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Petition for Rulemaking on Short and Distort

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Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Petition for Rulemaking on Short and Distort

Dear Ms. Countryman:

Petitioners signed below respectfully submit this petition for rulemaking pursuant to Rule 192(a) of the Commission's Rules of Practice.[1]

I. Background

Short selling serves a critical function in the capital markets by encouraging price discovery and preventing the formation of asset bubbles.[2] But recent years have seen a rise in "negative activism," a novel phenomenon which has flourished in the era of social media and algorithmic trading.[3] The typical negative activist opens a large short position; disseminates sometimes aggressive negative opinion about a public company (often stopping just short of factual falsehoods) on Twitter and elsewhere, which induces a panic and run on the stock price;[4] and rapidly closes that position for a profit, prior to the stock price partially or fully rebounding.[5]

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[1] This petition arose out of columns by Professors John C. Coffee, Jr. and Joshua Mitts of Columbia Law School. Professor Mitts has served as an expert in connection with market manipulation cases involving short sellers.

[2] *See, e.g.*, Merritt B. Fox et al., *Law, Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y. L. SCH. L. REV. 645 (2009) (finding that an increase in short selling predicts negative news the next day and summarizing the theoretical and empirical literature on short selling and price discovery).

[3] *See, e.g.*, Barbara A. Bliss et al., *Negative Activism*, 97 WASH. U. L. REV. (forthcoming, 2019) (considering whether negative activism enhances price discovery); Joshua Mitts, *A Legal Perspective on Technology and the Capital Markets: Social Media, Short Activism and the Algorithmic Revolution* (working paper, 2019), https://ssrn.com/abstract=3447235 (arguing that negative activism may sometimes reflect fraud and manipulation).

[4] Professor Donald Langevoort has analogized inducing a market panic to teenage drag racing, arguing that "deliberately say[ing] or do[ing] something designed to take advantage of heuristic thinking by investors, thereby at least temporarily destabilizing the market price" should be deemed manipulation, despite the challenge with proving manipulative intent in these cases. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, 97 N.W. L. REV. 135 (2002). For this reason, we advocate that the Commission engage in affirmative rulemaking in settings where it may be difficult to prove manipulative intent.

[5] This sort of trading strategy was identified over twenty years ago by Professor Zohar Goshen. *See* Zohar Goshen, *Fraud and Manipulation: Fraternal Twins,* MISHPATIM 591 (1999) (in Hebrew). It is similar to what Professor Merritt Fox and co-authors have characterized as "misstatement manipulation." Merritt B. Fox et al., *Stock Market Manipulation and Its Regulation*, 35 YALE J. ON REG. 67, 111 (2018). These have often been termed "scalping" schemes, which involve making statements that lead to investors to purchase or sell a stock, while failing to disclose a position or an intent to trade in the opposite direction of one's recommendation. *See, e.g.*, James Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 WASH. U. L. Q. 475 (1986) ("[T]he

For a recent example, on August 15, 2019, Harry Markopolos accused General Electric of being "A Bigger Fraud than Enron." Specifically, Mr. Markopolos (the first to publicly proclaim that Bernie Madoff was running a giant Ponzi scheme) produced a lengthy report that alleged a $38 billion accounting fraud at G.E. The key claims were that G.E. was "hiding $29 billion in Long-Term Care Losses" with respect to its insurance operations and was also concealing "$9.1 billion in Baker Hughes losses." When these disclosures hit the market in a well-orchestrated blitz, G.E.'s stock price fell from a close of $9.01 the prior day to a low of $7.76 per share on August 15 (when over 400 million G.E. shares were traded). Overall, G.E.'s stock price dropped 21 percent throughout August, while the Dow Jones Industrial Average fell only 1.7 percent that month.

Yet G.E.'s stock price subsequently rebounded and recovered most of August's losses. By November 2019, GE's stock price was trading over $10 a share. Most analysts, investment banks and reporters came to the conclusion that the Markopolos report was unfounded.[6] Just one month later, the website gefraud.com was taken down and replaced by a "403 Forbidden" error page,[7] highlighting the short-lived and possibly negligent nature of Markopolos's claims.

At the outset, Mr. Markopolos disclosed that he had "entered into an agreement with a third-party entity to review an advance copy of the Report in return for later-provided compensation," which would be "based on a percentage of the profits resulting from the third-party entity's positions in" G.E. securities and derivatives." However, no disclosure was given as to when such "third-party entity" closed its position following the posting of the Markopolos report. It is possible that the third-party entity had closed its position even prior to the close of trading on the day of the report.

Research shows that the GE-Markopolos episode is not a one-off phenomenon. A study of pseudonymous short attacks on public companies by one of us has found that these attacks are followed by price declines and sharp reversals.[8] These data suggest that these patterns are likely driven by manipulative stock options trading. Among 1,720 pseudonymous attacks on mid- and large-cap firms from 2010-2017 there is over $20.1 billion of mispricing. These reversals seem to persist because pseudonymity allows manipulators to switch identities without accountability.

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violation in scalping cases is the nondisclosure of the advisor's purchase and intent to sell after the recommendation is published. . . . A recommendation, therefore, is the *sine qua non* of a scalping violation. Prior to a recommendation, the advisor's isolated purchase is devoid of informational content. After a recommendation is proffered, the advisor's trading activity, past and future, has great meaning to investors assessing the recommendation's authenticity.").

[6] *See, e.g.*, Al Root, *Wall Street Is Shrugging Off Allegations of GE Accounting Fraud*, BARRON'S, Sep. 4, 2019, https://www.barrons.com/articles/wall-street-comfortable-with-ges-accounting-shrugs-off-markopolos-report-51567525632.

[7] Al Root, *The Website Alleging GE Accounting Fraud Just Disappeared*, BARRON'S, Sep. 26, 2019, https://www.barrons.com/articles/website-alleging-ge-accounting-fraud-disappears-51569540660

[8] Joshua Mitts, *Short and Distort* (Columbia Law & Econ. Working Paper No. 592, 2019), https://ssrn.com/abstract=3198384.

This evidence highlights shortcomings of the current regulatory framework as applied to manipulative short selling. We petition the Commission to employ its rulemaking power under Sections 10(a)(1) and 10(b) of the Securities Exchange Act of 1934 as follows:

- ***First***, precisely because there is no duty to disclose one's short position, we ask the Commission to impose a duty to update promptly a *voluntary* short position disclosure which no longer reflects current holdings or trading intention.

- ***Second***, we ask the Commission to clarify that rapidly closing a short position after publishing (or commissioning) a report, without having specifically disclosed an intent to do so, can constitute fraudulent scalping in violation of Rule 10b-5. We further propose that a safe harbor be drafted which would allow for closing a position at a price equal to or lower than a valuation stated, expressly or impliedly, by a short seller.

We discuss each of these in turn.

II. We ask the Commission to impose a duty to update promptly a voluntary short position disclosure which no longer reflects current holdings or trading intention.

The case law is clear that merely taking a large short position is insufficient to establish market manipulation.[9] Moreover, one can disagree with a short seller's analysis, but strongly stated opinions are not fraudulent on their own. However, a negative activist typically goes further, claiming not just that investors should sell the stock, but that the activist itself is posed to profit if the share price declines and lose if the share price rises.[10]

The truthful disclosure of an activist's short position can enhance price discovery. The fact that a short seller with a credible track record in identifying fraudulent companies has opened a short position in a new stock may very well "alter the total mix of information made available"[11] by aligning the activist's reputation and economic incentives with its analysis. This is likely why many investors sell shares following a report by a negative activist but may be less quick to do so upon encountering a "sell" rating by an ordinary analyst who lacks such "skin in the game."

It is precisely for this reason that the Commission should vigilantly ensure that short position disclosure, *when voluntarily initiated by a short seller*, remains truthful and accurate. We are not advocating that the Commission mandate the disclosure of short positions. However, when a short seller has chosen to disclose a short position, failure to disclose that the position has been closed is doubly misleading: first, because the statement that the activist has a short position is literally no longer true; and second, because, the author's negative opinion lacks the "skin in the game" element that gives market participants reason to believe the underlying claims are true.

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[9] ATSI Communications v. Sha'ar Fund, Ltd., 493 F.3d 87, at 101 (2d Cir. 2007).

[10] *See, e.g.*, Muddy Waters Research, *MW is Short OSI Systems (NASDAQ: OSIS)*, https://www.muddywatersresearch.com/research/osis/mw-is-short-osis/ ("We are short OSI Systems, Inc. (OSIS.US) because we think it is rotten to the core.").

[11] Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

At present, it is unresolved whether short sellers are subject to a duty under federal securities law to update a position disclosure which has been voluntarily initiated by the short seller but no longer reflects current holdings or trading intention. While the Second Circuit recognized a "duty to update" statements rendered false by intervening events in *In re Time Warner Securities Litigation*, the Seventh Circuit has categorically rejected any such duty,[12] and commentators have pointed out that courts rarely find the violation of such a duty in individual cases.[13]

For this reason, we call on the Commission to engage in affirmative rulemaking which imposes a duty to update promptly a voluntary short position disclosure which no longer reflects current holdings or trading intention.[14] We propose that the Commission define the term "promptly" as in Regulation FD: "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)."[15] That standard is generous compared to Regulation FD, which gives a 24-hour grace period to rectify selective disclosures of material nonpublic information only when such disclosures are unintentional, whereas intentional disclosures must be shared with the public immediately. Here, a change of current holdings or trading intention is deliberate, not inadvertent.

The Commission has been granted express authority to enact such a rule by Section 10(a)(1) and Section 10(b) of the Securities Exchange Act of 1934. Section 10(a)(1) grants the Commission broad authority to prescribe rules governing the effectuation of short sales and stop loss orders, which does not require any showing of scienter or fraudulent intent.[16] Moreover, Section 10(b) grants the Commission broad authority to enact antifraud rules.[17] The failure to update a voluntary short position disclosure which no longer reflects current holdings or trading intention is a deceptive device or contrivance and thus may be prohibited pursuant to the Commission's rulemaking authority under both Sections 10(a)(1) and 10(b).

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[12] Gallagher v. Abbott Laboratories, 269 F.3d 806, 808 (7th Cir. 2001).

[13] *See, e.g.*, Bruce Mendelsohn & Jesse Brush, *The Duties to Correct and Update: A Web of Conflicting Case Law and Principles*, SEC. REG. L. J. 67 (Spring 2015).

[14] This solution was first proposed by Professor John C. Coffee, Jr. in a *New York Law Journal* column on September 18, 2019. *See* John C. Coffee, Jr., *Markopolos, G.E. and Short Selling as Negative Activism*, NEW YORK L. J., Sep. 18, 2019 ("The SEC could make clear that a short seller who has published critical negative research and announced its short position must disclose immediately when it closes out its short position. That would inform the market that the short seller may no longer hold its prior position. This disclosure obligation would not be satisfied by a simple boilerplate statement by the short seller that it might, sometime in the future close out its short position.").

[15] 17 C.F.R. § 243.101(d).

[16] 15 U.S.C. § 78j(a)(1). Section 10(a)(1) could thus support a more prophylactic rule governing short position disclosure than could be adopted by the Commission with respect to transactions other than short sales.

[17] 15 U.S.C. § 78j(b) (rendering unlawful "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors").

We further urge the Commission to make clear that this disclosure obligation would not be satisfied by a simple boilerplate statement by the short seller that it might, sometime in the future, close out its short position. Instead, the Commission should require that the short seller provide as much detail as necessary in order to clarify that a prior position disclosure no longer reflects current holdings or trading intention. For example, the Commission should make clear that voluntarily making a statement like "we are short [company name]" imposes a duty to announce when the activist no longer stands to profit from a decline in the share price, *e.g.*, when the activist has closed the short position or purchased call options, swaps or other derivative securities which serve as a hedge against economic exposure to a decline in the share price.

III. We ask the Commission to clarify that rapidly closing a short position after publishing (or commissioning) a report, without having specifically disclosed an intent to do so, can constitute fraudulent scalping in violation of Rule 10b-5.

Courts have long held that newspaper columnists are subject to a duty to disclose their intent to close a position after advocating the purchase or sale of a stock. In *Zweig v. Hearst Corp.*, the Ninth Circuit found that a newspaper columnist violated Rule 10b-5 by failing to disclose his ownership of the underlying security and "his intent to sell when the market price rose:"[18]

> Columnists . . . ordinarily have no duty to disclose facts about their personal financial affairs or about the corporations on which they report. But there are instances in which Section 10(b) and Rule 10b-5 require disclosure. Here . . . **the defendant assumed those duties when, with knowledge of the stock's market and an intent to gain personally, he encouraged purchases of the securities in the market.** Campbell should have told his readers of his stock ownership, **of his intent to sell shares that he had bought at a discount for a quick profit**, and of the practice of having his columns reprinted verbatim as advertisements in the financial journal in which he had an interest.[19]

The *Zweig* anti-scalping rule has been applied repeatedly over the ensuing decades, with the U.S. District Court for the Southern District of New York recently holding in a 2017 decision that "scalpers have a duty to disclose their financial interests in touted securities so that their promotional materials are not materially misleading."[20]

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[18] 94 F.2d 1261, 1268 (9th Cir. 1979).

[19] *Id.* (emphasis added).

[20] SEC v. Thompson, 238 F.Supp. 575, 590 (S.D.N.Y. 2017) (aggregating case law on position disclosure); *see also* Mausner v. Marketbyte LLC, No. 12-cv-2461-JM (NLS), 2013 WL 12073832, at **7–8 (S.D. Cal. Jan. 4, 2013) (publishers of an online newsletter had a duty to disclose that companies whose stock they touted compensated them in cash, company stock, or both); United States v. Cannistraro, 800 F.Supp. 30, 82 (D.N.J. 1992) (brokers' statements regarding certain securities "were rendered incomplete and misleading in that they failed to provide the complete picture, i.e., that the author and disseminators of the statements were financially interested in the success of the securities in the market."); S.E.C. v. Blavin, 557 F.Supp. 1304, 1312 (E.D. Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985) (unregistered investment advisor's "failure to disclose his substantial ownership of stock in the companies he was touting, and his intent to sell them soon after recommending that they be bought, was a material omission in violation of § 10(b).")."

The Commission has recently pursued a similar theory in the matter of *Lidingo Holdings*, where the U.S. District Court for the Western District of Washington found that the Commission's allegations were sufficient to state a claim for violation of Section 10(b) when a defendant "engaged in scalping activity wherein he purchased issuer stock just prior to publishing an article about the issuer, then sold the stock at a profit soon after his article was published, which was contrary to the advice he gave in his articles advocating holding for the long-term."[21]

Nonetheless, we are unaware of any scalping cases which have been brought by the Commission against short sellers to date. We recognize this may reflect a certain reticence by the Division of Enforcement to apply a scalping theory beyond the traditional setting of stock promotion ("touting"). We therefore urge the Commission to clarify by rule that liability for fraudulent scalping applies to any individual who encourages the sale of a security and purchases shares "for a quick profit" soon after an article is published, while failing to specifically disclose intent to do so. This is a simple adaptation of the Ninth Circuit's holding in *Zweig* to short selling.

As before, this disclosure obligation would not be satisfied by a simple boilerplate statement by the short seller that it might, sometime in the future, close out its short position. To be clear, we are not suggesting, as some have,[22] that the Commission require that short sellers hold a position for any duration of time to avoid liability. Rather, our proposal focuses solely on ensuring adequate disclosure.

Finally, we recognize that the possibility of liability for fraudulent scalping may chill legitimate criticism of public companies by short sellers, who serve an important function in the capital markets. We thus propose that the Commission adopt a **safe harbor** which allows for short sellers to close a position at a price equal to or lower than a valuation stated expressly or impliedly.

The rationale for this safe harbor is straightforward: when a negative activist states that a company is worth a given valuation, investors may sell the company's securities until the share price reaches the given price target. When a short seller closes its position at a share price equal to or lower than a stated valuation, he or she furthers price discovery by making it more likely that the share price reflects that proffered valuation.

On the other hand, when a short seller states that a company is worth a given valuation but purchases the stock at a price higher than the indicated valuation, the short seller is not furthering price discovery. Rather, the short seller is *buying* at the same time that he or she is encouraging other investors to *sell*.

To be sure, short sellers may have legitimate, non-fraudulent reasons for closing a position before the company's share price reaches an express or implied stated valuation, such as risk

[21] SEC v. Lidingo Holdings, Order Granting In Part and Denying In Part Motion to Dismiss, Case No. C17-1600 RSM, ECF No. 73 (W.D. Wash. May 11, 2018).

[22] *See* Joshua Mitts, *A Legal Perspective on Technology and the Capital Markets: Social Media, Short Activism and the Algorithmic Revolution* (working paper, 2020), at *15 ("[A] rule that requires traders to hold a position until the market has reached a consensus as to the value of the stock can be justified under the rational view that to do otherwise is weakly suggestive of manipulative intent.").

management or liquidity needs. However, in general, price discovery would be furthered by encouraging short sellers to communicate valuations which are consistent with their internal trading plans. Consistency between what a negative activist *says* and *does* reduces the likelihood of overreaction by public-company shareholders and makes it more likely that the share price reflects the true, fundamental value of the information produced by the short seller.

By promulgating the proposed safe harbor, the Commission would give negative activists confidence that a well-researched short thesis, which advocates that the firm's stock is overvalued by a given amount, can be freely traded upon at or below the indicated valuation. On the other hand, short sellers who use words like "insolvent," "bankrupt" or "zero" to characterize a public company would be unable to enjoy such the benefit of the safe harbor. However, such negative activists would not necessarily be subject to liability for fraudulent scalping unless they purchased shares for a profit soon after the article was published and failed to disclose their intent to do so.

Finally, we leave to the Commission to resolve more complicated settings such as when a short seller should be deemed to have commissioned a report by someone else (as in the GE/Markopolos case). At minimum, we suggest that the Commission indicate that a speaker who is compensated by a short seller must disclose any compensation and acknowledge that he or she is subject to a potential conflict of interest.

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