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MORE MUSCLE BEHIND REGULATION SHO? SHORT SELLING AND THE REGULATION OF STOCK BORROWING PROGRAMS

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ABSTRACT

This Article is about the need for regulation of stock borrowing programs that, among other things, fail to disclose that the stock borrowed will often be sold short and that such sales may lead to a gradual, or even precipitous, decline in the stock's price. Using its police power over broker-dealers, the SEC could require that such programs provide a disclosure document, including a plain language risk factor statement, to every investor to whom the financial services firm offers participation in a stock borrowing program. Alternatively, lawyers could argue that, under the common law, participations in that program amount to investment contracts, and therefore securities, subject to formal or informal disclosure requirements.

INTRODUCTION

MOST experienced investors know what is involved in short selling. Betting that a stock's price will go down, rather than up, a short seller borrows stock that she then sells in the market. Subsequently, she reenters the market to "cover," hopefully buying an identical number of shares at a lower price. With the newly purchased shares, she replaces the shares she borrowed. Her profit, or loss, is the differential between the price at which she borrowed shares and the price at which she covered. She profits if the stock's price went down. She loses if she covers at a price higher than the price at which she earlier borrowed and sold the shares.¹

The standard margin account brokerage agreement gives the broker-dealer the unrestricted right to lend out stock that customers hold in their margin accounts.² In fact, the customers never know that the broker-dealer

1. See, e.g., RICHARD J. TEWELES & EDWARD S. BRADLEY, *THE STOCK MARKET* 171–72, 279 (7th ed. 1998); *SHORT SELLING: STRATEGIES, RISKS, AND REWARDS* 7–16 (Frank J. Fabozzi ed., 2004) (explaining short sale lending mechanics). See also SEC. & EXCH. COMM'N, DIVISION OF MARKET REGULATION: KEY POINTS ABOUT REGULATION SHO (2005), <http://www.sec.gov/spotlight/keyregshoissues.htm> [hereinafter *Key Points About Regulation SHO*] (footnote omitted):

A short sale is generally the sale of a stock you do not own (or that you will borrow for delivery). Short sellers believe the price of the stock will fall, or are seeking to hedge against potential price volatility in securities that they own.

If the price of the stock drops, short sellers buy the stock at the lower price and make a profit. If the price of the stock rises, short sellers will incur a loss.

2. See National Financial Services, LLC, Supplemental Application for NFS Margin Account Privileges, 4, http://www.oberweis.net/pdfs/Margin_Account_Application.pdf (last

has lent their stock. In actively traded stocks, each day the principal clearing entity, the Depository Trust Clearing Corporation (“DTCC”), and its subsidiary, the National Stock Clearing Corporation (“NSCC”), circulate an “Easy to Borrow” list that short sellers and their brokers peruse.³

Less actively traded stocks do not appear on the “Easy to Borrow” list. In fact, experienced brokers opine that one of the more difficult tasks they face is to borrow less actively traded stocks.⁴ There are several reasons for this. Many of the shares may still be in the hands of founders and their families (record ownership), or in brokerage house cash accounts (nominee or “street” name), rather than in margin accounts. The corporation may have earlier issued shares in an exempt transaction, which lead to restrictions on resale. Neither the corporation nor the shareholder may have seen fit or had the time to remove restrictive legends on the share certificates.⁵ Finally, shareholders in a particular company may tend to be long-term investors who hold their shares in record name, or in cash rather than margin accounts.

These reasons help to explain why stock borrowing may be difficult to locate in small- and medium-cap stocks.⁶ Consequently, many financial

visited Jan. 30, 2010) (“YOU ARE HEREBY AUTHORIZED TO LEND, HYPOTHECATE OR REHYPOTHECATE SEPARATELY OR WITH THE PROPERTY OF OTHERS, EITHER TO YOURSELVES OR TO OTHERS, ANY PROPERTY YOU MAY BE CARRYING FOR ME ON MARGIN.”) (upper case in original). Nowhere in the typical margin agreement does the broker-dealer clearly inform the customer that, pursuant to the clause, the broker may lend her shares to short sellers, thereby possibly contributing to decreases in the price of the stock. *See, e.g.*, James W. Christian et al., *Naked Short Selling: How Exposed are Investors?*, 43 HOUS. L. REV. 1033, 1057, 1057 n.183 (2006).

3. *See* Christian et al., *supra* note 2, at 1070. Presence on the list satisfies the “locate” branch of the borrowing requirement of Regulation SHO. *Id.* “Through its NSCC subsidiary, DTCC clears and settles virtually all broker-to-broker equity, listed corporate and muni bond and UIT trading in the U.S. . . .” DTCC: Welcome to Equities Clearance & Settlement Homepage, http://www.dtcc.com/products/cs/eq_index.php (last visited Jan. 30, 2010); Amendments to Regulation SHO, Exchange Act Release No. 34-60388, 74 Fed. Reg. 38,266, 38,268 n.35, 38,272 (July 27, 2009), *reprinted in* [2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,662, at 82,680 n.35, 82,685 (July 27, 2009) [hereinafter *Strict Close Requirement Release*].
4. *See, e.g.*, *Key Points About Regulation SHO*, *supra* note 1. (“[M]arket makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.”); Christian et al., *supra* note 2, at 1059 (“Often shares of small companies . . . are hard to find because founders and other initial investors hold the [sic] most of the shares in restricted form,” or at least in cash rather than margin accounts, so that broker-dealers cannot borrow the shares without the owner’s express consent).
5. *See, e.g.*, *infra* notes 91–92 and accompanying text (removal of restrictive legends).
6. Traders, stock market manuals, investment companies, and others define small cap companies as those whose stock market capitalization falls below approximately \$1 billion

service firms have formed stock borrowing departments and stock borrowing programs. Such programs offer holders above average returns (8% or 10% interest) and other inducements if the holders agree to lend their stock. An attractive feature is that the loans seem to be potentially short term: Contracts include the investor-lender's right to withdraw shares at the end of any month.

This Article is about the need for regulation of these stock borrowing programs that, among other things, fail to disclose that the stock borrowed will often be sold short and that such sales may lead to a gradual, or even precipitous, decline in the stock's price. Using its police power over broker-dealers, the SEC could require that such programs provide a disclosure document, including a plain language risk factor statement, to every investor to whom the financial services firm offers participation in a stock borrowing program.⁷ Alternatively, lawyers could argue that, under the common law, participations in such programs are investment contracts, and therefore securities, subject to formal or informal disclosure requirements.⁸

I. ADDED PRESSURES TO LOCATE AND BORROW STOCK: THE CAMPAIGN AGAINST NAKED SHORT SELLING

Selling short without having borrowed the stock in the first place, and with perhaps the intention of never borrowing the stock, is known as "naked short selling."⁹ Many stock market observers, and the SEC, believe that alone or in conjunction with other tactics (for example, "short and distort" campaigns), unscrupulous sellers use naked short selling to manipulate securities prices, forcing prices down to levels that bear no relationship to the

and medium cap as those whose capitalization falls below \$5 billion, or \$10 billion, depending upon the schematic. *See, e.g.,* Pat Regnier, *Defining the Categories*, MONEY, June 1, 1999, at 94, available at http://money.cnn.com/magazines/moneymag/moneymag_archive/1999/06/01/260993/index.htm.

7. *See infra* Section V.

8. *See infra* Section VI.

9. *See, e.g.,* Christian et al., *supra* note 2, at 1038; *Strict Close Requirement Release*, *supra* note 3, at 38,267, 82,678; Karl Thiel, *The Naked Truth About Short Selling*, THE MOTLEY FOOL, Mar. 24, 2005 ("Naked short sellers sell shares of stock they haven't borrowed, have no intention of borrowing, and that may not even exist."). Prolonged fails to deliver resulting from naked short selling may reach high levels. The amount of fails may exceed the number of shares in the public float of the security, resulting in great numbers of phantom shares. *See* Christian et al., *supra* note 2, at 1045. *See also* DOUG HENWOOD, WALL STREET: HOW IT WORKS AND FOR WHOM 31 (1998) (describing the mechanics of various "naked" securities transactions).

underlying economic reality.¹⁰ Traders use naked short selling to accelerate downward spirals in share prices.

In 2004, the SEC promulgated Regulation SHO, scheduled to take effect in early 2005.¹¹ Regulation SHO was the SEC's first salvo against naked short selling. The rule required that broker-dealers accept no more short sale orders for stock on the so-called "threshold list" unless the short seller owned the stock or had a credible agreement to borrow the stock. In September 2008, the SEC extended and broadened the regulation to cover all equity stocks and required that market participants close out failures to deliver at the open of the day following the close date. In other words, the SEC regulation required market participants to close out failures to deliver by the open of the day following T+3 (close of the third business day after the trader purported to sell stock), rather than in thirteen days as of old. In July 2009, the SEC made permanent as Rule 204 what had been temporary as Rule 204T, with one significant addition.¹² In addition to buying an identical number of shares to close out a failure to deliver, the permanent rule provides that for such purposes, market participants may borrow shares as well as buy them.

Since 2004 then, the SEC has increasingly ratcheted up the pressure on market participants to borrow shares.¹³ Both regulatory and enforcement efforts aim not only at policing but also at eliminating altogether naked short sales and failures to deliver.¹⁴ In turn, those added pressures raise

10. Former SEC Chairman Christopher Cox perceives distort and short campaigns as having "drastic consequences," leading the Commission to target them for special enforcement efforts. Christopher Cox, *What the SEC Really Did on Short Selling*, WALL ST. J., July 24, 2008, at A15. Earlier the SEC had issued 50 subpoenas to hedge funds suspected of spreading false rumors about companies and stocks. Kara Scannell & Jenny Strasburg, *SEC Moves to Curb Short Selling*, WALL ST. J., July 16, 2008, at A1.

11. See *infra* notes 40–41 and accompanying text.

12. *Strict Close Requirement Release*, *supra* note 3, at 38,266, 88,662.

13. See generally Amendments to Regulation SHO, Exchange Act Release No. 34-59748, 74 Fed. Reg. 18042 (Apr. 10, 2009), reprinted in [2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,601 (Apr. 10, 2009) [hereinafter *SEC Reform Proposals*]. See also 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, 70 (2009). Although to some degree, *Nibbling at the Edges* overlaps with this Article, that article is about SEC enactments and proposals for enactments (e.g., eliminating failures to deliver, curbing naked short selling, and restoring an uptick rule versus installation of circuit breakers restricting short selling in declining markets). This Article moves further afield, into areas where the SEC has yet to propose regulations, namely, in stock borrowing.

14. The SEC, or the applicable SRO, has instituted disciplinary actions against licensed professionals, most particularly the broker-dealer, for leaving open failures to deliver, thus violating Regulation SHO. See, e.g., *NYSER Imposes Largest Reg SHO Fine In Case Involving Deutsche Bank Securities*, 40 Sec. Reg. & L. Rep. (BNA) 1486, 1486 (Sept. 22, 2008) (fining

considerably the use and visibility of stock borrowing programs, along with the need to build into them protections that are “necessary or appropriate in the public interest or for the protection of investors.”¹⁵

II. BACKGROUND: SEC EFFORTS ON BEHALF OF INDIVIDUAL INVESTORS

A. The SEC’s Fall from Grace

“Once the guardian of the nation’s capital markets, known as an efficient regulator with a highly respected enforcement program, the [SEC] is now the subject of much criticism and is mired in scandal,” wrote securities attorney Thomas Gorman while reviewing the Commission’s activities during the 1990s and the Bush Administration.¹⁶ Since President Obama took office in January 2009, the SEC, led by SEC Chair Mary Schapiro, has undertaken a number of new regulatory initiatives, designed to impart a new tone at the top. Contrary to what Mr. Gorman wrote, noted commentator and attorney Stephen Crimmins said, “The Securities and Exchange Commission clearly has the Administration’s confidence and appears a winner in the opening phase of the financial services regulatory reorganization.” He continued, “[T]he Treasury proposal [for extensive reform of financial services regulation] now praises the SEC as ‘an experienced federal supervisor’ and . . . assigns it substantial new responsibilities.”¹⁷

B. Initiatives by or for the SEC for Individual Investors

The Obama administration wants all standardized derivatives to be traded on exchanges or cleared through the mechanisms of electronic trading platforms, where they would be subject to robust margin and record-keeping

five trading desks \$575,000 for failure to close positions after short sellers failed to produce borrowed securities in thirteen days).

15. This phrase is the lodestar the Commission must always keep in the forefront as it considers regulation. The enabling legislation is shot through with commands that the SEC continually follow this point of policy. *See, e.g.*, Securities Exchange Act of 1934 § 6(a), 15 U.S.C. § 78f(a) (2006) (rules governing national securities exchanges which the Commission “may prescribe as necessary or appropriate in the public interest or for the protection of investors”); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006) (adoption of antifraud rules—same); Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (2006) (adoption of proxy rules—same).
16. *Trends in SEC Enforcement 2009*, 41 Sec. Reg. & L. Rep. (BNA) 1255, 1255 (July 6, 2009).
17. *Securities Regulation Under the Obama Plan*, 41 Sec. Reg. & L. Rep. (BNA) 1209, 1209 (June 29, 2009).

requirements.¹⁸ Presently, such transactions often go unreported, even to the extent of taking place in back rooms. As part of the administration's proposals, the Treasury wants to require that hedge funds and private equity firms register with the SEC pursuant to the Investment Advisers Act.¹⁹

Closer to individual investor concerns, proposed Treasury reforms would require the classification of registered representatives (brokers) as fiduciaries in all cases, not merely when the broker or financial adviser had held herself out as being such.²⁰ The SEC could in effect (by a four out of five commissioner vote) put broker-dealer subsidiaries of large financial firms into involuntary "resolution" proceedings in which the SEC would be the conservator or receiver.²¹ Another plank in the new platform is the revocation of the ten-day rule, under which broker-dealers can vote shares on behalf of beneficial owners (often referred to as "street name" owners) if such beneficial owners had failed to vote, in part on the grounds that brokers never properly analyzed the issues, blindly voting with corporate management in most cases.²² These and other proposed reforms would widen and deepen SEC jurisdiction.

C. Reforms to Bring Back "A Sense of Urgency" to SEC Enforcement²³

SEC Chairman Mary Schapiro wants to put in place a number of measures that would make the agency's enforcement staff "more fleet-footed."²⁴ The SEC has taken or proposed to take certain steps, including the following:²⁵

18. *Id.* at 1209–10.

19. *Id.* at 1210.

20. *Id.* at 1210–11. Of course, a great, although perhaps not insurmountable, inconsistency exists between the broker-dealer's traditional role as a salesperson and his role as a fiduciary, requiring a duty of the utmost good faith and loyalty. *See generally* Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. (forthcoming 2010).

21. *Securities Regulation Under the Obama Plan*, *supra* note 17, at 1212. The SEC had already reversed itself on the near polar opposite, namely, no supervision or light supervision of large diversified financial firms. In fall 2008, after the failures and near failures of Lehman Brothers, Bear Stearns, and Merrill Lynch, the SEC terminated its voluntary supervision (supervision lite) program for "consolidated supervised entities" (CSEs). *Id.*

22. Sarah N. Lynch, *SEC Plan Aims to Better Foretell Risks*, WALL ST. J., July 2, 2009, at C3.

23. Kara Scannell, "Urgency" Drives SEC Crackdown, WALL ST. J., Aug. 11, 2009, at C1 (including comments of new SEC enforcement director Robert Khuzami).

24. *Id.*

25. These and other ways in which to bolster enforcement are also reviewed in detail by Professor Jayne Barnard. *See generally* Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. (forthcoming 2010).

- Returning Subpoena Power to the Staff from the Commission. Under former SEC Chairman Christopher Cox, attorneys had to seek authority from the full Commission before being able to sign and serve official discovery requests. The resulting delay caused considerable down time, or even dead time, in securities fraud investigations or other proceedings. One of Chairman Mary Schapiro's first reforms was to abolish the full Commission authorization requirement.²⁶
- Eliminating Extensions of Time for Wells Submissions.²⁷ A would-be defendant that has been a party to an SEC investigation is given a formal opportunity to present its side of the case, showing why it should not be sued. "The process will tighten by a good bit" under the new regime.²⁸ No extensions of time will be granted to putative defendants and their attorneys for these Wells submissions.
- Seeking the Authority to be Able to Pay Bounties to Whistleblowers. Presently, the SEC may only pay bounties, limited to ten percent, in insider trading cases. Chairman Schapiro wants to broaden the Commission's authority.²⁹ The SEC program would model itself after the Internal Revenue Service ("IRS") program, authorized by the Tax Relief and Health Care Act of 2006. Under the program, the IRS may pay whistle blowers from fifteen to thirty percent of the amount the IRS has recovered.³⁰

26. See, e.g., *The SEC's Blueprint to Reinovigate Enforcement*, 41 Fed. Sec. Reg. & L. Rep. (BNA) 669, at 671 (Apr. 13, 2009) (explaining that presently the duty officer or commissioners in seriatim may authorize a formal order allowing staff to use the agency's subpoena power).

27. Named after attorney John Wells who acted as Chairman of the SEC Advisory Committee on Enforcement Policies and Practices (1972). "Persons who become involved in preliminary or formal investigation may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation." X LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* §13.B.1, at 4977-78 (3d ed. 2005) (quoting SEC Rule of Practice 5(c) and describing procedure).

28. Yin Wilczek, *Enforcement Division to Tighten Processes; Penalty Guidance, Manual Are Under Review*, 41 Fed. Sec. Reg. & L. Rep. (BNA) 805 (May 4, 2009).

29. *The SEC's Blueprint to Reinovigate Enforcement*, *supra* note 26, at 669 (paraphrasing testimony of Chairman Schapiro before the House Committee on Appropriations and before the Senate Committee on Banking, Housing and Urban Affairs).

30. See Arden Dale, *Tax Whistle-Blowers Await Big Pay Day*, WALL ST. J., Oct. 14, 2009, at B5 (noting that in 2008 the IRS received 476 submissions, blowing the whistle on 1246

- Obtaining Collateral Bars Which Would Foreclose to Wrongdoing Professionals All Aspects of the Securities Business. Under the existing scheme, SEC attorneys may obtain bar orders against securities professionals only in business areas in which those professionals have been engaged (for example, a bar as to broker-dealer activity would not prohibit future affiliation with an investment adviser or a private equity firm).³¹ The administration proposal is for legislation granting the SEC authority to seek broader bars.³²
- Forming Specialized Investigative and Litigation Teams Within the Enforcement Division. There are now five units with specialized responsibilities for the following areas:
 1. Asset Management Companies;
 2. Market Abuse (including insider trading);
 3. Structured and New Products (such as credit default swaps);
 4. Bribery of Foreign Officials; and
 5. Municipal Securities and Public Pension Fund Wrongdoing (including “pay-to-play” allegations).³³
 Allocation of staff to pre-existing teams, with resources pre-allocated to those teams, will make for much quicker response times.
- Granting the SEC Staff Authority to Negotiate Civil Penalties without First Obtaining Commission Authorization. SEC-levied civil penalties had grown to \$800 million in 2003. Then SEC Chairman Christopher Cox instituted a policy requiring staff to seek from the full Commission a range of possible penalties before the SEC could enter into negotiations with a wrongdoer. Thereafter penalties dropped precipitously to \$637 million in 2006, \$310 million in 2007, and \$96 million in 2008. Chairman Schapiro revoked the Cox policy by allowing SEC staff to enter

taxpayers, yet after three years under the program, no whistleblower had received a cent.). Another complicating factor is that the SEC receives approximately 700,000 tips and referrals per year. *The SEC's Blueprint to Reinvigorate Enforcement*, *supra* note 26, at 669.

31. *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), holds that the SEC had no authority to seek wider bar orders. Previously, the Commission had tried to erect such bars. *See In re Westerfield*, Exchange Act Release No. 41,126 (Mar. 1, 1999), available at <http://sec.gov/litigation/opinions/3441126.txt>.
32. *See Securities Regulation Under the Obama Plan*, *supra* note 17, at 1212.
33. Kara Scannell, *SEC to Give Attorneys More Power*, WALL ST. J., Aug. 6, 2009, at C3; *Khuzami Cites Move to Specialized Teams, Other Initiatives to Improve SEC Enforcement*, 41 Fed. Sec. Reg. & L. Rep. (BNA) 849 (May 11, 2009).

into negotiations straightaway, without a detour to consult with commissioners.³⁴

D. Abandonment of Individual Investors—The Curious Case of Stock Borrowing Programs

Suddenly, on September 11, 2009, the SEC announced a two-day roundtable to be held on September 29–30 in Washington, D.C. The purpose of the roundtable was to discuss the main issue with which this Article deals, the regulation of stock borrowing.³⁵ The SEC program would address the concerns of “investors, corporate issuers, financial services firms, beneficial owner lenders, lending agents, borrowers of securities, self-regulatory organizations, international regulators and the academic community.”³⁶ The short advance notice made it very difficult for individual investor advocates, or indeed anyone from outside the New York–Washington D.C. corridor, to attend.

When the SEC announced the list of panelists, the list of persons and their affiliations confirmed any prediction that individual investor concerns would receive short shrift. Panelists included representatives from OneChicago, Pershing LLC, Citigroup, Invesco, Bank of New York Mellon, Ridgeworth Investments, Quadriserv, Brown Brothers Harriman, Sungard, eSecLending, State Street Corporation, Federated Investors, and Credit Suisse First Boston. The SEC list contained very few panelists who might be expected to voice individual investor concerns.³⁷

The SEC’s seeming slight of individual investors on this one issue, regulation of stock borrowing, is curious in light of all the other SEC-initiated reform efforts outlined above. This Article describes the predicaments individual investors might face and advocates possible solutions.

34. *See Back to the Future: Chairman Shapiro Ends Pilot Program for Corporate Penalties, Eliminates Commission Pre-authorization, Allows Staff to Negotiate*, 41 Fed. Sec. Reg. & L. Rep. (BNA) 307, 309 (Feb. 23, 2009).

35. Press Release, SEC No. 2009-196, SEC to Hold Securities Lending and Short Sale Roundtable (Sept. 11, 2009), <http://www.sec.gov/news/press/2009/2009-196.htm>.

36. *Id.*

37. *See* Press Release, SEC No. 2009-207, SEC Announces Panelists for Securities Lending and Short Sale Roundtable (Sept. 25, 2009), <http://www.sec.gov/news/press/2009/2009-207.htm>. (listing also, inter alia, representatives from the New Orleans Municipal Workers’ Retirement System and a professor from the University of North Carolina).

III. MORE ON THE SEC CAMPAIGN AGAINST NAKED SHORT SELLING

A. Adoption of Regulation SHO

As with the condemnation of “distort and short” manipulations, many market participants condemn the practice of naked short selling.³⁸ In theory, if short sellers do not have to, or simply do not, deliver shares which they have purported to sell, short interest in a stock can exceed the total number of shares outstanding. On a more realistic scale, when naked short selling takes place, short interest in a stock can mount rapidly, exerting excessive downward pressure on a stock’s price. Combined with the broadcast of false rumors, or an organized distort and short campaign, naked short selling can push a stock’s price so far down that the price level has no connection with underlying economic realities. Buyers of such stocks, deprived of delivery, do not have the right to receive dividends or to vote shares they have purchased. In the view of nearly every market participant, naked short selling, like the spread of false rumors, is a “hit out of bounds,” not considered to be within the boundaries marking a level playing field.³⁹

But how to police naked short selling? The SEC adopted Regulation SHO in August 2004, to take effect in January 2005.⁴⁰ The regulation forbids a broker-dealer from accepting a short sale order unless the would-be short seller has already borrowed the shares she proposes to sell, or has identified the shares she intends to borrow (the “locate” requirement).⁴¹

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38. See, e.g., Liz Moyer, *Crying Foul in Short Selling*, FORBES, June 21, 2006, available at http://www.forbes.com/2006/06/20/naked-short-selling-overstock-cx_lm_0621short.html; Thiel, *supra* note 9. In a distort and short campaign, short sellers and their confederates promulgate a number of misleading or even fraudulent press releases containing negative news about a company and its prospects. They then attempt, through short selling, to accelerate declines in the company’s share price first caused by the dissemination of negative news.
39. Cf. Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and a Modest Proposal for Letting More Shorts Go Naked*, 8 J. BUS. & SEC. L. 135, 145 (2008) (describing reasons why many market participants oppose naked short selling).
40. Regulation SHO, Exchange Act Release No. 50,103, 69 Fed. Reg. 48008 (2004), reprinted in Fed. Sec. L. Rep. (CCH) ¶ 87,244, at 80,813 (July 28, 2004).
41. A short seller must possess “reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due,” that is, by the close of the third business day after the trader purported to sell stock (T+3). SEC Rule 203(b), 17 C.F.R. § 242.203(b)(1)(ii) (2010). “This locate must be made and documented prior to effecting the short sale.” *Key Points About Regulation SHO*, *supra* note 1. Presence of the stock on DTC’s “Easy to Borrow” List satisfies the locate requirement. See Regulation SHO, *supra* note 40, at 48,014 n.59.

After the trade (sale of the shares), Regulation SHO reduces the duration for which failures to deliver are permitted to remain open. Broker-dealers must close out fail-to-deliver positions in “threshold securities” that have persisted for thirteen settlement days (the “closeout” requirement).⁴² Closeout means that the broker essentially will have to cover “open fails,” that is, the broker will have to buy in the requisite number of shares, closing out the short position.

A security is a “threshold security” if it is issued by an SEC reporting company and, over any running five-day period, fails to deliver equal or exceed 10,000 shares and 0.5% of the issuing company’s outstanding shares.⁴³

A broker-dealer cannot accept from any trader an order to sell short a threshold security if the trader has an open position (unfilled) in that security.⁴⁴ For two years following the original Regulation SHO’s adoption, the threshold list on average contained 300 names. It averaged 414 stocks in the first nine months of 2008, and peaked at 529 stocks as naked short selling of banks and other financial stocks crescendoed.⁴⁵

B. July 2008 Modification of SHO’s Application to Certain Financial Stocks

When the SEC revisited the regulation of short selling, the Commission announced that, effective July 21, 2008, and with license to continue for up to thirty days, the SEC would suspend the locate prong of Regulation SHO for

42. SEC Rule 203(b), 17 C.F.R. § 242.203(b)(1)(ii) (2010); *Key Points About Regulation SHO*, *supra* note 1.

43. *Key Points About Regulation SHO*, *supra* note 1. The various self-regulatory organizations (“SROs”), such as stock exchanges and the NASDAQ, are to disseminate daily lists of threshold securities that, inter alia, they publish on their websites. *Id.* Approximately 16,200 corporations (the number fluctuates daily) file periodic reports with the SEC. *See* ARTHUR PINTO & DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 150 n.19 (2d ed. 2004).

44. At the time of Regulation SHO’s adoption, Wall Street spokespersons expressed concern that the existence of a list (“Threshold Securities”) and the presence of issuing corporations’ names on it would result in less short selling, in turn permitting higher prices to persist. *See* Henry Sender, *New Rules Put the Squeeze on Shorts*, WALL ST. J., Jan. 27, 2005, at C5. The concerns never materialized. *See* Floyd Norris, *A New SEC Rule Fails to Raise Stock Prices, and Some Are Angry*, N.Y. TIMES, Feb. 18, 2005, at C1.

45. Tom McGinty & Jenny Strasburg, *Short Sellers Squeezed All Around*, WALL ST. J., Apr. 7, 2009, at C1.

nineteen of the most widely-traded financial stocks.⁴⁶ Would-be short sellers in those stocks would be required either to have borrowed the shares they proposed to sell short, or have a formal agreement from a lender to provide the requisite shares to the short seller on or before closing of a trade (T+3).⁴⁷ The prices of financial stocks had declined greatly. The SEC thought that a high level of short sales had contributed to the decline, or to the steepness of its slope.⁴⁸

On September 17, 2009, the SEC extended the T+3 mandate, requiring *all* open short positions to be closed out by the fourth day after the trade.⁴⁹ The number of stocks on the threshold list soon thereafter dropped well below two hundred, averaging seventy-nine in the first quarter of 2009.⁵⁰

Criticism of the SEC's efforts was nearly universal. Professor Owen Lamont, formerly of Yale, termed it a "silly but harmless" effort.⁵¹ The president of the Managed Funds Association, the hedge fund industry group, termed the SEC's actions "aberrant" and "without precedent."⁵² On the other side of the issue, the American Bankers Association expressed fear that with naked short selling curtailed for the largest banks, short sellers would

46. Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934, Exchange Act Release No. 58,166, 73 Fed. Reg. 42,379 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,247, at 86,944 (July 15, 2008).

47. *Id.* See also SEC Enhances Investor Protections Against Naked Short Selling, SEC Press Release 2008-143 (July 15, 2008), <http://www.sec.gov/news/press/2008/2008-143.htm> (announcing emergency rule making). "An arrangement to borrow requires more than a reasonable grounds to believe that the security can be borrowed. An arrangement to borrow means a bona fide agreement to borrow the security such that the security being borrowed is set aside at the time of the arrangement" Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Short Selling (July 18, 2008), <http://www.sec.gov/divisions/marketreg/emordershortsalesfaq.htm>.

48. See generally, Cox, *supra* note 10.

49. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,572, 73 Fed. Reg. 54,875 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,274, at 87,137 (Sept. 17, 2008). See also Statement From SEC Chairman Christopher Cox, SEC Press Release No. 2008-210 (Sept. 18, 2008), <http://www.sec.gov/news/press/2008/2008-210.htm> (adopting "a hard T+3 closeout" in cases of fails to deliver). The SEC adopted the strict or hard close requirement as an Interim Temporary Rule in October 2008. See Amendments to Regulation SHO, Exchange Act Release No. 58,773, 73 Fed. Reg. 61,706 (2008) *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,297, at 87,302 (Oct. 14, 2008).

50. McGinty & Strasburg, *supra* note 45.

51. Scannell & Strasburg, *supra* note 10, at A13.

52. *Id.* at A1.

focus on the banks not covered by the new SEC rules.⁵³ The rule's effect was immediate and startling. Price increases in the stocks of nineteen financial institutions covered under the SEC's emergency order ranged from highs of 89.5% (Fannie Mae), 74.5% (Freddie Mac) and 48.4% (Bank of America) to a mean of 27.5% and a median of 19.6%.⁵⁴ Short interest in some of those stocks had been high: 14.22% in Fannie Mae shares and 12.81% in Freddie Mac.⁵⁵ Relieved of naked short selling and its downward pressure on price, the share prices rebounded.

Of course, an argument may be made that curtailment of naked short sales merely prolonged the inevitable: Lehman Brothers shares, in which short interest had risen to 12.57%, rebounded 44.6%. Lehman Brothers entered bankruptcy in September 2008.⁵⁶ The same may be said of Fannie Mae and Freddie Mac—although they rebounded temporarily, their shares eventually became nearly worthless as well.⁵⁷

C. The SEC Returns to the Drawing Board

Many at the SEC believed that short selling had contributed to, inter alia, the collapse of Bear Stearns and Lehman Brothers.⁵⁸ So, in September, the

53. Kara Scannell, *SEC Short-Sale Rule Gets Negative Reviews*, WALL ST. J., July 19, 2008, at B1.
54. *Id.* at Tbl. "Shorts on Fire" (showing percentage change in stock prices from the day the new rule was announced on Tuesday, July 15, and Friday, July 18, 2008).
55. *Id.* On average, short interest amounts to 4% of the outstanding shares in individual stocks. See James S. Chanos, *Short Sellers Keep the Market Honest*, WALL ST. J., Sept. 22, 2008, at A23.
56. See, e.g., Jonathan G. Glater & Gretchen Morgenson, *Firm's Creditors, Large and Small, Compete for a Piece of What's Left*, N.Y. TIMES, Sept. 16, 2008, at C8 (the previous Sunday, Lehman filed the largest bankruptcy in history). See generally LAWRENCE G. McDONALD & PATRICK ROBINSON, *A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* 325 (2009) ("In the small hours of the morning, around two o'clock, Lehman Brothers filed for Chapter 11 bankruptcy. The 158-year-old investment bank was gone. It was Monday, September 15, in the year 2008. It was indeed the largest bankruptcy in history."). Wholesale" short selling of Lehman Brothers common stock began in May-June 2008). See, e.g., *id.* at 304.
57. See Eric Dash, *Few Stand to Gain on This Bailout, and Many Lose*, N.Y. TIMES, Sept. 8, 2008, at C1 (opining that shareholders would lose greatly in impending government takeover of mortgage giants). Nonetheless, on July 29, 2008, the SEC announced continuation of temporary rules to the maximum extent allowed, thirty days, until August 12, 2008. SEC Extends Order Limiting Naked Short Selling Through August 12, SEC Press Release 2008-155 (July 29, 2008), <http://www.sec.gov/news/press/2008/2008-155.htm>.
58. See generally, Susan Pulliam et al., *Anatomy of the Morgan Stanley Panic—Trading Records Tell Tale of How Rivals' Bearish Bets Pounded Stock in September*, WALL ST. J., Nov. 24, 2008, at A1 (identifying bear raids and possible naked short selling in many financial stocks).

Commission adopted additional temporary rules:

- The SEC increased penalties for short sellers who rely on the locate requirement and then fail to deliver on T+3. After any such failure to deliver, the SEC will bar the broker-dealer from executing any short sale unless the trader actually has borrowed the shares before placing the order.⁵⁹
- The SEC defined it as misleading and per se fraudulent for any trader to mislead a broker-dealer by saying that she has located shares to borrow when he has not.⁶⁰
- The SEC temporarily banned all short selling in financial stocks.⁶¹

The new rules, announced on September 17 and 18, went into effect at 12:01 AM on September 18 and quickly expanded thereafter.⁶² The hard delivery requirement was thought to be especially efficacious. Open fails declined from an average of 1.1 billion shares per day before the rule to an average of 582 million shares per day after the SEC had adopted the provision.⁶³

Effective Monday, September 22, the SEC also added 71 stocks to its list of 750 in which the Commission had prohibited short selling, including

59. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,572, 73 Fed. Reg. 54,875 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,274, at 87,137 (Sept. 17, 2008) (adopting temporary Regulation SHO Rule 204T and Rule 10b-21). *See also* SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses, SEC Press Release No. 2008-204 (Sept. 17, 2008), <http://www.sec.gov/news/press/2008/2008-204.htm>.

60. 17 C.F.R. § 240.10b-21 (2009):

It shall also constitute a “manipulative or deceptive device or contrivance” . . . for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.

61. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592, 73 Fed. Reg. 55,169 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. ¶ 88,277, at 87,141 (Sept. 18, 2008).

62. Kara Scannell, *SEC Issues Short-Selling Rules in Bid to Stop Manipulation*, WALL ST. J., Sept. 18, 2008, at A6.

63. *SEC Reform Proposals*, *supra* note 13, at 10.

shares of General Motors, Credit Suisse First Boston, American Express, Moody's, and the brokerage firm Legg Mason.⁶⁴ The trend of adding stocks to the list continued, with the SEC adding any retail or industrial corporation with a financial subsidiary, including CVS, Ford, IBM, Zales Jewelers, and Sears.⁶⁵ Regulators around the world, also faced with the gyrations of a world crisis, enacted short selling bans in their own countries.⁶⁶

Criticism mixed with bits of empathy for the SEC. "It looks like we have a bunch of amateurs [at the SEC] that don't know what they're doing [B]an[ning] short selling shows the desperation of the regulators," said Professor James Angel at Georgetown University.⁶⁷ The SEC just decided that "we needed a time-out [but] [t]here are a lot of us out there who are wondering what the SEC is thinking, whether they've gone off the rails . . . ," said Professor Charles Jones at Columbia.⁶⁸ "Stop the folly. End the ban," opined a Swiss Professor, finding that stocks on the ban list reacted more slowly than stocks outside the umbrella.⁶⁹

IV. REDUCING NAKED SHORT SALES BY POLICING FAILURES TO DELIVER: THE STRICT CLOSEOUT REQUIREMENT AND NEW RULE 204

A. Interim Final Temporary Rule 204T Made Permanent

In September 2008, the SEC added a temporary provision to Regulation SHO.⁷⁰ The temporary rule required participants in registered clearing agencies (broker-dealers mainly) to close out failures to deliver by buying in securities sufficient to cure all fails and to do so not within thirteen days, but at the market's opening following the day on which settlement should have occurred (that is, at the open on T+4).⁷¹ Further, these strict close requirements applied to fails to deliver in equity securities, not merely to

64. Kara Scannell, *SEC Quickly Revises Short-Selling Rules*, WALL ST. J., Sept. 23, 2008, at A9.

65. Kara Scannell & Serena Ng, *SEC's Ban on Short Selling Is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C1.

66. See, e.g., Kara Scannell, *Short-Sale Ban Spreads Around the Globe*, WALL ST. J., Sept. 22, 2008, at C1 (describing implementation of short-sale bans in Australia, United Kingdom, Taiwan, and the Netherlands); *Korea Toughens Its Rules*, WALL ST. J., Sept. 25, 2008, at C2.

67. Scannell, *supra* note 64.

68. *Id.*

69. Arturo Bris, *Shorting Financial Stocks Should Resume*, WALL ST. J., Sept. 29, 2008, at A25.

70. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, *supra* note 59.

71. *Id.* (establishing the provisions of SEC Rule 204T(a)).

those on the threshold list.⁷² The permanent rule upholds the strict close requirement but does permit participants either to buy in *or borrow* securities to close out the failure to deliver position.⁷³

The SEC did so because its Office of Economic Analysis (“OEA”) had found the temporary regulation particularly effective in reducing the numbers of failures to deliver, which was the SEC’s penultimate goal; the ultimate goals were the elimination of naked short selling and of market manipulation.⁷⁴ For example, fails to deliver in non-threshold securities averaged approximately 624 million shares or \$4.6 billion in value per day from January to July 2008.⁷⁵ After Rule 204T’s extension of strict close out requirements to non-threshold securities, from December 2008 to March 2009, OEA estimates of fails to deliver fell to 307 million shares or \$1.1 billion in value per day.⁷⁶

As has been seen,⁷⁷ the National Securities Clearing Corporation (“NSCC”), a subsidiary of Depository Trust Clearing Corporation (“DTCC”), clears “virtually all broker-to-broker” transactions in publicly traded securities.⁷⁸ In addition to circulating the “easy to borrow” list, each day NSCC notifies participants (broker-dealers such as Merrill Lynch or Morgan Stanley) of their payment and delivery obligations for that day.⁷⁹ If those participants fail to close out a fail to deliver position, in effect the rule requires the market participant to proffer no further naked short sales and requires that NSCC accept no further short sales from that broker-dealer for

72. “We have concluded that it is necessary to impose enhanced delivery requirements on sales of *all* equity securities . . .” *Id.* (emphasis added).

73. 17 C.F.R. § 242.204T(a) (2009):

A participant . . . must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale . . . by settlement date, or if a participant . . . has a fail to deliver position . . . the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quality.

See also Strict Close Requirement Release, supra note 3, at 38,265, 82,709–10.

74. *Strict Close Requirement Release, supra* note 3, at 38,273, 82,686.

75. *Id.*

76. *Id.* *See also id.* at 38,266, 82,677 (“[T]he average daily number of threshold securities declined from 480 securities to 108 securities . . . a decline of 77.5%.”).

77. *See supra* note 3 and accompanying text (discussion of easy to borrow list).

78. *Strict Close Requirement Release, supra* note 3, at 82,680 n.35 (“The NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter market.”). *See also id.* at 38,272, 82,685.

79. *Id.* at 38,272, 82,685.

settlement.⁸⁰ If the broker-dealer becomes net flat or net long in that security, across the board and not merely as to that particular client, it may again proffer short sales for settlement.⁸¹ In turn, to remove this disability, broker-dealers (participants) will require investor clients promptly to remedy deficiencies and also take added steps to prevent deficiencies from arising in the first place.⁸²

B. Pleas for Expanded Windows in Which to Close Fails

Commentators requested that the window in which participants (broker-dealers) could close out fails to deliver be expanded to the close of T+4, or to three days, or to five days, following the settlement day on which a failure to deliver had occurred.⁸³ They all recited a need to smooth out the upward pressure that an immediate close out requirement would cause on a security's price as numerous firms conducted nearly simultaneous buy-ins.⁸⁴ Other comment letters requested an exception for de minimis fails to deliver, which often occur when the broker fails to deliver the odd number of shares (ninety-nine or less) at the tail end of a short sale transaction (for example, the sixty-seven on top of six hundred).⁸⁵ The SEC abjured all such pleas for exceptions and expanded windows, reciting its mantra that the overall goal, reduction in fails to deliver, must be achieved. As adopted, the rule contains

80. SEC Rule 204(b), *Strict Close Requirement Release*, *supra* note 3, 38,292, 82,710:

If a participant . . . does not close out [a] fail to deliver position . . . the participant and any broker or dealer from which it receives trades for clearance and settlement . . . may not accept a short sale order . . . without first borrowing the security . . .

81. SEC Rule 204(e)(4), *Strict Close Requirement Release*, *supra* note 3, at 38, 293, 82,710. *See also id.* at 38,276, 82,689.

82. A principal Wall Street objection to the strict close requirement was that the bidding by securities firms at the opening, occasioned by the need to cure fails to deliver at the beginning of day T+4, would distort market prices. *See, e.g., Strict Close Requirement Release*, *supra* note 3, at 38,269–70, 82,681. The SEC allowed that such might be the case in individual cases but that the SEC's goal of vastly reduced failures to deliver outweighed any temporary market dislocations a strict close requirement might cause. *See id.* at 38,271, 82,683 (“Although we recognize commenters’ concerns regarding the potential market impact of the close-out requirements . . . particularly at the market open, we believe that these potential effects are justified by the benefits of retaining the strict close-out requirements of temporary Rule 204T.”).

83. *See, e.g., Strict Close Requirement Release*, *supra* note 3, at 38,270, 82,682.

84. *Id.*

85. *Id.* at 38,278, 82,693.

none of the expansions of time for which commentators contended.⁸⁶ The only short sale relaxation the SEC permitted from Rule 204T was that, under Rule 204 as adopted, broker-dealers may borrow as well as purchase securities of like kind and quantity, using such securities to close failures to deliver.⁸⁷

C. Three and Thirty-Five Day Extensions

The new SEC rule grants exemptions from the strict close requirement to two types of transactions, both of which involve long rather than short sales. In some cases, investors hold share certificates in their own name rather than brokerage firm nominee, or Wall Street, names. “[H]uman or mechanical errors or processing delays can result from transferring securities in custodial . . . rather than book-entry form, thereby causing a fail to deliver on a long sale.”⁸⁸ If a broker-dealer can demonstrate that such a failure to deliver resulted from a long sale, the “participant” (broker-dealer) has a three-day window in which to close out the failure to deliver.⁸⁹

The SEC grants a much longer extension in cases of Rule 144 securities, which may have been received in a private placement or may be control shares held by a control person. Resale of such shares is restricted until certain amounts of time have passed and/or information about the issuing company has become publicly available.⁹⁰ Issuers and their lawyers may enforce such restrictions on transfer by “lettering the stock,” that is, placing a legend on the margin of the stock certificate.⁹¹ In turn, the legend often states that an opinion of corporate counsel will be required before the corporation will effect any transfer. SEC Rule 204 grants a thirty-five day period following a sale in which a seller of Rule 144 stock may seek removal of the legend.⁹² In the meantime, a failure to deliver in a long sale will remain open.⁹³ Thereafter, the broker-dealer must close out the position by buying

86. See SEC Rule 204, *Strict Close Requirement Release*, *supra* note 3, at 38,292–93, 82,709–11.

87. SEC Rule 204(a)(3), *Strict Close Requirement Release*, *supra* note 3, at 38,276, 82,690.

88. *Strict Close Requirement Release*, *supra* note 3, at 38,271, 82,684 (footnote omitted).

89. SEC Rule 204(a)(1), *Strict Close Requirement Release*, *supra* note 3, at 38,271, 82,684.

90. See, e.g., Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71,546, (Dec. 17, 2007), reprinted in [2007–2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,024, at 85,674 (Dec. 6, 2007).

91. See, e.g., JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 362–72 (6th ed. 2009).

92. SEC Rule 204(a)(2), *Strict Close Requirement Release*, *supra* note 3, at 38,292, 82,710.

93. The new rule also contains thirty-five day windows in which to close fails to deliver may remain open in certain cases of “deemed to own securities,” which includes Rule 144 securities, but whose treatment is focused on cases in which a holder has a contractual

or borrowing sufficient securities and delivering them to the clearing agency for settlement.⁹⁴

V. REGULATORY REFORM: DEFINING SECURITY TO INCLUDE STOCK BORROWING PROGRAMS, OR DISCIPLINING INTERMEDIARIES WHO FACILITATE STOCK BORROWING WHEN THEY FAIL TO MAKE REQUIRED DISCLOSURES

A. Stock Borrowing

By now the picture should have become clearer. The SEC campaign against naked short selling and failures to deliver has steadily increased the pressure on broker-dealers and short sellers to locate and buy or borrow, often mostly borrow, shares to deliver to close short sale transactions. The Commission's rules and enforcement activities have the direct result of increasing pressure to borrow stock.⁹⁵

There have always been institutional investors who hold long positions in certain stocks and make a certain number of those shares available to brokers, who in turn will engineer loans to short sellers.⁹⁶ The institution receives a negotiated fee, often consisting of an above-market rate of interest and the right to call the stock back on specified notice, as well as at the end of each month. Brokering such transactions, market professionals operate firms that facilitate the lending and borrowing of stock. LocateStock.com is an Internet based firm offering such services.⁹⁷ Back on the borrowing side, market

right to receive securities (an option, warrant, right, conversion right), which she has exercised, but pursuant to which she has not yet received the securities. Regulation SHO lists six categories of "deemed to own" securities. See SEC Rule 200(b), Short Sales, Exchange Act Release No. 34-50103, 69 Fed. Reg. 48,008, 48,030 (Aug. 6, 2009), reprinted in [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,244, at 80,841 (July 28, 2004).

94. SEC Rule 204(a)(2), *Strict Close Requirement Release*, supra note 3, at 38,292, 82,710. See also *id.* at 38,277–78, 82,691–92.

95. Nonetheless, neutral observers marvel at how long the SEC took to police what plainly have been fraudulent and manipulative practices principally involving naked short selling. See, e.g., McGinty & Strasburg, supra note 45, at C3 (According to Peter Chepucavage, former SEC attorney who helped draft Regulation SHO, "the initial weakness of [Regulation SHO] and the years it took the SEC to stiffen it can be traced to the lobbying efforts of hedge funds and Wall Street?").

96. See, e.g., Kara Scannell & Tom Lauricella, *SEC Extends Short-Selling Rules*, WALL ST. J., July 30, 2008, at C1 ("Many fund companies, such as Vanguard, lend out some of the stocks and bonds in their portfolios in exchange for a fee.").

97. Randall Smith et al., *Street Gears Up for Short Changes*, WALL ST. J., July 17, 2008, at C1, C2 ("[B]ig funds get preferential access to borrow scarce shares [LocateStock.com] helps hedge funds and small brokerages locate hard-to-borrow shares.").

participants other than short sellers may also have a need to borrow stock. For example, an over-the-counter trader may find its inventory insufficient to fill an order it has taken. The trader may borrow shares with which to fill the order until the trader can buy in additional inventory elsewhere.⁹⁸

B. Borrowing Stock from Individual Investors and Risks Endemic to Such Ventures

The truth, though, is that stock borrowing efforts often aim themselves at individual investors. The large financial firms have formal stock borrowing departments whose principal role is to locate and facilitate the lending of shares. Stock borrowing department representatives promise above-market rates of interest to individual investors who will make their stock available.

What is not disclosed to the lender is that all, or almost all, of those shares are lent to hedge funds and other aggressive short sellers whose interests are antithetical to the lender. The lender wishes to see the shares increase in value, or at least trade sideways. The stock borrowing short seller only wants to see the stock price decrease.

Stock borrowing remains unregulated. Individual investors asked to participate in stock borrowing programs receive little disclosure. They certainly do not receive risk factor type disclosure of the kind often seen in prospectuses and private placement memoranda. Risk factor disclosure would bring home to stock lenders the distinct possibility of developments adverse to their interests, namely, that the short selling and bear raids which they are facilitating can reduce the value of their shares significantly in a matter of days. The shares that they continue to hold, as well as the shares the short seller eventually returns to them via the stock borrowing intermediary, may be worth a fraction of their original value. Many stock lenders, including individual investors, are pigeons waiting to be plucked.

If stock lenders (investors) suffer damages and complain, their complaints go to arbitration, in which opinions are seldom published and the outcomes of most cases are unknown. Since 1987, all customer-broker disputes have gone to arbitration, originally before NASD or NYSE panels of arbitrators, but since the NASD and NYSE dispute resolution mechanisms

98. See, e.g., NATIONAL SECURITIES CLEARING CORP., RULES AND PROCEDURES 285 add. C (2009) (“[A]ny share needs remaining unsatisfied . . . [may] also be borrowed from Members who have delivered instructions specifying available securities for the daytime stock borrow process.”).

have merged, disputes now go before the Financial Institutions Regulatory Authority (“FINRA”) panels of arbitrators.⁹⁹ Ultimately we do not know if any stock lenders, acting as private attorneys general, have succeeded with claims that stock-borrowing program participations are “securities” and, furthermore, securities as to which disclosure accompanying their offer is insufficient or misleading.

C. Proposed Regulation

The strict close requirements applicable to failures to deliver are not the only regulation that is necessary. Another regulation peripheral to short selling is needed—regulation of stock-borrowing programs. The Commission should adopt regulations making clear that the offer of participation in such a program is a security, which should be registered or have an exemption from regulation. As the offer of a security, the offer of any such participation should be accompanied by a formal disclosure document which brings home to investors the risks they are undertaking by lending their stock, and the precise nature of their withdrawal rights, if any.

D. Disciplining Brokers and Other Market Participant

On the regulatory front, an alternative would be for the SEC to add to its list of prohibited broker-dealer practices (the SEC Rule 15c series) the offer of participation in a stock-lending program without certain specified disclosure to the putative lender, that is, the investor.¹⁰⁰ The SEC has long

99. In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and again in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), the Supreme Court held that an arbitration clause in a customer agreement constituted merely a choice of forum rather than an illicit waiver of the securities laws’ protections. The Court thus overruled *Wilko v. Swan*, 346 U.S. 427 (1953), which held that an agreement to arbitrate violated the securities laws’ anti-waiver provisions and was therefore void. Since that time, virtually all customer disputes, employment disputes, and other securities cases as well, go to arbitration panels rather than courts.

100. Securities Exchange Act of 1934 § 15(c)(1)(A), 15 U.S.C. § 78o(c)(1)(A) (2006), provides that:

[n]o broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase, or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance.

required broker-dealers to have in their possession certain basic information about less well-known corporations and their securities before those broker-dealers can facilitate trading in those securities. Current regulations under Rule 15c2-11 require that “the broker or dealer . . . make reasonably available” the specified information “upon the request to any person expressing an interest in a proposed transaction in the security with such broker or dealer.”¹⁰¹ Requiring that brokers possess certain information, which must be disclosed to investors with or before the offer of participation in a stock-borrowing program, bears a strong resemblance to what is known as 15c2-11 disclosure.¹⁰²

VI. APPLICATION OF EXISTING LAW: STOCK BORROWING PROGRAMS AS INVESTMENT CONTRACTS

A. Investment Contract

*SEC v. W.J. Howey Co.*¹⁰³ involved primarily out-of-state tourists who barged over a series of lakes and rivers from Jacksonville, Florida, to Howey’s inland resort, Howey-in-the-Hills. When they came down from their hotel rooms, the tourists saw advertisements offering rows of orange groves. With the purchase of property in fee simple on which a row of trees was located, the purchaser could also buy a service contract: Howey-in-the Hills employees would prune and spray the trees, pick the fruit, pack it, and market it. Under the arrangement, purchasers had no rights to specific fruit (that is, from their trees), limited rights of entry, and a right only to receive a limited quantity of fruit at holiday time.

Pursuant to authority granted in the section, the SEC has adopted a number of rules to “define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative . . .” *Id.* at § 78o(c)(2)(D).

101. SEC Regulation 15c2-11(a)(5), 17 C.F.R. § 15c2-11(a)(5) (2010).

102. Before publishing or submitting a bid for others to publish, a broker-dealer must have in its possession and make available to investors, at least 16 items of information about the company issuing a security and about the security itself. *See* SEC Rule 15c2-11, 17 C.F.R. § 15c2-11(a)(5)(i–xii) (2010) (requiring, inter alia, exact name of issuer and any predecessor, address of principal and executive offices, state of incorporation, title and class of the security, par or stated value of the security, number of shares outstanding at the end of the most recent fiscal year, name and address of transfer agent, nature of the issuer’s business, nature of products or services offered, nature and extent of the issuer’s facilities, names of CEO and members of the board of directors, the issuer’s most recent balance sheet and profit and loss and retained earnings statements).

103. 328 U.S. 293 (1946).

The SEC challenged Howey Co. in one of the first cases under the relatively new Securities Act of 1933.¹⁰⁴ Howey defended, inter alia, on grounds that he was offering a sale of real estate and a service contract, neither of which were securities. The Supreme Court ultimately agreed with the SEC's response that Howey Co. did in fact offer the two items as a package. Securities law considers items as they are offered, not how they may eventually be sold.¹⁰⁵

So constituted, the package fell within the catch-all contained in the statute's definition of a security. While specifically enumerating twenty-four or so other items ("any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness" and so on), the statutory definition includes "investment contract."¹⁰⁶ Borrowing from state blue sky law jurisprudence, in *Howey*, Justice Murphy defined investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . ."¹⁰⁷ The test, which has remained the lodestar for over 65 years, has four elements: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others.

B. Investment of Money

In a stock borrowing program, the offeree investor furnishes money's worth rather than money itself, namely, shares of common stock in a publicly held corporation. Cases have long held that contribution of items readily convertible into money is equivalent to the contribution of money itself.¹⁰⁸

104. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa) (2006) [hereinafter *Securities Act*].

105. "The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough the respondents merely offer the essential ingredients of an investment contract." *Id.* at 301 (footnote omitted). In the case at bar (*Howey*), 85% of the land purchasers opted for the package (real estate plus a services contract) rather than the real estate alone. *Id.* at 295.

106. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).

107. 328 U.S. at 298–99.

108. *See, e.g., In re Trade Partners Inv. Litig.*, No. 1:07-MD-1846, 2008 WL 3992168, at *4 (W.D. Mich. Aug. 22, 2008) ("The test to establish the existence of an investment contract requires 1) an investment of money or money's worth. . . .") (quoting *Howell v. Ballard*, 801 P.2d 127, 128 (Okla. Civ. App. 1990) (viatical settlements)); *Battig v. Simon*, 237 F. Supp. 2d 1139, 1149 (D. Or. 2001) ("Oregon applies the [investment contract] definition

C. Common Enterprise

1. Commonality. This is the shorthand term used for this lynchpin element of the definition.¹⁰⁹ The sale of recreational real estate (say, a ski resort condominium) illustrates how, in many ventures, each investor's fortunes are tied both to the overall success of the venture, including that of the promoter (vertical commonality), and to fellow investors' fortunes (horizontal commonality). In typical recreational real estate sales, an exclusive rental agent requirement ties the investor's fate to that of the promoter or its affiliate, whose future may rise or fall depending upon the level of rentals. A rental pool feature, in which all investors' units' rents go into a single fund, ties every investor's fate to the fates of others, supplying horizontal commonality as well. In that manner, an item ordinarily real estate (a ski condominium) by virtue of collateral arrangements (exclusive agent requirement, rental pool) becomes an investment contract and therefore a security.¹¹⁰

2. Horizontal Commonality. The most restrictive courts hold that horizontal commonality must be present and that it, and only it, satisfies the common enterprise element of an investment contract.¹¹¹ The presence of multiple investors may not in itself suffice. In *Milnarik v. M-S Commodities, Inc.*,¹¹² the Seventh Circuit affirmed a finding of no horizontal commonality because profitability of the plaintiff's account was not influenced by the profitability or loss of other similar accounts managed by the same broker.

outlined in *Securities and Exchange Commission v. Howey* The relevant factors are: (1) an investment of money (or money's worth)").

109. See, e.g., Susan S. McDonald, *Toward Consistent Investor Protection Under the Securities Laws: The Solution to the Conflict Among the Circuits Regarding the So-called "Commonality" Requirement for an "Investment Contract,"* 32 SEC. REG. L. J. 68, 70 (2004); Rodney L. Moore, *Defining an "Investment Contract": The Commonality Requirement of the Howey Test*, 43 WASH. & LEE L. REV. 1057, 1062 (1986). See also Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2137–38 (1995).
110. See Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 33-5347, 38 Fed. Reg. 1735 (1973), reprinted in [1972–1973 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 79,163 (Jan. 4, 1973) (outlining collateral arrangements which may convert recreational real estate interests into investment contracts).
111. Of courts coming down firmly on the issues, the Sixth and the Seventh Circuits require horizontal commonality exclusively. See, e.g., SEC v. SG Ltd., 265 F.3d 42, 49–50 (1st Cir. 2001) (surveying circuit courts of appeal).
112. 457 F.2d 274, 276 (7th Cir. 1972) (finding that discretionary trading accounts in commodities futures are not investment contracts because no horizontal commonality).

The paradigm for horizontal commonality is one in which investors' contributions, as well as returns or losses, are pooled, as in the ski condominium hypothetical above.¹¹³

3. Vertical Commonality. At other end of the spectrum, vertical commonality is the least demanding interpretation of *Howey*'s common enterprise requirement. Vertical commonality requires an investor to allege and prove that her returns are dependent upon the promoter's expertise or efforts, or both. For example, in *SEC v. ETS Payphones, Inc.*,¹¹⁴ purchasers were dependent upon the promoter's ability and efforts in choosing the model and location for pay telephones. Further returns may also be dependent upon the promoter attracting an ever-expanding circle of investors. All the investor must do is furnish the money and sign a contract.

4. Strict Vertical Commonality. Strict vertical commonality requires more, namely that the investor's fortunes be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."¹¹⁵ *SEC v. Koscot Interplanetary, Inc.*¹¹⁶ began with the sale of various levels of participation, with ever greater amounts of override commissions, in the pyramid sales of self-improvement combined with cosmetics sales programs. The investor produced the new prospects while the promoter's sales staff closed the deals. Horizontal commonality was lacking but that was not determinative:

[T]hat an investor's return is independent of that of other investors in the scheme is not decisive. Rather, the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the Koscot

113. See, e.g., *SEC v. Infinity Group Co.*, 212 F.3d 180, 187–88 (3d Cir. 2000) (investors promised different returns, ranging from 138% to 181%, in "Asset Enhancement Program" but promoter pooled investors' contributions, "to create highly-leveraged investment power that would yield high rates of return," resulting in a finding of horizontal commonality). Other cases requiring a showing of horizontal commonality include *SEC v. Ljfe Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996), *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994), *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994), and *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222, 224 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982).

114. 408 F.3d 727, 732 (11th Cir. 2005).

115. *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) (quoting *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973)) (virtual stock exchange membership program, in which investors bought and sold shares of 11 virtual companies, nevertheless found also to evince horizontal commonality).

116. 497 F.2d 473 (5th Cir. 1974).

meetings and guidelines on recruiting prospects and consummating a sale.¹¹⁷

5. Offers Rather Than Sales. Participation in stock-borrowing programs may measure up as investment contracts or securities in jurisdictions in which courts require vertical commonality, but perhaps fall short in jurisdictions in which judges have held that only horizontal commonality will suffice. An investor who contributes her shares to an intermediary, to be lent out to a short seller, may not have her shares tied to the fortunes of other contributors to the program. Horizontal commonality is lacking. Whether an investment contract is present or not may depend on tracing, which can be difficult to do¹¹⁸ and determinable only on a case-by-case basis.

A first principle of securities regulation, however, is that judges, practitioners, and regulators will judge items on the basis of how they are offered rather than how they eventually may be sold. At his resort hotel, William Howey and his company offered orange trees and service contracts as a package even though, at the end of the day, a persistent purchaser could buy the real estate only.

In the first case under the Securities Act, *SEC v. C. M. Joiner Leasing Corp.*,¹¹⁹ the promoters attempted to escape the statutory definition, which lists only “fractional undivided interests in oil, gas or mineral rights” among the items enumerated, by selling divided interests in oil and gas leases (for example, the Southeast eighth of the Southwest quarter section). The courts, though, judged the items as to how they were offered, interests in land expertly selected under the guidance of a promoter in the vicinity of where the promoter would drill a test well, rather than how the rights eventually may have been sold (as a mere interest in real estate). The leaseholds, divided interests in oil and gas leases, while falling out of the list of more specific items in the statute, came back within the definition of a security, by means of the investment contract catch-all as well as judgments pertaining to how the items were offered, rather than how they might have been sold.¹²⁰

117. *Id.* at 479.

118. See Peter Oh, *Tracing*, 80 TUL. L. REV. 849, 854 (2006).

119. 320 U.S. 344, 352 (1943); Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).

120. 320 U.S. at 348 at 348. Justice Jackson noted that:

Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well it would have been a quite different proposition [*e.g.*, only the offer of interests in real property]. Purchasers then would have been left to their own devices for realizing

The offer of participation in stock borrowing programs always incorporates a right of the intermediary to combine the shares an investor contributes with the shares that other investors contribute. Yet the ultimate loan of the securities may end up strictly as a pass-through, with a single investor's shares lent out to a single short seller. No commingling occurs; horizontal commonality appears to be lacking. Nevertheless, courts judge items as to how they are offered (reserving the right to commingle), not as to how they are sold. Participation in stock-borrowing programs thus satisfies even the strictest interpretation of the common enterprise requirement (horizontal commonality) central to investment contract analysis.

D. Expectation of Profits.

In *SEC v. Edwards*,¹²¹ 10,000 people invested \$300 million in a payphone sale-and-leaseback arrangement. Promoters offered a sale of the payphone for \$7,000, a five-year leaseback, and payment to the investor of a fixed 14% annual return. The promoter defended an SEC complaint on the grounds that the arrangements were not investment contracts, and therefore not securities. The arrangements were not investment contracts because the expectations were not of profits from the efforts of a promoter or third party. Rather, as a matter of contract, the return was due because of the contractual provision and was due in any case.

The promoter of a stock borrowing scheme might make a similar argument. The above-market-rate of interest the intermediary (a broker-dealer firm) pays to the stock lender (an investor) may be due in any event, as a matter of the contract, rather than of the success or failure of the ultimate borrower of the shares.

Justice O'Connor had no difficulty rejecting such an argument. In investment contract analysis cases such as *Howey*,

[W]e were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest. We used "profits" in the sense of income or return

upon their rights. . . . The exploration enterprise was woven into these leaseholds

Stock lenders here perceive their economic prospects (a loan of stock at favorable rates) to be enhanced by the prospect of commingling their stock with the stock of others if necessary to make a loan.

121. 540 U.S. 389, 391 (2004).

. . . . There is no reason to distinguish between promises of fixed returns and promises of variable returns In both cases, the investing public is attracted by representations of investment income¹²²

“[A] promise of a fixed return,” as here in the case of stock-borrowing programs, “does not preclude a scheme from being an investment contract,” she concluded.¹²³

E. Solely From the Efforts of Others

Here the investor makes her contribution (the loan of stock) and does nothing further. The return, if any, comes necessarily from the successful efforts of the broker-dealer firm or other intermediary to lend the shares, either alone or in combination with other lenders' shares, to a short seller, and to receive interest payments, a portion of which it passes through to the stock lender.¹²⁴

F. Stock Borrowing Programs as Investment Contracts and Therefore Securities

Under the foregoing analysis, with or without SEC regulation, stock-borrowing programs are securities, the offer of which must be accompanied by full and fair disclosure. At least one case has so held. In *Hughes v. Dempsey-Tegeles & Co.*,¹²⁵ a brokerage firm requested the loan by an investor of his portfolio of municipal bonds, along with an agreement to subordinate his

122. *Id.* at 394. Justice O'Connor observed that “[n]o distinction between fixed and variable returns was drawn in the blue sky law cases that the *Howey* court used” *Id.* at 395 (citing *People v. White*, 12 P.2d 1078, 1079 (Cal. Dist. Ct. App. 1932) and *Stevens v. Liberty Packing Corp.*, 161 A. 193, 193–94 (N.J. Ch. 1932)).

123. *Id.* at 396.

124. Even if the stock borrowing program's provisions required stock lenders to perform some acts, which they usually do not, the critical inquiry is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973). In the pyramid sale of self-improvement programs (“Dare To Be Great”), upper level members received commissions and overrode commissions on lower level members' successes in attracting prospects to meetings. But the court found that the efforts of the Dare To Be Great staff in making presentations and procuring investors' signatures on purchase contracts had been “the undeniably significant ones.” *Id.*

125. No. 71-1299-MML, 1973 WL 421, at *1 (C.D. Cal. Sept. 4, 1973), *aff'd*, 534 F.2d 156 (9th Cir. 1976).

interest in the bonds to that of the firm. In that way, “the firm could utilize them [the bonds] as additional capital in meeting the Exchange’s net capital requirements” applicable to brokerage firms.¹²⁶ In return, the firm promised the lender an above market rate of interest that “would realize an additional income to Hughes from the securities in the amount of \$30,000.00.”¹²⁷ The district court found the arrangement (an individual investor’s loan of securities with an agreement providing for payment of interest) to be an investment contract under the *Honey* analysis.¹²⁸

CONCLUSION

To require of stock-borrowing intermediaries prospectus-type disclosure regarding stock-borrowing programs would be onerous, crimping the reach of such programs and the amount of stock investors would lend and short sellers could borrow. Regulation and probably restriction of stock borrowing would occur at a time when other SEC initiatives (for example, Regulation SHO amendments and enforcement) make the ability to borrow stock vastly more important to short sellers. Because naked short selling will not be tolerated, as it was in the past, the ability to borrow stock becomes extremely urgent.

On Main Street, stock lenders tend to be much different than market professionals and stock borrowers. Market professionals (traders at Vanguard, T. Rowe Price, or a hedge fund, for example) make judicious loans of stock from time to time, after careful calculations of the likely returns, weighed against the probability and magnitude of downward movement in the stock’s share price. In other financial circles, however, brokerage firms and intermediaries ask individual investors to lend stock, without disclosure of the principal use to which such shares of stock will be put—loans to short sellers and bear raid participants—and how antithetical to stock lenders’ interests the activities of typical borrowers are.¹²⁹ The outcomes for

126. *Id.* at *5.

127. *Id.* at *6.

128. No court, however, has so held recently and probably never will, as such claims by stock lenders disappear behind the veil of arbitration, which shields from view the outcomes of customer-broker-dealer disputes. *See supra*, note 99 and accompanying text.

129. Again, regulation *vel non* of stock borrowing programs is a Main Street versus Wall Street issue, as are the possible and actual adoption of other SEC regulations impinging on uninhibited short selling. *See, e.g.*, Branson, *supra* note 13, at 92. This author has previously written about the divergence in needs and attitudes between Main and Wall Streets. *See* Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death*

investors, almost all of which are bad, should be set forth in plain, readable form (“plain English”). Currently, individual investors are pigeons waiting to be plucked by sharp dealers from Wall Street.