling allegations, Jag presented evidence that the brokerage firms had unsettled trades and pointed to purported discrepancies between trading volume and “official” DTCC records of stock ownership.¹⁵⁰ To support a strong inference of scienter, Jag primarily relied on copies of e-mail exchanges between the brokerage firms and the issuer discussing the occurrence of some FTDs.¹⁵¹ The court dismissed the lawsuit for failure to state a claim, holding that evidence of FTDs does not alone support an inference of fraud.¹⁵² The court determined that the e-mail evidence showed only that the brokerage firms were attempting to settle the purported naked short sales, not that they were committing fraud.¹⁵³

As *Jag* illustrates, merely identifying a failure to deliver is insufficient to prove fraud via naked short-selling since deliv-

144. *Id.* at 2510.

145. 387 F. Supp. 2d 691 (S.D.Tex. 2004).

146. *Id.* at 694-95.

147. *Id.* at 696.

148. *Id.* at 697.

149. *Id.* at 696-97.

150. *Id.* at 698.

151. *Id.* at 700.

152. *Id.* at 708.

153. *Id.*

ery failures can occur for innocent reasons,¹⁵⁴ including human or mechanical errors or processing delays.¹⁵⁵ The SEC has identified at least five circumstances in which a delivery failure may occur: (1) delays in customer delivery of shares to the broker dealer; (2) an inability to borrow shares in time for settlement; (3) delays in obtaining transfer of title; (4) an inability to obtain transfer of title; and (5) deliberate failure to produce stock at settlement which may result in a broker dealer not receiving shares it had purchased to fulfill its deliver obligations.¹⁵⁶ Delivery failures can occur on both long and short sales, and they occur often—approximately 1.5% of all trades by dollar value fail to settle on a typical day.¹⁵⁷ Thus, neither the courts nor the SEC are willing to declare all delivery failures illegal or evidence of market manipulation out of fear of hampering liquidity in stocks where there is no fraudulent activity.¹⁵⁸

Jag implicitly followed the lead of the Third Circuit's opinion in *GFL Advantage Fund, Ltd. v. Colkitt*,¹⁵⁹ a case in which the court determined that short selling by itself can never be market manipulation and that something more is required. Merely alleging short-selling, or even demonstrating delivery fail-

154. See, e.g., Ralph Lambiase, NASAA Conference on Naked Short Selling (Nov. 30, 2005) (transcript on file with NASAA), at 3.

155. Simon, *supra* note 38.

156. U.S. Securities and Exchange Commission, *SEC Division of Market Regulation: Key Points About Regulation SHO*, (Apr. 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm>; see also Depository trust & clearing corp., *Media Statement on Robert Shapiro's Report on Naked Short Sales*, <http://www.dtcc.com/news/press/releases/2006/shapiro.php> (last visited Feb. 11, 2009).

157. Depository Trust & Clearing Corp., *Naked Short Selling and the Stock Borrow Program*, (Mar. 2005), http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked_short_selling.php; Simon, *supra* notes 38;38, 58;58. See also Depository Trust & Clearing Corp., *supra* note 154 (alleging that failed transactions represent less than one-tenth of one percent of transactions handled by the DTCC).

158. See Jim Brigagliano, Assistant Director for Market Regulation, Sec. Exch. Comm'n., NASAA Conference on Naked Short Selling (Nov. 30, 2005) (transcript on file with NASAA) at 4. Rule 10b-21, finalized in September, 2008, and discussed *infra* p. 55, clarifies that it is fraudulent for a short seller to deceive his broker about his ability to deliver shares and then ultimately, fail to deliver, but leaves open the questions of what constitutes deception or how deception can be proved.

159. 272 F.3d at 211.

ures—which plaintiffs claim are the hallmark of naked short-selling—is insufficient to plead market manipulation.

Questions remain in *Jag's* wake: What evidentiary allegations would have satisfied the pleading requirements for fraud? How, as a practical matter, can a plaintiff plead scienter? Is naked short selling really fraud at all? Or are unsettled trades arguably negligence on the part of brokerage firms instead? And if negligence is the better route to liability, what proof is necessary to establish a duty of care from brokerage firms to issuers?

Subsequent court decisions on naked short-selling illuminate some answers. In *ATSI Communications, Inv. v. The Shaar Fund, Ltd.*,¹⁶⁰ another convertible financing case, the Second Circuit provided another example of claims and evidence that do not meet the pleading requirements. In *ATSI*, the plaintiffs alleged both misrepresentation and market manipulation by the defendants.¹⁶¹ With respect to the market manipulation claim, plaintiffs alleged that defendants' ownerships of their convertible preferred securities gave them an incentive to drive down the market price of ATSI common stock in order to obtain more shares at the time of conversion, a typical death spiral/short selling scheme.¹⁶² The plaintiffs alleged, on information and belief, that defendants "employed a variety of manipulative devices and techniques, including, without limitation, painting the tape, hitting the bids, failing to obtain the best price, naked short-selling, and dumping stock in large numbers on the market."¹⁶³ To help support their claims, the plaintiffs provided charts containing trading data for the period in question, which asserted that the data indicated manipulative trading.¹⁶⁴ The Court affirmed dismissal of the plaintiffs' pleadings, holding that they failed to meet the requirements of Federal Rule of Civil Procedure 9(b), that allegations that are "conclusory" or "unsupported by assertions of fact" are insufficient, and that allegations of fraud generally cannot be based on "information and belief" absent specific allegations

160. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98-108 (2d Cir. 2007), *aff'g* 2004 WL 616123 (S.D.N.Y. Mar. 30, 2004).

161. *Id.* at 98.

162. *See id.* at 103-04.

163. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, No. 02 Civ.8726(LAK), 2004 WL 616123, at *3 (S.D.N.Y. Mar. 30, 2004).

164. *Id.* at * 3 n.7.

of fact to warrant the alleged belief.¹⁶⁵ Specifically, the court concluded that the plaintiffs' list of "devices and techniques" failed to explain why they were manipulative; where, when, and how they occurred; which defendants committed them; and the effect of the devices on the stock's trading volume and price.¹⁶⁶ Further, the data charts provided by the plaintiffs did not explain how the data was linked to the defendants or how it supported market manipulation.¹⁶⁷ The court emphasized that it is not enough to claim that naked short-selling or convertible financing occurred; the law requires that these allegations be supported by facts, and not conclusions.¹⁶⁸ Accordingly, because the PSLRA and federal rules pleading standards were not satisfied, the Second Circuit upheld the district court's dismissal of the plaintiffs' naked short-selling claims.¹⁶⁹

In contrast to the Second Circuit's stringent standard, a federal district court in Arkansas adopted a more sympathetic view of the plaintiffs' attempt to compile evidence in support of its market manipulation allegations in *Pet Quarters, Inc. v. Badian*.¹⁷⁰ The court determined that a detailed chart of stock conversions and stock price differences in support of a death spiral theory was sufficient to satisfy the PSLRA and rule 9(b) pleading requirements.¹⁷¹ Likewise, in another death spiral case, *Sedona Corp. v. Ladenburg Thalmann & Co, Inc. et al.*,¹⁷² a New York district court adopted a more lenient pleadings standard for securities fraud claims. The court concluded that with respect to motive and opportunity, claims of motive are insufficient to support scienter without allegations that the defendant would have substantially profited from the financing agreement in question.¹⁷³ However, the court also noted that "[f]actual determinations of motive and opportunity are not the only means by which a securities fraud plaintiff may plead

165. *Id.* at *1.

166. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101-03 (2d Cir. 2007).

167. *See id.* at 102-03.

168. *See id.* at 101-03.

169. *Id.* at 103-104.

170. *Pet Quarters, Inc. v. Badian*, No. 4:04-CV-697 (RSW), 2007 WL 1020538 (E.D. Ark. Mar. 30, 2007).

171. *Id.* at *6.

172. *Sedona Corp. v. Ladenburg Thalmann & Co., Inc.*, No. 03CIV3120(LTS)(THK), 2006 WL 2034663 (S.D.N.Y. July 19, 2006).

173. *Id.* at *4.

scienter. Allegations of ‘facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness’ are also sufficient.”¹⁷⁴ The court concluded that Sedona met the scienter pleading standard by alleging that

[the defendant,] Ladenburg[,], played a central role in the alleged scheme to defraud Sedona by (1) obtaining investors for Sedona that Ladenburg knew would likely manipulate Sedona’s stock; (2) creating a “bait and switch” scenario through which Sedona would ultimately be forced to procure its financing solely through Ladenburg’s investors; (3) concealing from Sedona that it had significant prior working relationships with entities such as Amro and Markham, and that together they had participated in similar schemes in the past; and (4) misrepresented its investment capabilities as a trick to mislead the market.

Together, these factors supported a strong inference that Ladenburg either intended to defraud Sedona, had knowledge of the alleged fraud, or recklessly disregarded the truth in connection with that fraud.¹⁷⁵ Consequently, Sedona survived some of its defendants’ motions to dismiss, with its market manipulation claims still largely in tact, a feat Jag was unable to accomplish.

Similarly, in *Internet Law Library, Inc. v. Southridge Capital Management, LLC*,¹⁷⁶ another court in the Southern District court determined that claims alleging naked short selling as market manipulation are entitled to a more relaxed pleading standard because “the facts relating to a manipulation scheme are often known only by the defendants.”¹⁷⁷ Plaintiffs must still specify, at a minimum, “what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue.”¹⁷⁸ In *Jones v. Intelli-Check, Inc.*, another district court, interpreting *Internet Law Library*, noted that to take advantage of such a relaxed pleading stan-

174. *Id.* at *4 (citing *Rombach v. Chang*, 355 F.3d 164, 176 (2d Cir. 2004)).

175. *Id.* at *4.

176. 223 F. Supp. 2d 474, 486 (S.D.N.Y. 2002).

177. *Id.*

178. *Id.*

dard, plaintiffs must both plead that the necessary factual support for their manipulation claim is within the defendants' exclusive control and detail the extent of their futile efforts to obtain that information.¹⁷⁹ In *Internet Law Library*, the court's leniency was ultimately for naught as the plaintiffs' market manipulation claims were dismissed because of discovery process abuses.¹⁸⁰

Sedona, *Internet Law Library*, and *Pet Quarters* suggest that plaintiffs can survive the pleadings stage on naked short-selling claims; the strong dicta and holdings in *Sullivan and Long*, *Jag Media*, *GFL*, and *ATSI* suggest that they cannot. There is thus a need for further appellate review and clarification of the market manipulation pleadings standards in light of the recent *Tel-labs* opinion. What specific factual allegations must a plaintiff plead to survive a motion to dismiss? And is evidence to support those factual allegations likely available to plaintiffs pre-discovery? If such evidence is not realistically available to prospective plaintiffs, the PSLRA achieves only the first of its twin goals to "curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."¹⁸¹

4. *The Lack of Viable Defendants*

Even if a plaintiff could meet the rigorous requirements of standing, the Federal Rules, and the PSLRA, no lawsuit is viable without a defendant. So who can be sued? The most obvious choice is the naked short seller, who is both morally and legally the most culpable. Identifying naked shorters, and more importantly, collecting judgments from them, are problematic issues, however, making them unappealing targets for the plaintiffs' bar.

Similarly, the death spiral financiers, whom plaintiffs frequently allege are the puppeteers of naked short-selling, are also difficult to find and collect from, as many are located outside of the United States, or are protected by offshore shell

179. *Jones v. Intelli-check, Inc.*, 274 F. Supp. 2d 615, 629 (D.N.J. 2003).

180. *Internet Law Library, Inc. v. Southridge Capital Mgmt.*, 2003 WL 21537782 at *5 (S.D.N.Y. July 8, 2003).

181. *Tellabs*, 127 S. Ct. at 2509.

companies.¹⁸² The good news for plaintiffs is that in addition to securities fraud claims, the death spiral financiers may also be easy targets for common law breach of contract, common law fraud, or breach of fiduciary duty causes of action.¹⁸³

With their deep pockets, brokerage firms are superficially attractive defendants, but as discussed *supra*, the PSLRA's scienter requirement poses a steep hurdle to their liability in federal court. Moreover, brokerage firms owe no fiduciary duty to issuers nor, under SEC rule 202(a)(11)-1, to typical investors with non-discretionary accounts; additionally, they have no apparent incentive to commit fraud or encourage naked short-selling. Thus, the best case against brokerage firms would be negligence-based, not securities fraud. Even a negligence claim might not pass muster, since arguably, it could be preempted by the PSLRA, or in certain class actions involving certain covered securities, barred by the SLUSA.¹⁸⁴ If not preempted, issuer-plaintiffs would need to articulate the precise duty of care owed to them by brokerages, how that duty of care was breached, and whether the injuries caused were foreseeable. Once more, this is an arduous standard, as brokerage firms can argue that, under SEC rules, they have a right to rely on the DTCC. DTCC rules are promulgated under the SEC's auspices and thus essentially blessed by a federal agency. The strong federal interest in, and supervision of, the DTCC's electronic clearance and multilateral netting system leaves brokerage firms little room for deviance or autonomy. At best, a plaintiff might claim that brokerage firms should not credit the accounts of purchasers of securities until the securities actually deliver and settle, which would reduce the incidence of multiple beneficial ownership and thus curb phantom shares. However, because federal regulators are unlikely to impose such a rule—other than on a temporary, emergency basis—

182. See, e.g., Matthew McClearn, *Predator or Prey: The Mysterious World of Death-Spiral Finance*, TORONTO STAR, Oct. 15, 2002, at B1, available at <http://www.rgm.com/articles/predatororprey.html>.

183. See, e.g., *Sedona Corp. v. Ladenburg Thalmann & Co., Inc., et al.*, No. 03CIV3120(LTS)(THK), 2006 WL 2034663 (S.D.N.Y. July 19, 2006); Matthew McClearn, *Predator or Prey: The Mysterious World of Death-Spiral Finance*, TORONTO STAR, Oct. 15, 2002, at B1, available at <http://www.rgm.com/articles/predatororprey.html>;

184. 15 U.S.C. §§ 77p(b)-(c), 78bb(f)(1)-(2) (2006).

out of legitimate concern for market liquidity, it remains unlikely that any court would do so, either.

Unable to win against the brokerage firms, plaintiffs have targeted the DTCC, alleging two claims: first, that the DTCC should force close-outs of FTDs to curb naked shorting; second, that the DTCC essentially counterfeits stock shares through its stock borrow program, which allows the National Securities Clearing Corporation (“NSCC”), a DTCC subsidiary to borrow shares from its members and use the shares to fulfill delivery obligations after the selling brokers failed to deliver their shares. With respect to the first criticism, the SEC clearly states that the DTCC, through the NSCC, “does not have the authority to execute buy-ins on behalf of its members. Moreover, forcing close-outs of all fails can increase risk in clearing and settlement as well as potentially interfering with the trading and pricing of securities.”¹⁸⁵ Regarding the allegations against its stock borrow program, the DTCC defends itself with this explanation:

Under the Stock Borrow program, NSCC only borrows shares from a lending member if the member actually has the shares on deposit in its account at the DTC and voluntarily offers them to the NSCC. If the member doesn't have the shares, it can't lend them. Once a loan is made, the lent shares are deducted from the lender's DTC account and credited to the DTC account of the member to whom the shares are delivered. Only one NSCC member can have the shares credited to its DTC account at any one time. . . . The Stock Borrow Program was created in 1981 with the approval of the SEC to help reduce potential problems caused by fails, by enabling NSCC to make deliveries of shares to brokers who bought them when there is a “fail to deliver” by the delivering broker. Even if a “fail to receive” is handled by Stock Borrow, the “fail to deliver” continues to exist, and is counted as part of the total “fails to deliver.” If the total fails to deliver for that issue exceeds 10,000

185. Press Release, Depository Trust & Clearing Corp., Media Statement on Robert Shapiro's Report on Naked Short Sales (Mar. 15, 2006), http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked_short_selling.php.

shares, it gets reported to the markets and the SEC.¹⁸⁶

In short, the DTCC posits that the DTCC always holds someone accountable for a FTD, and thus, it does not enable naked short-selling or fraudulent market manipulation. The DTCC further shields itself from liability by arguing that its functions are regulated and overseen by the SEC; as a result, any naked short-selling claims based in common law negligence are preempted by federal law. As the following cases illustrate, no plaintiff yet has won a final judgment against DTCC based on naked short selling claims; most suits against the DTCC do not progress beyond the initial pleadings.

As of the end of 2007, the DTCC or its subsidiaries had been sued fourteen times on allegations of naked short-selling. In at least four of these suits, including *Williamson v. Goldman, Sachs & Co., et al.*,¹⁸⁷ *Genemax Corp. v. Knight Securities, LP, et al.*,¹⁸⁸ *Miller, as Trustee v. Boston Partners Management LP, et al.*,¹⁸⁹ and *Intergold Corp. v. Depository Trust Corp.*,¹⁹⁰ plaintiffs never served the DTCC defendants and the suits against the DTCC thus did not proceed.

In *Nutek v. Ameritrade, Inc.*,¹⁹¹ the plaintiffs voluntarily dismissed the DTCC with prejudice, and the remaining DTCC defendants were dismissed two months later. Similarly, in

186. Depository Trust and Clearing Corp., *Naked Short Selling and the Stock Borrow Program*, Mar. 30, 2005, http://www.dtcc.com/news/newsletters/dtcc/2005/mar/naked_short_selling.php

187. Filed Jan. 31, 2003, dismissed Mar. 17, 2004. DTCC, Naked Short Selling Cases, <http://www.dtcc.com/leadership/issues/nss/cases.php> (last visited Jan. 22, 2009).

188. Filed Nov. 14, 2003 in U.S. District Court for the District of Nevada; dismissed Nov. 9, 2004. DTCC, Naked Short Selling Cases, <http://www.dtcc.com/leadership/issues/nss/cases.php> (last visited Jan. 22, 2009).

189. Filed Jan. 2006; DTCC not served; DTCC defendants dropped from litigation. DTCC, Naked Short Selling Cases, <http://www.dtcc.com/leadership/issues/nss/cases.php> (last visited Jan. 22, 2009). (Filed Jan. 2006; DTCC not served; DTCC defendants dropped from litigation).

190. Filed Mar. 10, 2003; never served on DTCC; DTCC, Naked Short Selling Cases, <http://www.dtcc.issues/nss/cases.php> (last visited Jan. 18, 2009).

191. Filed Mar. 21, 2003; dismissed voluntarily by plaintiffs as against DTCC, with prejudice, May 18, 2004. Dismissed as against remaining DTCC defendants, July 30, 2004. DTCC, Naked Short Selling Cases, <http://www.dtcc.issues/nss/cases.php> (last visited Jan. 18, 2009).

Capece v. Elgindy,¹⁹² the plaintiffs voluntarily dismissed the DTCC defendants three months after filing suit. The DTCC also won dismissal of the naked short-selling allegations against it in *X-Clearing Corp. v. Depository Trust Corp.*, (the Intergold action)¹⁹³ *X-Clearing Corp. v. Depository Trust Corp.*, (the Petrogen action)¹⁹⁴ and *Walters v. Depository Trust and Clearing Corp.*¹⁹⁵

Nanopierce Technologies, Inc., et al. v. The Depository Trust and Clearing Corp., et al.,¹⁹⁶ a lawsuit brought in Nevada state court, illustrates the weaknesses in naked short-selling lawsuits against the DTCC. Nanopierce, a biotechnology holding company, sued the DTCC in April 2004,¹⁹⁷ arguing under state law that the DTCC was responsible for the drop in the company's stock price because the DTCC's Stock Borrow Program had enabled brokerages to engage in naked shorting of Nanopierce shares.¹⁹⁸ The DTCC responded that its clearing and settlement activities are subject to the oversight and approval of the SEC and thus, under the Constitution's federal preemption doctrine, cannot be challenged under state law.¹⁹⁹ The SEC filed an amicus brief in support of the DTCC.²⁰⁰ Ulti-

192. *Capece v. Elgindy*, No. 04-CV-80403 (S.D. Fla. filed Apr. 28, 2004; dismissed voluntarily by plaintiff as against DTCC defendants, Aug. 3, 2004). DTCC, Naked Short Selling Cases, <http://www.dtcc.leadership.issues/nss/cases.php> (last visited Jan. 18, 2009).

193. Intergold, Inc. Action; filed Feb. 18, 2003; dismissed by court on DTCC Defendants' motion to dismiss, Oct. 3, 2003. DTCC, Naked Short Selling Cases, <http://www.dtcc.leadership.issues/nss/cases.php> (last visited Jan. 18, 2009).

194. Petrogen Corp. action; filed Feb. 25, 2003; dismissed by court on DTCC Defendants' motion to dismiss; Sept. 5, 2003. DTCC, Naked Short Selling Cases, <http://www.dtcc.leadership.issues/nss/cases.php> (last visited Jan. 18, 2009).

195. Filed Aug. 30, 2004; dismissed by court on DTCC motion to dismiss (no opposition filed), Dec. 7, 2004. DTCC, Naked Short Selling Cases, <http://www.dtcc.leadership.issues/nss/cases.php> (last visited Jan. 18, 2009).

196. 168 P.3d 73 (Nev. 2007).

197. Complaint, *Nanopierce Technologies, Inc. v. Depository Trust and Clearing Corp.*, 2004 WL 3629226 (Nev. Dist. Ct. Apr. 29, 2004) (No. 04-01079).

198. 168 P.3d at 76.

199. *Id.* at 84.

200. Brief for Securities and Exchange Commission as Amici Curie Supporting Defendants, *Nanopierce Technologies, Inc. v. Depository Trust and Clearing Corp.*, 168 P.3d 73 (Nev. 2007) (No. 45364), available at <http://www.404.gov/litigation/briefs/nanopiercesecbrief.pdf>.

mately, the court adopted the DTCC's argument, noting, "[S]tate law may not be applied as to impose damages on [the DTCC]. To do this would be to forbid Defendants from doing what the SEC authorized them to do."²⁰¹ The Supreme Court of Nevada upheld the dismissal.²⁰²

Following *Nanopierce*, the DTCC achieved victory in *Sporn v. Elgindy*.²⁰³ The suit, filed by Trident Systems International Inc. and its president, Alan Sporn, alleged that Anthony Elgindy engaged in naked short selling of Trident shares.²⁰⁴ The plaintiffs contended that the DTCC and various brokerages facilitated Elgindy's naked short-selling by allowing improper trades in Trident's stock.²⁰⁵ The plaintiffs sued the DTCC on both securities fraud and breach of contract grounds.²⁰⁶ In addition to dismissing the claims against the DTCC, the court sanctioned the plaintiffs.²⁰⁷

In *Capece v. The Depository Trust and Clearing Corp., et al.*,²⁰⁸ the DTCC once again successfully defended itself against naked short-selling allegations. The Capece plaintiffs were stockholders in Cybercare, Inc., a Florida corporation publicly traded on the NASDAQ.²⁰⁹ After Cybercare's stock plummeted from the plaintiffs' purchase price of \$15.06 to an average sale price of \$0.25,²¹⁰ the plaintiffs sued the DTCC for common law negligence, alleging that the DTCC failed to monitor its stock borrow program thereby enabling naked shorting.²¹¹ The negligence claim was thus preempted, and the case against the DTCC dismissed. In its dismissal order, the court relied on the *Nanopierce* decision, concluding that

201. *Nanopierce Technologies, Inc. v. Depository Trust and Clearing Corp.*, No. 04-01079, 2005 WL 4712388 (Nev. Dist. Ct. Apr. 28, 2005).

202. 168 P.3d 73.

203. USDCData.com, http://www.usdcdata.com/CACD/2/2004/cv06417.Alan_R_Sporn_v._Amr_I_Elgindy_et_al/DS_1_04064171.html (Filed Aug. 3, 2004; dismissed by court on DTCC motion to dismiss, July 25, 2005; sanctions awarded against plaintiffs; plaintiffs appealing to 9th Circuit).

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. No. 05-80498 CIV RYSKAMP, 2005 WL 4050118 (S.D. Fla. Oct. 11, 2005).

209. *Id.* at *1.

210. *Id.*

211. *Id.* at *3.

[a]llowing Plaintiffs to assert a state law cause of action against Defendants [DTCC and its subsidiaries] would require Defendants to tailor their practices with regard to the SBP [stock borrow program] to satisfy each state's formulation of the standard of care in a negligence action. Such a result would destroy the Congressionally-mandated uniform system governing securities trading.²¹²

In *Whistler Investments, Inc. v. DTCC, et al.*,²¹³ the Ninth Circuit similarly held that DTCC's clearing and settlement rules, which had been approved by the SEC, cannot be challenged under state law.²¹⁴ Adopting part of the *Capece* court's reasoning, the *Whistler* court determined that because the DTCC's Stock Borrow Program is explicitly approved by and subject to the ongoing oversight of the SEC, the Supremacy Clause of the United States Constitution bars Whistler's legal challenge on "conflicts," but not "field," preemption grounds.²¹⁵

Finally, the DTCC recently scored another dismissal from an Arkansas federal court in *Pet Quarters, Inc. v. The Depository Trust and Clearing Corp., et al.*²¹⁶ Pet Quarters, Inc. ("PQI"), an internet-based pet supply, alleged similar claims to those in *Nanopierce, Whistler, and Capece*.²¹⁷ Specifically, PQI claimed that through its Stock Borrow Program, the DTCC, conspired with death spiral financiers to artificially increase the supply of PQI stock and permitted significant open FTD positions on "millions of shares" of PQI stock to exert additional downward pressure on the stock price.²¹⁸ PQI contended that it relied on the DTCC's misrepresentation that the Stock Borrow Program is used to clear and settle trades efficiently and sought \$400

212. *Id.* at *9.

213. 539 F.3d 1159 (9th Cir. 2008).

214. *Id.*; see also *Whistler Invs., Inc. v. The Depository Trust and Clearing Corp.*, No. CV-S-05-0634-RCJ (D.Nev. June 1, 2006); *Depository Trust and Clearing Corp., Federal Court Dismisses Lawsuit Against DTCC*, June 2, 2006, available at <http://www.dtcc.com/news/press/releases/2006/whistler.php>.

215. 539 F.3d at 1167; see also *Whistler Invs., Inc. v. The Depository Trust and Clearing Corp.*, No. CV-S-05-0634-RCJ (D. Nev. June 1, 2006).

216. 545 F. Supp. 2d 845 (E.D.Ark. 2008).

217. *Id.* at 851.

218. *Id.* at 848-49.

million in damages.²¹⁹ The court dismissed PQI's claims with prejudice on preemption grounds.²²⁰

The results to date in these state-law based suits against the DTCC are sensible, given the DTCC's consecrated purpose: to provide an efficient, uniform mechanism for clearing and settlement of securities trade.²²¹ Permitting each state to hold the DTCC to its own standards would undermine the efficacy of a centralized system. However, the DTCC's persistent defense is that it is just fulfilling its SEC-regulated functions. If that is indeed the case, given the apparent systemic flaws, the onus is then on the SEC to reconsider its directive to and oversight of the DTCC and its subsidiaries.

IV.

TRENDS IN NAKED SHORT-SELLING LITIGATION

With the limited success of traditional securities fraud claims, the search for naked shorting culpability continues along more creative routes. Now hedge funds are suing brokerages on antitrust grounds. The SEC launched an assault on hedge funds that engage in private investment in public equity ("PIPE") transactions. For their part, state attorneys general are investigating brokerages for naked short-selling abuses. And the plaintiffs' bar has turned its attention to state court claims of fraud, negligence, and conversion. This section previews each.

A. *Antitrust Suits Against Brokerages*

In April 2006, Electronic Trading Group, LLC, a hedge fund, sued eleven major broker-dealers, accusing them of collusion in improperly charging fees by failing to borrow or deliver stock needed to back naked short sales.²²² The plaintiffs, who sought class action certification, contended that the banks

219. *See id.*

220. *Id.* at 853.

221. *See* Depository Trust & Clearing Corporation, *Our Business: An Overview*, <http://www.dtcc.com/about/business/index.php>.

222. Complaint, *In re* Short Sale Antitrust Litigation, No. 06-CV-2859 (S.D.N.Y. Apr. 12, 2006). Electronic Trading Group's lawsuit was followed a few days later by a nearly identical suit brought by another hedge fund, Quark Fund, LLC.

dominate the market for prime brokerage services to short sellers and tolerate among themselves chronic failures to deliver by which clients are charged for 'borrowing' when in fact no borrowing actually takes place. Defendants collusively condone and engage in these practices to their individual and collective enrichment, routinely alternating among themselves in the roles of prime broker who fails to deliver and third-party broker who permits the fail to persist.²²³

The plaintiffs did not challenge the practice of naked short-selling; they challenged only the lending costs and fees that they were charged and paid, when they did not receive the bargained-for-value (borrowed shares) in return.²²⁴ They based their allegations, in part, on violations of section 1 of the Sherman Antitrust Act,²²⁵ which requires plaintiffs to prove that a conspiracy (i.e., a "combination") exists, and that interstate commerce is restrained. To support their antitrust claims, plaintiffs alleged that defendants collectively control 83% of aggregate client assets in the market and thus "set prices and institute industry practices in order to benefit themselves at the expense of their clients."²²⁶ This novel approach to brokerage liability for naked short-selling schemes did not rely on proof of market manipulation or misrepresentation and did not even attempt to show that naked shorting itself is illegal; rather, the complaint was that brokerages are permitting naked shorting but still charging clients as if their positions are covered through borrowed shares. The defendants responded that the Supreme Court's June 2007 ruling in *Credit Suisse Securities (USA) v. Billing*²²⁷ precludes antitrust claims on activities "within the heartland" of securities regulation.²²⁸ The defendants argued that "even conduct that violates the securities laws is immune from the antitrust laws where the alleged antitrust conspiracy depends on finely drawn lines between per-

223. *Id.* at 2.

224. *See id.* at 11.

225. 15 U.S.C. § 1.

226. *See* Complaint, *In re Short Sale Antitrust Litigation*, No. 06-CV-2859 (S.D.N.Y. Apr. 12, 2006).

227. 127 S. Ct. 2383 (2007).

228. Defendants' Supplemental Brief Re: The Supreme Court's Decision in *Credit Suisse Securities (USA) LCC v. Billing* at 1, *In re Short Sale Antitrust Litigation*, No. 06-CV-2859 (S.D.N.Y. Aug. 7, 2007).

missible and impermissible conduct. In such cases, the court ruled that regulation must be left to the expertise of securities regulators.”²²⁹

Billing did not expressly address antitrust concerns in short selling cases. Instead, *Billing* involved allegations that defendant underwriting firms had violated antitrust laws by engaging in certain conduct in connection with a series of initial public offerings that was also prohibited by federal securities laws and regulations.²³⁰ In short, the defendants in *Billing* had allegedly violated federal securities law, but instead of suing for these violations, the plaintiffs sued under antitrust law instead, hoping to recover treble damages.²³¹ The Supreme Court concluded first, that there was a “plain repugnancy” between the plaintiffs’ antitrust claims and the federal securities law, and second, that federal securities laws implicitly preclude the application of antitrust law to the alleged securities brokerage conduct.²³² The lesson in *Billing* seems clear: If federal securities law expressly prohibits certain conduct, that conduct should be litigated under federal securities law, and not under a more creative antitrust claim.

In the Electronic Trading Group case, the district court ultimately held that under *Billing*, there is clear incompatibility between securities law and antitrust law with respect to short sales, and that the SEC regulations supersede.²³³ The court worried that if it allowed the plaintiffs’ antitrust suit to proceed, there was substantial risk that a non-expert jury might mistake legal conduct under the securities laws for evidence of a conspiracy under antitrust laws,²³⁴ and allowing antitrust suits such as this could chill activities that securities laws permit.²³⁵ Thus, the court dismissed the plaintiffs’ suit.²³⁶

229. *Id.* (citing *Billing* at 2395-6).

230. 127 S. Ct. at 2388-89.

231. *Id.* at 2395-97.

232. *Id.* at 2387.

233. *In re Short Sale Antitrust Litig.* (Electronic Trading Group), 527 F. Supp. 2d 253, 260 (S.D.N.Y. 2007).

234. *Id.* at 260.

235. *Id.*

236. *Id.* at 262.

B. *Lawsuits Against Hedge Funds*

The SEC now carefully scrutinizes hedge funds generally, and PIPE transactions specifically, for market manipulation activity. However, most of the resulting lawsuits focus on technical violations of trading rules, not on substantive market manipulation claims,²³⁷ probably because until its recent anti-fraud rule,²³⁸ discussed *infra*, the SEC had refrained from declaring deceptive naked short selling to be market manipulation.

For example, in *SEC v. Lyon*, the SEC filed fraud charges against Lyon, a hedge fund manager, and Gryphon Hedge Funds for engaging in illegal “PIPE” trading schemes.²³⁹ The SEC alleged that the defendants implemented an unlawful trading scheme, which realized more than \$6.5 million in “ill-gotten gains” by investing in PIPE offerings without incurring market risk.²⁴⁰ Specifically, the SEC claimed that the defendants then engaged in naked short-selling of the issuer’s stock in Canada, after agreeing to invest in a PIPE transaction.²⁴¹ The defendants then used the PIPE shares to cover the short positions, a practice prohibited by the registration provisions of federal securities law, while trying to avoid regulatory scrutiny by employing wash sales, matched orders, and pre-arranged trades to appear as if the short sales were covered by open market shares instead.²⁴² Further, the defendants allegedly made materially false representations to the PIPE issuers to induce them to sell securities to defendants by falsely claiming that they would not sell or transfer the PIPE shares other than in compliance with the registration provisions of the Securities Act of 1933,²⁴³ despite intending all along to distribute the restricted PIPE securities in violation of the Securities

237. Barr, *supra* note 14 (citing Barry Barbash).

238. See Press Release, SEC, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses, No. 2008-204 (Sept. 17, 2008), available at <http://www.sec.gov/news/press/2008/2008-204.htm>; SEC Rule 10b-21, Exchange Act Release No. 34-57511; 73 Fed. Reg. 15376 (proposed Mar. 21, 2008) (to be codified at 17 C.F.R. pt. 240).

239. 529 F. Supp. 2d 444 (S.D.N.Y. 2008).

240. See Complaint at 1, *Lyon*, 529 F. Supp. 2d 444 (No. 06-CV-14338).

241. *Id.* at 2.

242. *Id.*

243. *Id.* at 5.

Act.²⁴⁴ Finally, the SEC argued that the defendants engaged in insider trading by short selling the securities of certain PIPE issuers prior to the public announcement of the PIPE, while using nonpublic information received while being solicited to invest in the PIPE.²⁴⁵ In considering Lyon's motion to dismiss, the district court determined that the SEC had met its pleading burden with respect to the securities fraud and insider trading claims but not with respect to the claims of unlawful distribution of unregistered securities.²⁴⁶ No final judgment has been reached in the case.

The *Lyon* case follows an SEC suit against Friedman Billings, an investment bank (now known as Friedman Billings Ramsey Group), which the SEC alleged had engaged in insider trading related to a PIPE the bank arranged for CompuDyne.²⁴⁷ That suit settled for \$7.7 million in December 2006.²⁴⁸ The SEC has also targeted a group known as the Rhino Advisers ("Rhino") in *SEC v. Badian*.²⁴⁹ The *Badian* suit alleges fraud and other securities violations in connection with a PIPE transaction and the subsequent manipulative naked short selling of the stock of Sedona Corporation ("Sedona"), a software company.²⁵⁰ According to the SEC, Rhino, representing hedge-fund Amro International, S.A. ("Amro"), lent Sedona \$2.5 million in a convertible debt offering, typical floorless death spiral financing.²⁵¹ Sedona required the investors to agree not to sell the shares short, but Amro, via Rhino, naked shorted the stock anyway, causing the shares to plummet and Sedona to face a cash crisis.²⁵²

244. *Id.*

245. *Id.* at 6.

246. *Lyon*, 529 F. Supp. 2d at 446-47.

247. SEC Press Release, SEC Files Settled Enforcement Action Against Broker-Dealer Friedman, Billings, Ramsey & Co., Inc., No. 2006-214 (Dec. 20, 2006), available at <http://www.sec.gov/news/press/2006/2006-214.htm>.

248. Liz Moyer, *Piped Again by the SEC*, FORBES.COM, Dec. 20, 2006, http://www.forbes.com/business/2006/12/20/pipes-sec-insider-trading-biz-cx_lm_1220pipes.html.

249. *SEC v. Badian*, No. 06-CV-2621, 2006 WL 1432080, at 1 (S.D.N.Y. Apr. 4, 2006), Complaint available at <http://www.sec.gov/litigation/complaints/2006/comp19639.pdf>.

250. *See id.*

251. *See id.*

252. *See id.* ¶¶ 1-2, 25-30.

Issuers are following the SEC's lead in suing hedge funds. In 2005, Overstock sued Rocker Partners ("Rocker"), a hedge fund, and Gradient Analytics ("Gradient"), a research firm, claiming that Rocker paid Gradient to issue disparaging reports on Overstock, driving down the price of Overstock shares and allowing Rocker, which had short positions in Overstock, to profit.²⁵³ Overstock's lawsuit did not allege naked short-selling, and Rocker claimed that the firm did not engage in naked short-selling, but in the media, Overstock CEO Patrick Byrne has blamed hedge funds like Rocker for naked shorting Overstock stock.²⁵⁴ This lawsuit, based primarily on defamation and intentional inference with prospective economic advantage, survived the defendants' motions to strike²⁵⁵ and is expected to go to trial in April, 2009.²⁵⁶

C. State Government Lawsuits

Louisiana Attorney General Charles Foti launched an investigation into UBS's stock-lending practices with respect to Sedona (the Pennsylvania software firm discussed *supra*), filing motions to compel all of UBS's electronic and paper communications files relating to Sedona stock, trading records, monthly stock inventories, stock loan documentation, information regarding commission payments, customer account records, market-making activities, clearing and settlement procedures, and in-house research.²⁵⁷ The SEC contends that Sedona's stock price plummet—from approximately \$10.25 a share to less than \$0.20 per share—was caused by manipulative short-selling by hedge funds and collusive brokers.²⁵⁸ Illinois

253. Compl. at 6-7, *Overstock.com, Inc. v. Gradient Analytics, Inc.*, No. CV-053693 (Cal. Super. Ct. Aug. 11, 2005), available at http://cdn.overstock.com/05-0811_CivilComplaint_NSS.pdf.

254. Barr, *supra* note 14.

255. *Overstock.com, Inc. v. Gradient Analytics, Inc.*, No. CV-053693 (Cal. Super. Ct. Mar. 7, 2006) (ruling on Gradient's motion to dismiss), available at http://cdn.overstock.com/06-0307_FinalMotionRuling_NSS.pdf.

256. Press Release, Gradient Analytics, Gradient Analytics Looks Forward to Jury Trial in Overstock.com Case (June 23, 2008), available at <http://www.gradientanalytics.com/news/GA%20Trial%20Date%2020080623.pdf>.

257. Liz Moyer, *Naked Justice?*, FORBES.COM, Aug. 29, 2006, http://www.forbes.com/2006/08/29/naked-shorts-sedona-louisiana-cx_lm_0829naked_print.html.

258. *Id.*

and Connecticut are also investigating the investment banks and hedge funds.²⁵⁹

D. *Issuer Suits Against Brokerages in State Courts*

With little hope for remedies in the federal courts, alleged targets of naked shorting schemes are focusing on the state courts instead. In February 2007, Overstock.com filed a \$3.5 billion lawsuit against major brokerage firms in the Superior Court of California, alleging state-law causes of action for conversion, trespass to chattels, intentional interference with prospective economic advantage, and various violations of the California Corporations Code and Unfair Business Practices Act.²⁶⁰ In July 2007, the Superior Court judge allowed the case to proceed, ruling that Overstock's claims were viable under California law.²⁶¹ Overstock's California litigation may illuminate one path to remedies for victims of naked short-selling schemes. State court litigation of state law claims is not a panacea, though; state court litigation is subject to forum non conveniens disputes, forum shopping accusations, and other jurisdictional problems.

V.

ALTERNATIVE SOLUTIONS

With no instant remedy from the judicial system, alleged victims of naked short selling have turned to regulators and the legislative branch for relief.

A. *Regulation SHO*

Although the 1934 Act, when interpreted broadly, prohibits all market manipulation, arguably including naked shorting, federal securities law historically has not provided any specific guidance as to how such market manipulation can be identified and mitigated. In 2004, the SEC crafted Regulation

259. *Id.*

260. Compl. at 1, *Overstock.com, Inc. v. Morgan Stanley & Co., Inc.*, No. CGC-07-460147 (Cal. Super. Ct. July 6, 2007), available at http://cdn.overstock.com/07-0202_LegalDoc_PRIME.pdf.

261. See Overstock.com Press Release, *Overstock.com Wins Ruling in Prime Brokerage Litigation*, July 18, 2007, available at <http://investors.overstock.com/phoenix.zhtml?c=131091&p=irol-newsArticle&ID=1027457&highlight=>.

SHO,²⁶² comprised of SEC rules 200, 202T,²⁶³ and 203, an attempt to update²⁶⁴ short-selling restrictions and curb delivery failure abuses. Effective on September 7, 2004, with required compliance by January 3, 2005,²⁶⁵ Regulation SHO establishes uniform “locate” requirements, creates a “threshold security list” to identify possible targets of naked short-selling and warn would-be investors, requires broker-dealers to “close-out” FTD positions of these threshold securities, and then articulates exceptions to these rules.

First, Regulation SHO establishes uniform “locate” requirements. A “locate” is the short-seller’s arrangement with a broker-dealer to confirm that it is able to make delivery of the shorted stock. Under SEC rule 203(b)(1), brokers and dealers may not accept short sales unless they have borrowed the security, entered into a bona-fide arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed by the delivery due date (the so-called “easy to borrow” exception).²⁶⁶ Second, Regulation SHO requires exchanges to publish daily a “threshold securities” list of companies where at least 10,000 shares or more than 0.5% of the

262. Final Rule: Short Sales, Release No. 34-50103, 7 C.F.R. 240-42 (2004), available at <http://www.sec.gov/rules/final/34-50103.htm>. For a detailed discussion of Regulation SHO’s provisions, see Dickerson, *supra* note 31. Note that SHO is short for “SHORt selling.”

263. Rule 202T creates a pilot program through which the SEC may temporarily suspend all price tests for investors’ securities short sales for certain designated securities so that ultimately, the SEC may determine the most effective price test for short sales. For a more thorough discussion of this provision, which is beyond the scope of this paper, see Dickerson, *supra* note 31, at 184-85.

264. The SEC had last updated short-selling regulations in 1938.

265. SEC. & EXC. COMM’N, DIVISION OF MARKET REGULATION: RESPONSES TO FREQUENTLY ASKED QUESTIONS CONCERNING REGULATION SHO, Oct. 11, 2006, available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

266. Final Rule: Short Sales, Exchange Act Release No. 34-50103 at 11. Generally, “easy to borrow” stocks are highly capitalized, with large numbers of shares in circulation. MARK JICKLING, REGULATION OF NAKED SHORT SELLING, CRS Report for Congress, Mar. 30, 2005 at 3. Note, however, that if a security included on an “Easy to Borrow” list suffers repeated delivery failures, reliance on the list no longer provides reasonable grounds for the broker-dealer to believe it will be obtained. Philip Dickerson, *Regulation SHO*, 24 ANN. REV. BANKING & FIN. L. 181, 185 (2005) (citing Final Rule: Short Sales, Exchange Act Release No. 34-50103 at 12).

company's total outstanding shares²⁶⁷ have been shorted and not delivered to a buyer for five consecutive trading days.²⁶⁸ Third, after thirteen trading days, brokers or dealers who are participants of a registered clearing agency must settle, or "close-out," failure-to-deliver positions in these threshold securities by buying shares "of like kind and quantity."²⁶⁹ Until the trade is closed out, broker-dealers involved in the trade may not engage in any further short sales of that security.²⁷⁰

Regulation SHO intends to reduce persistent delivery failures, but its exceptions may undermine its rules. Regulation SHO permits legal short sales: (1) when a broker or dealer accepts a short sale from another registered broker or dealer; (2) in bona-fide market making; and (3) when a broker-dealer effects a sale on behalf of a customer that is deemed to own the security pursuant to rule 200²⁷¹ but through no fault of the customer or broker-dealer does not expect the security to be in the broker-dealer's possession by the delivery date.²⁷² The effect of the broker-to-broker exemption is that if the brokers trade back and forth between themselves, the thirteen-day clock for mandatory close-outs restarts each time.²⁷³ If the bro-

267. Final Rule: Short Sales, Exchange Act Release No. 34-50103 at 14. See also Thiel, *supra* note 63.

268. Final Rule: Short Sales, Securities Exchange Act Release No. 34-50103 at 14. See also Marie Leone, *SEC Releases Reg. SHO Amendments*, CFO.COM, July 13, 2006, http://www.cfo.com/printable/article.cfm/7180899/c_7161792?f=options.

269. Final Rule: Short Sales, Exchange Act Release No. 34-50103 at 16. See also Leone, *supra*, note 268.

270. Final Rule: Short Sales, Exchange Act Release No. 34-50103 at 16.

271. A person shall be deemed to own a security if he: (1) or his agent has title to it; or (2) has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or (3) owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) has an option to purchase or acquire it and has exercised such option; or (5) has rights or warrants to subscribe to it and has exercised such rights or warrants; or (6) holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security. *Id.* at 41. Note also that "a person shall be deemed to own securities only to the extent that he has a net long position in such securities." *Id.*

272. *Id.* at 13.

273. See Thiel, *supra* note 63 (quoting Sen. Robert Bennett (R-UT)); see also *Of Stocks and Socks: Senator Bennett Bores In On SEC's Dismal Naked Short Sales Record*, FINANCIALWIRE, Mar. 14, 2005, at 1.

kers trade between themselves indefinitely, they theoretically may never have to settle the naked short positions. The second exemption provides an exception that gives bona fide “market-makers” who short sell “thinly traded, illiquid stock” extra time to obtain the securities for delivery.²⁷⁴ Market-makers are dealers who stand ready to buy or sell a stock at any time and who publish the prices at which they are willing to trade.²⁷⁵ Their role is to maintain an inventory of readily available stock, to mitigate volatility, and to manage their own risk; they sometimes need to short shares to accomplish their objectives.²⁷⁶ The problem is that almost anyone can apply to become a market maker, and thus almost anyone, however unscrupulous, can take advantage of the exemption and engage in naked short selling.²⁷⁷ In addition to these problematic exemptions, the SEC reserves the right to grant an exemption, “either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.”²⁷⁸ In short, the SEC retains significant discretionary power to exempt people and practices from the rules, and such exemptions may not even be publicly known.²⁷⁹ The existence of so many exemptions undermines confidence in SHO’s efficacy.

Perhaps the largest SHO controversy occurred when the SEC “grandfathered in” any failed deliveries before January 3,

274. Marie Leone, *supra* note 268.

275. See 15 U.S.C. 78c(a)(38) (2007). MARK JICKLING, REGULATION OF NAKED SHORT SELLING, CRS REPORT FOR CONGRESS, Mar. 30, 2005, at CRS-3, note 4. (“[Market-makers] are the key intermediaries on the NASDAQ; on the New York Stock Exchange, they are called specialists.”)

276. Thiel, *supra* note 36;36.

277. *Id.*

278. SEC Rule 200(h), 17 C.F.R. § 242.200 (2009).

279. See, e.g., NYSE Regulation, Threshold Securities, <http://www.nyse.com/RegulationFrameset.html?displayPage=1;tp://www.nyse.com/threshold/home.html> (“From time to time, upon application from a NYSE specialist to continue to fulfill its obligation to maintain a fair and orderly market pursuant to NYSE Rule 104, a temporary exemption from the close out and/or borrowing requirements of Regulation SHO, 17CFR 242.203 (b)(3), may be recommended by the New York Stock Exchange and granted to the NYSE specialist in the security, by the Securities and Exchange Commission. The temporary exemption would normally last no longer than 30 days but may be renewed, depending upon the particular circumstances. The fact that a NYSE specialist has been granted an exemption will initially remain confidential to protect the NYSE specialist’s position in the subject security.”).

2005 in an effort to avoid pre-compliance-date short-squeezes caused by close outs of naked short positions.²⁸⁰ The result was that in the four months between Regulation SHO's effective date and compliance date, the grandfather provision provided that "anyone who was so inclined a generous period of time to build up naked short positions in any stock he liked. Or, to use the counterfeit analogy, imagine outlawing the printing of funny money, but giving everyone four months to print up as much as they'd like. Only then would counterfeit dollars be illegal—but only to print, not to use."²⁸¹ The SEC exempted these failed deliveries from SHO's close-out requirement.²⁸² The SEC did not submit the grandfather exemption for public comment, and accordingly, it was the most-criticized SHO provision until removed in June 2007.²⁸³

Collectively, SHO's exceptions amount to toothless red flags—SHO helps identify some, but not all, incidents of probable naked shorting, but lacks an enforcement mechanism in that it does not impose unavoidable penalties for failing to deliver and thus does not provide any practical disincentive for naked short-selling.

The SEC claims that Regulation SHO is working, albeit slowly and inefficiently. The SEC credits SHO with helping to reduce average daily FTDs by 34% during the period January 2005 to May 2006 from the period April to December 2004.²⁸⁴ This data is difficult to verify because the SEC does not voluntarily release data on FTDs; Freedom of Information Act ("FOIA") requests for this information indicate that some companies have actually seen increases in delivery failures since SHO's enactment.²⁸⁵ Further, SHO critics respond that

280. Kelleher, *supra* note 8;8.

281. *Id.*

282. See SEC Release 34-56212, 17 CFR Part 242 (Aug. 7, 2007), 73 Fed. Reg. 45544 (Aug.14, 2007), available at <http://www.sec.gov/rules/final/2007/34-56212fr.pdf>.

283. See *id.*

284. *Naked Short Selling*, THE FINANCIAL TIMES, July 6, 2006.

285. See, e.g., SEC Response to Freedom of Information Act Request No. 05-05810-FOIA (June 22, 2005), available at <http://www.thesanitycheck.com/Portals/0/FOIANYSE.pdf>; John W. Welborn, *Married Puts, Reverse Conversions, and Abuse of the Options Market Maker Exception on the Chicago Stock Exchange* (2007), available at [http://antisocialmedia.net/media/2007.10.09%20\(J%20Welborn\)%20Married%20Puts%20and%20Reverse%20Conversions.pdf](http://antisocialmedia.net/media/2007.10.09%20(J%20Welborn)%20Married%20Puts%20and%20Reverse%20Conversions.pdf); John W. Welborn, *The 'Phantom Shares' Menace*, Regulation 52, 54-

the threshold securities list simply “turn[s] rampant abuse into a spectator sport”²⁸⁶ and “adds more smoke to the fire”²⁸⁷ in that, while it identifies persistent FTDs, it does not provide information about whether naked short-selling is to blame. In addition, anecdotes suggest that the threshold securities list has unintentionally created more market manipulation, in the form of short squeezes, by identifying stocks where short sellers are presumably active.²⁸⁸ Reportedly, traders make large purchases, through long positions, of some of these threshold securities, which in turn, drive up the prices of these stocks, put pressure on short sellers as their positions lose money, cause brokers to issue margin calls seeking more collateral to protect themselves against default, force short sellers to close out their positions by purchasing more shares, and thus drive the price even higher.²⁸⁹

More certainly, Regulation SHO does not dictate a course of action when particular companies remain on the threshold securities list for months, or even years, at a time. In addition to Overstock.com, well-known companies like Netflix, Inc., Krispy Kreme, Delta Airlines, and Martha Stewart Living, for instance, have been frequent guests on the threshold securities list since it was introduced.²⁹⁰ The list may do a good job in alerting investors, regulators, and the issuers themselves that something is wrong, but Regulation SHO does not take the next step and fix the purported problem.

In June 2007, the SEC amended Regulation SHO to eliminate the grandfather provision.²⁹¹ SEC Chairman Christopher Cox noted that the amendments were intended to curb “the serious problem of abusive naked short sales, which can be

56 (Spring 2008), available at <http://www.cato.org/pubs/regulation/regv31n1/v31n1-7.pdf>; see also, e.g., Letter from Thomas Vallarino, investor, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 15, 2007), available at <http://www.sec.gov/comments/s7-12-06/s71206-466.pdf>.

286. Thiel, *supra* note 63.

287. Barr, *supra* note 14.

288. Dean Foust, *Why the Shorts Have Long Faces*, BUS. WK., Feb. 28, 2005, at 86, cited in MARK JICKLING, REGULATION OF NAKED SHORT SELLING, CRS REPORT FOR CONGRESS, at 4 (2005).

289. *Id.*

290. Thiel, *supra* note 63.

291. See SEC Release 34-56212, 17 CFR Part 242 (Aug. 7, 2007), 73 Fed. Reg. 45544 (Aug. 14, 2007), available at <http://www.sec.gov/rules/final/2007/34-56212fr.pdf>.

used as a tool to drive down a company's stock price to the detriment of all its investors" and recognized that "persistent failures to deliver. . . may be due to loopholes in the Commission's Regulation SHO."²⁹² In September, 2008, the SEC also announced the elimination of the options market maker exception.²⁹³ Options market-makers are now subject to the same "T+3" delivery rules as all other market participants.²⁹⁴ These amendments and proposals address much of the SHO criticism, but still do not go far enough in mitigating the weaknesses of the threshold securities list paradigm.

B. SEC Rule 10b-21

In March 2008, in apparent response to investor concerns over naked short-selling, the SEC proposed a new anti-fraud rule to "highlight the liability" of short sellers who misrepresent their ability to obtain shares to settle their trades.²⁹⁵ Effective September 18, 2008,²⁹⁶ rule 10b-21, entitled "'Naked' Short-Selling Anti-Fraud Rule," provides:

It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10-b of this Act for any person to submit an order to sell an equity if such person deceives a broker or dealer, a participant of a

292. Christopher Cox, Chairman, Securities and Exchange Commission, Opening Statements at the Commission Open Meeting (July 12, 2006), *available at* <http://www.sec.gov/news/speech/2006/spch071206cc2.htm>.

293. Emergency Order Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 34-58572, 73 Fed. Reg. 54875 (Sept. 17, 2008), *available at* <http://www.sec.gov/rules/other/2008/34-58572.pdf>. *See also* Cox, *supra* note 292. Press Release, SEC, SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate Tick Test (June 13, 2007), *available at* <http://www.sec.gov/news/press/2007/2007-114.htm>.

294. Emergency Order Taking Temporary Action to Respond to Market Developments, Exchange Act Release 34-58572, 73 Fed. Reg. 54875 (Sept. 17, 2008), *available at* <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

295. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 34-57511, 73 Fed. Reg. 15376 (proposed Mar. 21, 2008), *available at* <http://www.sec.gov/rules/proposed/2008/34-57511.pdf>. For a thorough discussion of this proposed rule, see Alexis B. Stokes & Peter A. Stokes, *Naked No More? An Assessment of Proposed SEC Rule 10b-21*, 22 J. TAX'N. & REG. FIN. INST. 14 (2008).

296. Press Release, SEC, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-204.htm>.

registered clearing agency, or a purchaser about its intention or ability to deliver the security on the settlement date, and such person fails to deliver the security on or before the settlement date.²⁹⁷

The SEC intends this rule to indicate “zero tolerance for abusive naked short selling”²⁹⁸ by prohibiting short sellers from deceiving their brokers about their ability to locate shares. In short, the SEC emphasizes that it is deceptive to deceive. However, rule 10b-21 does not clarify what constitutes deception, or how the *Tellabs* scienter standard might be met by a plaintiff alleging harm from naked shorting. Further, because the SEC acknowledges that deceptive naked short selling has always been illegal under rule 10b-5,²⁹⁹ it is unclear how rule 10b-21 adds anything new to the regulatory framework. At most, rule 10b-21 acknowledges that naked shorting might be more of a problem than first admitted, while sending a message to manipulative naked shorters that they are on the SEC’s radar.³⁰⁰

C. SEC’s New “Hard T+3” Delivery Rule

On the same day it finalized rule 10b-21, the SEC adopted, on an interim final basis, a new “hard T+3” delivery rule that imposes strict penalties for delivery failures.³⁰¹ Specifically, if a short-seller fails to deliver within three days of the sale, the seller’s broker-dealer will be prohibited from facilitating any further short sales of that security for any of its customers unless it pre-borrows the shares.³⁰² This penalty ideally encourages broker-dealers to prevent naked short-selling by its customers. This rule does not remedy the instance of naked

297. SEC Release 34-58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008), *available at* www.sec.gov/rules/other/2008/34-58572.pdf.

298. Press Release, SEC, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-204.htm>.

299. See SEC Release 34-57511, 73 Fed. Reg. 15,376 (Mar. 21, 2008), *available at* <http://www.sec.gov/rules/proposed/2008/34-57511.pdf>.

300. Press Release, SEC, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-204.htm>.

301. SEC Release 34-58572 (Sept. 17, 2008), 73 Fed. Reg. 54,875 (Sept. 23, 2008), *available at* <http://www.sec.gov/rules/other/2008/34-58572.pdf>.

302. *Id.*

short-selling which triggered the broker-dealer's penalty in the first place, however.

D. SEC's Increased Regulation of Hedge Funds

As a signal of increased oversight of hedge fund short-selling activity, and also in September, 2008, the SEC announced an emergency, temporary order requiring hedge funds and other large institutional investors (defined as those with discretionary accounts of at least \$100 million) to disclose certain short positions on a routine basis.³⁰³ Initially met with great resistance by the hedge fund industry, which claimed that public disclosure of their trading strategies was unfair,³⁰⁴ the SEC ruled that such disclosures would be kept private by the SEC for a two-week period before public release on the SEC's EDGAR website.³⁰⁵ The SEC's move to require increased transparency and disclosure stemmed from a concern that hedge funds were responsible for short-and-distort schemes in which an issuer's stock is shorted, and false rumors about that company's viability are then spread, thus driving down the share price and allowing the short-sellers to profit.³⁰⁶ In the wake of the collapse of Bear Stearns, Lehman Brothers, and other financial industry stalwarts, the SEC's order underscored its commitment to use "every weapon in its arsenal"³⁰⁷ to fight abusive short-selling and consequent market instability. However, once again, despite the good intentions and resulting in-

303. SEC Release 34-58591 (Sept. 18, 2008), 73 Fed. Reg. 55175 (Sept. 24, 2008), available at <http://www.sec.gov/rules/other/2008/34-58591.pdf> ("SEC Release 34-58591"); Press Release, SEC, SEC Approves Amended Order Requiring Reporting of Short Positions by Certain Investment Managers (Sept. 21, 2008), available at <http://www.sec.gov/news/press/2008/2008-217.htm>. *Id.*

304. See, e.g., *FSA Cracks Down on Short Selling*, BBC NEWS, June 13, 2008, <http://news.bbc.co.uk/1/hi/business/7452312.stm> (noting hedge fund manager complaints about required public disclosure of trading strategies in the UK).

305. Press Release, SEC, SEC Approves Amended Order Requiring Reporting of Short Positions by Certain Investment Managers, (Sept. 21, 2008), available at <http://www.sec.gov/news/press/2008/2008-217.htm>.

306. SEC Release 34-58591 (Sept. 18, 2008), 73 Fed. Reg. 55175 (Sept. 24, 2008), available at <http://www.sec.gov/rules/other/2008/34-58591.pdf>.

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

crease in transparency, it is unclear how the SEC's order will translate into more accessible remedies for the parties injured by abusive shorting.

E. *FINRA Rules*

The Financial Industry Regulatory Authority ("FINRA")³⁰⁸ requires that when one of its members makes a short sale for its own accounts or accepts a short sale for a customer, the member must make a written affirmative determination.³⁰⁹ The affirmative determination must state that the FINRA member will be able to provide the security for delivery on demand.³¹⁰ This affirmative determination rule limits short selling to the ability to borrow a stock at the time of sale.³¹¹ In practice, this rule curbs short sales of stock in companies with small amounts of free trading shares because such companies' stock is usually more difficult to borrow.³¹²

Until April 1, 2004, however, the affirmative determination rule applied only to NASD members.³¹³ Non-members, like Canadian brokerage firms,³¹⁴ specialists,³¹⁵ and options

308. FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers ("NASD") and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. FINRA Home Page, <http://www.finra.org>.

309. FINRA Rule 3370. *See also* Carol S. Remond & Steve D. Jones, *Canadian Regulators Review Naked Short Selling*, (Dec. 11, 2002), available at <http://www.rgm.com/articles/nakedreview.html>.

310. *Id.*

311. *Id.*

312. *Id.*

313. *See* Interpretation No. 04 to article III, section 1, of the NASD's Rules of Fair Practice, NASD Manual (CCH) ¶ 2151.04. Richard Geist, *New Short Selling Regulations*, Bull & Bear Financial Report (accessed Aug. 19, 2005), http://www.thebullandbear.com/articles/2004/_04-print/p-0304-geist.html.

314. Canadian short-selling rules have long contributed to problems for American companies and investors. Canadian law permits naked short-selling in that it does not follow the affirmative determination rule, which would limit short-selling based on the ability to borrow the stock at the time of sale. American investors and issuers thus complain that naked short-selling in Canada can manipulate the stock of American companies. *See* Remond & Jones, *supra* note 309.

315. Specialists, as on the New York Stock Exchange, are market professionals who are responsible for making the market in a particular stock. They act as auctioneers by matching the best prices for buyers and sellers.

players, were not required to comply with NASD delivery rules.³¹⁶ In response to criticism, the NASD promulgated a new rule that requires NASD firms to treat non-member broker-dealers the same as members regarding delivery of shares sold through U.S. registered broker-dealers, thus strengthening delivery accountability and reducing naked short-selling.³¹⁷ Market-makers, however, are still exempt from the rule.³¹⁸

Although the FINRA affirmative determination rule should act as a deterrent, if naked shorting nevertheless occurs, investors have no private right of action to sue for these rule violations.³¹⁹ Investors are left only to hope that the brokerage industry polices its own rule infractions, a hope that may be unrealistic when most of the brokerage industry denies that these rules are violated in the first place. And even when the FINRA enforces the affirmative determination rule, the result for the offender is a fine and expulsion from FINRA membership³²⁰ —serious consequences, for sure, but no real remedy for the parties injured by the naked shorting scheme.

F. State Legislation

With little practical relief coming from the federal government, self-proclaimed targets of naked short selling have focused lobbying efforts at the state level. In May 2006, for example, Utah-based Overstock.com, Inc. won a major, but temporary, legislative victory when the governor of Utah signed a bill which would have required brokers to regularly disclose trades

316. See Remond & Jones, *supra* note 309.

317. *Id.*

318. FINRA Rule 3370 (b)(2)(A).

319. See, e.g., *MM&S Financial, Inc. v. Nat'l Ass'n of Securities Dealers, Inc.*, 364 F.3d 908, 911-912 (8th Cir. 2004).

320. See, e.g., Press Release, NASD, NASD's NAC Upheld Previous Decision; Fraudulent Manipulation and Illegal Short Sales Result in Expulsion of Fiero Bros., Bar of John Fiero and Fine of \$1 Million (Oct. 30, 2002), available at <http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002884>; Press Release, NASD, NASD's NAC Upheld Previous Decision; Fraudulent Manipulation and Illegal Short Sales Result in Expulsion of Fiero Bros., Bar of John Fiero and Fine of \$1 Million (2002), available at <http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002884>; see also Edgar Ortega, *Piper Fined by the NYSE Over Short-Sale Violations*, BLOOMBERG.COM (2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afpYSjiXF7iE>.

that fail to settle.³²¹ The law, which was to take effect on June 1, 2007,³²² would have imposed fines starting at \$10,000 per day on brokers who accumulate too many unsettled trades in any company's shares.³²³

The brokerage industry, represented by the Securities Industry and Financial Markets Association ("SIFMA"; formerly the Securities Industry Association or "SIA"), sued in opposition to the legislation,³²⁴ arguing that the paperwork necessary to comply with the law would be cumbersome,³²⁵ that federal securities law preempted the state standard,³²⁶ and that the legislation violated the Commerce Clause.³²⁷ Specifically, SIFMA argued that the Utah law is preempted by section 17A of the Exchange Act, which directs the SEC to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities."³²⁸ If each state is granted the authority to set its own rules regarding national markets, SIFMA posited, "the resulting labyrinth of regulation would choke our financial system" and negatively affect consumers through increased costs, inefficiencies, and a reduction in "service and innovation."³²⁹ SIFMA suggested that the American financial market would suffer on a macroeconomic level as well, as "[a]lready, companies launching IPOs shop globally for more accommodating regulatory environments. Without uniform national standards, U.S. mar-

321. Paul Foy, *Utah Gov. Signs Naked Short Selling Bill*, ASSOCIATED PRESS (May 26, 2006).

322. The law was originally to have taken effect on October 1, 2006, but was delayed in a settlement with the Securities Industry Association. See Liz Moyer, *Utah Governor Caves on Shorts*, FORBES.COM (Aug. 11, 2006), available at http://www.forbes.com/business/2006/08/11/naked-shorts-sia-utah-cx_lm_0811shorts.html.

323. Foy, *supra* note 321.

324. Complaint, *Securities Industry Assoc. v. Klein*, No. 2:06CV00623 DAK (D. Utah July 28, 2006) available at http://www.sia.com/utah_lawsuit/pdf/complaint.pdf.

325. *Id.*

326. Moyer, *supra* note 322.

327. Securities Industry and Financial Markets Ass'n, *Utah Settlement and Clearing Law Questions and Answers*, http://www.sifma.org/regulatory/litigation/utah_lawsuit/html/Q_and_A.html.

328. *Id.*; see also http://www.sifma.org/regulatory/litigation/utah_lawsuit/html/Q_and_A.html.

329. *Id.*

kets would find themselves at an even greater disadvantage.”³³⁰ SIFMA also objected to the Utah law on Commerce Clause³³¹ grounds, arguing that it “regulates wholly out-of-state brokerage transactions and imposes burdens on interstate commerce that clearly exceed the Utah law’s local benefit.”³³² Given the courts’ strong position on the preeminence of federal securities law in the suits against the DTCC, discussed *supra*, SIFMA’s preemption arguments were likely meritorious, as were the Commerce Clause claims, which emphasized the Utah law’s burden on interstate commerce. SIFMA’s litigation campaign against the Utah statute worked. In February, 2007, the Utah legislature voted to repeal the law.³³³ Similarly, in 2007, Arizona, Oklahoma, and Virginia all considered and rejected short selling bans after being threatened with litigation;³³⁴ Missouri is still considering the issue.³³⁵

Undeterred by other states’ failures, South Dakota voters are now considering amending their Uniform Securities Act of 2002 to prohibit any broker-dealer who is registered in South Dakota from engaging in short selling and also penalize any sales which do not result in delivery in three days or less.³³⁶ SIFMA has again threatened litigation, chiefly on preemption grounds.³³⁷

330. *Id.*

331. U.S. CONST. art. I, § 8, cl. 3.

332. Complaint, *Securities Industry Assoc. v. Klein*, Case No. 2:06CV00623 DAK, filed July 28, 2006, D. Utah, available at http://www.sia.com/utah_lawsuit/pdf/complaint.pdf.

333. See Brice Wallace, *House Acts to Put An End to ‘Naked Short Selling’ Bill*, DESERET MORNING NEWS, Mar. 1, 2007, available at <http://deseretnews.com/article/1,5143,660199597,00.html?pg=1>; see also SIFMA Press Release, *Utah Legislature Votes to Repeal ‘Fail to Deliver Law’ Challenged by SIFMA* (Mar. 1, 2007), available at <http://www.sifma.org/news/40455117.shtml>.

334. Liz Moyer, *Wall Street Wins in Utah*, FORBES.COM, Mar. 1, 2007, http://www.forbes.com/business/2007/03/01/naked-shorting-repeal-biz-cx_lm_0301naked.html.

335. See SIFMA, *Quick Read: Naked Short-Selling*, <http://www.sifma.org/legislative/state/Naked-Short-Selling.html> (last updated Nov. 14, 2008).

336. See Initiated Measure 9, South Dakota Small Investors Protection Act, available at <http://www.sdsos.gov/electionsvoterregistration/electvoterpdfs/2008/2008InMeasUniformedSecuritiesAct.pdf>.

337. See Letter from Nancy Donohoe Lancia, Vice President State Government Affairs, SIFMA, to Gail Sheppick, Director, South Dakota Securities Division, June 25, 2007, available at http://www.sifma.org/regulatory/comment_letters/47599597.pdf.

Given that no other state to date has passed legislation to curb naked short-selling, some companies are choosing to reincorporate and affect a custody-only trading rule. Custody-only trading requires that shares be registered to the holder by name and only be traded in physical form.³³⁸ Purchases or transfers of stock must be placed through the issuer's transfer agent.³³⁹ The brokerage industry and investors claim that the rule makes stock less liquid and harder to sell.³⁴⁰ Thus, while companies who incorporate to take advantage of the rule may seek a decline in the naked shorting of their stock,³⁴¹ they may also find their stock less attractive to legitimate investors who value liquidity. Thus, the typical strategy for a company concerned about the impact of naked short-selling on its stock would be to reincorporate, adopt a custody-only trading rule to effect a short squeeze, and then after the naked shorters make a run on the company's stock to cover their positions (thus driving up the share price with their higher demand), revise their by-laws to remove the custody-only trading rule.³⁴²

G. Other Options?

With state regulations sparse and controversial, and when litigation is unsuccessful or imprudent, what can companies concerned about the effect of naked short-selling on their stock price do? First, companies can encourage investors to demand paper stock certificates by issuing a dividend that may only be redeemed through an exchange of paper shares. Jag Media Holdings, the issuer-plaintiff discussed *supra*, did just that, in effect creating a short squeeze in which phantom share holders engaged in a price war to acquire real certificates, thus artificially and temporarily inflating the price of the

338.

339. Investopedia, *Custody-Only Trading*, <http://www.investopedia.com/terms/c/custodyonly.asp> (last visited March 20, 2009).

340. SEC Release 34-50758A (Dec. 7, 2004), *available at* <http://www.sec.gov/rules/final/34-50758a.htm>.

341. *See, e.g.*, BioCurex, Inc. BioCurex Inc. Announces Company's Consideration of 'Certificate Only' Trading as Part of an Overall Re-Structure Initiative, *available at* <http://www.globenewswire.com/newsroom/news.html?d=35551>.

342. *See* Press Release, JAG Media Holdings, Inc., (Feb. 25, 2005), JAG Media Holdings, Inc. Announces Results of Annual Stockholders Meeting, *available at* <http://www.jagnotes.com/PR2.pdf>.

stock. Orbit E-Commerce, Inc. (“OECI”), a communications company, also encouraged investors to demand delivery of their stock certificates from their brokers so that naked shorters would be forced to cover, and the demand for OECI stock would increase, along with the price.³⁴³ In addition, companies may request beneficial owner lists and proxies to improve communication with shareholders, encourage settlement of trades, and help identify short sellers. If those strategies fail, companies may choose to reincorporate and require paper-only trades;³⁴⁴ the adverse effect to such a move is that paper-only trading reduces stock liquidity and thus its attractiveness to investors.

Lawyers for issuers allegedly harmed by naked short-selling practices argue that there is a “simple” way to solve the problem: force the DTCC to go into the market and buy any unsettled shares at the end of thirteen business days and then charge the brokerage firm handling the sale.³⁴⁵ Such “short squeezes” could rein in “undisciplined” short sellers, the plaintiffs’ bar argues.³⁴⁶ In response, the DTCC and the SEC contend that the DTCC does not have authority to execute forced buy-ins, and further, that forced buy-ins would increase clearing and settlement risks and could interfere with the trading and pricing of securities.³⁴⁷ Thus, unless the law changes, issuers and investors alike are left only with a caveat emptor warning with respect to future convertible/ death spiral financing, PIPE transactions, and delivery failures.

CONCLUSION

In the naked short-selling blame game, investors and hedge funds sue the brokerages, the brokerages point to the

343. *OECI to Aggressively Combat Naked Short Selling of OTC Bulletin Board Stocks*, MARKETWIRE, Aug. 4, 2003, http://findarticles.com/p/articles/mi_pwwi/is_200308/ai_mark1930545199.

344. *See, e.g., Mike W. Thomas, Two San Antonio Firms Claim Fraud Stinging Stock*, SAN ANTONIO BUS. J., Jan. 30, 2004 available at <http://sanantonio.bizjournals.com/sanantonio/stories/2004/02/02/story1.html> (noting that ATSI Communications, Inc. reincorporated in Nevada to “shine a light on” and “squeeze out” naked short sellers because Nevada law requires paper delivery of shares).

345. Barr, *supra* note 14 (citing Robert Shapiro).

346. *Id.*

347. *Id.*

DTCC, the DTCC hides behind the skirts of the SEC, and in full circle, the SEC investigates the hedge funds, all while skeptics question the existence and the extent of the naked short-selling “problem.” Plaintiffs’ lawyers claim that naked short selling is the Holy Grail and could be “bigger than tobacco”³⁴⁸ in terms of damage awards if ever proved. But, so far, litigation has been unproductive, and even occasionally wasteful, in curtailment or “catching” alleged naked short sellers, despite an overall post-Enron, pro-plaintiff trend. Meanwhile, overregulation can do more harm than good in that it can reduce liquidity and efficiency, but the under-regulation to date has hurt vulnerable businesses, including some former Wall Street mainstays.

In the naked short-selling debate, two uniquely American value systems collide: the value of an efficient, liquid, open, nationwide market versus the values of entrepreneurship and the opportunity for young, struggling companies to have a fair shot at success. How to balance those values? One solution rests with the judiciary, who could declare all naked short-selling market manipulation as a matter of law, but then set a high bar for damages assessments by requiring proof of real economic harm. If companies can prove that but for naked short-selling, their stock price would not have declined to the extent it did—a test that requires them to affirmatively prove their business model, management practices, and/or products were not to blame—they deserve a remedy. If they cannot, they do not. The problem with that open-door approach is that while the court system sorts out deserving plaintiffs from frivolous ones, the defendant brokerages, hedge funds, and the DTCC incur legal expenses, discovery burdens, and perhaps undeserved negative publicity.

Another option is to place the burden with the regulators. Rule 10b-21, the recent amendments to Regulation SHO, and movement toward publicly releasing timely information on delivery failures are all good steps for the SEC, but they are reactionary in approach. Thus, long-term, the SEC should consider an overhaul of DTCC systems, including greater transparency, to better curb naked shorting abuses and rebut the

348. Rob Wherry, *Wall Street's Next Nightmare?*, FORBES.COM, Oct. 5, 2003, available at <http://www.forbes.com/forbes/2003/1013/066.html> (quoting John O'Quinn).

DTCC's persistent refrain of "It's not our job to regulate or enforce, therefore naked short selling is not our fault." Further, the SEC must back up rule 10b-21 with more aggressive enforcement measures. FINRA, too, must proactively enforce its affirmative determination rule and consider ways it might better cooperate with the SEC in releasing accurate information about delivery failures and their causes.

Wrongs, no matter how small or infrequent, must be checked with remedies. But until a court declares naked short selling as market manipulation as a matter of law and clarifies the issuer's and investor's burdens in proving the occurrence of naked short selling, the practice will continue without a check from the judiciary. And until the executive or legislative branches effect better regulation and accountability, that means there is no real check at all.