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The Alternative Uptick Rule - Restoring Short Selling as an Asset to the Market and Striking a Regulatory Balance Between Those That Favor or Oppose Regulation

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By David Max Fleischer*

I. Introduction

The majority of stock holders[1] purchase and hold stocks with an expectation that the stock will gain value over time.[2] Imagine that you purchased shares of stock in the company Bear Stearns in the year 2008, or perhaps had held these shares for years. During the week of March 11, 2008 to March 17, 2008 the value of Bear Stearns stock dropped from $62.97 to $2.00 per share.[3] You would expect that everyone who held this stock suffered some level of loss financially. The expectation is that all the holders of the security lost between $.01 per share up to $60.97 per share. Imagine hearing that not of all the holders of Bear Stearns lost money, some holders of Bear Stearns stock actually made a huge profit on this decline of value! Some investors may have made a mirrored dollar of profit for each dollar that declined. That information may not sit well with investors and often leaves investors with many questions. Profiting from a decline in stock price is possible because some investors participate in a practice called short selling. Short selling is a legally accepted investment practice where an investor sells borrowed stock with the expectation that the price will decline. The practice of short selling has been occurring since the early 1900's and has gone through phases of regulation and de-regulation by the Securities and Exchange Commission (SEC). The latest de-regulation occurred in 2007 shortly before the latest stock market crash of 2008. After the crash there was conjecture

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[1] Merritt B. Fox, Lawrence R. Glosten, Paul C. Tetlock, *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y.L. SCH. L. REV. 645, 646 (2010).

[2] http://www.investopedia.com/terms/l/long.asp#axzz1dj1Nro5R.

[3] Richard E. Ramirez, *Falling Short: Has the SEC's Quest to Control Market Manipulation and Abusive Short-Selling Come to an End, or Has it Really Just Begun?*, 2 NO. 1 U. PUERTO RICO BUS. L.J. 76, 83.

as to the role of short selling in the financial crash. Recently, in 2010, the SEC re-enacted regulation of short selling by promulgating the Alternative Uptick Rule. The Alternative Uptick Rule restores short selling to its position as an asset to the market and strikes a regulatory balance between those that favor or oppose regulation.

This paper will provide a history and overview of short selling since the enactment of the Exchange Act of 1934. Part I reviews the definition of short selling and its history until the crisis of 2008. Part II will explore the market and regulatory response to the recall of the uptick rule. This section will review each of the perceived positives and negatives of short selling as applied to a regulated or de-regulated market. Part III will review the decision of the SEC to re-instate an uptick rule and how this alternative uptick rule restores short selling to its position as an asset to the market and strikes a regulatory balance between those that favor or oppose regulation.

PART I – Short Selling and Regulation – A Background

Stock holders purchase stocks, have been given stock certificates from a family member, or perhaps even received stock as compensation from their employer. If these investors are holding the stock with the expectation that the security will rise in value, the financial term is known as holding a long position.[4] An alternative investing practice, one which is based on the belief that a security's price will decline, is called a short position or short selling.[5] Short sales are the sale of borrowed stock. A stock is borrowed and sold on the market. The borrower immediately sells the borrowed stock at the current market price and deposits the proceeds into their margin account.[6] Since the stock is borrowed, the investor is required to replace that stock.

[4] http://www.investopedia.com/terms/l/long.asp#axzz1dj1Nro5R

[5] http://www.investopedia.com/terms/s/short.asp#axzz1eCHVnWFe

[6] See JAMES D. COX, ROBERT W. HILLMAN, DONALD C. LANGEVOORT, SECURITIES REGULATION CASES AND MATERIALS 6TH EDITION (2009). A margin account is an account held by an investor that is authorized by the Federal Reserve Board. This

Because the investor believes that the price of the stock will fall, the goal is to repurchase the stock at a lower price and then subsequently return the stock to the original owner. If done properly this will generate a profit for the investor.[7] Consider this hypothetical situation to explain short selling. An investor believes that HypoStock which is currently trading for $100 will be valued at $80. If the investor were to own shares of HypoStock, then the loss in value would result in a lowering of the net worth of the investor. If the investor does not own HypoStock, then the investor can participate in a short sale to profit on the loss of HypoStock value. The investor borrows a share of HypoStock and sells it as a short sale. The investor receives $100 which is placed into his margin account. Since the stock is borrowed, the investor must replace it with the same stock. The investor's hunch was correct and the value of HypoStock falls to $80. The investor buys a share of HypoStock at $80, and returns that share of stock to the individual that it was borrowed from. The investor earns $20 from this transaction.[8] Short selling can be perceived as a, "bet against the team', anti-economic growth, or 'un-American'"[9] as an investor earns a profit when the stock price drops. This perception is a reason why short selling has been regulated.

Regulation of the securities market has its foundation in the creation of the Securities and Exchange Commission (SEC) which was created by the Securities Exchange Act

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account is a loan that the investor takes from a broker-dealer in order to invest into the market. A margin account allows an investor to take a larger financial position albeit with a larger amount of risk. A broker-dealer charges an investor interest and transaction costs. The New York Stock Exchange requires that a margin account contain 25 percent of the value of the long securities in the investors account. Once the value of the margin account dips below that percentage, the investor may need to add additional funds to the margin account to regain the 25 percent value. This is known as a margin call. Margin calls added to the 2008 stock market crash.

[7] Division of Market Regulation: Key Points About Regulation SHO, (April 11,2005), *available at* http://www.sec.gov/spotlight/keyregshoissues.htm.

[8] *id.*

[9] Melissa W. Palombo, *Why a Short Sale Price Test Rule Is Necessary in Today's Markets*, 75 BROOK. L. REV. 1447,1458 (2010).

of 1934.[10] The Securities Exchange Commission's mission is, "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[11] The SEC was given the authority to protect investors which includes the authority to regulate short sales.[12] The mission of the SEC is accomplished by issuing new rules and amending existing rules.[13] The Securities Exchange Act of 1934 states that securities markets are vulnerable to manipulation.[14] Short selling is viewed as manipulative by both CEO's and politicians.[15] Even though manipulation is not defined in the Securities Exchange Act[16] it has been defined by various commentators.[17] Conduct is defined as manipulative, "if it is designed to do one of three things: (1) interfere with free play of supply and demand, (2) induce people to trade; or (3) force a security's price to an artificial level."[18]

The Uptick Rule (10a-1) was created to prevent or reduce manipulative short selling.[19] The SEC in 1938 adopted rule 10a-1 which limited the short sale of a security.[20] A security to be sold as a short sale may only be purchased if the security was, "at a price higher than the immediately preceding sale price of the security."[21] Alternatively if, "the short sale was at the same price as the last sale price so long as the last sale price was greater than the last different

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[10] 15 U.S.C.A. § 78d (West)
[11] http://www.sec.gov/about/whatwedo.shtml
[12] 2010 WL 675942 (S.E.C. Release No.), 8.
[13] http://www.sec.gov/about/whatwedo.shtml
[14] Steve Thel, *$850,000 in Six Minutes – The Mechanics of Securities Manipulation*, 79 CORNELL L. REV. 219 (1994).
[15] Fox, supra note 1, at 646.
[16] Daniel R. Fischel and David J. Ross, *Should the Law Prohibit "Mauipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 506 (1991).
[17] *id*. at 507.
[18] *id*. at 507.
[19] Joshua Kenneth Partington, *The Down-Low on the Uptick: Why Rule 10-A Will Not Deter Naked Short Selling*, 15 NEXUS: CHAP. J.L. & POL'Y 163, 164 (2010).
[20] Ruth A. Hargens Horvatich, *The Long and Short of It: The Securities and Exchange Commission Should Reinstate A Price Restriction Test to Regulate Short Selling*, 43 CREIGHTON L. REV. 593 (2010).
[21] *id*. at 593.

price of the security"[22] the investor can proceed with the short sale. The Uptick rule (10a-1) was promulgated to combat manipulation specifically to reduce extreme price drops and to combat bear raids.[23] Extreme price drops may induce investors to trade as the securities price may have been forced to an artificially low level.

On at least four occurrences in the last 75 years the regulation of short selling has come into the spotlight. After the stock market crash in 1929, regulations were imposed to guard against manipulative short selling and there was consideration to ban short selling.[24] The stock market decline that occurred in 1987 unleashed another round of attention towards short selling.[25] More recently after the events of September 11, 2001, there was an investigation into an increase of short sales of airline and insurance companies' days before the attacks, to determine if there was any evidence of foul play.[26] Conversely, during the 70 years from 1938 until 2007 there were also attempts to remove the Uptick Rule. One such occurrence was in 1963 when a Special Study showed that the New York Stock Exchange had been requesting the Securities Exchange Commission to change the rule to allow short sales to be permitted as long as the price was higher than the previous days close.[27] In 1976 an investigation by the Securities Exchange Commission led the Securities Exchange Commission to comment that manipulative practices that were being curtailed by the uptick rule were no longer affecting the market as had happened in the past. The increased surveillance by the Securities Exchange Commission and the improved reporting required to the Securities Exchange Commission created a more stable environment for investors by making it more difficult for manipulative attempts such as bear

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[22] *id.* at 593.
[23] Partington, *supra* note 19, at 169.
[24] Palombo, *supra* note 9, at 1455.
[25] *id.* at 1455.
[26] *id.* at 1455.
[27] Jonathan R. Macey, *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 805 (1989).

raids.[28] Despite all of these events and investigations, the uptick rule remained in effect until July 3, 2007 when it was repealed.[29]

Momentum to repeal the uptick rule gained ground when the Securities Exchange Commission created a pilot program in 2004 which temporarily removed the uptick rule for some securities.[30] This program lasted for two years. The Securities Exchange Commission was studying whether it should continue to enforce the uptick rule, eliminate the uptick rule, or make changes to the securities that the uptick rule governed.[31] Specifically the Securities Exchange Commission was testing "(1) whether or not the uptick rule was in fact controlling the downward movement of securities that were being sold short and (2) whether the rule was preventing naked short selling."[32] The SEC study removed the short sale uptick rule for approximately one-third of the largest stocks.[33] These stocks represented different levels of liquidity.[34] There was also a control group of similarly situated stocks. After two years, the results were analyzed. The Office of Economic Analysis stated, "[t]hat it found little empirical justification for sustaining short sale price test restrictions including the uptick rule."[35] Based upon the results of the study and public comments supporting the elimination of price test restrictions, the uptick rule was removed in July 2007.[36] After the repeal of the uptick rule, there were some disastrous results.

Two large investment banking companies, Lehman Brothers and Bear Stearns, collapsed in 2008 along with a stock market crash in October of that same year. Short sellers are believed

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[28] *id*. at 805.
[29] Hargens, *supra* note 20, at 598.
[30] *id*. at 596.
[31] *id*. at 597.
[32] Partington, *supra* note 19, at 171.
[33] Amendments to Regulation SHO, 74 FED. REG. 18,042-01 (April 20, 2009) (to be codified at C.F.R. pt.242)
[34] Hargens, *supra* note 20, at 598.
[35] *id*. at 598.
[36] *id*. at 598.

to be a reason for the rapid share price decline and a reason for the subsequent failure of these two firms.[37] One commentator even states that the 2008 economic crisis was, "triggered by the collapse of Bear Stearns." [38] Bear Stearns' collapse occurred between March 11, 2008 and March 17, 2008. During that time, there was an increase in short selling the stock. A set of options worth $1.7 million dollars was betting on the failure of Bear Stearns. During that week, there was an increase also in the Fails to Deliver[39] for short selling stock. This may signify that many investors were naked short selling. Naked short selling is when an investor fails to repurchase and replenish the stock after a short sale, which is referred to as a "Fails to Deliver." The combination of rumors, Fails to Deliver, and investor confidence drove the stock price of Bear Stearns from $62.97 on March 11,2008 to $2.00 on March 17, 2008.[40] The final result was that Bear Stearns was sold to JPMorgan Chase & Co..[41] Lehman Brothers was another investment firm that also failed in 2008. The failure of Lehman Brothers was attributed to manipulation and rumors. The form of manipulation was 32.8 million shares of stock that was not delivered after short selling. Two traders were rumored to be leaving and the company was going to be sold to Barclays Bank.[42] Not everyone believed that those two factors lead to the decline of Lehman Brothers, as there is conflicting belief that the failures were not due to short selling, but a lack of the Securities Exchange Commission's oversight of broker-dealers was a factor in these firms' failures.[43] In response to the failures of Bear Stearns and Lehman Brothers, and more recently

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[37] Erik R. Sirri, *Regulatory Politics and Short Selling*, 71 U. PITT. L. REV. 517, 519 (2010).

[38] Roberta S. Karmel, *The Future of the Securities and Exchange Commission As A Market Regulator*, 78 U. CIN. L. REV. 501, 528 (2009).

[39] See "Naked" Short Selling Antifraud Rule, 73 FR 61666-01. Fails to Deliver refers to a practice that occurs where an investor or a broker-dealer uses deception about their intention to deliver a security marked as a short sale, or a deception in the ownership of the securities and fails to deliver the securities that are required within the three day settlement period. Therefore the investor fails to deliver the security back to the purchaser.

[40] Ramirez, *supra* note 3, at 85.

[41] *id*. at 85.

[42] *id*. at 86.

[43] Karmel, *supra* note 38, at 521.

the credit crisis and market tumble of 2008, caused regulators to focus on short selling and how the elimination of the longstanding uptick rule factored into those events.[44] The Securities Exchange Commission responded to these results by issuing emergency orders.[45] One emergency order implemented on July 15, 2008 created restrictions on borrowing and delivery of securities for certain financial companies.[46] A second emergency order was implemented on September 17, 2008 which expanded delivery requirements on all securities, not only the financial companies.[47] And a third was implemented on September 18, 2008 which added a prohibition on securities of publically traded financial companies.[48] The Securities Exchange Commission was faced with the situation that they needed to re-regulate short selling.[49]

Regulatory Options Available To The Securities Exchange Commission

An approach that the Securities Exchange Commission could have taken to remove or eliminate additional regulation on short selling would be to rely on the initial rules promulgated by two acts, The Securities Act of 1933 and the Exchange Act of 1934. The 1933 Securities Act contains section 17(a) which prohibits "fraud or deceit" through the sale of securities.[50] Section 9(a) of the 1934 Act "prohibits the manipulation of securities prices."[51] Rule 10b-5 of the Exchange Act of 1934 contains language that enforces fraudulent short selling. "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

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[44] Palombo, *supra* note 9, at 1455.
[45] Hargens, supra note 20, at 601.
[46] *id*. at 601.
[47] *id*. at 601.
[48] *id*. at 601.
[49] *id*. at 602.
[50] Palombo, *supra* note 9, at 1474.
[51] *id*. at 1474.

employ and device, scheme, or artifice to defraud"[52] Returning on reliance of these rules would have removed almost all regulation of short sales. However, the SEC did not rely solely on these rules and needed to do something additional to regulate the market one again.

When the Securities Exchange Commission chooses to regulate there are different regulatory schemes and standards that the Securities Exchange Commission can undertake. There are four regulatory schemes and four standards that the Securities Exchange Commission can impose. Starting with regulatory schemes, the most restrictive is a complete ban on all short selling.[53] Less restrictive but still paternalistic would be a partial ban on short selling that is limited to time, industry or specific company.[54] The Securities Exchange Commission can tighten prohibitions on naked short selling by ensuring that there is a decline on fails to deliver.[55] Finally, the Securities Exchange Commission can return to the safety and security of the previous regulation of short selling, the original uptick rule.[56]

The four standards that the Securities Exchange Commission can use as a foundation for regulating short selling are detailed by the International Organization of Securities Commissions. The first of the four standards would be controlling the stability of financial markets through appropriate controls that would minimize the potential risks that could disturb the efficient functioning of the markets.[57] The second is implementing a reporting regime for short selling that gives the market and market authority's timely information.[58] The third is managing an effective compliance system along with an effective enforcement system to successfully regulate

[52] 93 A.L.R. Fed. 444 (Originally published in 1989).
[53] Douglas M. Branson, *Nibbling at the Edges-Regulation of Short Selling: Policing Fails to Deliver and Restoration of an Uptick Rule*, 65 BUS. LAW. 67, 71 (2009).
[54] *id*. at 71.
[55] *id*. at 71.
[56] *id*. at 71.
[57] Hargens, *supra* note 20, at 609.
[58] *id*. at 609.

short selling.[59] The fourth standard is to create proper exceptions for certain categories of transactions to promote market efficiency.[60]

Banning or preventing short selling is one of the schemes that the Securities Exchange Commission can use to regulate. There are reasons that argue against a ban which are liquidity, price discovery, and pricing efficiency.[61] However, the Securities Exchange Commission took emergency measures in 2008 and enacted a Short Sale Emergency Ban Order which lasted three weeks.[62] This ban prevented the short selling (minus some exceptions) of securities for 799 financial companies.[63] Some commentators argue that there was no positive impact on the stock market other than providing a political remedy to an economic crisis.[64] It has been stated that the Securities Exchange Commission was trying to prevent a "'crisis of confidence' resulting from sharp declines in stock prices."[65] The reaction from investors was not favorable. In fact, the Chief Executive of the New York Stock Exchange stated that he favored the return of the uptick rule over a complete ban on short selling.[66] After three weeks, the Securities Exchange Commission lifted its ban on short selling as it and the market believed that during a market crisis a a short sale price test would be a better solution.[67]

A price test is another way that the Securities Exchange Commission can regulate short selling. The price tests that the Securities Exchange Commission implements or proposes are not put into place to prevent or prohibit investors from short selling, they are implemented to manage

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[59] *id.* at 609.
[60] *id.* at 609.
[61] 2010 WL 675942 (S.E.C. Release No.), 14.
[62] 2010 WL 675942 (S.E.C. Release No.), 47.
[63] Palombo, *supra* note 9, at 1448.
[64] Luca Enriques, *Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View*, 30 U. PA. J. INT'L L. 1147, 1149 (2009).
[65] Palombo, *supra* note 9, at 1457.
[66] Palombo, *supra* note 9, at 1470.
[67] *id.* at 1487.

and lessen any negative consequences, especially in a declining market.[68] A price test allows a short sale to occur when a sale price equals or exceeds a reference price.[69] A price test is used to allow short selling to occur while keeping wild price drops in check.[70] Price tests have been described as a "permanent backstop" to assist with other regulation to curtail manipulative short selling.[71] Price tests can also assist to slow down bear raids or rapid declines in a securities price as a result of rumor, unconfirmed, or false information.[72] In fact the Securities Exchange Commission states that a factor in their decision to implement a price test rule was because of the, "recent turmoil in the financial sector and steep declines and extreme volatility in securities prices."[73]

During a rising market, price tests such as the proposed modified uptick rule will not restrict short selling.[74] In support of this belief, in 1999 when the Securities Exchange Commission welcomed comments on revising short sales, the Securities Exchange Commission stated that in a rising bubble market, short selling benefits the market. Commissioner Christopher Cox stated that, "[w]e need the shorts in the market for balance so that we don't have bubbles."[75]

Pricing manipulation is also less of a concern in a rising market.[76] A price test can also have negative effects on short selling. If a security is very active or has a low price then a price

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[68] Hargens, *supra* note 20, at 604.
[69]http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2948%5CSEC_Requests_Comment_On_New_Short_Selling_Price_Test.pdf.
[70] Hargens, *supra* note 20, at 604.
[71]Palombo, *supra* note 9, at 1481.
[72] *id*. at 1481.
[73] Amendments to Regulation SHO, 74 FED. REG. at 18042-01.
[74] Hargens, *supra* note 20, at 604.
[75] Branson, *supra* note 53, at 72.
[76] David P. McCaffrey, *Review of the Policy Debate over Short Sale Regulation During the Market Crisis*, 73 ALB. L. REV. 483, 484 (2010).

test imposes higher restrictions on those securities.[77] Periods of low volatility where there is not much movement on securities would restrict short sales.[78] And bid increments on a low priced stock with little movement that are high can also affect short selling.[79]

The question is if those scenarios add to the market the sustainable pricing efficiency, hedging strategies, and liquidity that the market requires to function, or if these restrictions only affect a small segment of investors. It appears that a price test rule does need to be in effect, looking at the history of the market with a focus on the failures of Bear Stearns and Lehman Brothers. Regulation by price tests looks to be a sustainable and necessary action that the SEC needs to continue implementing. The benefits of the price test rule, by slowing down bear raids and declining markets, has a greater effect on stabilizing the markets which affects many more investors than the percent of investors who are short selling.

A Circuit Breaker rule can be implemented by the SEC either in conjunction with a price test rule, or separately.[80] A Circuit breaker rule is defined as, "a measure designed to prevent panic selling by stopping trading after a security or an index has fallen by a certain amount."[81] The intent of the circuit breaker is to create a pause so investors or the SRO[82] can assess the situation that caused the trigger of the circuit breaker.[83] A circuit breaker can be dependent on a

[77] *id.* at 483.
[78] *id.* at 483.
[79] *id.* at 483.
[80] Hargens, *supra* note 20, at 604.
[81] Farlex Financial Dictionary (2009).
[82] See Cox, *supra* note 6, at 17. A SRO is a Self Regulating Organization. The Securities Exchange Act provides that there is to be regulation of securities through the Securities Exchange Commission in conjunction with SRO's. There are four types of SRO's. The NYSE is a SRO. The SEC defers to the SRO development of procedures for the market to function. Each SRO also proscribes their own set of requirements for a company to list on the stock exchange.
[83] Farlex Financial Dictionary 2009.

specific security or a sharp decline in price.[84] The SEC proposed two versions of a circuit breaker rule. The first was a Circuit Breaker Halt rule which would be triggered if a security dropped 10% in value in a day. The Halt rule would prohibit any investor from selling that security short for the remainder of the day.[85] The second Circuit Breaker rule was a Circuit Breaker Modified Uptick Rule. This circuit breaker would not halt trading after a 10% decline, rather it would trigger a price test rule.[86] Some commentators have stated that a circuit breaker is a solution for a problem that has already taken its course. One description of the rule is, "closing the barn door after the horse is gone."[87] A 10% decline and triggering of the circuit breaker could occur on successive days with short sellers starting off the next day with aggressive short selling.[88] However this scenario appears to be exactly what the circuit breaker rule is manufactured for. Investors would have given pause during the previous day's trading and short selling would be curbed or limited by a price test rule which would allow holders of long positions to determine if they wish to sell or hold their positions.[89] The next morning, after contemplation of the previous day's events, if short sellers wish to continue with their plan of action both short sellers and long sellers have had sufficient time to contemplate their decisions and take appropriate action.

Securities Exchange Commission's Choice in Implementing a Regulatory Scheme

Once the decision had been made to implement a price test rule, the Securities Exchange Commission had a few options in regards to the type of price test rule that it could choose to

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[84] Hargens, *supra* note 20, at 604.
[85] Branson, *supra* note 53, at 73.
[86] *id.* at 73.
[87] *id.* at 85.
[88] *id.* at 85.
[89] Ramirez, *supra* note 3, at 96.

implement. There were four options available to the Securities Exchange Commission. Two options for price tests and two options for a circuit breaker rule. The options were, "a modified uptick rule, a proposed uptick rule, a circuit breaker halt rule, or a circuit breaker price test rule."[90]

The modified uptick rule short sale price test is based on the national best bid of a security.[91] A national best bid is a central price that is the highest bid amongst all the markets.[92] Under a modified uptick rule, a short sale can not be traded at a price that would be lower than the national best bid.[93] The second option was the alternative uptick rule. This rule would use the last sale price of the security not the national best bid.[94] A short sale could not be made below the last sale price, unless the last sale price is above the last different price of that stock.[95] Arguments in favor of implementing the modified uptick rule are based upon the foundation of the national best bid as the price to regulate a short sale.[96] In the end, after the Securities Exchange Commission reviewed its options and comments it went with the, "Alternative Uptick rule for the remainder of the day and the following day if the price of an individual security declines intra-day by 10% or more from the prior day's closing price for that security as determined by the covered security's listing market"[97]

Regarding the circuit breaker rule the Securities Exchange Commission decided on a circuit breaker which would be based upon if the price of a security declined by 10% or more is

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[90] Hargens, *supra* note 20, at 603.
[91] *id.* at 602.
[92] *id.* at 603.
[93] *id.* at 602.
[94] *id.* at 603.
[95] *id.* at 603.
[96] *id.* at 616.
[97] 2010 WL 675942 (S.E.C. Release No.), 5, 11251.

based off of the listing market for the stock at the end of trading for the previous day.[98] The Securities Exchange Commission received multiple comments regarding the approach that they should use. The arguments presented for and against the circuit breaker centered on the premise of either having a price test with a circuit breaker or a permanent market wide restriction.[99] The Securities Exchange Commission's position is that market impediments should not overshadow the market, and therefore the best cause of action to benefit the market using a narrowly tailored approach would be to implement the circuit breaker rule in conjunction with the price test.[100]

Based upon all the history, de-regulation, and implementation of emergency orders, public and private commenting, the Securities Exchange Commission promulgated the rule 17 CFR Part 242, Amendments to Regulation SHO on March 10, 2010.[101] This final rule adopted among other things that there will be a short sale price test or restriction which will impose a short sale related circuit breaker, which when triggered will impose restrictions on the price which a security may be sold short.[102] These restrictions are that policies are to be put into place to prevent the short sale at a price that is less than or equal to the current national best bid if the price of the security decreases 10% or more from the previous day's closing. The restriction is enforced for the remainder of the initial day including the following day.[103] The Securities Exchange Commission stated that this is a narrowly tailored rule, which prevents "potentially manipulative or abusive short selling from driving down the price of a security that has already experienced a significant intra-day decline."[104] It is important that the Securities Exchange

[98] 2010 WL 675942 (S.E.C. Release No.), 5, 11251.
[99] 2010 WL 675942 (S.E.C. Release No.), 5, 11251.
[100] 2010 WL 675942 (S.E.C. Release No.), 5, 11252.
[101] 2010 WL 675942 (S.E.C. Release No.), 1.
[102] 2010 WL 675942 (S.E.C. Release No.), 1.
[103] 2010 WL 675942 (S.E.C. Release No.), 1.
[104] 2010 WL 675942 (S.E.C. Release No.), 1.

Commission created this narrowly tailored rule to prevent manipulation and abuse, as there are many views regarding short selling and whether it should be permitted or restricted. Those that favor short selling[105] always point to pricing efficiency, hedging, and liquidity, while those against mention bear raids, naked short selling, investor confidence and public perception. This rule, Amendments to Regulation SHO, assists the Securities Exchange Commission with the negative connotations of short selling, while allowing it to accentuate the positive benefits of short selling. The next section will review each of the positive and negative aspects of short selling against the current regulatory scheme to show that the Alternative Uptick Rule restores short selling to its position as an asset to the market and strikes a regulatory balance between those that favor or oppose regulation.

PART II – The Alternative Uptick Rule as Applied to Regulatory Standards and Schemes

As discussed above, for all of its difficulties and negative associations short selling has endured because it adds benefits to the market. One of the reasons why the Uptick Rule was re-introduced was to allow short selling to be managed in order to retain its useful character. Chairman Mary L. Schapiro of the Securities Exchange Commission stated in her speech supporting the enactment of Rule 201 that, "[t]he reason this rule makes sense is because it recognizes that short selling can potentially have both a beneficial and a harmful impact on the market – depending on the circumstances."[106] The circumstances generally stated as positive are

[105] See Horvatich, *supra* note 20 at 604. The Securities Exchange Commission recognizes liquidity and pricing efficiency as assets to the market. *id.* at 611. Regulation of short selling should not restrict hedging which provides a benefit to the market.
[106] Speech by SEC Chairman: Statement at SEC Open Meeting – Short Sale Restrictions by Chairman Mary L. Shapiro, (February 24, 2010), *available* at http://www.sec.gov/news/speech/2010/spch022410mls-shortsales.htm.

adding liquidity to the market, hedging investments[107] and pricing efficiency.[108] Circumstances generally stated as negative are manipulation (including bear raids)[109] and naked short selling.[110]

Liquidity is an important provision for a market to function. It is stated that liquidity lacks a precise definition however it is linked to the, "ability to trade immediately.'[111] A liquid asset is capable of easily being converted into cash.[112] Commissioner Parades in a speech given at the Fordham Law School on October 27, 2011 stated that liquidity on the market means that when a seller wants to sell, there is someone to buy.[113] In the Amendment to Regulation SHO, the Securities Exchange Commission defines liquidity as, "[...] market liquidity by, for example, adding to the selling interest of stock available to purchasers, and, when sellers are covering their short sales, adding to the buying interest of stock available to sellers."[114] Market liquidity is affected if investors do not invest in the market.[115]

Liquidity is decreased because investors' capital is otherwise engaged in holding stock as inventory.[116] Short selling adds liquidity to the market therefore when the Securities Exchange Commission was seeking comments on Regulation SHO in 2003, the commission was interested in studying the effects of unrestricted short selling on liquidity.[117] Short selling adds liquidity to the market when a short seller purchases shares on the open market to return to the lender.[118]

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[107] Fox, *supra* note 1, at 646.
[108] Short Sales, 68 FR 62972-01.
[109] Short Sales, 68 FR 62972-01.
[110] "Naked" Short Selling Antifraud Rule, 73 FR 61666-01.
[111] Macey, *supra* note 27, at 811.
[112] Black's Law Dictionary (9th ed. 2009).
[113] Speech by Commissioner Parades at Fordham University, October 27,2011.
[114] Amendments to Regulation SHO, 74 FR 18042-01.
[115] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 2007 WL 1701940 (U.S.), 8 (U.S.,2007)
[116] Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for Otc Derivatives*, 48 DUKE L.J. 701, 716 (1999).
[117] Short Sales, 68 FR 62972-01.
[118] Short Sales, 68 FR 62972-01.

Mostly this is provided by market professionals[119] who use short selling to offset temporary imbalances when buying and selling.[120] When short sellers must purchase securities to replace securities borrowed, this may increase the interest in that security, adding to liquidity.[121] Based on these factors, it appears that any regulation of short selling may reduce liquidity on the market which could have negative consequences. Investors that are opposed to a re-instatement of the uptick rule quickly point to a decrease in liquidity in the market.[122] Regulation may add costs to transactions which could be passed onto investors.[123] Also regulation may cause a decline in trading or investing in the exchange markets because the regulation may be more restrictive than what was previously in place.[124]

However, there are arguments that favor regulation. The Securities Exchange Commission believes that without regulation of Short selling, precisely Fails to Deliver[125], it is, "questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is in fact engaged in providing liquidity for customers, or rather is engaged in a speculative trading strategy."[126] The Securities Exchange Commission states that an exception for market makers would not decrease liquidity as the price test allows unrestricted trading at the offering price as well as a price that is one cent or higher.[127] As well, the Securities Exchange Commission believes that regulation of short sales with a bid test would allow

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[119] See Ronald J. Gilson Reinier, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 571 (1984). A market professional is part of a group of professionals who evaluate and research companies for information. Included in this are portfolio managers, brokers, investment professionals, and researchers
[120] Short Sales, 68 FR 62972-01.
[121] Short Sales, 68 FR 62972-01.
[122] Amendments to Regulation SHO, 74 FED. REG. at 18042-01.
[123] Short Sales, 68 FR 62972-01.
[124] Short Sales, 68 FR 62972-01.
[125] Fails to Deliver is defined as when parties to a transaction do not meet their obligation. Specifically in a short sale scenario the seller does not replace the borrowed shares to the original owner. http://www.investopedia.com/terms/f/failuretodeliver.asp#axzz1f9SJadZD.
[126] Short Sales, 68 FR 62972-01.
[127] Short Sales, 68 FR 62972-01.

liquidity to remain, where previously, certain market strategies were exempted from rule 10a-1 to allow for market liquidity when these strategies were "providing liquidity in response to customer buy orders."[128]

After considering each of the views of liquidity, it appears that liquidity is best served by regulation. Without regulation, liquidity would occur, however at the possible detriment of the market as a whole. Manipulative strategies would be harder to recognize. Regulation appears to have some additional costs but still allows the market to retain an amount of liquidity that supports a well-tuned market. Regulation can continue to add to the market the benefit of liquidity without the negative associations. Liquidity is closely tied to hedging, and they appear to work in tandem in regards to short selling.

Hedging is when an investor, "takes opposite positions in similar assets" to reduce their risk.[129] This is accomplished by the strategy of holding long positions (purchasing stock without intent to short sell) that will increase in value as the market increases with short positions (purchasing stock marked as short sale) that will increase in value as the market goes down.[130] Hedging is linked to liquidity because the less risk that a trader exposes themselves to, the larger investment they may make into the market.[131] When the Securities Exchange Commission banned all short selling during the Short Sale Ban Emergency Order, it was met with concerns from commenters that there were no exceptions for activities such as hedging.[132] Investors believe that hedging should not be regulated because the fear of manipulation is lowered as the

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[128] Short Sales, 68 FR 62972-01.
[129] Macey, *supra* note 27, at 811.
[130] McCaffrey, *supra* note 76, at 483.
[131] Macey, *supra* note 27, at 812.
[132] 2010 WL 675942 (S.E.C. Release No.), 47.

investor's gains from hedging are offset by losses, which results in an "economically neutral position."[133]

Short selling is not just investors who believe that there will be a price decline.[134] The largest share of short selling is comprised of market makers or institutional investors who hedge not specifically targeting a security to decline in price, rather as a technique that is based on the pricing differences of different securities.[135] Investors may also hedge because they own a bond with an embedded call option, therefore the investor wishes to sell the stock short and hold a long position on the bond.[136] If regulation increases costs of hedging then it lowers the benefits of hedging including lowering liquidity.[137] Regulation, specifically the circuit breaker rule, may create a scenario which could cause a delay in trading for market makers who are hedging and could negatively impact options markets.[138] The Securities Exchange Commission admits that regulation will not prohibit short selling to hedge, but it could increase the cost of adjusting a hedge if the market declines significantly.[139] Although regulation on hedging appears to have some more potential negative effects on the market than with liquidity, nonetheless the Securities Exchange Commission puts forth the view that hedging will be a viable trading strategy under the Alternative Uptick Rule.

The Security Exchange Commission believes that the Alternative Uptick Rule allows hedging to remain viable as even if the circuit breaker has been triggered, as there still will be investors willing to purchase within the parameters of the alternative uptick rule, which will

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[133] Short Sales, 68 FR 62972-01.
[134] Sirri, *supra* note 37, at 520.
[135] McCaffrey, *supra* note 76, at 483.
[136] Sirri, *supra* note 37, at 520.
[137] Macey, supra note 27, at 823.
[138] 2010 WL 675942 (S.E.C. Release No.), 63.
[139] 2010 WL 675942 (S.E.C. Release No.), 130.

result in investors short selling hedging transactions.[140] Hedging increases liquidity[141] which is shown above to be a valuable necessity to the market. It appears that hedging has a delicate balance with the market, and that regulation that prohibits hedging could have widespread negative effects on the market. The Alternative Uptick rule eliminates exceptions for hedging which were present with the original Uptick Rule. It remains to be seen if the Securities Exchange Commission can keep the Alternative Uptick Rule exception free.

The third positive circumstance of Short Selling is pricing efficiency. Pricing efficiency is a theory that the market price of a security already factors in all available publicly available information.[142] Short sellers are publically indicating to the market that they believe that the market price of a security should be lower. The combination of holders of long positions and short positions therefore gives a more accurate reflection of the securities market price.[143] There are some beliefs that short selling creates an undervaluation of stocks.[144] However, market professionals are thought to provide a rational view of the stock price in relation to its value.[145] Furthermore, the Securities Exchange Commission states that pricing efficiency is required for smooth functioning of the market.[146]

If the Securities Exchange Commission were to ban short selling it would negatively affect pricing efficiency. In the law journal note Review of the Policy Debate Over Short Sale Regulation During the Market by David P McCaffery, the author reviews multiple studies and posits that, "the largest share of empirical research in the debate over short selling concludes that

[140] 2010 WL 675942 (S.E.C. Release No.), 63.
[141] Macey, *supra* note 27, at 812.
[142] http://www.investopedia.com/terms/p/price-efficiency.asp#axzz1f9SJadZD
[143] 2010 WL 675942 (S.E.C. Release No.), 7.
[144] McCaffrey, *supra* note 76, at 491.
[145] William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in A Time of Madness?*, 54 EMORY L.J. 843, 847 (2005).
[146] 2010 WL 675942 (S.E.C. Release No.), 5.

short selling does in fact enhance pricing efficiency."[147] Partially banning short selling by limiting it to specific times, industries, or companies without exceptions would also affect pricing efficiency. Merrill Lynch, a large brokerage firm, wrote in a letter to the Securities Exchange Commission that an exemption is needed "to prevent the uptick rule from interfering in an "unwarranted way" with actions that contribute to pricing efficiency among and between markets."[148]

Regulation of short selling via the Alternative Uptick rule as it affects pricing efficiency has received concerns. The Securities Exchange Commission states that it received comments stating that the Alternative Uptick rule will intensify market decline because investors will view short sales as a negative view of the value of a security, thereby causing buyers to drop off.[149] The Securities Exchange Commission relying on evidence that regulation of short selling under the previous Uptick Rule did not negatively affect pricing efficiency, states that it anticipates the Alternative Uptick rule will also not have a negative effect on pricing efficiency.[150] The Securities Exchange Commission reviewed empirical evidence that showed that the prior Uptick Rule did not have a negative effect on pricing efficiency and extends that belief to the current Alternative Uptick rule.[151] Because the Alternative Uptick rule will only restrict short selling on a declining market, during a rising market short selling will continue to provide the benefit of pricing efficiency.[152]

Pricing efficiency regulation appears to have an effect on the valuation of a security. As discussed above, the ability to determine the price of a security is dependent on allowing short

[147] McCaffrey, *supra* note 76, at 516.
[148] Macey, *supra* note 27, at 890.
[149] 2010 WL 675942 (S.E.C. Release No.), 23.
[150] 2010 WL 675942 (S.E.C. Release No.), 24.
[151] 2010 WL 675942 (S.E.C. Release No.), 24.
[152] Horvatich, *supra* note 20, at 624.

selling to remain as a viable trading strategy. The Securities Exchange Commission has stated that the alternative uptick rule's goal is to regulate manipulative short selling while not having an effect on pricing efficiency.[153] Manipulation can affect price efficiency which is why regulation is necessary for short selling. Manipulation was a concern that was addressed during the drafting of the Exchange Act of 1934 when Congress defined short sales as one of the practices that could be manipulative.[154]

Manipulation can take the form of a Bear Raid. A Bear Raid can be both an attempt or a successful lowering of a stock price. Certain investors try to create a perception to regular shareholders that there is a negative price outlook on the stock. The regular stockholders may sell off the stock, which will lower the stock price, therefore the short sale investor will generate a higher profit.[155] These short sales can make a declining market worse.[156] The successful bear raid creates the impression that the price of the security is falling because of true financial reasons, not because of the actions of a short seller attempting to increase their profit.[157] These actions fulfill all three elements of manipulative conduct as described in Part I. There is a greater fear that this conduct of bear raids could even affect the entire market negatively.[158] In fact, a study by the SEC in 1937 on the NYSE published that the newly imposed rule against short selling met the objective of "[p]revent[ing] short selling at successively lower prices-thus, eliminate[ing] the use of the short sale by the "bear raider" to drive the market down."[159] In 1976 when the Securities Exchange Commission was considering de-regulating short sales it was

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153 Palombo, *supra* note 9, at 1473.
154 Fischel, *supra* note 16, at 504.
155 Palombo, *supra* note 9, at 1455.
156 Horvatich, *supra* note 20, at 599.
157 *id.* at 599.
158 Macey, *supra* note 27, at 802.
159 *id.* at 803.

under the belief that improved reporting and monitoring would detect and stop traditional bear raids.[160]

Banning short selling would prevent a bear raid from occurring, but at the cost of pricing efficiency, hedging, and liquidity. A partial ban on short selling as to time, industry, or company could be beneficial for certain industries that may be more prone to this type of manipulation. However, the Securities Exchange Commission and various commentators of the Alternative Uptick rule believe that the rule regulates better when casting a wide net across all securities instead of narrowing the rules focus to specific time, place, or industry.[161] The Securities Exchange Commission's position is that regulation of short selling via the circuit breaker rule would specifically target short selling geared toward potential bear raids.[162] The circuit breaker rule applies to certain specific securities, those that have declined more than 10% in a single trading session, therefore the rule will only apply when a security is declining rapidly and not imposing a complete ban on a specific company or industry.[163] This approach assists in the elimination of bear raids and limits the impact to the market that may occur with other price restrictions on short sales.[164]

Other research has stated that the Alternative Uptick rule is only an effective remedy for eliminating bear raids for stocks that are traded on major exchanges.[165] This research states that securities traded on major markets are closely watched and less likely to be manipulated by rumor, unlike stocks that are traded thinly over the counter.[166] As a result, the position is that the

[160] *id.* at 804.
[161] 2010 WL 675942 (S.E.C. Release No.), 28.
[162] 2010 WL 675942 (S.E.C. Release No.), 5.
[163] 2010 WL 675942 (S.E.C. Release No.), 6.
[164] 2010 WL 675942 (S.E.C. Release No.), 29.
[165] Macey, *supra* note 27, at 821.
[166] *id.* at 822.

uptick rule is not a necessary component to prevent bear raids but in fact reduces other more important market aspects such as pricing efficiency and the ability to hedge.[167] Douglas Branson addresses this view in his note and dispels the belief that bear raids only occur to thinly traded over the counter securities. Branson states that bear raids are difficult to detect.[168] Evidence shows that bear raids have occurred to large companies including Bear Stearns and Lehman Brothers as discussed in part I.[169] The effect of a bear raid on a large company is that there is wider publicity of the event and both consumer confidence and market efficiency declines.[170] The alternative uptick rule provides the brake that the market needs to stop a securities decline and allow investors to review the data to understand if there is a bear raid in progress and react appropriately to stop the raid from occurring.[171] Another form of manipulation, naked short selling, has also been addressed by the Securities Exchange Commission.

Naked short selling invokes a strong response from investors. "The naked short selling scandal, which has largely been overlooked, equates to economic terrorism and should be stopped immediately. The next Microsoft or Apple Computer may have already been wiped out by these illegal activities."[172] This statement is indicative of multiple comments that the Securities Exchange Commission received when requesting comments before instating the alternative uptick rule. When the Securities Exchange Commission imposed the emergency order banning short selling for certain investment securities in July 2008, the agency stated that

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[167] *id.* at 835.
[168] Branson, *supra* note 53, at 74.
[169] *id.* at 74.
[170] *id.* at 74.
[171] *id.* at 82.
[172] 2004 WL 3388643 (S.E.C. Misc.), 1.

panic selling fueled by rumors can be intensified by naked short selling which would be a disruption of the markets.[173]

Naked short selling is when a seller misrepresents the ownership or source of shares that the seller must deliver back.[174] Abusive naked short selling is not defined but is described as "selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle."[175] Naked short selling affects the market in multiple ways. Naked short selling falsely increases the shares of stock available to trade and a high number of fails to deliver inhibits the Security Exchange Commissions ability to determine if the cause was indeed naked short selling.[176] The Uptick rule and Regulation SHO contains a locate requirement that helps to prevent fails to deliver.[177]

Banning short selling would be an option to prevent naked short selling. Regulating with a price restriction does not prevent the manipulative activity of naked short selling.[178] A price restriction such as the original uptick rule and the Alternative Uptick rule does not directly regulate naked short selling.[179] A price restriction rule makes it more difficult for naked short sellers to create a price decline because the uptick rule requires that the short sale occur at a higher uptick price.[180] Therefore a naked short seller has to consider the rise in price when saturating the market with sell orders to drive down the price of the security.[181] Regulation that

[173] 2010 WL 675942 (S.E.C. Release No.), 12
[174] "Naked" Short Selling Antifraud Rule, 73 FR 61666-01.
[175] "Naked" Short Selling Antifraud Rule, 73 FR 61666-01.
[176] Partington, *supra* note 19, at 167.
[177] "Naked" Short Selling Antifraud Rule, 73 FR 61666-01.
[178] "Naked" Short Selling Antifraud Rule, 73 FR 61666-01.
[179] Partington, *supra* note 19, at 170.
[180] *id.* at 170.
[181] *id.* at 170.

would deter or prevent naked short selling needs to address the fails to delivery issue and implement a penalty to those investors who do not deliver.[182]

Part III – The Alternative Uptick Rule Restores Short Selling To Its Position as An Asset

In 2004 the Securities Exchange Commission took steps to research the effect of repealing the uptick rule which had been in effect since 1938. The Securities Exchange Commission was interested in knowing if the uptick rule was a controlling factor in the downward movement of stocks, and if the rule was effective in preventing short selling. [183] Repealing the uptick rule in 2007 provided both sides of the ongoing short sale debate with a real world result of that decision. The collapse of two major financial institutions and a generally recognized stock market crash occurred shortly after the repeal.[184] The Securities Exchange Commission quickly implemented emergency orders to regain control of this financial situation. The final result was an introduction in 2010 of a new price restriction rule coupled with a circuit breaker, the Alternative Uptick rule.

The alternative uptick rule strikes a balance between banning short selling and the need for regulation in order to allow short selling to remain an asset to the market. This rule is superior to the previous uptick rule. The alternative uptick rule's superiority is that it allows investor's freedom to short sell and receive all the positive benefits of short selling until a 10% decline in price triggers the circuit breaker, and only then provides a price restriction to take effect to mitigate the negative consequences of short selling.

[182] Partington, *supra* note 19, at 180.
[183] *id.* at 171.
[184] Horvatich, *supra* note 20, at 604.

Short selling adds liquidity to the market and allows market professionals the opportunity to invest and transact in the market. A complete ban on short selling would negatively impact liquidity. The alternative uptick rule although restrictive, allows liquidity which is needed to support the market. Hedging is a valuable technique used by investors which assists additional risks and investment of greater sums in the market. A complete ban on hedging would be detrimental on the market. The alternative uptick rule allows hedging to remain a technique and while it may add some costs to hedging, the rule keeps hedging viable. Pricing efficiency gives all investors the true value of a security. The alternative uptick rule allows investors to indicate to the market the belief that a security is overvalued. A complete ban on short selling could lead to inflated securities valuation. The alternative uptick rule allows minimal interference with pricing efficiency.

The alternative uptick rule also assists with managing and preventing manipulation and manipulative practices from occurring. The alternative uptick rule's circuit breaker rule slows market decline and can frustrate attempts at a bear raid. This pause in the market allows both long position holders and short position holders a chance to evaluate and respond accordingly to a potential bear raid. The alternative uptick rule with the circuit breaker is also effective in assisting with the prevention of naked short selling.

The alternative uptick rule strikes a regulatory balance between those that favor or oppose regulation. The reinstatement of an uptick rule signaled that there needed to be some form of short sale regulation re-imposed onto the markets. The Securities Exchange Commission followed one of the standards advocated by the International Organization of Securities Commission. The Securities Exchange Commission controlled "the stability of the financial markets through appropriate controls on short selling that minimize the potential risks that could disturb the efficient functioning of the markets."[185] The Securities Exchange Commission reviewed the regulatory schemes available and addressed the situation in a manner that most regains a balance of regulation between those that favor or oppose regulation of short selling. This paper reviewed each of the positive and negative consequences of a price regulation against the regulatory schemes that were available to the Securities Exchange Commission. These schemes are a complete ban on short selling, a partial ban limited to time, industry, or company, or to restore the uptick rule.

If the original uptick rule had not been repealed, then the Securities Exchange Commission would not have had the same opportunity to review all available data and promulgate an updated rule for a new century. Granted, it is not certain that but for the repeal of the uptick rule would the crash of 2008 had occurred. However, the Securities Exchange Commission took this opportunity to review their previous decision, receive comments from the public, and craft a new rule to restore short selling to its position as an asset to the market and strike a regulatory balance between those that favor or oppose regulation.

[185] Horvatich, *supra* note 20, at 609.