

SEC Enforcement Actions and Issuer Litigation in the Context of a “Short Attack”

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Issuers faced with a short attack—short selling of the issuer’s stock combined with the spread of negative rumors—may contemplate defensive strategies such as litigation and contacting government regulators, in addition to the investor and public relations efforts that are typically utilized in the wake of negative media coverage. Precedent calls for caution in these circumstances, as the record shows that the results of such strategies are mixed, with the SEC often turning its investigative focus to the issuer, and with costly litigation frequently resulting in compromise. This article begins with a discussion of the recent history of regulatory and legislative efforts to address concerns around short attacks and “naked” short selling. It then turns to a discussion of the SEC enforcement cases and private litigation relating to short attacks, and concludes that the SEC has appropriately brought enforcement cases only in clear-cut instances of fraud, while policing the margins through enforcement of the technical requirements of Regulation SHO. The article shows that the SEC enforcement record in this area, and the proof issues generally attendant to these cases, present important considerations for issuers who perceive themselves under siege in a short attack.

A “short attack” on an issuer, in its most blatant form, involves massive short selling of the issuer’s stock combined with the spread of negative rumors (and, in many cases, the spread of misleading or outright false information) about the company in the media.¹ Perhaps the most noted alleged short attacks in the recent past are those cited in connection with the demise of Bear Stearns

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1. The term “short attack” does not have a precise definition, and whether a particular series of actions by market participants in fact merit denomination by that term may be the subject of debate in any particular case. Commentators have also described “distort and short” campaigns (or “bear raids”) in which groups of traders “attempt to manipulate the market by spreading disparaging rumors about a particular company [while] [s]imultaneously . . . sell[ing] short, hoping to profit by the price decrease the rumor causes.” 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, 76 (2009) (footnote omitted). For purposes of this article, the term “short attack” is not limited to cases of manipulation, and refers to any situation in which an analyst or other third party disseminates misleading negative information about an issuer while selling short the issuer’s shares (or acting in concert with others who are short selling). As discussed below, whether a particular matter involves an intent to manipulate or deceive is often an outcome-determinative disputed question of fact.

Companies, Inc. (“Bear Stearns”) and Lehman Brothers Holdings Inc. (“Lehman”)—both of which claimed to have been felled by short sellers and rumor mongering in the midst of the financial crisis.² The Bear Stearns and Lehman cases, however, are simply two of the more notorious examples of alleged short attacks. Numerous other issuers have confronted the difficulties created by large short positions in their stock, while simultaneously dealing with negative news in the marketplace.

Short selling—the sale of a security that the seller does not own, or that is otherwise consummated by the delivery of a borrowed security—is, of course, both legal and in many cases beneficial to the market.³ Certain practices, however, such as where short selling is used to manipulate prices illegally, or is combined with the dissemination of false and misleading information, are rightly subject to criticism and legal action.⁴

Issuers faced with a short attack may consider defensive strategies such as litigation and contacting government regulators, in addition to the investor and public relations efforts that are routinely invoked in response to negative media coverage. The public record indicates that the results of such strategies are mixed, and that issuers should exercise caution before taking steps—such as reaching out to the U.S. Securities and Exchange Commission (“SEC” or “Commission”) or filing a lawsuit—that may open up a company to unanticipated and unwanted scrutiny.

With regard to the SEC, public statements by the commissioners and staff demonstrate a deep ambivalence on the part of the agency with respect to short selling and alleged short attacks. As discussed in Part I.B below, the SEC took steps to rein in short sellers in response to the severe market disruptions of 2008, and, in that context, the agency made statements suggesting that short sellers may have abused the market.⁵ On balance, however, the SEC’s

2. In the case of Bear Stearns and Lehman, the reports were that “naked” short selling (discussed below) was behind the firms’ demise. Lehman CEO Richard Fuld, testifying before Congress in fall 2008, stated: “The naked shorts and the rumor mongers succeeded in bringing down Bear Stearns, . . . [a]nd I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers.” Gary Matsumoto, *Naked Short Sales Hint Fraud in Bringing Down Lehman (Update1)*, BLOOMBERG.COM (Mar. 19, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=BJlqmqmFOTCA>. The SEC, in its 2008 emergency order banning “naked” short selling with respect to certain securities, also noted the “market impact of rumors” preceding the sale of Bear Stearns. See 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. 58166, 73 Fed. Reg. 42379 (July 15, 2008); see also Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Statement Before Open Commission Meeting (Apr. 8, 2009), available at <http://www.sec.gov/news/speech/2009/spch040809lass.htm> (stating that short selling appears to be “part of the story” behind “the collapse of Lehman Brothers and Bear Stearns”).

3. See, e.g., Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. 11232, 11235 (Mar. 10, 2010) (“Short selling provides the market with important benefits, including market liquidity and pricing efficiency.”). The mechanics of short selling and the regulatory framework are discussed in Part I.

4. *Id.* (discussing “bear raids”).

5. For example, in September 2008, the SEC noted its concern “about the possible unnecessary or artificial price movements based on unfounded rumors . . . exacerbated by short selling.” Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934, Taking Temporary Action

prevailing attitude toward short attack allegations has been skepticism. On the enforcement front, there is a discrete set of enforcement actions brought by the SEC over the past fifteen years in matters that may be characterized as “short attack” cases. A few of these cases involve enforcement actions against analysts and short sellers allegedly behind the short attacks. A number, however, involve enforcement actions against issuers and their principals. An analysis of these enforcement actions indicates that the SEC will take action against a short seller and associated persons where clear evidence links them to demonstrably false statements that are designed to affect the market for a target issuer’s securities. Where, however, a short seller or associated persons advance plausible allegations about an issuer, the SEC is often as likely to investigate the issuer as well as the short seller.

As to litigation, several issuers have sued alleged perpetrators of short attacks, asserting claims of state-law defamation, tortious interference, conspiracy, fraud, and market manipulation. A few issuers have achieved modest settlements. In many cases, however, issuers have struggled to overcome jurisdictional and procedural barriers, or muster sufficient proof to establish the elements of their claims or their entitlement to relief. Furthermore, a number of defendants in such suits have successfully defended themselves on the basis of constitutional or statutory free-speech protections. The public record also indicates that, although SEC investigations often accompany short attack litigation, few of those cases result in SEC enforcement action. There is some indication that free-speech concerns may have deterred the SEC from aggressively investigating alleged perpetrators of short attacks.⁶

This article begins with a discussion of the relatively short but somewhat convoluted recent history of the regulatory and legislative efforts by the SEC and Congress, respectively, to address concerns around short attacks and “naked” short selling. It then turns to a discussion of the SEC enforcement cases and private litigation relating to short attacks, with a focus on the difficulties faced by issuers in these cases. The article thereafter discusses the SEC’s numerous recent enforcement actions alleging “naked” short selling and related manipulation—cases that do not involve the tougher evidentiary issues presented by actions alleging fraud. The article concludes that the SEC has appropriately staked out a middle ground in short attack cases, bringing enforcement cases only in clear-cut instances of fraud, while policing the margins through enforcement of the technical requirements of Regulation SHO and allowing the market to assess the balance. This enforcement focus, and the proof issues generally attendant to “short

to Respond to Market Developments, Exchange Act Release No. 58591, 73 Fed. Reg. 55175, 55175 (Sept. 24, 2008). That concern came to the fore in the financial crisis, leading to a number of emergency orders in response to market developments. See *infra* Part I.B.

6. As discussed in Part III.B, the SEC subpoenaed several journalists in early 2006 in connection with an investigation into a research firm that allegedly conspired with short sellers to manipulate the stock of Overstock.com. The agency came under withering criticism, however, and it ultimately elected not to enforce those subpoenas.

attack” cases, present important considerations for issuers who perceive themselves under siege in a short attack.⁷

I. THE MECHANICS AND REGULATORY FRAMEWORK OF SHORT SELLING

A. MECHANICS OF SHORT SELLING

The mechanics of short selling are relatively straightforward: A short sale is the sale of stock that the seller does not own, or a sale that is consummated by the delivery of stock borrowed by the seller.⁸ In the typical case, the short sale is settled by the delivery of the borrowed security to the buyer; the seller subsequently will purchase securities on the open market in order to close out the position by returning shares to the lender.⁹ The short seller will profit by the difference between the (later) open-market purchase price and the (earlier) sale price (minus transactions costs, such as commissions and fees). In the typical case, the short seller makes arrangements to borrow the shares within the standard three-day settlement period and delivers the shares at settlement to the buyer.

In a “naked” short sale, the seller has not borrowed the shares, or otherwise made arrangements to borrow the shares, in time to deliver them to the buyer on the settlement date.¹⁰ Such a failure to deliver (“FTD”) may occur for various reasons and is not necessarily illegal. In fact, “naked” short selling is not in itself necessarily a violation of the federal securities laws.¹¹ However, actions that the

7. In addition to cases involving “short attacks,” the Commission has recognized that, under certain circumstances, short selling in and of itself, in the absence of rumor mongering, can be fraudulent or manipulative. *See, e.g., SEC v. Rhino Advisers, Inc.*, Litigation Release No. 18003, 79 SEC Docket 2079 (Feb. 27, 2003), 2003 WL 549243 (announcing a settled enforcement action arising out of an alleged scheme to manipulate the stock of Sedona Corporation to enhance the economic interest of the owner of a convertible debenture issued by Sedona, which allegedly involved extensive naked short selling that depressed the price of Sedona stock); *see also SEC v. Badian*, Litigation Release No. 22593 (Jan. 15, 2013), 2013 WL 152522 (announcing the settled resolution of a related enforcement action). Private plaintiffs, too, have charged securities market participants with engaging in abusive short selling schemes without accompanying allegations of rumor mongering. *See, e.g., Notice of Removal with Complaint, Taser Int'l, Inc. v. Morgan Stanley & Co.*, No. 1:10-cv-03108-JEC (N.D. Ga. Sept. 28, 2010) (removing action by Taser against eleven brokerage firms for allegedly conspiring to manipulate fraudulently Taser stock in the context of naked short selling, and charging the defendants with violations of Georgia statutory and common law). In this article, we focus primarily on cases in which allegations of abusive short selling are accompanied by allegations of disparagement of the issuer.

8. 17 C.F.R. § 242.200(a) (2012); *see U.S. Sec. & Exch. Comm'n, Short Sales*, <http://www.sec.gov/answers/shortsale.htm> (last modified Sept. 6, 2011).

9. U.S. Sec. & Exch. Comm'n, *Short Sales*, <http://www.sec.gov/answers/shortsale.htm> (last modified Sept. 6, 2011).

10. The “settlement date” is the date on which the participants to the transaction deliver and pay for the securities. Generally, the settlement date is three days after the trade date, commonly referred to as “T+3.” *See Amendments to Regulation SHO, Exchange Act Release No. 58775*, 73 Fed. Reg. 61690, 61691 n.4 (Oct. 17, 2008).

11. The SEC’s Division of Market Regulation (now the Division of Trading and Markets) has stated: Naked short selling is not necessarily a violation of the federal securities laws or the Commission’s rules. Indeed, in certain circumstances, naked short selling contributes to market liquidity. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when

SEC characterize as abusive “naked” short selling—such as selling stock short and failing to deliver shares at settlement with the intent to drive down the stock price, or selling short without having located stock for delivery at settlement (other than in the case of a market-maker)—are prohibited.¹² It was in response to such abusive practices that the SEC adopted Regulation SHO in 2004.¹³

B. FRAMEWORK OF SEC REGULATION

The Commission’s ambivalence regarding short selling and short attack allegations is evidenced by the regulatory actions taken by the agency over the past few years. Until the adoption of Regulation SHO, the primary restriction on short selling was former Rule 10a-1, which imposed (with certain exceptions) short sale price test restrictions commonly referred to as the “uptick rule.” Under that rule, a listed security could be sold short “(i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it was higher than the last different price (zero plus tick).”¹⁴ Rule 10a-1 was intended to restrict short selling in a declining market.¹⁵

Regulation SHO temporarily suspended applicable short sale price tests, including the “uptick rule,” in a specific group of securities in order to permit the SEC to evaluate those price tests.¹⁶ Regulation SHO also imposed new substantive restrictions on short selling, requiring that (i) broker-dealers locate a source of borrowable shares prior to selling short and (ii) firms that clear and settle trades “close out” FTD trades in certain so-called “threshold securities”¹⁷ by purchasing

there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. This is especially true for market makers in thinly traded, illiquid stocks such as securities quoted on the OTC Bulletin Board, as there may be few shares available to purchase or borrow at a given time.

Key Points About Regulation SHO, U.S. SEC. & EXCH. COMM’N (Apr. 11, 2005), <http://www.sec.gov/spotlight/keyregshoissues.htm> (footnotes omitted).

12. *Id.* § I.D. Market action with the intent to manipulate the price as a general matter would violate section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Selling short without having located the stock for delivery would violate Regulation SHO, subject to certain exceptions, such as for bona-fide market making.

13. See Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. 48008, 48028 (Aug. 6, 2004).

14. Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. 11232, 11235 n.41 (Mar. 10, 2010) (citing the adopting release for former Rule 10a-1, Exchange Act Release No. 1548 (Jan. 24, 1938), 1938 WL 32911). The NASD’s former “bid test” served a similar function for certain securities traded on Nasdaq or the over-the-counter (“OTC”) market. *Id.* at 11236 n.43.

15. *Id.* at 11235.

16. Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. 48008, 48030 (Aug. 6, 2004) (adopting 17 C.F.R. § 242.202T) (effective Sept. 7, 2004, to Aug. 6, 2007).

17. “Threshold securities,” as defined in the regulation, are equity securities of reporting companies (issuers registered or required to file reports with the SEC) that have large and persistent FTDs (that is, FTDs over five consecutive days totaling 10,000 shares or more and equal to at least 0.5 percent of the issuer’s total shares outstanding). 17 C.F.R. § 242.203(c)(6) (2012).

shares and settling by a date certain.¹⁸ That regulation also created uniform marking requirements for sales of all equity securities (such that they are marked as short or long sales).¹⁹

In June 2007, the SEC eliminated former Rule 10a-1 and adopted Rule 201 of Regulation SHO, which provided that “[n]o short sale price test, including any short sale price test of any self-regulatory organization, shall apply to any short sales in any security.”²⁰ Although the SEC did receive comments opposing the new rule on the ground that the price test restrictions were needed to prevent “bear raids,”²¹ as well as warnings of possible broader adverse market effects,²² the rule was implemented unchanged from the initial proposal.

The year following the repeal of the “uptick rule” saw allegations of short attacks on both Citigroup and Bear Stearns, the latter by some accounts leading to the demise of the firm, as noted above.²³ The SEC responded to these and other events with a series of emergency orders in the summer and fall of 2008.²⁴ The

18. *Id.* § 242.203(b). Regulation SHO initially required close-out within ten days of the settlement date (T+13). The close-out requirement was later made immediate, and certain exceptions to the close-out requirement (the “grandfather exception” and the “options market maker exception”) were eliminated in subsequent amendments to the regulation. The regulation prohibits the party responsible for the FTD from effecting further short sales until the position is closed out, unless arrangements are made to borrow the security. *Id.* § 242.203(b)(3)(iv). The regulation also amended Rule 105 of Regulation M to eliminate the shelf offering exception from the prohibition on covering short sales with offering securities purchased from an underwriter or broker or dealer participating in the offering. Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. at 48020.

19. 17 C.F.R. § 242.200(g) (2012). The regulation also calls for marking a short sale order “short exempt” if the seller is relying on an exception from the then-applicable “tick test” of former Rule 10a-1, or any short sale price test of any exchange or national securities association. *Id.* § 242.200(g)(2).

20. Regulation SHO and Rule 10a-1, Exchange Act Release No. 55970, 72 Fed. Reg. 36348, 36359 (July 3, 2007) (adopting 17 C.F.R. § 242.201) (amended, effective May 10, 2010, by Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. 11232 (Mar. 10, 2010)).

21. *See id.* at 36350.

22. The New York Stock Exchange (“NYSE”) commented:

The Exchange remains concerned about unrestricted short selling during periods of unusually rapid and large market declines, the effects of which could not be measured or analyzed as part of the Commission’s pilot suspending the provisions of Rule 10a-1 and any price test of any SRO, as such a decline did not occur during that period. Accordingly, the NYSE submits that it would be prudent to permit markets to propose rules to be applied in this specific situation should they deem it appropriate, subject to the Commission’s SRO rule-making and approval process.

Letter from Mary Yeager, Assistant Sec’y, NYSE, to Nancy M. Morris, Sec’y, U.S. Sec. & Exch. Comm’n (Feb. 14, 2007), available at <http://www.sec.gov/comments/s7-21-06/s72106-34.pdf>.

23. *See supra* note 2. On the alleged short attack on Citigroup, see, for example, VEDANT MISRA ET AL., EVIDENCE OF MARKET MANIPULATION IN THE FINANCIAL CRISIS 3 (Jan. 3, 2012), available at <http://necsi.edu/research/economics/bearraid.pdf> (analyzing certain market activity in November 2007, and concluding that “[t]he magnitude and coincidence of short activity is evidence of a concerted effort to drive down Citigroup’s stock price and achieve a profit, i.e., a bear raid”).

24. *See, e.g.*, Amendment to Order and Order Extending 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. 58724, 73 Fed. Reg. 58987 (Oct. 8, 2008).

Of the steps taken by the SEC in this time period, reinstatement of the “uptick rule” was not one of them, despite protests seeking its reinstatement. *See, e.g.*, Letter from Edward D. Herlihy & Theodore A. Levine, Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (June 17, 2009), available at <http://www.sec.gov/comments/s7-08-09/s70809-3690.pdf>;

initial series of orders in July 2008 imposed borrowing and delivery requirements on short sales of the equity securities of certain financial institutions.²⁵

Shortly thereafter, the SEC stated that its concerns were “no longer limited to just the financial institutions that were the subject of the July Emergency Order[s],” and that it was “concerned about the possible unnecessary or artificial price movements based on unfounded rumors regarding the stability of financial institutions and other issuers exacerbated by ‘naked’ short selling.”²⁶ To address these concerns, the SEC issued additional emergency orders temporarily prohibiting short selling the securities of a broad list of financial firms²⁷ imposing enhanced delivery requirements on short sales of all equity securities²⁸ and implementing a new “naked” short selling antifraud rule, Rule 10b-21.²⁹ The Commission also announced that, in response to “reports of trading irregularities and allegations of false rumor mongering, abusive short selling and possible manipulation of financial stocks,” the SEC’s Enforcement Division would expand an

Edward D. Herlihy & Theodore A. Levine, *The “Uptick Rule” and Other Measures to Address Abuses in the CDS Market Are Urgently Needed*, WACHTELL, LIPTON, ROSEN & KATZ (Jan. 21, 2009), <http://amlawdaily.typepad.com/files/the-uptick-rule-and-other-measures-to-address-abuses-in-the-cds-market-are-urgently-needed.pdf>; Edward D. Herlihy & Theodore A. Levine, *Reinstate the “Uptick Rule.”*, WACHTELL, LIPTON, ROSEN & KATZ (Nov. 20, 2008), http://amlawdaily.typepad.com/amlawdaily/files/reinstate_the_uptick_rule.pdf; Edward D. Herlihy & Theodore A. Levine, *It’s Time for the SEC to Constrain Abusive Short Selling*, WACHTELL, LIPTON, ROSEN & KATZ (July 1, 2008), http://www.abajournal.com/files/July_1_client_memo.pdf.

25. The July 15, 2008 order prohibited short sales in the securities of certain specified financial firms “unless such person or its agent has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting such short sale and delivers the security on settlement date.” 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. 58166, 73 Fed. Reg. 42379, 42379 (July 21, 2008). Subsequent orders provided for certain exceptions and extended the applicable time period for the restrictions until August 12, 2008. See Amendment to 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. 58190, 73 Fed. Reg. 42837 (July 23, 2008); Order Extending 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. 58248, 73 Fed. Reg. 45257 (Aug. 4, 2008).

26. 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. 58572, 73 Fed. Reg. 54875, 54875 (Sept. 23, 2008) [hereinafter Sept. 17, 2008 Emergency Order]; see also 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. 58591, 73 Fed. Reg. 55175, 55175 (Sept. 24, 2008) [hereinafter Sept. 18, 2008 Emergency Order].

27. 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. 58592, 73 Fed. Reg. 55169, 55170–74 (Sept. 24, 2008) (the prohibition in the order expired by its terms on October 2, 2008).

28. Sept. 17, 2008 Emergency Order, *supra* note 26, 73 Fed. Reg. at 54876 (the enhanced delivery requirements were included in new Rule 204T, which created penalties on market participants for failing to close out FTDs immediately after they occur).

29. *Id.* The Commission also made immediately effective regulatory amendments to “eliminate the options market maker exception from Regulation SHO’s close-out requirement.” *Id.* In addition, the Commission adopted a temporary rule requiring institutional money managers to report information daily on short sales of securities. Sept. 18, 2008 Emergency Order, 73 Fed. Reg. at 55175.

ongoing formal “investigation into possible market manipulation in the securities of certain financial institutions.”³⁰

In October 2008, the Commission made permanent its emergency adoption of Rule 10b-21, aimed at “naked” short selling.³¹ That rule prohibits a person from submitting 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.”³² At that time, the Commission also adopted Rule 204T (as an “interim final temporary rule”), which applied close-out requirements on fails to deliver resulting from sales of all equity securities (and not just threshold securities) and reduced the time frame within which fails to deliver must be closed out. Specifically, that rule required “that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred.”³³ The Commission also made permanent at this time the elimination of the options market-maker exception to the close-out requirement of Regulation SHO.³⁴

Each of these regulatory amendments was intended to address abusive “naked” short selling by reducing FTDs. In connection with the 2009 amendments to Regulation SHO, the Commission stated, “[t]o the extent that fails to deliver might be part of manipulative ‘naked’ short selling, which could be used as a tool to drive down a company’s stock price, such fails to deliver may undermine the confidence of investors.”³⁵ In July 2009, the Commission made permanent Rule 204T in the form of Rule 204, which imposed all of the same substantive restrictions as did the former temporary rule.³⁶ The adopting release stated that the rule was intended, among other things, to “help limit the use of ‘naked’ short selling as part of a manipulative scheme.”³⁷

30. Press Release, U.S. Sec. & Exch. Comm’n, SEC Expands Sweeping Investigation of Market Manipulation (Sept. 19, 2008) (No. 2008-214), available at <http://www.sec.gov/news/press/2008/2008-214.htm>.

31. “Naked” Short Selling Antifraud Rule, Exchange Act Release No. 58774, 73 Fed. Reg. 61666, 61677 (Oct. 17, 2008) (adopting 17 C.F.R. § 240.10b-21).

32. *Id.* The regulation specifically notes that it is not intended to limit or restrict the applicability of Rule 10b-5 or the other antifraud provisions of the federal securities laws. 17 C.F.R. § 240.10b-21 (2012).

33. Amendments to Regulation SHO, Exchange Act Release No. 58773, 73 Fed. Reg. 61706, 61707 (Oct. 17, 2008).

34. Amendments to Regulation SHO, Exchange Act Release No. 58775, 73 Fed. Reg. 61690, 61693 (Oct. 17, 2008). The Commission also adopted a disclosure rule, Rule 10a-3T, as an interim final temporary rule requiring institutional money managers to report short sales of certain securities. Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 58785, 73 Fed. Reg. 61678, 61680 (Oct. 17, 2008). That rule expired by its terms on August 1, 2009. See Troy A. Paredes, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks Before the Symposium on “The Past, Present and Future of the SEC” (Oct. 16, 2009).

35. Amendments to Regulation SHO, Exchange Act Release No. 60388, 74 Fed. Reg. 38266, 38267–68 (July 31, 2009) (footnote omitted).

36. *Id.* at 38266.

37. *Id.* at 38272.

At the same time, however, the staff of the SEC's Enforcement Division expressed reluctance to address allegedly abusive "naked" short selling through enforcement mechanisms. In March 2009, the Office of the Inspector General of the SEC ("OIG") issued an audit report regarding the Enforcement Division's handling of complaints and referrals regarding naked short selling ("OIG Audit").³⁸ The OIG Audit found, among other things, that the SEC received a large number of complaints regarding naked short selling, and that the OIG itself had received a number of complaints regarding the Enforcement Division's failure to take action regarding naked short selling.³⁹ The OIG Audit found that the Enforcement Division usually did not follow up on these complaints and "brought very few enforcement actions based on conduct involving abusive or manipulative naked short selling."⁴⁰

In response, the Enforcement Division observed the lack of unanimity regarding dangers associated with naked short selling, despite "a small but vocal cadre of advocates [that] has emerged decrying the practice and suggesting that it has damaging market effects."⁴¹ By way of example, the Division noted a recent instance in which it alleged that an issuer had concocted allegations of "naked" short selling to cover up its own dumping of large blocks of unregistered shares into the market.⁴² The Division argued that its resources are limited and must be leveraged intelligently, and therefore the Division has focused on:

complaints with a high likelihood of accuracy and credibility (like those of purported insiders or scam victims), those whose information can be readily vetted (i.e., visible price swings in a possible manipulation or insider trading allegation), or those involving demonstrated, immediate investor hazard in the current market environment (Ponzi schemes, improper sales of auction rate securities).⁴³

The Division suggested that most naked short selling complaints do not meet these criteria.⁴⁴

In February 2010, the Commission returned in a limited way to short sale price restrictions with the adoption of Rule 201, a "circuit breaker" intended to prevent short selling of an equity security, "including potentially manipulative or abusive short selling," in situations where that security has already seen a significant intra-day price decline.⁴⁵ That rule is intended to provide:

38. OFFICE OF AUDITS, OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, PRACTICES RELATING TO NAKED SHORT SELLING COMPLAINTS AND REFERRALS (2009), available at <http://www.sec-oig.gov/reports/AuditsInspections/2009/450.pdf>.

39. *Id.* at i–ii.

40. *Id.* at iii.

41. *Id.* at 40.

42. *Id.* at 40–41 (referencing the SEC's enforcement action against CMKM Diamonds and associated persons).

43. *Id.* at 42.

44. *Id.* at 21–22.

45. Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. 11232, 11232 (Mar. 10, 2010). As adopted, Rule 201 had an effective date of May 10, 2010, and a compliance date of November 10, 2010. *Id.* Due to potential operational concerns, the Commission later extended the compliance date to February 28, 2011. Regulation SHO, Exchange Act Release No. 63247, 75 Fed. Reg. 68702, 68702 (Nov. 9, 2010).

a targeted short sale price test restriction that will apply the alternative uptick rule [permitting short selling at a price above the current national best bid price] for the remainder of the day and the following day if the price of an individual security declines intra-day by 10% or more from the prior day's closing price for that security as determined by the covered security's listing market.⁴⁶

The Commission stated that it was “mindful that short selling provides benefits to the market,” and that the circuit breaker test of Rule 201 was “designed to limit any potentially unnecessary impact on legitimate short selling.”⁴⁷

C. RECENT LEGISLATION AND REGULATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) contains certain provisions relating to the regulation of short sales. Section 929X(b) of the Dodd-Frank Act prohibits the “manipulative short sale of any security.”⁴⁸ Section 929X(c) of the Dodd-Frank Act requires broker-dealers to:

provide notice to [their] customers that they may elect not to allow their fully paid securities to be used in connection with short sales. If a broker or dealer uses a customer's securities in connection with short sales, the broker or dealer shall provide notice to its customer that the broker or dealer may receive compensation in connection with lending the customer's securities. The Commission, by rule, as it deems necessary or appropriate in the public interest and for the protection of investors, may prescribe the form, content, time, and manner of delivery of any notice required⁴⁹

Sections 929X(b) and 929X(c) took immediate effect. Section 929X(a) of the Dodd-Frank Act mandated that the SEC promulgate rules requiring at least monthly public disclosure by institutional investment managers of:

the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the Commission following the end of the reporting period.⁵⁰

The Commission has not yet exercised its authority under sections 929X(a) and 929X(c) to promulgate new rules regulating short sales.

Section 417(a)(2) of the Dodd-Frank Act requires the SEC's Division of Risk, Strategy, and Financial Innovation to study:

(A) the feasibility, benefits, and costs of requiring reporting publicly, in real time short sale positions of publicly listed securities, or, in the alternative, reporting such short positions in real time only to the Commission and the Financial Industry Regulatory Authority; and

46. Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. at 11234.
47. *Id.* at 11241.

48. Pub. L. No. 111-203, § 929X(b), 124 Stat. 1376, 1870 (2010) (to be codified at 15 U.S.C. § 78i(d) (Supp. V 2011)).

49. *Id.* § 929X(c), 124 Stat. at 1870–71 (to be codified at 15 U.S.C. § 78o(e) (Supp. V 2011)).

50. *Id.* § 929X(a), 124 Stat. at 1870 (to be codified at 15 U.S.C. § 78m(f) (Supp. V 2011)).

(B) the feasibility, benefits, and costs of conducting a voluntary pilot program in which public companies will agree to have all trades of their shares marked “short”, “market maker short”, “buy”, “buy-to-cover”, or “long”, and reported in real time through the Consolidated Tape.⁵¹

To better inform the study required by section 417(a)(2) of the Dodd-Frank Act, the SEC released a wide-ranging request for comments on the existing uses of short selling, the adequacy of currently available information regarding short sales, and the likely impact of possible future reporting regimes.⁵² The Commission requested comment on, among other issues:

the ways and the extent to which, if any, commenters believe that short selling has been associated with abusive market practices, such as “bear raids” where an equity security is sold short in an effort to drive down the security’s price by creating an imbalance of sell-side interest? In addition, the Commission requests comment on the ways and extent to which, if any, commenters believe trade-based manipulation (i.e., manipulating without a corporate action or spreading false information) using short sales is possible? Would greater transparency of short positions or short sale transactions help to better deter or prevent such abuses, or assist in additional appropriate actions to prevent them?⁵³

The Commission also requested comment on whether disclosure of “real time short position data,” either to regulatory agencies or to the public, “[c]ould . . . help to detect more easily, better deter, or better prevent short selling abuses,” and, similarly, whether the marking of trades as “long,” “short,” “market maker short,” “buy,” and “buy to cover” could “help to better detect, deter, or prevent identified short selling abuses,” or whether they might alternatively “present opportunities for alleged unfair or otherwise abusive market practices, such as bear raids or short squeezes.”⁵⁴

The SEC received over 170 comments in response to its request.⁵⁵ A large proportion of those comments were from individuals, most of whom voiced support for increased regulation of short selling (or an outright ban).⁵⁶ One commenter observed that, although recent regulatory innovations have reduced FTDs, FTDs persist at a significant level, suggesting that abusive “naked” short selling remains

51. *Id.* § 417(a)(2), 124 Stat. at 1579. The term “Consolidated Tape” refers to the current reporting systems for transactions in all exchange-listed stocks and ETFs, but not unlisted equities, options, or non-equity securities. Short Sale Reporting Study Required by Dodd-Frank Section 417(a)(2), Exchange Act Release No. 64383, 100 SEC Docket 3701 (May 3, 2011), 2011 WL 1681680, at *1 n.2 [hereinafter Short Sale Reporting Study Release].

52. Short Sale Reporting Study Release, *supra* note 51, 2011 WL 1681680, at *2.

53. *Id.* at *3 (footnotes omitted).

54. *Id.* at *4, *6.

55. See *Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/comments/4-627/4-627.shtml> (last modified July 23, 2012).

56. See, e.g., *Comment from Mouran Zarouri, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM’N (May 10, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>; *Comment from Steven Holloway, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM’N (Sept. 22, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>.

a problem.⁵⁷ This observation complemented another commenter's assertion, based on a survey of corporate communications officers, that many issuers believe their stocks have been affected by unfounded rumors combined with short selling, and that this has been exacerbated by a lack of transparency around short selling.⁵⁸ Several commenters argued that better information about the quantity and nature of short selling would facilitate identification of abusive practices by short sellers.⁵⁹

A number of commenters, including various financial industry trade associations, have argued against additional regulation of short selling. Some of these commenters have cited what they view as an incorrect belief that short sellers have a special propensity for fraud or market abuse.⁶⁰ Indeed, commenters have argued that short sellers play a special role in identifying fraud, not perpe-

57. Letter from Janet L. McGinness, Senior Vice President—Legal & Corporate Sec'y, NYSE Euronext, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N, 2 (June 21, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> (stating that "FTDs continue at significant levels, especially for a discrete number of companies and exchange traded funds," and that, as of May 13, 2011, there were "outstanding FTDs total[ing] 305,264,811 shares").

58. Letter from Jeffrey D. Morgan, President & CEO, Nat'l Investor Relations Inst., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N (June 21, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>.

59. See Letter from Dennis Nixon, CEO & Chairman, Int'l Bancshares Corp., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N (July 18, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> ("Reporting of short positions will protect against market manipulation and panic-fueled stampedes . . . by allowing investors to trace the source of misleading rumors . . ."); Letter from James J. Angel, Assoc. Professor of Fin., Georgetown Univ., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N, 2 (June 24, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> ("[I]t is very difficult to identify and prosecute malicious rumor-mongers. Information related to the identity and size of economic short positions—whether in cash equities or derivatives—would help to identify those with a motive to engage in defamatory practices."); Letter from Donal Smith, CEO, Data Explorers, Inc., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N, 7 (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> [hereinafter Data Explorers Letter] ("It is theoretically possible for short sellers to drive down share prices when they cause the balance of overall supply to significantly exceed demand Smaller, thinly traded stocks are . . . most vulnerable to manipulation. . . . We believe the regulator would benefit from increased disclosure of significant position changes which would alert the regulator to abnormal behavior or material changes/acceleration of shorting activity."); Letter from Jonathan E. Johnson III, President, Overstock.com, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N, 2 (May 19, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>. ("If issuers suspect that market manipulation is occurring, the availability of real-time trade data may help to support these suspicions.").

60. See Letter from Jiří Król, Dir. of Gov't & Regulatory Affairs, Alt. Inv. Mgmt. Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> [hereinafter AIMA Letter]; Letter from James S. Chanos, Chairman, Coal. of Private Inv. Cos., to Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM'N (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> [hereinafter CPIC Letter].

trating it.⁶¹ Commenters noted that no enforcement actions resulted from the SEC's efforts in 2008 to investigate whether hedge funds and other short sellers were engaged in rumor-mongering and market abuse during the financial crisis.⁶² Similarly, one commenter observed that the Commission in 2008 temporarily required certain institutional investors to report short positions so that the agency could monitor for manipulative short selling practices. The commenter inferred that no manipulation was identified, because the requirement was allowed to expire in 2009.⁶³ Commenters also cited evidence that the likely culprits behind precipitous declines in equity prices during the financial crisis were not short sellers, but long investors fleeing their positions.⁶⁴

Several groups argued that additional regulation of short selling is unnecessary because existing regulations, including Rules 204 and 10b-21, have reduced FTDs and addressed abusive short selling to the extent that it occurs.⁶⁵ Some commenters also argued that a wealth of short selling data is already available to the public,⁶⁶ and that further disclosure of short selling data—particularly data that identifies the short seller—could result in a raft of undesirable out-

61. See CPIC Letter, *supra* note 60, at 3; *Comment of John Bird, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM'N (May 6, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>. Mr. Bird is a Texas-based investor who is said to have been among the first to take short positions in U.S.-listed Chinese reverse merger companies, while publicizing discrepancies between Chinese and U.S. regulatory filings. See, e.g., Daniel Baseet, et al., *Special Report: The "Shorts" Who Popped a China Bubble*, REUTERS.COM (Aug. 5, 2011), <http://www.reuters.com/article/2011/08/05/us-china-accounting-shorts-idUSTRE7740PC20110805>; Dune Lawrence, *Texas Short Seller Fights China Fraud in \$20 Billion U.S. Shares*, BLOOMBERG.COM (Jan. 13, 2011), <http://www.bloomberg.com/news/2011-01-13/texas-short-seller-fights-china-fraud-in-20-billion-u-s-shares.html>.

62. See CPIC Letter, *supra* note 60, at 5 (citing Press Release, U.S. Sec. & Exch. Comm'n, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008) (No. 2008-140)); *Letter from Stuart J. Kaswell, Exec. Vice President & Managing Dir., Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM'N, 2 (June 22, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> [hereinafter MFA Letter].

63. *Letter from Jennifer S. Choi, Assoc. Gen. Counsel, Inv. Adviser Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM'N, 2-3 (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>. (citing Rule 10a-3T, discussed at *supra* note 34).

64. See *Letter from Ira D. Hammerman, Senior Managing Dir. & Gen. Counsel, Sec. Indus. & Fin. Mkts. Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM'N, 12 (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml> [hereinafter SIFMA Letter] (citing a December 2008 analysis by the Commission's Office of Economic Analysis); MFA Letter, *supra* note 62, at 4-5 (same); see also Data Explorers Letter, *supra* note 59, at 6 ("[C]ompared with the activities of long only funds, the scale of short positions is usually small. Long only funds, as the owners or managers of assets, clearly have a vested interest in higher share prices, but are also the primary providers of lendable inventory which makes short selling possible. This suggests that for most stocks, at most times, the impact of short selling will be minimal.")

65. See *Letter from Kimberly Unger, Exec. Dir., Sec. Traders Ass'n of N.Y., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)*, U.S. SEC. & EXCH. COMM'N, 5 (July 5, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>; SIFMA Letter, *supra* note 64, at 2; MFA Letter, *supra* note 62, at 3.

66. See, e.g., CPIC Letter, *supra* note 60, at 11-12 (noting that the public has access to data regarding aggregate and/or specific short sales from various exchanges, self-regulatory organizations, the

comes, such as revealing proprietary trading strategies of legitimate short sellers, abusive “short squeezes,” market-distorting “copycat” trading, and front-running of institutional order flow by sophisticated traders.⁶⁷

The Dodd-Frank Act called for the Commission to deliver its report on the results of the study required by section 417(a)(2) to Congress by July 21, 2011.⁶⁸ Section 417(a)(1) of the Dodd-Frank Act also requires the Division of Risk, Strategy, and Financial Innovation to conduct a second study, “taking into account current scholarship, on the state of short selling on national securities exchanges and in the over-the-counter markets, with particular attention to the impact of recent rule changes and the incidence of (A) the failure to deliver shares sold short; or (B) delivery of shares on the fourth day following the short sale transaction.”⁶⁹ The statute requires the Commission to submit to Congress a report on this study by July 21, 2012.⁷⁰

Section 984 of the Dodd-Frank Act amends section 10 of the Securities Exchange Act of 1934 (“Exchange Act”) (prohibiting “[m]anipulative and deceptive devices”).⁷¹ As amended, that provision prohibits the effectuation, acceptance, or facilitation of any “transaction involving the loan or borrowing of securities 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.”⁷² The statute required the Commission to, by July 21, 2012, promulgate rules “designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities.”⁷³

II. SEC ENFORCEMENT ACTIONS IN THE CONTEXT OF SHORT ATTACKS

A. SEC ACTIONS AGAINST SHORT SELLERS AND RELATED PARTIES

Consistent with the Commission’s caution in this area, the cases in which the SEC has pursued an enforcement action against a short seller in the context of a short attack involve clear evidence linking the short seller to false statements that

Commission and Bloomberg, and that vendors such as Data Explorers and SunGard offer stock lending data).

67. See MFA Letter, *supra* note 62, at 9; AIMA Letter, *supra* note 60, at 4–16; CPIC Letter, *supra* note 60, at 37; Letter from Karrie McMillan, Gen. Counsel, Inv. Co. Inst., to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM’N (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>; Letter from Charles M. Jones, Professor of Fin. & Econ., Columbia Bus. Sch., Adam V. Reed, Prof. of Fin., Univ. of N.C. & William Waller, Fin. Dep’t Ph.D. Student, Univ. of N.C., to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n, Comments on Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), U.S. SEC. & EXCH. COMM’N (June 23, 2011), <http://www.sec.gov/comments/4-627/4-627.shtml>; SIFMA Letter, *supra* note 64, at 4–6.

68. Pub. L. No. 111-203, § 417(b)(2), 124 Stat. 1376, 1579 (2010). The agency did not meet this deadline.

69. *Id.* § 417(a)(1), 124 Stat. at 1579.

70. *Id.* § 417(b)(1), 124 Stat. at 1579. The agency did not meet this deadline.

71. *Id.* § 984(a), 124 Stat. at 1932 (to be codified at 78j(c)(1) (2006 & Supp. V 2011)).

72. *Id.*

73. *Id.* § 984(b), 124 Stat. at 1933. The agency did not meet this deadline.

were disseminated for the purpose of depressing the price of a shorted stock. One significant short attack resulting in enforcement action involved Barry Minkow and Lennar Corporation (“Lennar”). The court filings in a private civil fraud action against Minkow by Lennar provide the details of Minkow’s alleged scheme.⁷⁴ In 2009 (and prior years), Minkow operated a company called the Fraud Discovery Institute, Inc. (“FDI”) out of San Diego, California.⁷⁵ In January 2009, FDI allegedly issued a fraudulent press release citing the “Top 10 Red Flags for Fraud at Lennar Corporation.” The press release directed readers to a website containing false information about Lennar, accusing the company of fraud and “financial crime.”⁷⁶ Minkow and others allegedly spread additional false information about Lennar over the internet and through press releases over the course of the next year. Minkow was said to have engaged in this conduct in order to “artificially manipulate and depress Lennar’s stock price.”⁷⁷ The primary purpose of Minkow’s scheme was allegedly to extort money from Lennar and associated persons,⁷⁸ but Minkow also reportedly sold Lennar short around the time he issued the January 2009 press release.⁷⁹

In late 2011, the SEC filed a settled administrative proceeding against Minkow, barring him pursuant to section 203(f) of the Investment Advisers Act of 1940 from association with any investment adviser, broker, dealer, municipal securities dealer, or transfer agent.⁸⁰ That action arose out of Minkow’s guilty plea to one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.⁸¹ In that criminal case, Minkow pled guilty to the allegation that he had:

knowingly and intentionally conspired to execute a scheme and artifice to defraud in connection with Lennar Corporation (“Lennar”) common stock and obtained, by means of false and fraudulent pretenses, representations, and promises, money and property in connection with the purchase and sale of Lennar securities, that

74. See *Lennar Corp. v. Briarwood Capital, LLC*, No. 08-55741 CA 40, slip op. at 3–6 (Fla. Cir. Ct. June 1, 2011) (stipulated final judgment against defendants Barry Minkow and Fraud Discovery Institute, Inc.) [hereinafter *Lennar Judgment*], available at <http://www.courthousenews.com/2011/06/21/Minkow.pdf>.

75. *Id.* at 1–4. Minkow had a criminal history prior to this incident. He was found guilty of racketeering and securities fraud in December 1988 in connection with the ZZZZ Best Ponzi scheme and sentenced to twenty-five years in prison. See *Minkow of ZZZZ Best Gets 25 Years*, N.Y. TIMES, Mar. 28, 1989, at D19. Released after seven-and-a-half years, Minkow thereafter established FDI as a for-profit investigative firm, and he held himself out as a reformed felon. See Roger Parloff, *Barry Minkow: All-American Con Man*, FORTUNE.COM (Jan. 5, 2012), <http://features.blogs.fortune.cnn.com/2012/01/05/barry-minkow-con-man>.

76. *Lennar Judgment*, *supra* note 74, at 3.

77. *Id.* at 3–5.

78. See *id.* at 4–6.

79. See Robbie Whelan, *Minkow Will Plead to Insider Trading*, WALL ST. J., Mar. 17, 2011, at C3 (reporting statement by Minkow’s lawyer).

80. Barry J. Minkow, Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions, Investment Advisers Act Release No. 3320, at 1–2 (Nov. 22, 2011) [hereinafter *Minkow Release*], available at <http://www.sec.gov/litigation/admin/2011/ia-3320.pdf>.

81. Plea Agreement at 1, *United States v. Minkow*, No. 1:11-cr-20209-PAS (S.D. Fla. Mar. 22, 2011).

the purpose of the conspiracy was to artificially manipulate and depress Lennar's stock price to induce Lennar to make payments of cash and common stock to Minkow's co-conspirator, and that Minkow induced a law enforcement agency to open a criminal investigation against Lennar with a false and misleading report, and subsequently misappropriated that information by trading in Lennar securities for his own personal benefit.⁸²

Minkow was sentenced in the criminal case to five years in prison and ordered to pay restitution in the amount of \$583,573,600.⁸³ Lennar and Minkow settled Lennar's civil case for the same amount.⁸⁴

Another action in which the SEC filed charges against a short seller who spread false rumors arose out of The Blackstone Group's ("Blackstone") announced acquisition of Alliance Data Systems Corp. ("ADS") in 2007.⁸⁵ ADS had entered into a definitive agreement to be acquired by Blackstone for \$81.75 per share.⁸⁶ Subsequently, Paul Berliner, a trader at Schottenfeld Group, LLC, drafted and disseminated a number of instant messages containing the false rumor that the ADS board of directors was meeting to consider a revised proposal from Blackstone to acquire ADS at \$70 per share.⁸⁷ ADS stock, which had been trading in the range of \$77 per share, promptly dropped to an intraday low of \$63.65 per share.⁸⁸ Berliner sold short 10,000 shares of ADS stock within minutes of disseminating the false rumor and was able to cover that short position upon the drop in stock price, making a profit in excess of \$25,000.⁸⁹

The SEC sued Berliner for fraud under both section 17(a) of the Securities Act of 1933 (the "Securities Act") and section 10(b) of the Exchange Act, as well as for market manipulation under section 9(a)(4) of the Exchange Act.⁹⁰ Berliner

82. Minkow Release, *supra* note 80, at 2.

83. United States v. Minkow, No. 1:11-cr-20209-PAS, slip op. at 2, 5 (S.D. Fla. July 21, 2011) (judgment).

84. *Lennar* Judgment, *supra* note 74, at 6–8. The United States and Minkow agreed that any sums paid against the civil award would reduce the outstanding amount of restitution in the criminal case. Stipulation Regarding Restitution at 1, United States v. Minkow, No. 1:11-cr-20209-PAS (S.D. Fla. July 21, 2011).

85. Complaint, SEC v. Berliner, No. 1:08-cv-03859-JES (S.D.N.Y. Apr. 24, 2008).

86. *Id.* ¶ 1.

87. *Id.*

88. *Id.* ¶ 2.

89. *Id.* ¶¶ 1–3.

90. *Id.* ¶¶ 4, 20–28. The claim under section 9(a)(4) of the Exchange Act, 15 U.S.C. § 78i(a)(4), was unusual, although not unprecedented. "The central purpose of section 9(a) is . . . to keep an open and free market where the natural forces of supply and demand determine a security's price." *Trane Co. v. O'Connor Sec.*, 561 F. Supp. 301, 304 (S.D.N.Y. 1983) (citing *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 383 (2d Cir. 1973)). Section 9(a)(4) prohibits false or misleading statements by a purchaser, seller, or offeror of a listed security or certain swaps based on such securities "for the purpose of inducing the purchase or sale of such security." 15 U.S.C. § 78i(a)(4) (2006 & Supp. V 2011). The subsection is "intended to apply to misrepresentations made in the course of manipulative schemes banned by section 9." *Chemetron Corp. v. Bus. Funds, Inc.*, 682 F.2d 1149, 1161 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983). The Commission has on occasion brought actions to enforce section 9(a)(4). *See, e.g.*, District Court Enters Final Judgment of Permanent Injunction and Other Relief Against Defendant Richard Karp, Litigation Release No. 21496, 98 SEC Docket 1197 (Apr. 21, 2010), 2010 WL 1617154; A.R. Baron & Co., Exchange

settled that action without admitting or denying the allegations of the SEC's complaint, consenting to an injunction against future violations of the antifraud and anti-manipulation provisions of the federal securities laws; and agreeing to disgorge profits and interest, and to pay a penalty.⁹¹ In a related administrative proceeding, Berliner agreed to be barred from association with any broker or dealer.⁹²

In what appears to be one of the most clear-cut cases of an improper short attack, Mark Jakob, a twenty-three-year old employee of Internet Wire, Inc. ("Internet Wire"), a press release distribution company, allegedly sold short the stock of Emulex Corporation ("Emulex"), while causing a fraudulent press release about Emulex to be issued.⁹³ Jakob apparently undertook his actions to extricate himself from a jam. According to the SEC, a week before issuing the fraudulent press release, Jakob had sold short 3,000 shares of Emulex at an average price of \$80 per share.⁹⁴ Emulex stock thereafter rose over the course of the week to above \$113 per share, allegedly resulting in unrealized losses for Jakob of more than \$97,000.⁹⁵ It was at this point that Jakob allegedly e-mailed his employer, using an alias and purporting to be acting for Emulex, and instructed Internet Wire to issue a press release stating that the SEC was investigating Emulex, that the CEO had resigned, and that the company would be revising its earnings to report a loss rather than a profit.⁹⁶ This false press release roiled the market, causing the stock to drop by \$61 per share on heavy trading volume.⁹⁷ Jakob allegedly covered his short position in Emulex stock, making a profit of \$54,000.⁹⁸

Within days, the SEC filed a civil injunctive action against Jakob, charging him with violations of section 17(a) of the Securities Act and section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.⁹⁹ Jakob was also arrested and charged criminally.¹⁰⁰ Jakob subsequently settled the SEC's lawsuit, consenting to an injunction against future violations of the federal securities laws and agreeing to disgorgement and the payment of a penalty.¹⁰¹ In the criminal case, Jakob

Act Release No. 37830, 63 SEC Docket 45 (Oct. 17, 1996), 1996 WL 595669; SEC v. Weakland, Litigation Release No. 12746, 47 SEC Docket 1329 (Dec. 27, 1990), 1990 WL 322590; Brentlinger & Hosea, Inc., Exchange Act Release No. 3460, 13 S.E.C. 622 (1943), 1943 WL 29588.

91. SEC Charges Wall Street Trader with Fraud for Spreading False Rumor, Litigation Release No. 20537, 93 SEC Docket 214 (Apr. 24, 2008), 2008 WL 1827759.

92. Paul S. Berliner, Exchange Act Release No. 57774, 93 SEC Docket 545 (May 5, 2008), 2008 WL 1945982.

93. See SEC v. Jakob, Litigation Release No. 16671, 73 SEC Docket 415 (Aug. 31, 2000), 2000 WL 1232989, at *1.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.* Jakob also allegedly purchased additional shares at the time, later selling those shares for a profit of over \$186,000. *Id.*

99. *Id.*

100. *Id.* at *2.

101. SEC Settles Case Against Defendant in Emulex Hoax, Litigation Release No. 17079, 2001 WL 844393, at *1 (July 25, 2001). Under the court order approving the settlement, Jakob was required to disgorge his gains of \$241,000, plus an amount equal to the trading losses he allegedly avoided by his

pleaded guilty to two counts of securities fraud and one count of wire fraud and was sentenced to forty-four months in prison.¹⁰²

Although these SEC enforcement actions demonstrate that the SEC will, in appropriate cases, sue perpetrators of short attacks, they also show the high bar that must be met before the Commission will file a case. The facts in each of the cases discussed above were, as alleged, egregious, with criminal prosecutions pursued in two of those matters. It appears that, absent comparably glaring misconduct, SEC enforcement action against market participants undertaking an alleged short attack should not be expected.

B. SEC ACTIONS AGAINST ISSUERS

The Commission's ambivalence regarding short attack claims may be rooted in the fact that, in several high-profile cases, allegations of short attacks led to investigations and enforcement actions against the purported victims—the issuers and their executives. One such case of an alleged short attack that received a fair amount of publicity at the time and still reverberates today involved a feud between David Einhorn's firm, Greenlight Capital LLC ("Greenlight Capital"), and Allied Capital Corporation ("Allied"). That feud resulted in, inter alia, a report by the SEC's OIG titled *Allegations of Conflict of Interest, Improper Use of Non-Public Information and Failure to Take Sufficient Action Against Fraudulent Company* (the "OIG Report").¹⁰³ The OIG Report states that:

The feud began in May 2002 when Einhorn gave a negative speech at a conference about Allied and described why Greenlight Capital had a short position in Allied. Einhorn's speech compelled many to also short and sell Allied's stock the next day. . . .

Einhorn claimed that Allied overvalued many of its investments.¹⁰⁴

According to the OIG Report, both parties sought to convince the SEC to investigate the other:

The [OIG] investigation revealed that Allied successfully lobbied the SEC to begin investigating Einhorn and his hedge fund Greenlight Capital without specific evidence of wrongdoing, after Einhorn's negative speech about Allied in May 2002. . . .

actions, approximately \$97,000, plus interest. Those funds were held for distribution to shareholders in a federal class action case that had been filed against Jakob. Jakob was also required to pay a civil penalty of \$102,642. *Id.*

102. Defendant in *Emulex Hoax Sentenced*, Litigation Release No. 17094, 75 SEC Docket 1317 (Aug. 8, 2001), 2001 WL 892789, at *1.

103. See OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, REPORT OF INVESTIGATION, CASE NO. OIG-496, ALLEGATIONS OF CONFLICT OF INTEREST, IMPROPER USE OF NON-PUBLIC INFORMATION AND FAILURE TO TAKE SUFFICIENT ACTION AGAINST FRAUDULENT COMPANY (2010) (partially redacted) [hereinafter OIG Report], *redacted text available at* [http://www.sec-oig.gov/Reports/OOI/2011/OIG-496%20\(redacted\).pdf](http://www.sec-oig.gov/Reports/OOI/2011/OIG-496%20(redacted).pdf).

104. *Id.* at 2.

The OIG investigation further revealed that during the same time Allied was able to convince the SEC to investigate Einhorn, even without any evidence of wrongdoing, Einhorn was submitting specific and detailed letters to the SEC outlining evidence of Allied's overvalued investments and requesting the SEC to investigate Allied.¹⁰⁵

The OIG Report provides some detail on Allied's efforts to convince the SEC to open an investigation of Einhorn and Greenlight Capital:

According to a Senior Official in [the Division of] Investment Management, Allied requested a meeting with [the Division of] Enforcement in June 2002 to try to convince them to investigate Einhorn. . . . When asked what evidence Allied presented that Einhorn and Greenlight Capital had engaged in wrongdoing the Senior Official testified,

Well, they had his speech, they had his admission that he was short. They had their beliefs that they were doing the right thing. From their perspective, they were in the right and he was in the wrong and Enforcement should hop to it.

The result of the meeting, the Senior Official said, was that the facts presented two possible wrongdoers: Einhorn or Allied. . . . The Senior Official testified that he took the position that Allied should be investigated. But instead, Enforcement started investigating Einhorn first.¹⁰⁶

Ultimately, the investigation of Greenlight Capital was closed and no enforcement action was taken against the firm or Einhorn.¹⁰⁷

Einhorn had greater success in his efforts to convince the SEC to pursue Allied, and the Enforcement Division ultimately did investigate Allied regarding the claims raised by Einhorn.¹⁰⁸ That investigation spanned three years and included a parallel criminal investigation by the United States Attorney's Office (the "USAO") for the District of Columbia.¹⁰⁹ The SEC filed a settled enforcement action at the conclusion of its investigation of Allied.¹¹⁰ The administrative settlement in that matter included findings, which Allied neither admitted nor denied, that Allied had violated the Exchange Act's books and records and internal controls provisions by failing to maintain accounts that accurately and fairly reflected the valuations it recorded of its securities and certain portfolio companies.¹¹¹ Allied agreed in that settlement to continue to employ a Chief Valuation

105. *Id.*

106. *Id.* at 14–15 (citations omitted).

107. *See id.* at 3. The OIG Report states that "although the investigation against Einhorn was a practical matter completed by mid-2003, the investigation was not formally closed until December 2006 and Einhorn was never notified that he was no longer a subject of investigation, despite his request for such notification." *Id.*

108. *See id.* at 3–4. Einhorn apparently wrote "detailed complaints about Allied" to the SEC, sending a dozen letters and meeting twice with the Enforcement staff, while providing "specific examples" of his "systemic valuation concerns." *Id.* at 17.

109. *Id.* at 53. The USAO investigation did not result in criminal charges. *Id.*

110. *See* Allied Capital Corp., Exchange Act Release No. 55931, 90 SEC Docket 2389 (June 30, 2007), 2007 WL 1773811.

111. *Id.* at *1. According to the settlement order, Allied was a closed-end investment company that had elected to be run as a business development company pursuant to section 54 of the Investment Company Act of 1940. *Id.* As the majority of Allied's portfolio consisted of securities for which market quotations were not readily available, it had to calculate fair value based on other factors

Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation process, and to continue to employ third-party valuation consultants to assist in its quarterly valuation process.¹¹² No penalty was assessed against Allied.

Another case of an issuer alleging a short attack only to be subsequently sued by the SEC involved Spongetech Delivery Systems, Inc. (“Spongetech”). Spongetech was a New York based company that held itself out as a producer and distributor of sponge-based cleaning products.¹¹³ In April 2010, Spongetech, its CEO, and its CFO sued the *New York Post*’s holding company and others, alleging a “short and distort” stock market manipulation scheme” pursuant to which a *New York Post* writer, other writers, and affiliated traders were alleged to have harmed the company through:

the publication of negative, false and/or defamatory statements in various New York Post articles concerning plaintiff, its executives, officers and directors. “Short Selling” stock, although it has not been restricted by the Securities and Exchange Commission since July 2007, has a dark side in that a small number of unethical traders use the practice of “short and distort” to manipulate the process in a bear market by taking short positions and then using smear campaigns to drive down the target stocks. This is a mirror version of the “pump and dump” where unethical individuals buy stock (take a long position) and issue false and misleading statements that cause the target stock’s price to increase. . . .

The clear purpose of the negative articles about [Spongetech] and its executives was to “smear” their public persona and reputation and, upon information and belief, drive the stock price of the Company down for the benefit of [trader defendant] and other “short sellers”¹¹⁴

The plaintiffs alleged multiple counts of fraud and libel against the defendants and sought compensatory and punitive damages.¹¹⁵

A few days after Spongetech had filed its lawsuit, the SEC sued the company, Michael E. Metter, the company’s CEO, and Steven Y. Moskowitz, the Company’s CFO, alleging that they had:

engaged in a scheme to increase demand illegally for, and profit from, the unregistered sale of publicly-traded stock in Spongetech. . . . [They] accomplished this by,

under Accounting Series Release No. 118. *Id.* at *2 & n.1. The order alleges that Allied was unable to support and document its valuations. *Id.* at *2–4. The findings in the order included violations of Exchange Act section 13(b)(2)(A) (requiring reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of assets); section 13(b)(2)(B)(ii) (requiring reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP); and section 13(b)(2)(B)(iv) (requiring reporting companies to provide reasonable assurances that the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences). *Id.* at *4–5.

112. *Id.* at *5.

113. Complaint ¶ 7, *Spongetech Delivery Sys., Inc. v. NYP Holdings, Inc.*, No. 601047/2010 (N.Y. Sup. Ct. Apr. 22, 2010).

114. *Id.* ¶¶ 1–2.

115. *See id.* ¶¶ 75–177.

among other things, “pumping” up demand for Spongetech stock through false public statements about non-existent Spongetech customers, bogus sales orders, and phony revenue. They also repeatedly and fraudulently understated the number of Spongetech’s outstanding shares in press releases and public filings. The purpose of flooding the market with false public information was to fraudulently inflate the price for Spongetech shares so [defendants] could then “dump” the shares by illegally selling them to the public through affiliated entities in unregistered transactions.¹¹⁶

The SEC complaint alleged multiple violations of the securities laws and sought an injunction, penalties, disgorgement, and officer and director bars against Metter and Moskowitz.¹¹⁷ The same day the SEC filed its civil complaint, Metter and Moskowitz were arrested and criminally charged.¹¹⁸

A little over two months after the SEC initiated its action against Spongetech, the company filed for bankruptcy.¹¹⁹ Spongetech agreed to a permanent injunction against future violations of the federal securities laws and to allow access to any records in the company’s possession relating to the SEC’s allegations, the company’s finances, or the potential sale of the company’s securities.¹²⁰ The

116. SEC Charges Spongetech Delivery Systems, Inc., Its Senior Officers, and Others for a “Pump and Dump” Scheme Involving Fictitious Customers and Sales, Litigation Release No. 21515, 98 SEC Docket 1536 (May 5, 2010), 2010 WL 1800939, at *1 [hereinafter SEC Charges Spongetech]. The SEC’s complaint also named as defendants RM Enterprises International, Inc. (“RM Enterprises”), a company that was a majority owner of Spongetech and was controlled by Metter and Moskowitz; George Speranza, a self-employed stock consultant; Joel Pensley, Spongetech’s former corporate counsel; and Jack Halperin, another former attorney for Spongetech. Complaint ¶¶ 2–7, SEC v. Spongetech Delivery Sys., Inc., No. 1:10-cv-02031-DLI-JMA (E.D.N.Y. May 5, 2010).

117. SEC Charges Spongetech, *supra* note 116, 2010 WL 1800939, at *2. The SEC alleged that Spongetech violated sections 5(a), 5(c), and 17(a) of the Securities Act and sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 15(d) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-13, 15d-1, 15d-11, and 15d-13 thereunder. The SEC also alleged that the former CEO and CFO violated sections 5(a), 5(c), and 17(a) of the Securities Act, sections 10(b) and 13(b)(5) of the Exchange Act, Rules 10b-5, 1362-1, and 15d-14 thereunder, and section 304 of the Sarbanes-Oxley Act of 2002, and aided and abetted violations by Spongetech, and that the former CFO also violated Exchange Act Rule 13b2-2. *Id.* The SEC also alleged various violations by RM Enterprises, Speranza, Pensley and Halperin. *Id.*

118. *Id.* Five other individuals, including Speranza and others, were also charged in a superseding indictment. See Superseding Indictment, United States v. Metter, No. 1:10-cr-00600-DLI (E.D.N.Y. Oct. 14, 2010).

119. See Suggestion of Bankruptcy, SEC v. Spongetech Delivery Sys., Inc., No. 1:10-cv-02031 (E.D.N.Y. July 20, 2010). Spongetech’s civil action against the *New York Post*’s holding company is stayed due to the bankruptcy. See Spongetech Delivery Sys., Inc. v. NYP Holdings, Inc., No. 601047/2010 (N.Y. Sup. Ct. Aug. 24, 2010) (order).

120. SEC v. Spongetech Delivery Sys., Inc., No. 1:10-cv-02031, slip op. at 5–6 (E.D.N.Y. Nov. 10, 2011) (judgment as to defendant Spongetech Delivery Systems, Inc.) [hereinafter Judgment as to Defendant Spongetech]. Also in November 2011, the SEC commenced a related civil action against Myron Weiner for alleged unregistered sales of shares of Spongetech in 2009, in violation of section 5 of the Securities Act. SEC Charges Myron Weiner with Unregistered Sales of Spongetech Delivery Systems, Inc. Stock, Litigation Release No. 22168 (Nov. 23, 2011), 2011 SEC LEXIS 4148, at *1. The SEC complaint alleged that Weiner purchased the shares from a Spongetech affiliate at a discounted price of five cents, and later sold them for twenty cents, for a profit of \$1,215,057. Complaint at 1–2, SEC v. Weiner, No. 11-cv-05731 (E.D.N.Y. Nov. 22, 2011). In December 2011, the SEC announced the case had settled. Without admitting or denying the allegations, Weiner consented to a final judgment in which he agreed to: (i) pay a total of approximately \$1.3 million in disgorgement, prejudgment interest, and a civil penalty; (ii) be permanently enjoined from violating section 5 of the Securities Act; and (iii) a one-year penny stock bar. SEC Obtains Injunction Against Myron Weiner

court deferred ruling on the amount of any disgorgement or penalties to be paid by Spongetech.¹²¹

The court subsequently entered consent judgments against the former CEO, Metter, and the former CFO, Moskowitz.¹²² They were permanently enjoined from violating the antifraud, securities registration, reporting, recordkeeping, and internal controls provisions of the federal securities laws, barred from serving as officers or directors of public companies or engaging in any offering of penny stock, and ordered to pay penalties and disgorgement in amounts to be determined by the court.¹²³

In the criminal action against the Spongetech executives, Moskowitz reportedly pleaded guilty to criminal securities fraud charges.¹²⁴ Metter agreed to plead guilty to a single count of making a false filing with the SEC, and other charges against him were dropped.¹²⁵

One of the more tumultuous matters in which claims of a short attack were made involved Biovail Corporation (“Biovail”), a Canadian pharmaceutical company that was subsequently acquired by Valeant Pharmaceuticals International, Inc. (“Valeant”).¹²⁶ Biovail sued a number of hedge funds, including SAC Capital Management, LLC (“SAC”) and a number of analysts, including Gradient Analytics, Inc. (“Gradient”), alleging that the defendants:

launched a devastating attack on Biovail, its business, and its stock. In furtherance of their scheme, after having taken short positions, defendants manipulated the market for Biovail Corp. stock and artificially lowered its stock price by, among other things, disseminating materially false and misleading information concerning Biovail and tortiously interfering with Biovail’s business. . . . One of defendants’ primary

for Unregistered Sales of Spongetech Delivery Systems, Inc. Stock; Weiner Ordered to Pay Over \$1.3 Million, Litigation Release No. 22206 (Dec. 21, 2011), 2011 SEC LEXIS 4499, at *1.

121. Judgment as to Defendant Spongetech, *supra* note 120, at 7.

122. SEC Obtains Judgments Against Former Spongetech Executives Michael E. Metter and Steven Y. Moskowitz, Litigation Release No. 22586 (Jan. 4, 2013), 2013 WL 53798, at *1.

123. *Id.* at *1. In March 2012, two entities associated with Metter’s radio business were added as relief defendants. *Id.* at *2. The SEC’s litigation against one of those entities and the two former Spongetech attorneys is pending. See *id.*; SEC v. Spongetech Delivery Sys., Inc., No. 1:10-cv-02031 (E.D.N.Y. Mar. 11, 2013) (judgment as to relief defendant Blue Star Media Group, Inc.).

124. Aaron Elstein, *In the Markets*, CRAIN’S N.Y. BUS., Aug. 29, 2011, at 4. Documents relating to Moskowitz’s guilty plea have been sealed. *Id.*

125. See Letter from Loretta E. Lynch, U.S. Attorney, to Hon. Dora L. Irizarry (Jan. 8, 2013). Metter’s plea agreement followed his successful effort to suppress certain evidence against him and a motion to suppress additional evidence. See *id.* at 2. Under the plea agreement, he was sentenced to probation and ordered to pay a special assessment of \$100. See *id.*: United States v. Metter, No. 1:10-cr-00600-DLI (E.D.N.Y. Apr. 25, 2013) (judgment). In addition to Metter and Moskowitz, five other criminal defendants pleaded guilty to various charges and received sentences of ranging from probation to imprisonment. See United States v. Eisenberg, No. 1:10-cr-00600-DLI (E.D.N.Y. Mar. 7, 2013) (order); United States v. Tepfer, No. 1:10-cr-00600-DLI (E.D.N.Y. Mar. 7, 2013) (order); United States v. Nicolais, No. 1:10-cr-00600-DLI (E.D.N.Y. June 4, 2012) (judgment); United States v. Tepfer, No. 1:10-cr-00600-DLI (E.D.N.Y. Mar. 8, 2012) (minute entry); United States v. Cavanagh, No. 1:10-cr-00600-DLI (E.D.N.Y. Dec. 21, 2011) (judgment); United States v. Eisenberg, No. 1:10-cr-00600-DLI (E.D.N.Y. Oct. 21, 2011) (minute entry); United States v. Speranza, No. 1:10-cr-00600-DLI (E.D.N.Y. Oct. 19, 2011) (judgment).

126. See Complaint and Jury Demand at 1–6, Biovail Corp. v. S.A.C. Capital Mgmt., LLC, No. ESX-L-01583-06 (N.J. Super. Ct. Law Div. Feb. 22, 2006).

methods in executing their attack on Biovail (as on other companies) was to “ghost write” negative and false analyst reports concerning Biovail’s stock¹²⁷

The complaint included claims for violation of New Jersey’s racketeering statute, commercial disparagement, tortious interference with contractual relationships, tortious interference with prospective economic advantage, and common law civil conspiracy under New Jersey state law.¹²⁸ Among other things, the complaint charged defendants with spreading “negative rumors” that the company was improperly “paying doctors to write prescriptions” for its new drug Cardizem LA, and with “spreading unfounded criticisms about its accounting and business practices.”¹²⁹

About a month after Biovail filed its lawsuit, a putative class action lawsuit was filed against SAC, Gradient, and other defendants. The complaint, styled *Del Giudice v. S.A.C. Capital Management, LLC*,¹³⁰ was largely based on the same facts set forth in Biovail’s lawsuit.

Biovail, its CEO, CFO, and other senior executives were subsequently sued by the SEC in a lawsuit charging them with “engaging in a number of fraudulent accounting schemes and making a series of misstatements to analysts and investors.”¹³¹ Specifically, the SEC alleged that:

Obsessed with meeting quarterly and annual earnings guidance, Biovail’s executives repeatedly overstated earnings and hid losses in order to deceive investors and create the appearance of achieving that goal. And, when it ultimately became impossible to continue to conceal the Company’s poor performance, Biovail actively misled investors and analysts as to its cause.¹³²

Biovail settled that case by consenting to a final judgment in which it agreed to: (i) pay a penalty of \$10 million, (ii) retain an independent consultant, and

127. *Id.* at 3.

128. *Id.* at 62–86.

129. *Id.* at 30, 37–38. In April 2006, the case was removed to the United States District Court for the District of New Jersey. See Notice of Removal, *Biovail Corp. v. S.A.C. Capital Mgmt., LLC*, No. 2:06-cv-01625-SRC-CCC (D.N.J. Apr. 5, 2006). In January 2007, however, that court remanded the case back to the Superior Court for Essex County, New Jersey. *Biovail Corp. v. S.A.C. Capital Mgmt., LLC*, No. 2:06-cv-01625-SRC-CCC (D.N.J. Jan. 9, 2007) (order).

130. See Complaint, *Del Giudice v. S.A.C. Capital Mgmt., LLC*, No. 2:05-cv-01413-SRC-MAS (D.N.J. Mar. 24, 2006).

131. SEC Charges Biovail Corporation and Its Former CEO, CFO and Two Current Senior Executives with Securities Fraud: Biovail Settles Charges and Agrees to Pay \$10 Million Civil Penalty, Litigation Release No. 20506 (Mar. 24, 2008), 2008 WL 762990, at *1 [hereinafter SEC Charges Biovail Corp.].

132. Complaint at 2, *SEC v. Biovail Corp.*, No. 1:08-cv-02979-LAK (S.D.N.Y. Mar. 24, 2008). Among the allegations in the complaint was the notable claim that Biovail falsely attributed its failure to meet its third quarter 2003 earnings guidance to a truck accident involving the shipment of one of its products, Wellbutrin XL. Although there was in fact an accident—a truck with \$5 million worth of Wellbutrin XL was involved in a multi-vehicle crash in Illinois while on its way from the Biovail facility in Manitoba to a distributor in North Carolina—the product had been shipped “FOB destination,” and the truck had left the Manitoba facility on the last day of the quarter. Shipment FOB destination meant that delivery occurred and revenue recognition was appropriate only once the shipment had reached the distributor which, given the shipment date, would not have happened before the end of the quarter under any circumstances. *Id.* at 8–10.

(iii) be permanently enjoined from future violations of certain federal securities laws and rules.¹³³ Thereafter, a subsidiary of Biovail, Biovail Pharmaceuticals, LLC, headquartered in Bridgewater, New Jersey, pleaded guilty to conspiracy and kickback charges in connection with a program pursuant to which physicians were paid in order “to induce them to prescribe Cardizem, L.A.” in violation of the federal False Claims Act.¹³⁴

The U.S. District Court for the District of New Jersey subsequently found that the *Del Giudice* action was based on “tainted” facts, because the information contained in the *Del Giudice* complaint (as well as in Biovail’s complaint in the New Jersey state court lawsuit against SAC and Gradient) came from documents that Biovail had obtained through discovery in an earlier securities fraud class action against Biovail,¹³⁵ which were subject to a protective order and not permitted to be used in other lawsuits.¹³⁶ The court found that the Biovail and shareholder litigations against SAC and Gradient “were all part of a choreographed strategy by Biovail and its attorneys designed to constitute a counterattack against the Biovail securities action,” and the attorneys who prosecuted both lawsuits “were ready and willing tools of Biovail. They ignored their professional and ethical obligations and aided Biovail for

133. SEC Charges Biovail Corp., *supra* note 131, 2008 WL 762990, at *2. Biovail settled that matter without admitting or denying the allegations, consistent with standard SEC practice. The injunction in that case permanently enjoined the company from violating section 17(a) of the Securities Act, sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, Rules 10b-5, 12b-20, 13a-1, and 13a-16 thereunder, and Rule 302(b) of Regulation S-T. Various individual defendants subsequently settled with the SEC. See SEC Obtains Stipulated Judgment Against Former Biovail CEO on Stock Accumulation Disclosure Charges: Eugene Melnyk Stipulates to a Judgment Imposing a \$1 Million Civil Penalty, Litigation Release No. 20880, 2009 WL 260474, at *1 (Feb. 4, 2009) (announcing settlement with former CEO); District Court Denies Defendants’ Motions to Dismiss SEC’s Amended Complaint in Biovail Matter: Motions of Defendants Crombie, Miszuk, and Howling Denied in All Respects, Litigation Release No. 20903, 2009 WL 383494, at *1 (Feb. 17, 2009) (announcing denial of individual defendants’ motion to dismiss); SEC Settles Accounting Fraud Case Against Former Biovail Senior Executive, Litigation Release No. 21650, 2010 WL 3588435, at *1 (Sept. 15, 2010) (announcing settlement with former vice president, controller, and assistant secretary); Final Judgments Entered Against Former Biovail Executives Eugene Melnyk and Brian Crombie, Litigation Release No. 21938, 2011 WL 1483352, at *1 (Apr. 19, 2011) (announcing settlement with former CEO and CFO).

134. Information (Felony) as to Biovail Pharmaceuticals, Inc., *United States v. Biovail Pharms., LLC*, No. 08-10124-NG (D. Mass. May 19, 2008); Assented to Motion to Permit the Entry of Guilty Plea by Counsel, *United States v. Biovail Pharma, LLC*, No. 08-10124-NG (D. Mass. Oct. 27, 2008). Biovail Pharmaceuticals, LLC was ordered to pay \$2,404,286 in restitution, a special assessment of \$2,800, and a fine of \$22,243,590. *United States v. Biovail Pharma, LLC*, No. 08-10124-NG, slip op. at 4 (D. Mass. Sept. 22, 2009) (judgment).

135. *Del Giudice v. S.A.C. Capital Mgmt., LLC*, No. 06-1413 (SRC), 2009 WL 424368, at *4–5 (D.N.J. Feb. 19, 2009). The earlier lawsuit was *In re Biovail Securities Litigation*, No. 03-CV-8917 (S.D. N.Y. filed Nov. 12, 2003), a securities fraud class action by Biovail shareholders against Biovail, in which the plaintiffs alleged that a drop in Biovail’s stock price in 2003 was caused by Biovail’s artificial inflation of the stock price through market misrepresentations and accounting fraud.

136. *Del Giudice*, 2009 WL 424638, at *2.

their own benefit.¹³⁷ The court entered an order of dismissal without prejudice.¹³⁸

Biovail's claims against SAC and Gradient were also dismissed.¹³⁹ The New Jersey Superior Court, Law Division, Essex County, found that Biovail failed to state a claim, and that it lacked jurisdiction over SAC and Gradient.¹⁴⁰

Subsequently, SAC and Gradient separately sued Biovail for malicious prosecution.¹⁴¹ The Gradient action advanced to the motion to dismiss stage, and the court allowed Gradient's claim to proceed.¹⁴² The litigation resulted in an ignominious end for Biovail. After Biovail was acquired by Valeant, Valeant settled both malicious prosecution lawsuits, apologized to SAC and Gradient, and paid \$10 million to SAC.¹⁴³ In a joint statement announcing its settlement with Valeant, SAC stated that it "continues to believe that Biovail's lawsuit and the media campaign that accompanied it were designed to distract critics from the company's own conduct. We are pleased with this outcome."¹⁴⁴ In a joint statement with Gradient, the research company stated, "[o]ur business, founders and employees suffered significantly as a result of the actions of Biovail, its attorneys, private investigators and public relations agents. . . . [W]e remain resolute in our right to freely express our opinions about publicly traded companies and will continue to do so in the future."¹⁴⁵

137. *Id.* at *11.

138. *Id.* at *12.

139. *Biovail Corp. v. S.A.C. Capital Mgmt., LLC*, No. ESX-L-1583-06, slip op. at 47, 49 (N.J. Super. Ct. Law Div. Aug. 20, 2009).

140. *See id.* at 26–47.

141. Complaint, *S.A.C. Capital Advisors, LLC v. Biovail Corp.*, No. 3:10-cv-00237-MRK (D. Conn. Feb. 17, 2010); Complaint, *Gradient Analytics, Inc. v. Biovail Corp.*, No. 2:10-cv-00335-FJM (D. Ariz. Feb. 17, 2010).

142. *Gradient Analytics, Inc. v. Biovail Corp.*, No. CV-10-0335-PHX-FJM, 2010 WL 2991573 (D. Ariz. July 26, 2010). The court held that, under applicable New Jersey law, Gradient was required to show a "special grievance" resulting from Biovail's lawsuit. *Id.* at *6. The court concluded that Gradient satisfied this burden by pleading that Biovail's litigation chilled its constitutionally protected free speech and damaged its reputation, thereby diminishing the value of its business. *Id.* at *6–7.

143. *See* Press Release, Valeant Pharms. Int'l, Inc., Valeant Pharmaceuticals and S.A.C. Capital Settle Lawsuit (Nov. 4, 2010), [hereinafter Valeant/SAC Press Release] available at <http://www.prnewswire.com/news-releases/valeant-pharmaceuticals-and-sac-capital-settle-lawsuit-106676383.html>; Press Release, Valeant Pharms. Int'l, Inc., Valeant Pharmaceuticals and Gradient Analytics Settle Lawsuit (Nov. 4, 2010), [hereinafter Valeant/Gradient Press Release] available at <http://www.thelobeandmail.com/globe-investor/news-sources/?date=20101104&archive=prnews&slug=LA94933>; Stipulation of Dismissal with Prejudice, *Gradient Analytics, Inc. v. Biovail Corp.*, No. 2:10-cv-00335-FJM (D. Ariz. Nov. 16, 2010); Stipulation of Dismissal with Prejudice, *S.A.C. Capital Advisors, LLC v. Biovail Corp.*, No. 3:10-cv-00237-MRK (D. Conn. Nov. 12, 2010).

144. Valeant/SAC Press Release, *supra* note 143.

145. Valeant/Gradient Press Release, *supra* note 143.

Another older but notable alleged short attack case with a turbulent history involved Solv-Ex Corporation (“Solv-Ex”). Prior to filing for bankruptcy in August 1997, Solv-Ex was a publicly held New Mexico corporation listed on the Nasdaq Small Cap Market.¹⁴⁶ Solv-Ex held itself out as a company with operations in New Mexico and Alberta, Canada, that had developed methods to extract and process oil and industrial minerals from oil sands, as well as a new technology to produce aluminum.¹⁴⁷

Solv-Ex filed a complaint in the United States District Court for the Southern District of New York against Parker Quillen, Quilcap Corporation, Martin Zweig, and Weir-Jones Engineering Consultants, Ltd. (the “New York action”).¹⁴⁸ Solv-Ex claimed that the defendants had falsely represented that they were interested in providing financing for a Solv-Ex project in order to gain access to confidential information, which was then used to disparage Solv-Ex, driving down the price of its stock and allowing the defendants to profit from short positions.¹⁴⁹ On the basis of these allegations, Solv-Ex asserted claims of conspiracy, breach of contract, fraud, and interference with prospective economic advantage.¹⁵⁰ The district court denied the defendants’ motions to dismiss the New York action, finding that Solv-Ex had adequately stated its claims.¹⁵¹

Solv-Ex’s litigation victory was short-lived. Shortly after prevailing on the motion to dismiss, Solv-Ex filed for bankruptcy in Canada and voluntarily dismissed the action.¹⁵² Thereafter, the SEC sued Solv-Ex, its CEO John Rendall, and its General Counsel Herbert M. Campbell II in federal court in New Mexico (the “SEC action”).¹⁵³ The complaint in that case alleged that defendants:

falsely presented the company as poised on the verge of commercial production of oil and minerals and made false statements concerning the success of product testing. In fact, Solv-Ex’s products and processes were unproven and testing of the technology to produce aluminum had failed.¹⁵⁴

Following a bench trial, the district court found that, from 1995 through 1997, Solv-Ex, Rendall, and Campbell “created the false impression that Solv-Ex was

146. See SEC v. Solv-Ex Corp., Litigation Release No. 15817, 67 SEC Docket 1395 (July 20, 1998), 1998 WL 400210, at *1 [hereinafter Solv-Ex Corp. Litigation Release]; Complaint at 4, SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP (D.N.M. July 20, 1998).

147. Solv-Ex Corp. Litigation Release, 1998 WL 402210, at *1.

148. Complaint, Solv-Ex Corp. v. Quillen, No. 1:96-cv-06057-JSR-LB (S.D.N.Y. Aug. 9, 1996).

149. Solv-Ex Corp. v. Quillen, No. 96 CIV. 6057 (JSR), 1997 WL 452023, at *1–3 (S.D.N.Y. Aug. 7, 1997).

150. *Id.*

151. *Id.* at *1.

152. *Id.*

153. Solv-Ex Corp. Litigation Release, 1998 WL 402210, at *1.

154. Complaint at 1–2, SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP (D.N.M. July 20, 1998).

on the verge of generating revenues from” its operations.¹⁵⁵ The ruling was ultimately affirmed on appeal.¹⁵⁶

In each of these cases, an issuer that alleged a short attack was itself subsequently investigated and sued by the SEC. Although no broad conclusions may be warranted in light of the unique facts of each of these cases, caution is clearly appropriate for issuers in assessing defensive action in the face of a short attack.

155. SEC v. Solv-Ex Corp., Litigation Release No. 16502, 2000 WL 350239, at *1 (Apr. 5, 2000). Based on its findings, the district court ruled that Solv-Ex and Rendall violated section 17(a) of the Securities Act, sections 10(b) and 13(a) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, and 13a-13 thereunder, and that Campbell violated section 17(a) of the Securities Act and section 10(b) of the Exchange Act and aided and abetted certain of Solv-Ex's violations. *Id.* On May 16, 2000, the district court enjoined Solv-Ex, Rendall, and Campbell, and ordered Rendall and Campbell each to pay a \$5,000 penalty. SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP, slip op. at 2-3 (D.N.M. May 16, 2000) (final judgment of permanent injunction and other relief). In a related administrative proceeding, Campbell was suspended from practicing as an attorney before the SEC pursuant to Commission Rule 102(e). See Herbert M. Campbell, Release No. 266, 83 SEC Docket 3212 (Oct. 24, 2007), 2004 WL 2413297 (permanently disqualifying Campbell from practicing before the Commission as an attorney).

156. Proceeding pro se, Rendall and Campbell appealed the district court's determination that they violated the securities laws. The United States Court of Appeals for the Tenth Circuit made a limited remand, requiring that the district court make specific findings regarding: (a) who made actionable misstatements and when they were made; (b) what was false or misleading about the defendants' statements, including what information was omitted that caused the statements to be misleading; (c) the defendants' state of mind; and (d) which SEC filings were false and misleading. SEC v. Solv-Ex Corp., No. 00-2339, slip op. at 9-19 (10th Cir. Aug. 4, 2003). The district court submitted amended findings, SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP (D.N.M. Sept. 24, 2003) (court's amended findings of fact and conclusions of law), and the Tenth Circuit affirmed, SEC v. Solv-Ex Corp., 101 F. App'x 271 (10th Cir. 2004). Rendall moved for a retrial and to disqualify the trial judge, arguing that he was biased and relied on non-existent evidence. Motion for Retrial Based on Federal Rules 60(b)(1), (2), (4), and (6) and 28 U.S.C. § 144, SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP (D.N.M. Aug. 19, 2004). The district court denied this motion, SEC v. Solv-Ex Corp., No. 1:98-cv-00860-BB-RLP (D.N.M. Nov. 2, 2004) (order), and the Tenth Circuit affirmed, SEC v. Solv-Ex Corp., 164 F. App'x 765 (10th Cir. 2006). During the pendency of the SEC action, Solv-Ex filed a lawsuit in state court in New Mexico against the former defendants from the New York action and a number of other defendants (the "New Mexico action"). As in the New York action, Solv-Ex alleged that the defendants feigned interest in entering into a deal with Solv-Ex, and thereby gained nonpublic information about Solv-Ex pursuant to a confidentiality agreement. See Solv-Ex Corp. v. Deutsche Bank AG, No. 1:99-cv-00003-JEC-KBM, slip op. at 15 (D.N.M. May 2, 2000). Solv-Ex further claimed that the defendants used the confidential information to drive down the price of Solv-Ex stock in order to profit by selling it short. *Id.* at 15-16. According to Solv-Ex's complaint, the resulting decline in the price of Solv-Ex's stock allegedly prevented it from securing needed financing, leading to the company's eventual bankruptcy. *Id.* at 16. Solv-Ex also sued Deutsche Bank AG, Deutsche Morgan Grenfell, Inc., and Morgan Grenfell Asset Management Ltd. (the "Deutsche Bank defendants"). Solv-Ex claimed that, in violation of a confidentiality agreement, the Deutsche Bank defendants purchased Solv-Ex stock in an effort to artificially *inflate* its price, leaving it vulnerable to market swings and resulting in instability that hurt investor confidence and ultimately led to Solv-Ex's bankruptcy. *Id.* at 7-8. The New Mexico action was removed to federal court. Notice of Removal, Solv-Ex Corp. v. Deutsche Bank AG, No. 1:99-cv-0003 (D.N.M. Jan. 4, 1999). It was thereafter dismissed without prejudice for lack of personal jurisdiction over the defendants. Solv-Ex Corp. v. Deutsche Bank AG, No. 1:99-cv-00003, slip op. at 28 (D.N.M. May 2, 2000); Solv-Ex Corp. v. Deutsche Bank AG, No. 1:99-cv-00003 (D.N.M. May 12, 2000) (amended final order).

III. SHORT ATTACK LITIGATION AND RELATED SEC INVESTIGATIONS

Companies may consider litigation against alleged perpetrators of short attacks regardless of (or in addition to) any SEC investigative interest. The track record of this type of litigation suggests that companies will be hard-pressed to score decisive victories in the courtroom, as problems of proof, procedural barriers, and substantive defenses often stand in the way of recovery. Furthermore, engaging in a public battle with short sellers may not have the desired effect for the issuer, as such battles may bring unwanted attention upon the issuer and lead to lengthy and costly investigations.

A. RECENT LITIGATION: THE CHINA CASES

Recent lawsuits by U.S.-listed companies based in China provide the most notable current examples of litigation against alleged perpetrators of short attacks. In the past few years, short sellers and others have leveled accusations of fraud and accounting impropriety at a number of these companies and, in particular, at China-based companies that accessed U.S. capital markets through so-called “reverse mergers.” Several of these companies have fought back, asserting that they were victims of short attacks and instituting lawsuits against the alleged perpetrators. A number of companies brought lawsuits in New York Supreme Court in Manhattan against an anonymous blogger or group of bloggers using the pseudonym “Alfred Little.” To date, however, none of these “Alfred Little” lawsuits have been successful.

In the first of these lawsuits, Deer Consumer Products, Inc. (“Deer”), a China-based maker of home and kitchen appliances, sued Alfred Little, a website operator doing business as Seeking Alpha Ltd. (“Seeking Alpha”), and a number of John Doe defendants in state court in New York (the “Deer action”).¹⁵⁷ Deer alleged that Alfred Little published false reports about Deer through Seeking Alpha as part of a market manipulation scheme perpetrated by Little and others.¹⁵⁸ According to Deer’s complaint, Little published reports containing false assertions of misappropriation and other fraud in connection with recent Chinese land acquisitions by Deer.¹⁵⁹ The goal of the alleged manipulation scheme was to “artificially drive down the price of [Deer] common stock in order to obtain illicit profits on short sales.”¹⁶⁰

According to Deer, as a result of Little’s defamatory statements, Deer’s stock price fell almost 30 percent.¹⁶¹ Deer further alleged that “market data showed that at least tens of thousands of shares of [Deer] common stock had been sold short in transactions where the seller had not borrowed the stock by settle-

157. Complaint, *Deer Consumer Prods., Inc. v. Little*, No. 650823/2011 (N.Y. Sup. Ct. Mar. 28, 2011).

158. *Id.* ¶ 1.

159. *Id.* ¶¶ 13–23.

160. *Id.* ¶ 11.

161. *See id.* ¶ 24.

ment date”—i.e., “naked” short sales.¹⁶² Deer’s complaint charged the defendants with defamation.¹⁶³

Deer thereafter amended its complaint. The amended complaint charged that “Alfred Little” was, in fact, the “Little Group,” comprised of various individuals and entities, all of which were added as defendants.¹⁶⁴ The amended complaint alleged additional defamatory statements by the defendants, including, among others, an assertion that Deer was under investigation by the SEC.¹⁶⁵ In addition to defamation, Deer charged the defendants with violating section 349 of New York’s General Business Law, which prohibits unlawful and deceptive acts and practices in the conduct of business, trade, or commerce, as well as tortious interference with business relations.¹⁶⁶

A second U.S.-listed, China-based firm, Sino Clean Energy Inc. (“Sino Clean”), filed a similar complaint against Alfred Little and other defendants (the “*Sino Clean* action”), claiming that the defendants engaged in a scheme to profit from short sales by manipulating Sino Clean’s stock through false and defamatory reports and internet posts.¹⁶⁷ The allegedly defamatory reports and internet posts said, among other things, that Sino Clean’s SEC filings were false and misleading and inconsistent with Chinese tax records.¹⁶⁸

162. *Id.* ¶ 12.

163. *Id.* ¶¶ 25–30. Deer sought in excess of \$1 million in damages, \$10 million in punitive damages, and \$100 million in disgorgement, as well as costs and injunctive relief. *Id.*

164. Verified Amended Complaint ¶¶ 1–62, *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011 (N.Y. Sup. Ct. June 5, 2012) [hereinafter *Deer Amended Complaint*]. The Little Group allegedly includes Jon Carnes, Eos Holdings LLC (“Eos”), Simon Moore, Xiaofu Huang, Joseph Ramelli, Andrew Wong, Shawn Jason Rhynes, Walter Carnes, International Financial Research and Analysis Group (“IFRA”), and Quantum Asset Group LLC (“Quantum”). *Id.* According to the *Deer Amended Complaint*, Jon Carnes is, among other things, the president and founder of Eos, a Dominican investment company, and Wong is an alias Carnes uses in acting as a Senior Analyst at IFRA, a provider of analysis, research, and due diligence services. *Id.* ¶¶ 26–38, 47–48, 57–58. Huang, Ramelli and Walter Carnes are allegedly associated with Eos. *Id.* ¶¶ 40–46, 53–56. Rhynes is allegedly the Managing Director of Quantum Asset Group LLC, a Delaware company. *Id.* ¶¶ 49–50, 52, 59–60. Jon Carnes is a former associate of Carson Block, the founder of Muddy Waters LLC and a noted short seller who has also been involved in alleged short attacks. See Christopher Donville & Dune Lawrence, *Short Seller Drops Muddy Waters Model for SEC*, BLOOMBERG.COM (May 10, 2012), <http://www.bloomberg.com/news/2012-05-09/short-seller-drops-muddy-waters-model-for-sec.html>.

165. *Deer Amended Complaint*, *supra* note 164, ¶¶ 91–96. According to the *Deer Amended Complaint*, allegedly defamatory statements regarding an SEC investigation of Deer were “based on the SEC’s refusal of the Little Group’s Freedom of Information Act [FOIA] request for non-public records concerning [Deer].” *Id.* ¶ 95. A December 20, 2011 blog post by “Alfred Little” stated that the SEC denied a FOIA request by a class action plaintiffs’ lawyer, citing 5 U.S.C. § 552(b)(7)(A), which exempts from public disclosure “records or information compiled for law enforcement purposes” that “could reasonably be expected to interfere with enforcement proceedings,” and which, according to Department of Justice guidance, is applicable when an enforcement proceeding is pending or prospective. See *Freedom of Information Act Request Uncovers Pending or Prospective SEC Law Enforcement Proceedings Against DEER*, ALFREDLITTLE.COM (Dec. 20, 2011), <http://labemp.wordpress.com/2011/12/20/freedom-of-information-act-request-uncovers-pending-sec-law-enforcement-proceedings-against-deer/>.

166. *Deer Amended Complaint*, *supra* note 164, ¶¶ 98–119.

167. Amended Complaint ¶¶ 1–9, 17–83, *Sino Clean Energy Inc. v. Little*, No. 651248/2011 (N.Y. Sup. Ct. Dec. 6, 2011).

168. *Id.* ¶¶ 22–29, 39–83. Sino Clean Energy also claimed that Little sent false and defamatory e-mails to Sino Clean’s auditors and an independent director. *Id.* ¶¶ 33–38. Sino Clean brought claims for

Sino-Canadian silver concern Silvercorp Metals Inc. (“Silvercorp”) also initiated a lawsuit against Alfred Little and other alleged perpetrators of a “short-selling stock manipulation scheme” (the “*Silvercorp* action”).¹⁶⁹ Silvercorp’s allegations were similar to those in the *Deer* and *Sino Clean* actions. According to Silvercorp’s complaint, a hedge fund called Anthion Management LLC (“Anthion”) authored false and defamatory letters to Canadian regulators, Silvercorp’s auditor, and various media outlets, as well as a false and defamatory internet posting.¹⁷⁰ The Anthion letters and internet postings allegedly asserted that there were inconsistencies between Silvercorp’s filings with the SEC and its filings with the Chinese State Administration for Industry and Commerce (“SAIC”), and they raised questions regarding purported misstatements by Silvercorp and related-party transactions.¹⁷¹ Silvercorp also alleged that, as part of the same scheme, a group of individuals publishing reports under the name “Alfred Little” published false and defamatory internet postings.¹⁷² The internet postings alleged that Chinese government mining reports and independent tests of a Silvercorp mine contradicted public statements regarding production by Silvercorp and raised questions regarding Silvercorp’s customers and related-party transactions.¹⁷³ According to Silvercorp, the defendants’ false and defamatory statements caused Silvercorp’s stock price to drop and allowed the defendants to cover profitably short positions in the stock.¹⁷⁴

In response, Anthion asserted counterclaims under New York’s “anti-Strategic Lawsuit Against Public Participation” or “anti-SLAPP” law.¹⁷⁵ According to Anthion, Silvercorp’s claims constituted an illegal “campaign to retaliate against, in-

fraud, defamation, and tortious interference with business relationships, and sought compensatory damages in excess of \$55 million, punitive damages of at least \$10 million, disgorgement of illicit trading profits, attorney’s fees, and other relief. *Id.* ¶¶ 19–86.

169. See Complaint for Damages and Equitable Relief ¶ 9, *Silvercorp Metals Inc. v. Chinastockwatch.com*, No. 150374/2011 (N.Y. Sup. Ct. Sept. 22, 2011).

170. Second Amended Complaint ¶¶ 6–18, *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, No. 150374/2011 (N.Y. Sup. Ct. Mar. 16, 2012).

171. *Id.* ¶¶ 27–30, 36–39.

172. *Id.* ¶¶ 6–18.

173. *Id.* ¶¶ 31–33, 40–41.

174. *Id.* ¶¶ 1–1A, 24–26, 30, 34, 39, 42. Silvercorp asserted claims of defamation, unjust enrichment, trade libel and interference, and unlawful and deceptive acts and practices, and sought in excess of \$4 million in compensatory damages, at least \$10 million in punitive damages, as much as \$100 million in disgorgement of illicit trading profits, a permanent injunction, attorney’s fees, and other relief. *Id.* ¶¶ 49–65, ¶¶ 1–9 (relief sought).

175. Answer to the Amended Complaint and Counterclaim at 12–28, *Silvercorp Metals Inc. v. Chinastockwatch.com*, No. 150374/2011 (N.Y. Sup. Ct. Mar. 12, 2012). In New York, “[a] defendant in an action involving public petition and participation . . . may maintain an action, claim, cross claim or counterclaim to recover damages, including costs and attorney’s fees, from any person who commenced or continued such action.” N.Y. CIV. RIGHTS LAW § 70-a(1) (McKinney 2009). An “action involving public petition and participation” is defined as “an action, claim, cross claim or counterclaim for damages that is brought by a public applicant or permittee, and is materially related to any efforts of the defendant to report on, comment on, rule on, challenge or oppose such application or permission.” *Id.* § 76-a(1)(a). A “public applicant or permittee” is “any person who has applied for or obtained a permit, zoning change, lease, license, certificate or other entitlement for use or permission to act from any government body, or any person with an interest, connection or affiliation with such person that is materially related to such application or permission.” *Id.* § 76-a(1)(b).

timidate, and deter good faith criticism of Silvercorp's business practices made to appropriate authorities and experts."¹⁷⁶ Anthion sought damages, including costs and attorney's fees.¹⁷⁷

Silvercorp's claims were dismissed on the merits as to most of the defendants, setting the stage for the ultimate resolution of the *Deer* and *Sino Clean* actions.¹⁷⁸ Significantly, the court in the *Silvercorp* action held that the allegedly defamatory statements were constitutionally protected statements of opinion.¹⁷⁹ The court "recognize[d] that [its holding] could be viewed as a green light to those who *could* use this kind of vehicle to manipulate the market," but stated that it felt "constrained to conclude" that constitutionally protected statements of opinion cannot support a defamation claim.¹⁸⁰ The court dismissed Silvercorp's trade libel claim for the same reason.¹⁸¹ The court also dismissed Silvercorp's unjust enrichment claim, holding that it merged with the defamation claim, and that defendants' alleged profits (which resulted from the short sales) were not taken from Silvercorp.¹⁸² Finally the court held that Silvercorp lacked standing to assert a claim under New York General Business Law section 349 because it is a "consumer protection statute" and Silvercorp does not come within the ambit of its protection.¹⁸³

176. *Id.* at 13.

177. *Id.* at 28–29.

178. See *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, No. 150374/2011, 2012 WL 3569952, at *7–16 (N.Y. Sup. Ct. Aug. 16, 2012). The *Silvercorp* action remains pending as to certain defendants that did not move for dismissal.

179. See *id.* at *9–12. The court reasoned that its conclusion was supported by the context of the statements, including the anonymity of the authors and disclosures that they held short positions in Silvercorp, qualifying words contained in the statements, and accompanying disclosure of supporting facts that allowed readers to reach their own conclusions. See *id.* at *9–10. The court also reasoned that Silvercorp's own public response to earlier statements demonstrated the existence of a debate and signaled that subsequent statements were non-actionable opinions. See *id.* at *11.

180. *Id.* at *12.

181. See *id.* at *12–13.

182. *Id.* at *12.

183. See *id.* at *13–15. Silvercorp initially appealed from the court's order dismissing its claims, see Notice of Appeal, *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, No. 150374/2011 (N.Y. Sup. Ct. Aug. 17, 2012), but the parties subsequently stipulated to the discontinuance of the action, and Silvercorp withdrew its appeal. Stipulation of Discontinuance, *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, No. 150374/2011 (N.Y. Sup. Ct. Mar. 8, 2013) [hereinafter *Silvercorp/Anthion Stipulation*]. The court also dismissed Anthion's anti-SLAPP counterclaims. See *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, 948 N.Y.S.2d 895, 901–02 (N.Y. Sup. Ct. 2012). The court did find that Anthion sufficiently alleged that Silvercorp—a public company that must receive permission from the SEC before listing its shares—is a "public applicant or permittee." *Id.* at 900–01. Nevertheless, the court found that Anthion failed to allege that its statements directly challenged any application or permission of Silvercorp, and the court therefore dismissed the counterclaim. *Id.* at 901–02. Anthion had appealed this order, see Notice of Appeal, *Silvercorp Metals Inc. v. Anthion Mgmt. LLC*, No. 150374/2011 (N.Y. Sup. Ct. Aug. 10, 2012), but this appeal, too, was withdrawn. On August 28, 2012, following the court's dismissal of its claims, but during the pendency of its appeal, Silvercorp had also initiated a related lawsuit in order to prevent the statute of limitations from running against certain additional, related defendants. See Complaint, *Silvercorp Metals, Inc. v. Goetz*, No. 155852/2012 (N.Y. Sup. Ct. Aug. 28, 2012); *Silvercorp Metals, Inc. v. Goetz*, No. 155852/2012, at 8–11 (N.Y. Sup. Ct. Jan. 29, 2013) (transcript of proceedings). Days after it stipulated to discontinue the Anthion action, Silvercorp discontinued this related action.

As a result of the ruling in the *Silvercorp* action, Sino Clean moved to withdraw its complaint.¹⁸⁴ The court granted the motion and dismissed the *Sino Clean* action with prejudice.¹⁸⁵

The *Deer* action was the last of the three “Alfred Little” actions to be resolved. With the exception of default judgments against certain entities,¹⁸⁶ Deer’s claims were dismissed on the merits in a series of rulings in late 2012 and early 2013.¹⁸⁷ Notably, the court dismissed the plaintiff’s defamation claims for substantially the same reasons that Silvercorp’s defamation claims were dismissed—i.e., allegedly defamatory statements were held to be constitutionally protected opinions.¹⁸⁸

The *Sino Clean* and *Deer* actions coincided with the delisting of both companies’ securities from the Nasdaq Stock Market. Sino Clean disclosed that Nasdaq had “determined to delist [Sino Clean’s] securities pursuant to its discretionary authority under Listing Rule 5101,” because of “allege[d] violations by [Sino Clean] of Listing Rule 5250(b)(1) and IM-5250-1, which sets [sic] forth a listed company’s obligation to make public disclosures, and Listing Rule 5250(a), which sets forth a listed company’s obligation to provide information to Nas-

See Notice of Discontinuance, *Silvercorp Metals, Inc. v. Goetz*, No. 155852/2012, at 8–11 (N.Y. Sup. Ct. Mar. 11, 2013).

184. See Notice of Motion, *Sino Clean Energy Inc. v. Little*, No. 651248/2011 (N.Y. Sup. Ct. Sept. 6, 2012); Affirmation of Eugene Licker in Support of Plaintiff’s Motion to Discontinue Action ¶ 4, *Sino Clean Energy Inc. v. Little*, No. 651248/2011 (N.Y. Sup. Ct. Sept. 6, 2012).

185. *Sino Clean Energy Inc. v. Little*, No. 651248/2011, slip op. at 1 (N.Y. Sup. Ct. Sept. 27, 2012) (order). At the time of the court’s order dismissing the *Sino Clean* action, Alfred Little was the only remaining named defendant. Seeking Alpha, named as a defendant in the original complaint, see Complaint, *Sino Clean Energy Inc. v. Little*, No. 651248/2011 (N.Y. Sup. Ct. May 9, 2011), was not named as a defendant in the amended complaint. See Amended Complaint, *Sino Clean Energy Inc. v. Little*, No. 651248/2011 (N.Y. Sup. Ct. Dec. 6, 2011) (Seeking Alpha no longer named as a defendant). GeoInvesting was dismissed from the action on jurisdictional grounds on March 30, 2012. See *Sino Clean Energy Inc. v. Little*, No. 651248/2011, slip op. at 1 (N.Y. Sup. Ct. Mar. 29, 2012) (order).

186. The court had previously entered default judgments against IFRA and Quantum, but reserved an assessment of damages for trial. See *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 1 (N.Y. Sup. Ct. Oct. 26, 2012) (decision and order); *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 1 (N.Y. Sup. Ct. Sept. 13, 2012) (unified order and judgment). Subsequently, Deer’s counsel disclaimed any intention to seek damages from those entities. See Transcript of Proceedings at 31–32, *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011 (N.Y. Sup. Ct. Dec. 17, 2012). A default judgment against “Andrew Wong,” an alias used by Jon Carnes, was vacated. See *Deer Consumer Prods., Inc. v. Little Grp.*, slip op. at 3, No. 650823/2011 (N.Y. Sup. Ct. Dec. 4, 2012) (decision and order).

187. See *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 26–37 (N.Y. Sup. Ct. Dec. 17, 2012) (decision/order); *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 21–26 (N.Y. Sup. Ct. Nov. 16, 2012) (decision/order); *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, 2012 WL 5898052, at *12–15 (N.Y. Sup. Ct. Nov. 15, 2012) (decision/order); see also *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 1 (N.Y. Sup. Ct. Mar. 7, 2013) (consent order); *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 1 (N.Y. Sup. Ct. Dec. 17, 2012) (consent order); *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 1 (N.Y. Sup. Ct. Dec. 17, 2012) (order). Defendant Seeking Alpha had previously been dismissed on the grounds that it was protected under federal law from liability for content posted on its website by others. See *Deer Consumer Prods., Inc. v. Little*, 938 N.Y.S.2d 226 (N.Y. Sup. Ct. 2010) (Table), 2011 WL 4346674, at *6–9 (N.Y. Sup. Ct. 2011).

188. See *Deer Consumer Prods., Inc. v. Little Grp.*, No. 650823/2011, slip op. at 26–32 (N.Y. Sup. Ct. Nov. 29, 2012).

daq.”¹⁸⁹ Deer likewise disclosed that it had been notified that Nasdaq had determined to delist its securities based on allegations that Deer: (a) made “false and misleading disclosures regarding the operational status of” certain manufacturing facilities in China; (b) failed to provide complete responses to “questions regarding [its] customers, suppliers and shipping providers”; and (c) was involved in a “scheme to illicitly transfer corporate funds to a group of stockbrokers through a bogus consulting contract.”¹⁹⁰

The *Silvercorp Metals* action coincided with regulatory investigations. The British Columbia Securities Commission announced an investigation into the “anonymous allegations against Silvercorp Metals Inc.,” including “both the nature of the complaint and the allegations contained in the letter.”¹⁹¹ Silvercorp Metals also disclosed contemporaneous probes by the SEC, the Federal Bureau of Investigation, and the Royal Canadian Mounted Police (“RCMP”).¹⁹² In March 2013, Silvercorp reportedly received an SEC subpoena.¹⁹³

Another U.S.-listed Chinese company, SkyPeople Fruit Juice, Inc. (“SkyPeople”), initiated a lawsuit in response to an alleged short attack by Absaroka Capital

189. Sino Clean Energy, Inc., Current Report (Form 8-K), Item 3.01 (Aug. 13, 2012). Sino Clean Energy subsequently disclosed that Nasdaq had informed the company that its late filing of a quarterly report served as “an additional basis for delisting” Sino Clean Energy’s securities. Sino Clean Energy, Inc., Current Report (Form 8-K), Item 3.01 (Aug. 27, 2012). On September 28, 2012, Sino Clean Energy disclosed that a Nasdaq hearing panel had denied its appeal from the delisting decision. Sino Clean Energy, Inc., Current Report (Form 8-K), Item 3.01 (Sept. 28, 2012). Sino Clean Energy also announced that its independent auditor had withdrawn its audit report, which was included in Sino Clean Energy’s Form 10-K for the fiscal year 2011, and that Sino Clean Energy and its audit committee had concluded that Sino Clean Energy’s quarterly report numbers for the first quarter of 2012 “should no longer be relied upon, as they may be subject to revision as well.” *Id.* Item 4.02.

190. Deer Consumer Products, Inc., Current Report (Form 8-K), Item 3.01 (Oct. 9, 2012). Additionally, on October 5, 2012, Deer Consumer Products announced the resignation of Arnold F. Staloff, an independent director and the chairman of the audit committee of Deer Consumer Products’ board of directors, and disclosed that it had notified Nasdaq that, as a result of Staloff’s resignation, it was not in compliance with listing requirements, including certain independent director and audit committee requirements. Deer Consumer Products, Inc., Current Report (Form 8-K), Item 3.01 (Oct. 5, 2012). Deer Consumer Products later disclosed that Staloff resigned after Deer Consumer Products’ board of directors decided to reduce his compensation to \$1. Deer Consumer Products, Inc., Current Report (Form 8-K), Item 5.02 (Oct. 16, 2012). On October 16, 2012, Deer Consumer Products disclosed that, on October 10, 2012, Nasdaq informed Deer Consumer Products that its noncompliance with independent director and audit committee requirements served as an additional basis for delisting Deer Consumer Products’ securities. *Id.* Item 3.01. Nasdaq held a hearing, which resulted in a final determination to delist Deer’s securities. Press Release, NASDAQ OMX Grp., Inc., NASDAQ Suspends Deer Consumer Products, Inc. (Jan. 9, 2013), <http://www.nasdaq.com/article/nasdaq-suspends-deer-consumer-products-inc-20130109-01085>.

191. Press Release, B.C. Sec. Comm’n, B.C. Regulator Reviewing Anonymous Complaint Against SilverCorp Metals Inc. (Sept. 9, 2011) (2011/74), <http://www.bcsc.bc.ca/release.aspx?id=13582>.

192. Silvercorp Metals Inc., Report of Foreign Private Issuer (Form 6-K), Ex. 99.1 (Sept. 14, 2011). Press reports suggest that, in September 2012, the RCMP was considering whether to open an investigation into allegations that Silvercorp Metals helped pay for a criminal probe by Chinese authorities that resulted in the arrest and detention of an associate of Jon Carnes in China. Andy Hoffman & Mark MacKinnon, *RCMP Eyes Silvercorp Investigation: Mounties Consider Formal Probe of Mining Company Alleged to Have Helped Chinese Police Investigate Canadian Critic*, GLOBE & MAIL (Sept. 17, 2012), <http://investdb4.theglobeandmail.com/servlet/story/GAM.20120917.RBCHI.NAHOFFMAN0916ATL/G1Story/>.

193. Andy Hoffman, *SEC Probes Silvercorp Short-Seller Fight*, GLOBE & MAIL, Apr. 2, 2013, at B1.

Management, LLC (“Absaroka”), an investment management firm, its principals, and one of its analysts.¹⁹⁴ SkyPeople claimed that Absaroka published a false and libelous research report containing the assertion that Chinese SAIC filings showed that SkyPeople overstated its value in filings with the SEC, among other assertions.¹⁹⁵ According to SkyPeople, the defendants made these false and libelous statements in order to cause SkyPeople’s stock price to drop so they could profit from a short position in the stock.¹⁹⁶

In response, Absaroka brought counterclaims against SkyPeople.¹⁹⁷ Absaroka asserted that SkyPeople waged a “campaign” to ruin Absaroka’s reputation, with the knowledge that Absaroka’s allegations regarding SkyPeople’s financial information were true.¹⁹⁸

SkyPeople and Absaroka subsequently announced an out-of-court settlement.¹⁹⁹ According to a press release issued by SkyPeople, under the terms of the settlement, all claims and counterclaims were dismissed, and neither party admitted any wrongdoing or liability.²⁰⁰ SkyPeople’s press release also stated that Absaroka agreed to remove the research report at issue from its website, and that, “after an exhaustive internal investigation, SkyPeople . . . raised serious questions regarding the accuracy of” certain information, including SAIC documents, that had been provided to Absaroka and discussed in its report.²⁰¹

Although these recent cases involving China-based issuers were litigated and came to resolution fairly quickly, the dismissals and settlements in the litigation brought by those issuers highlight the pleading and proof difficulties encountered in short attack cases, as well as the risks faced by companies considering initiating public legal proceedings against alleged perpetrators of short attacks. We turn now to a discussion of two cases that further demonstrate the inherent problems with litigation in this area, and that involved lengthier and more contentious battles between issuers and alleged short attackers—the *Fairfax* and *Overstock* matters.

194. That lawsuit alleged libel and tortious interference with a contract or prospective economic advantage, and asked for disgorgement, damages, and injunctive relief. Complaint and Jury Demand at 15, *SkyPeople Fruit Juice, Inc. v. Absaroka Capital Mgmt., LLC*, No. 2:11-cv-00238-NDF (D. Wyo. July 7, 2011).

195. First Amended Complaint at 6–7, *SkyPeople Fruit Juice, Inc. v. Absaroka Capital Mgmt., LLC*, No. 2:11-cv-00238-NDF (D. Wyo. Oct. 31, 2011).

196. *Id.* at 6, 10–11. SkyPeople sought general, special and punitive damages, restitution, disgorgement, and judgment interest, costs, and injunctive relief. *Id.* at 17.

197. See Answer of Defendants Absaroka Capital Management, LLC and Kevin Barnes to Plaintiff’s First Amended Complaint, *SkyPeople Fruit Juice, Inc. v. Absaroka Capital Mgmt., LLC*, No. 2:11-cv-00238-NDF (D. Wyo. Nov. 14, 2011).

198. *Id.* at 41–49. Absaroka asserted claims of defamation and abuse of process and sought more than \$75,000 in damages. *Id.* at 49–55.

199. *SkyPeople Fruit Juice, Inc.*, Current Report (Form 8-K), Ex. 99.1 (June 22, 2012) [hereinafter *SkyPeople Current Report* June 22, 2012].

200. *Id.*; see also Order Dismissing All Claims and Counterclaims with Prejudice, *SkyPeople Fruit Juice, Inc. v. Absaroka Capital Mgmt., LLC*, No. 2:11-cv-00238-NDF, slip op. at 1 (D. Wyo. June 28, 2012) (order dismissing all claims and counterclaims with prejudice).

201. *SkyPeople Current Report* June 22, 2012, *supra* note 199, Ex. 99.1.

B. THE BIG BATTLES: THE *FAIRFAX* AND *OVERSTOCK* CASES

1. Fairfax Financial Holdings Limited

The short attack litigation brought by Fairfax Financial Holdings Limited (“Fairfax”) demonstrates many of the procedural difficulties endemic to these cases, even where there is evidence suggesting the existence of an effort to drive down an issuer’s stock price. Fairfax, a Canadian insurance and financial services company, and Crum & Forster Holdings Corporation (“C&F”), an associated holding company, filed a lawsuit in New Jersey against Morgan Keegan & Company (“Morgan Keegan”) and several hedge funds and associated individuals, including, inter alia, David Rocker and Rocker Partners, L.P. (“Rocker Partners”), Steven A. Cohen and SAC, Daniel Loeb and Third Point LLC (“Third Point”), and James Chanos and Kynikos Associates LP (“Kynikos”), as defendants.²⁰²

The complaint described an alleged “massive, illegal and continuing stock market manipulation scheme, which has targeted and severely harmed Fairfax, among other companies, and which has resulted in immense ill-gotten profits” for the defendants.²⁰³ Plaintiffs claimed there was a conspiracy, allegedly referred to among the defendants as “the ‘Fairfax Project,’” to publish and disseminate false and defamatory information about Fairfax via Morgan Keegan and Fitch analyst reports, among other means, in order to drive down Fairfax’s stock prices improperly so defendants could profit from short positions in Fairfax stock.²⁰⁴ Fairfax alleged that the defendants collaborated with a Morgan Keegan analyst named John Gwynn, one of the named defendants, to create a negative report regarding Fairfax.²⁰⁵ Certain defendants then allegedly acquired large short positions in Fairfax stock in anticipation of the publication of the report, the release of which caused Fairfax’s stock price to decrease.²⁰⁶ Based on the alleged scheme, plaintiffs asserted claims of racketeering, commercial disparagement, tortious interference with contractual relationships, tortious interference with prospective economic advantage, and common law conspiracy.²⁰⁷

202. See Complaint, *Fairfax Fin. Holdings Ltd. v. S.A.C. Capital Mgmt. LLC*, No. L-002032-06 (N.J. Super. Ct. Law Div. July 26, 2006) [hereinafter *Fairfax Financial Holdings Complaint*]; Ben White, *Fairfax Adds Fund Manager Chanos to Suit*, *FIN. TIMES* (June 26, 2007), <http://www.ft.com/intl/cms/s/0/2c3f9c02-237c-11dc-9e7e-000b5df10621.html#axzz2Kgu632nO>. At the time it initiated the litigation, Fairfax was a 14 percent owner of Overstock, another issuer that was engaged in a legal battle with short sellers in connection with an alleged short attack (as discussed in greater detail below). See Alistair Barr, *Fairfax Sues Hedge Funds, Alleges Manipulation*, *NEWS WATCH* (July 26, 2006), http://articles.marketwatch.com/2006-07-26/news/30750663_1_short-sellers-biovail-fairfax-financial-holdings.

203. *Fairfax Financial Holdings Complaint*, *supra* note 202, ¶ 1.

204. See *id.* ¶¶ 3–6.

205. *Id.* ¶¶ 91–95.

206. *Id.* ¶¶ 92–93, 95–96.

207. *Id.* ¶¶ 150–205. Plaintiffs sought more than \$6 billion in compensatory damages, in addition to treble damages under New Jersey’s anti-racketeering law and other relief. *Id.* ¶¶ 6, 206. Fairfax later asserted that its damages had grown to \$8 billion. See Thom Weidlich, *Fairfax’s Once-Sprawling Racketeering Suit Shrinks as Hedge Funds Drop Out*, *BLOOMBERG.COM* (Mar. 1, 2012), <http://www>.

The lawsuit was pared down significantly in the years after Fairfax and C&F filed it, as various defendants were dismissed for procedural reasons or due to a lack of evidence connecting them to the alleged short attack conspiracy.²⁰⁸ In contrast to the “Alfred Little” cases, discussed above, the court refused to dismiss the case against the remaining defendants, Morgan Keegan and Exis Capital Management Inc. (“Exis”), on free-speech grounds.²⁰⁹ Ultimately, however, although the court recognized there was evidence of an effort to harm Fairfax’s business, the action concluded with the dismissal of the plaintiffs’ claims against the remaining defendants.²¹⁰ The court concluded that Fairfax failed to prove that it was entitled to the damages it sought.²¹¹

Fairfax’s lawsuit came in the wake of a series of public disclosures concerning government investigations into certain insurance transactions by Fairfax and its subsidiaries.²¹² A day after it initiated its lawsuit alleging a short attack conspir-

bloomberg.com/news/2012-03-01/fairfax-s-once-sprawling-racketeering-suit-shrinks-as-hedge-funds-drop-out.html.

208. A number of the defendants named in Fairfax’s suit were dismissed early in the case. See Weidlich, *supra* note 207. Two defendants—Lone Pine Capital LLC and Trinity Capital—were voluntarily dismissed in 2007. *Id.* David Rocker’s former fund company, then known as Rocker Partners LP, won summary judgment in 2008. *See id.* The court found insufficient evidence linking that defendant to the alleged conspiracy. *See id.* In September 2011, the court granted summary judgment in favor of Steven A. Cohen and SAC, finding that the evidence did not show that they were part of a conspiracy against Fairfax. *Id.* In fact, for most of the relevant period, SAC held a long position in Fairfax shares, and Cohen was almost totally uninvolved in SAC’s Fairfax trading. *Id.* In December 2011, the court granted summary judgment in favor of Daniel Loeb and Third Point LLC, as well as James Chanos and Kynikos Associates LP, on jurisdictional grounds. *Id.* The court also granted summary judgment in favor of Institutional Credit Partners LLC (“ICP”) and William Gahan, a trader formerly associated with ICP. *Id.*

209. *See* Thom Weidlich, *Morgan Keegan Loses Dismissal Bid in \$8 Billion Fairfax Suit*, BLOOMBERG.COM (Mar. 16, 2012), <http://www.bloomberg.com/news/2012-03-16/morgan-keegan-loses-dismissal-bid-in-8-billion-fairfax-suit-1-.html>.

210. On September 12, 2012, prior to the beginning of a scheduled trial, the court dismissed the plaintiffs’ claims of commercial disparagement, tortious interference with contractual relationships, and common law conspiracy against Morgan Keegan and Exis. David Voreacos & Anthony Effinger, *Fairfax Case Against Morgan Keegan, Exis Dismissed*, BLOOMBERG.COM (Sept. 13, 2012), <http://www.bloomberg.com/news/2012-09-12/fairfax-lawsuit-against-morgan-keegan-exis-dismissed-by-judge.html>. Despite “evidence of intent to adversely affect the actual business dealings’ of Fairfax,” *id.*, the court granted the defendants’ motion to dismiss after disqualifying the testimony of the plaintiffs’ damages expert. Ben Horowitz, *Judge Tosses Lawsuit Alleging Conspiracy*, STAR-LEDGER (N.J.), Sept. 13, 2012, at 20. Previously, in May 2012, Morgan Keegan and Exis won dismissal of the plaintiffs’ claims under New Jersey’s anti-racketeering law, which the court held did not apply to the defendants’ alleged conduct in New York. David Voreacos, *Morgan Keegan Wins Dismissal of Fairfax Racketeer Claims*, BLOOMBERG.COM (May 15, 2012), <http://www.bloomberg.com/news/2012-05-15/morgan-keegan-wins-dismissal-of-fairfax-racketeer-claims.html>. Additionally, on June 27, 2012, the court dismissed the plaintiffs’ tortious interference with prospective economic advantage claim. David Voreacos, *Fairfax Had ‘Massive’ Loss in Morgan Keegan Case: Judge*, BLOOMBERG.COM (June 28, 2012), <http://www.bloomberg.com/news/2012-06-28/fairfax-had-massive-loss-in-morgan-keegan-case-judge-says-1-.html>.

211. *See* Voreacos & Effinger, *supra* note 210; Horowitz, *supra* note 210, at 20.

212. In June 2005, the company announced that a subsidiary, Fairmont Specialty Group, had been subpoenaed by the SEC for information regarding certain nontraditional insurance arrangements. Fairfax Fin. Holdings Ltd. (Form 6-K), Ex. 99.1 (June 29, 2005). In September of that year, Fairfax disclosed a second SEC subpoena seeking information regarding non-traditional insurance contracts, this one directed to Fairfax. Fairfax Fin. Holdings Ltd. (Form 6-K), Ex. 99.1 (Sept. 7, 2005). A few weeks later, Fairfax announced a third SEC subpoena “as part of [the SEC’s] investigation

acy, Fairfax disclosed that it had identified certain accounting errors and would restate the company's financial reports for affected periods.²¹³ Some suggested that, by filing the suit, Fairfax sought to deflect attention away from its own woes.²¹⁴

Ultimately, the SEC closed its investigation into Fairfax without taking any action against the company.²¹⁵ The SEC also reportedly opened another investigation into whether several hedge funds that were named in Fairfax's lawsuit—including SAC, Third Point, and Kynikos—improperly traded Fairfax stock.²¹⁶ The investigation followed the release of e-mails and instant messages submitted as exhibits in Fairfax's lawsuit, which reportedly suggested that Kynikos and SAC were aware of Gwynn's report before it was published.²¹⁷ Thereafter, the SEC reportedly informed SAC and Kynikos that it would not pursue an enforcement action against the firms.²¹⁸

2. Overstock.com, Inc.

Despite the procedural hurdles inherent in litigation against short sellers, at least one issuer demonstrated some modicum of success in its challenge. In that case, the company—Overstock.com, Inc. (“Overstock”)—had the benefit of witness testimony from a former employee of an affiliate of the short seller. Nevertheless, the *Overstock* case also highlights the difficulty of obtaining meaningful relief in this type of case and the risk of regulatory scrutiny of the issuer. The *Overstock* case indicates that, for most companies that perceive themselves to be victims of short attacks, litigating against the alleged perpetrators may be a high-risk, low-reward proposition.

Overstock filed its lawsuit against Gradient, Rocker Partners, and others in California Superior Court, Marin County, alleging that analysts at Gradient,

into certain loss mitigation products . . .” Fairfax Fin. Holdings, Ltd. (Form 6-K), Ex. 99.1 (Sept. 26, 2005). In October 2005, the *Wall Street Journal* reported that the U.S. Attorney's Office for the Southern District of New York had opened a related probe into Fairfax. Ian MacDonald & Kara Scannell, *U.S. Prosecutors Join Fairfax Probe*, WALL ST. J., Oct. 10, 2005, at C3. Following the *Journal's* report, Fairfax stated its understanding “that the U.S. attorney's office for the Southern District of New York will review information that Fairfax provides to the SEC in response to SEC subpoenas, but that Fairfax has not been advised that it is the target of an investigation by that office.” Fairfax Fin. Holdings Ltd. (Form 6-K), Ex. 99.2 (Oct. 11, 2005). Fairfax and its subsidiaries conducted a review of the insurance transactions that were the subject of the investigations, leading to a restatement by OdysseyRe, a Fairfax subsidiary. Fairfax Fin. Holdings Ltd. (Form 6-K), Ex. 99.1 (July 27, 2006) [hereinafter Fairfax Restatement Announcement]. Fairfax's restatement reportedly ultimately reduced shareholder equity by \$261.7 million. Duncan Mavin, *Fairfax Takes \$262M Hit in Restatement*, NAT'L POST (Can.), Nov. 11, 2006, at FP7.

213. Fairfax Restatement Announcement, *supra* note 212.

214. See Joe Nocera, *Making Sure the Negative Can Be Heard*, N.Y. TIMES, May 12, 2007, at C1; Rob Robertson, *Morgan Keegan Sued for Fraud*, COM. APPEAL (Memphis, Tenn.), Aug. 2, 2006, at C2.

215. Fairfax Fin. Holdings Ltd. (Form 6-K), Ex. 99.1 (June 25, 2009).

216. Tom McGinty & Kara Scannell, *SEC Looks at Hedge Funds' Trades*, WALL ST. J., Feb. 13, 2009, at C1.

217. *Id.*

218. Matthew Goldstein, *SEC Closes Fairfax Propose on Hedge Funds: Sources*, REUTERS.COM (Dec. 8, 2011), <http://www.reuters.com/article/2011/12/08/us-fairfax-sec-idUSTRE7B725P20111208>.

acting under the direction of hedge fund investors at Rocker Partners, published reports containing false and defamatory statements about Overstock in order to depress share prices so that Rocker Partners could profit from short sales.²¹⁹

The court subsequently denied the defendants' motion to have the case dismissed under California's anti-SLAPP statute.²²⁰ On the issue of actual malice, which Overstock was required to show in connection with its libel claims, the trial court held that a declaration by Demetrios Anifantis, a former employee of Gradient's predecessor, who stated that Gradient routinely tailored negative research reports for paying customers who held short positions in the companies that were the subject of the reports, constituted prima facie evidence that Gradient acted with "reckless disregard of the truth."²²¹

The Rocker defendants filed counterclaims against Overstock.²²² In their countersuit, the Rocker defendants asserted that Overstock engaged in manipulative "short squeezes" in an effort to distract from its own questionable accounting and mismanagement.²²³ Thereafter, Overstock and Gradient reached a settlement.²²⁴ As part of the settlement, Gradient retracted statements it had made regarding Overstock's accounting and apologized for asserting that certain Overstock directors were not independent.²²⁵ Rocker Partners reportedly settled the remainder of the lawsuit (including its own counterclaims) for \$5 million.²²⁶

219. Complaint ¶¶ 1–23, *Overstock.com, Inc. v. Gradient Analytics, Inc.*, No. CV-053693 (Cal. Super. Ct. Aug. 11, 2005). Overstock asserted claims of negligence and violations of California's Business and Professions Code. *Id.* ¶¶ 24–31. On October 12, 2005, Overstock amended its complaint, asserting new claims of libel per se, libel per quod, interference with prospective economic advantage, and violations of California's Corporations Code, in addition to violations of California's Business and Professions Code. *See* First Amended Complaint ¶¶ 2, 45–86, *Overstock.com, Inc. v. Gradient Analytics, Inc.*, No. CV-053693 (Cal. Super. Ct. Oct. 12, 2005). Overstock sought general, special and punitive damages, as well as injunctive and other relief. *Id.* at 21–23.

220. *See Overstock.com, Inc. v. Gradient Analytics, Inc.*, 61 Cal. Rptr. 3d 29, 38 (Ct. App. 2007). In California, in certain cases, "[a] cause of action against a person arising from any act of that person in furtherance of the person's right of petition or free speech under the United States Constitution or the California Constitution in connection with a public issue shall be subject to a special motion to strike, unless the court determines that the plaintiff has established that there is a probability that the plaintiff will prevail on the claim." CAL. CIV. PROC. CODE § 425.16(b)(1) (West Supp. 2013); *see also id.* § 425.17 (limiting cases in which anti-SLAPP motions to strike may be used). A defendant prevailing upon an anti-SLAPP motion to strike may be entitled to recover litigation costs. *See id.* § 425.16(c).

221. *Overstock.com*, 61 Cal. Rptr. 3d at 35, 38. The trial court's decision was upheld on appeal. *Id.* at 46–48, 54.

222. Bethany McLean, *Overstock.com Drama Spurs Lawsuits*, *FORTUNE.COM* (Nov. 28, 2007), http://money.cnn.com/2007/11/28/magazines/fortune/overstock_1128.fortune/index.htm.

223. Roddy Boyd, *Hedge Fund Counter Sues Overstock*, *N.Y. POST* (Nov. 13, 2007), http://www.nypost.com/p/news/business/item_mpaQjx1Gyu4hcUiaU8DMVM;jsessionid=AB8129DB5AC1B917E752CDFC1FBAEC37.

224. *Overstock Says Settled Claims Against Gradient*, *REUTERS.COM* (Oct. 13, 2008), <http://www.reuters.com/article/2008/10/13/overstock-settlement-idUSN1346384320081013>.

225. Paul Beebe, *Overstock.com Settles Suit with Research Firm*, *SALT LAKE TRIB.* (Oct. 14, 2008), http://www.sltrib.com/business/ci_10713775.

226. *Overstock Says It Settles with Hedge Fund*, *REUTERS.COM* (Dec. 8, 2009), <http://www.reuters.com/article/2009/12/08/overstock-suit-idCNN0821943720091208?rpc=44>.

The Rocker defendants claimed to have settled solely to avoid litigation costs, and they continued to deny Overstock's allegations.²²⁷

While the lawsuit against Gradient and Rocker Partners was pending, Overstock also sued a number of major prime brokers.²²⁸ Overstock alleged that, in their role as settlement agents, the defendants caused Overstock's share price to drop by executing short sales of Overstock shares with no intention of delivering stock to settle the transactions (resulting in naked shorts).²²⁹

The defendants brought numerous motions to dismiss or strike Overstock's claims on various grounds and, although partially successful,²³⁰ Overstock

227. Eric Savitz, *Overstock: Copper River Says It Settled to Avoid Litigation Costs, and Didn't Defame the Company*, BARRON'S TECH TRADER DAILY (Dec. 10, 2009), <http://blogs.barrons.com/techtraderdaily/2009/12/10/overstock-copper-river-says-it-settled-to-avoid-litigation-costs-and-didnt-defame-the-company/>.

228. The original defendants included Morgan Stanley & Co., Inc., The Goldman Sachs Group, Inc., Bear Stearns Securities Corp., Banc of America Securities, LLC, The Bank of New York, Citigroup, Inc., Credit Suisse (USA) Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., and UBS Financial Services, Inc. Complaint ¶¶ 8–17, *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (Cal. Super. Ct. Feb. 2, 2007). The final operative complaint also named as defendants Lehman Brothers, Inc., Goldman Sachs & Co., Goldman Sachs Execution & Clearing, L.P., Citigroup Global Markets, Inc., Credit Suisse Securities (USA) LLC, and Merrill Lynch Professional Clearing Corp. Fourth Amended Complaint at 1, *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (Cal. Super. Ct. Jan. 27, 2011).

229. Complaint ¶¶ 1, 24–37, *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (Cal. Super. Ct. Feb. 2, 2007). Overstock asserted claims of conversion, trespass to chattels, intentional interference with prospective economic advantage, violations of the California Business and Professions Code, and market manipulation under the California Corporations Code. *Id.* ¶¶ 38–56. Overstock initially sought \$3.48 billion in general damages, unspecified special and punitive damages, and injunctive and other relief. *Id.* at 11. Overstock subsequently amended its complaint on several occasions. Overstock's final Fourth Amended Complaint did not specify an amount of general damages. Fourth Amended Complaint at 15, *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (Cal. Super. Ct. Jan. 27, 2011). One media source estimated that Overstock sought damages of \$55 million. *See A Not-So-Short Story*, ECONOMIST (Jan. 11, 2012), <http://www.economist.com/blogs/schumpeter/2012/01/naked-short-selling>. Overstock's lawsuit against the prime brokers was controversial, and two independent directors reportedly resigned due to their disagreement with the company's decision to pursue it. *See Overstock.com, Inc.*, Current Report (Form 8-K), Item 3.01(b) (May 24, 2007); *Overstock.com Director Resigns*, N.Y. TIMES, Feb. 24, 2007, at C2.

230. The defendants sought dismissal of Overstock's claims on federal preemption grounds, among others, but the court largely denied this motion. *See Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147, slip op. at 1–2 (Cal. Super. Ct. Sept. 19, 2007) (order overruling in part and sustaining in part defendants' demurrers to plaintiffs' complaints and granting leave to amend) (holding that: (a) the plaintiffs' claims were not preempted, because application of California law in the context of allegedly intentional market manipulation scheme does not conflict with federal law, which does not permit such conduct; (b) California's Business and Professions Code applies to the alleged securities transactions; and (c) the plaintiffs alleged sufficient facts to sustain market manipulation claims under the Corporations Code, as well as claims of conversion and trespass; but (d) sustaining the defendants' demurrer as to the claim of intentional interference with prospective economic advantage because the plaintiffs failed to allege a factual basis upon which to determine whether they were likely to receive the expected benefit, or knowledge or intent on the part of the defendants, and granting leave to amend). Subsequently, certain other claims were struck, including those for restitution, conspiracy, and aiding and abetting under California's Corporation Code. *See Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147, slip op. at 1–2 (Cal. Super. Ct. Aug. 29, 2008) (order on defendants' motion to strike) (holding that the plaintiffs' claims were for damages or disgorgement of ill-gotten gain, not for restitution, and that no cause of action for conspiracy or aiding and abetting exists under the Corporations Code); *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (Cal. Super. Ct. May 22, 2008) (order on defendants'

was permitted to proceed with certain claims, including market manipulation claims under California law. Most of the defendants settled with Overstock for a total of \$4.5 million.²³¹

Following these settlements, in January 2012, the remaining defendants succeeded in getting the balance of Overstock's suit dismissed.²³² Crucially, with respect to Overstock's claim of market manipulation, the court held that mere failure to deliver stock, without conduct designed to deceive or defraud investors, is insufficient to sustain a claim, highlighting the problems of proof that face issuers who allege that they are victims of short attacks.²³³

Overstock's lawsuits coincided with a series of SEC investigations—including investigations of Overstock. The SEC reportedly began investigating Gradient in the fall of 2005.²³⁴ Press reports indicate that the SEC sought to determine whether Gradient conspired with hedge funds to drive down the price of Over-

motion to strike). Finally, the court dismissed Overstock's conversion and trespass to chattels claims as to certain defendants. *See* Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147 (Cal. Super. Ct. Aug. 6, 2009) (order sustaining demurrer and granting motion to strike); Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147, slip op. at 1–2 (Cal. Super. Ct. Apr. 7, 2009) (order sustaining demurrer and granting motion to strike) (holding that diminution of stock value through dilution is insufficient to support claims of conversion and trespass to chattels, and dismissing those claims with leave to amend; dismissing punitive damages claim under the Corporations Code).

231. Overstock.com, Inc., Annual Report (Form 10-K), at F-28 (Mar. 2, 2012). Other terms of settlement were confidential. *Id.* In addition to the settlements, Overstock chose not to pursue claims against Lehman Brothers following that company's bankruptcy. *See id.*; *see also* Dismissal with Prejudice as to Banc of Am. Sec. LLC, Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147 (Cal. Super. Ct. Sept. 26, 2011).

232. *See* Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147, slip op. at 10–11 (Cal. Super. Ct. Jan. 10, 2012) (order granting defendants' motion for summary judgment or, in the alternative, summary adjudication). The court found that plaintiffs had failed to establish that any of the defendants had engaged in acts of market manipulation within California, and therefore California Corporations Code section 25400 did not apply. *Id.* at 5–9. With respect to plaintiffs' claim for an injunction under the Business and Professions Code, the court found that the allegedly manipulative conduct was not likely to recur and, moreover, that the activity plaintiffs sought to enjoin was already prohibited by SEC rules. *Id.* at 9–10; *see also* Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147 (Cal. Super. Ct. Apr. 11, 2012) (further and final order granting defendants' motions for summary judgment). Previously, Goldman Sachs and Merrill Lynch had succeeded in obtaining the dismissal of Overstock's racketeering claim under New Jersey's anti-racketeering law, which carries the potential for treble damages. *See* Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147, slip op. at 2–3 (Cal. Super. Ct. Dec. 6, 2011) (order (1) sustaining defendants' demurrer to the third cause of action in plaintiffs' fourth amended complaint; and (2) denying plaintiffs' request for leave to file fifth amended complaint).

233. Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147, slip op. at 8 (Cal. Super. Ct. Jan. 10, 2012) (order granting defendants' motion for summary judgment or, in the alternative, summary adjudication). Judgment was awarded in favor of Goldman Sachs and Merrill Lynch, and those defendants were awarded costs. Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147 (Cal. Super. Ct. Apr. 12, 2012) (judgment). In a related dispute regarding the defendants' efforts to seal papers relating to the summary judgment motions, a lawyer for the defendants accidentally filed as an exhibit to another document an unredacted version of Overstock's opposition to the defendants' motion to seal. Gary Weiss, *The Naked Truth?*, BARRON'S, Aug. 4, 2012, at 16. That document quoted numerous internal e-mails from Goldman Sachs and Merrill Lynch, in which employees of those companies discuss trading with short sellers and—according to Overstock—naked short selling. *See id.*

234. Bob Mims, *SEC Investigates Gradient Report in Overstock Suit*, SALT LAKE TRIB., Nov. 18, 2005, at C13.

stock shares.²³⁵ Notably, the SEC subpoenaed several journalists in order to learn about their contacts with Gradient.²³⁶ These subpoenas were highly controversial. The news organizations refused to comply with them, and then-SEC Chairman Christopher Cox subsequently criticized the subpoenas and reportedly placed them “on hold.”²³⁷ Thereafter, the SEC announced a new policy statement setting forth limited circumstances under which it would issue subpoenas to journalists.²³⁸ The SEC closed the investigation without taking any action against Gradient.²³⁹

One day after Overstock filed its suit against Gradient and Rocker Partners, Byrne stated during a telephone call with reporters that the SEC had opened an informal inquiry into Overstock.²⁴⁰ In February 2006, Overstock restated certain previously reported financial results to correct freight cost-related accounting errors.²⁴¹ Subsequently, Overstock reported that it had received an SEC subpoena requesting “a broad range of documents, including,” among other things, documents relating to Overstock’s accounting policies, targets, projections, and estimates; Overstock’s communications with and regarding analysts; and Overstock’s complaint against Gradient.²⁴² Two years later, Overstock reported that the SEC had completed its investigation of Overstock and did not intend to pursue any action against the company or its officers.²⁴³

Overstock later announced its intention to restate previously reported earnings for certain periods, “to correct errors related to the accounting of customer refunds and credits” and to correct the company’s method of recording revenue.²⁴⁴ Thereafter, Overstock reported that the SEC had initiated a new investigation into the company’s accounting and its previously announced financial

235. *Id.* In the course of its investigation, the SEC reportedly obtained testimony from three former employees of Gradient who had submitted affidavits in Overstock’s lawsuit against Gradient, Rocker, and other defendants. *Id.* The affidavit of one of the former employees, Demetrios Anifantis, was cited by the court in the Overstock litigation as *prima facie* evidence that Gradient acted with malice to defame Overstock. See *Overstock.com*, 61 Cal. Rptr. 3d at 38. Anifantis, who also testified before the Senate Judiciary Committee, asserted that he was fired for questioning Gradient’s practices and its ties to hedge funds. Judith Burns, *SEC Declines to Bring Charges After Probe of Gradient Analytics*, WALL ST. J., Feb. 15, 2007, at A11.

236. Kara Scannell, *Moving the Market: SEC Subpoenas Research Firm*, WALL ST. J., Mar. 27, 2006, at C3.

237. *Id.*

238. See Press Release, U.S. Sec. & Exch. Comm’n, Policy Statement of the Securities and Exchange Commission Concerning Subpoenas to Members of the News Media (Apr. 12, 2006) (No. 2006-55), available at <http://www.sec.gov/news/press/2006/2006-55.htm>.

239. Burns, *supra* note 235, at A11. Press reports indicate that, in addition to the SEC investigation, the U.S. Department of Justice looked at Mr. Byrne’s allegations of conspiracy, although it is not clear whether the DOJ opened a formal investigation. See Dan Dorfman, *Justice Department Eyes Overstock.com Fight*, N.Y. SUN, May 22, 2006, at 10.

240. See Roddy Boyd, *Byrne Flames Out; Overstock CEO Stuns with Wild, Wily Rant*, N.Y. POST, Aug. 14, 2005, at 29.

241. Overstock.com, Inc., Current Report (Form 8-K), at 2–3 (Feb. 28, 2006).

242. Overstock.com, Inc., Current Report (Form 8-K), Item 8.01 (May 9, 2006).

243. *Overstock.com Says SEC Probe Ended*, REUTERS.COM (June 6, 2008), <http://www.reuters.com/article/2008/06/06/overstock-probe-idINWNAS748220080606?rpc=44>.

244. Overstock.com, Inc., Current Report (Form 8-K), Item 4.02(a) (Oct. 24, 2008).

restatements.²⁴⁵ A few weeks later, Overstock reportedly fired its independent auditor in a dispute regarding the booking of revenue.²⁴⁶

Subsequently, the SEC was said to have subpoenaed Overstock and the Rocker defendants for documents that were produced in discovery during their litigation.²⁴⁷ Soon thereafter, a financial journalist published an article in which he relied on some of those same documents to raise questions about Overstock's financial health and internal controls during the period between 2003 and 2006.²⁴⁸ The article referred to internal e-mails between David Chidester, Overstock's former CFO, and others at the company.²⁴⁹ Five days later, Chidester left Overstock.²⁵⁰ In February 2010, Overstock announced another restatement of previously filed financial reports and admitted to a "deficiency" in its internal controls related to the company's relationship with certain business partners.²⁵¹ In April 2012, Overstock disclosed that the SEC had notified the company that it had closed its renewed investigation and would not recommend any enforcement action against Overstock.²⁵²

The *Fairfax* case presents a stark portrait of the procedural hurdles confronted by an issuer in short attack litigation. Although the *Overstock* litigation showed some success, the plaintiffs in that case had the benefit of certain unique facts, including, in particular, testimony from a former employee of a defendant. Even then, the modest settlements and ultimate dismissal of many claims in that case raise a question as to the benefits of litigation against short sellers in this context.

C. DIFFICULTIES OF PROOF: THE PRE-LENNAR MINKOW CASES

Two Barry Minkow-related matters that predate the *Lennar* case²⁵³ demonstrate the difficulty of obtaining meaningful relief against an alleged perpetrator of a short attack (even when that person is an alleged former Ponzi-schemer). In the first case, USANA Health Sciences, Inc. ("USANA") filed an amended complaint for damages and injunctive relief alleging that Minkow and his Fraud Discovery Institute, as part of a scheme of illegal market manipulation, created and

245. See Overstock.com, Inc., Current Report (Form 8-K), Item 8.01 (Sept. 17, 2009); *id.* Ex. 99.1, at 1 (Press Release, Overstock.com, Inc., Overstock.com Announces Receipt of Another SEC Subpoena (Sept. 17, 2009)).

246. Overstock.com, Inc., Current Report (Form 8-K), at 2 (Nov. 23, 2009).

247. See Carol S. Redmond, *In the Money: SEC Subpoenas Overstock/Copper for Discovery Docs*, DOW JONES NEWSWIRE, Jan. 15, 2010 (LEXIS, News & Business, Dow Jones News Service).

248. Roddy Boyd, *America's Nastiest CEO*, CNBC (Jan. 20, 2010, 12:01 PM EST), <http://www.cnbc.com/id/34955970/>.

249. *Id.*

250. Overstock.com, Inc., Current Report (Form 8-K), Item 5.02 (Jan. 25, 2010). A spokesman for Overstock denied that Chidester's departure was related to the publication of the article. Paul Beebe, *Exec's Exit from Overstock Comes Amid Probe, After Article*, SALT LAKE TRIB., Feb. 2, 2010, at E2, 2010 WLNR 2157875.

251. Overstock.com, Inc., Current Report (Form 8-K), Item 4.02(a) (Feb. 4, 2010).

252. Overstock.com, Inc., Current Report (Form 8-K), Item 8.01 (Apr. 2, 2012).

253. See *supra* Part II.A.

distributed libelous reports and statements about USANA's products and business model, among other statements.²⁵⁴

Despite USANA's contentions that their lawsuit centered on market manipulation, and not on the statements made by Minkow in his report, the court dismissed USANA's four state-law claims under California's anti-SLAPP statute, finding that the statements were in furtherance of constitutionally protected conduct, based on the evidence presented, and that USANA was not likely to prevail on any of their state law claims, making particular note of the fact that USANA had presented "no evidence" of naked short selling by the defendants.²⁵⁵ The parties then settled the remaining Rule 10b-5 claim with Minkow and the other defendants, who agreed to the issuance of an injunction against manipulation of USANA stock and publishing further comments about USANA.²⁵⁶

The SEC initiated an informal inquiry into USANA's business practices, but reportedly closed the investigation less than a year later, recommending that no further action be taken.²⁵⁷

The other Minkow-related matter involved Medifast, Inc. ("Medifast"), a Maryland-based company that sells weight-loss programs and related products through direct marketing. According to Medifast, starting in February 2009, Barry Minkow and others allegedly propagated false and defamatory statements about Medifast in an effort to drive down the company's share price and profit from short positions.²⁵⁸ Among other things, Minkow and others compared Medifast to a pyramid scheme, publicized a letter to the Federal Trade Commission ("FTC") that was critical of Medifast, and attacked the independence of Medifast's auditor, alleging that the auditor was "moonlighting" as a Medifast stock promoter.²⁵⁹

254. First Amended Complaint ¶¶ 64–94, *USANA Health Scis., Inc. v. Minkow*, No. 2:07-cv-00159-TC (D. Utah July 12, 2007). USANA presented claims for violations of state unfair competition law, the state corporations code, Exchange Act Rule 10b-5, intentional interference with economic advantage, and tortious exposure to litigation with third parties against Minkow, as well as various John Does believed to include "institutional investors or hedge funds," *id.* ¶ 5, and stated that Minkow's report was "intended to drive USANA's stock price down." *Id.* ¶ 56; see also *USANA Health Scis., Inc. v. Minkow*, No. 2:07-cv-00159-TC, 2008 WL 619287 (D. Utah Mar. 4, 2008). USANA also claimed that the defendants engaged in naked short selling of USANA stock. First Amended Complaint, *supra* ¶ 5.

255. *USANA Health Scis.*, 2008 WL 619287, at *7. The court made a point of noting that Minkow did not engage in naked short sales of USANA stock but engaged only in "the lawful trading of securities." *Id.*

256. *USANA Health Scis., Inc. v. Minkow*, No. 2:07-cv-00159-TC, slip op. ¶ 7 (D. Utah July 30, 2008) (permanent final injunction and order of dismissal). Minkow and FDI denied any involvement in naked short selling or market manipulation, and the settlement agreement was filed under seal. See *id.* ¶¶ 3–4.

257. See Press Release, *USANA Health Scis., Inc.*, SEC Closes Informal Inquiry of USANA (Jan. 11, 2008), available at http://phx.corporate-ir.net/phoenix.zhtml?c=95179&p=irol-newsArticle_print&iD=1095232&highlight=

258. First Amended Complaint at 2–3, 9–19, *Medifast, Inc. v. Minkow*, No. 3:10-cv-00382-CAB-BGS (S.D. Cal. Apr. 12, 2010) [hereinafter *Medifast First Amended Complaint*].

259. *Id.* at 9–13.

Medifast subsequently reported that an independent committee of its board of directors had investigated Minkow's allegations and concluded that they were meritless.²⁶⁰ Medifast further disclosed that it had "filed formal complaints" with the SEC, the New York Stock Exchange, and the Attorney General of Maryland,²⁶¹ and that it also had "pending complaints" before the Maryland Securities Commissioner and the U.S. Attorney's Office.²⁶²

Medifast filed a lawsuit against Minkow and other defendants on February 17, 2010.²⁶³ It asserted claims of defamation, conspiracy to defame, market manipulation, and unfair business practices under California law, and sought \$270 million in damages and injunctive and other relief.²⁶⁴ The defendants moved to strike the complaint under California's anti-SLAPP law.²⁶⁵

On March 29, 2011, the court largely granted the defendants' motions to strike.²⁶⁶ In a ruling that highlights the problems of proof faced by companies that contemplate legal action in response to perceived short attacks, the court found that Medifast was unlikely to prevail on its defamation claim, because the defendants' statements "do not charge Medifast with commission of a crime, nor are they otherwise defamatory without the necessity of explanatory matter."²⁶⁷ As to the conspiracy claim, the court found that Medifast failed to present evidence of an agreement among the defendants to injure Medifast's reputation, notwithstanding that Minkow's co-defendants "clearly had preconceived notions regarding Medifast."²⁶⁸ The court struck Medifast's market manipulation claims on the grounds that Medifast failed to submit evidence that it was a purchaser or seller of its own securities during the relevant period.²⁶⁹ The court also struck Medifast's unfair business practices claim as derivative of the stricken defamation and market manipulation claims.²⁷⁰

260. Medifast, Inc., Quarterly Report (Form 10-Q), at 18 (Aug. 6, 2009); *id.* Item 5.

261. *Id.* at 18.

262. Medifast, Inc., Annual Report (Form 10-K), at 23 (Dec. 31, 2011); *id.* Item 3.

263. See Complaint, Medifast, Inc. v. Minkow, No. 3:10-cv-00382-CAB-BGS (S.D. Cal. Feb. 17, 2010).

264. Medifast First Amended Complaint, *supra* note 258, at 20–24.

265. Medifast, Inc. v. Minkow, No. 10-CV-382 JLS (BGS), 2011 WL 1157625 (S.D. Cal. Mar. 29, 2011).

266. *Id.* at *16. Defamation claims remain pending against one defendant, an expert hired by Minkow to write a report on Medifast. *Id.*

267. *Id.* at *9.

268. *Id.* at *14.

269. *Id.* at *14–15.

270. *Id.* at *15–16. With respect to defamation claims against the expert, which were not stricken, the court held that Medifast failed to establish the expert's "report was likely to deceive a reasonable consumer." *Id.* at *16. Medifast has appealed the court's ruling. See Medifast, Inc. v. Minkow, No. 11-55687 (9th Cir. filed Apr. 27, 2011). The expert also appealed from the partial denial of his motion to strike. See Medifast, Inc. v. Fitzpatrick, No. 11-55699 (9th Cir. filed Apr. 28, 2011). The submission of both appeals has been vacated and deferred pending the disposition of the petition for rehearing *en banc* in Makaeff v. Trump University, LLC, 2013 WL 1633097 (9th Cir. 2013). See Medifast, Inc. v. Minkow, Nos. 11-55687, 11-55699, slip op. at 2 (9th Cir. May 20, 2013).

The litigation between Medifast and Minkow coincided with two financial restatements by Medifast,²⁷¹ a decision to change auditors,²⁷² and several CFO changes.²⁷³

It is unclear whether the SEC or any other law enforcement authority ever investigated Medifast as a result of Minkow's statements.²⁷⁴ The dispute between Medifast and Minkow apparently did prompt the SEC to investigate Minkow. According to press reports, the SEC subpoenaed Minkow and others associated with him in June 2010 to obtain all communications regarding Medifast, Lennar, USANA, and other companies, as well as information regarding contacts with journalists and others.²⁷⁵

* * *

As the short attack cases discussed above show, issuer litigation alleging state law claims against short sellers and related parties can be fraught with difficulties. Although discovery may uncover facts allowing a lawsuit to survive a motion to dismiss, as in the Overstock case, pre-trial discovery is a two-way street, and an issuer's internal books and records relating to its financial reporting will be fair game for a defendant's discovery requests. Similarly, SEC investigations in this context are rarely limited in scope, and are likely to entail subpoenas to all involved parties, with the possibility of enforcement action should the facts warrant.

IV. SEC ENFORCEMENT ACTIONS INVOLVING "NAKED" SHORT SELLING

Although the SEC has brought only a handful of actions relating to short attacks (and has brought those cases only where it has been able to allege unambiguous claims of fraud or manipulation), the agency has continued to state that

271. On March 30, 2010, Medifast restated previously announced earnings for 2006, 2007, and 2008 due to an error in accounting for certain tax liabilities, which reduced net income in those years. Medifast, Inc., Annual Report (Form 10-K), at 22 (Mar. 30, 2010). Medifast also delayed reporting its financial results for fiscal 2010, and subsequently announced the restatement of previously announced earnings for 2008 and 2009, "principally due to errors in recording certain ordinary course of business expenses in the proper period," but also due to a write-off related to an intangible asset and the failure to record properly certain up-front customer payments over applicable service periods, which reduced net income in those years. Medifast, Inc., Annual Report (Form 10-K), at 29 (Apr. 1, 2011).

272. Medifast, Inc., Current Report (Form 8-K), at 2 (Apr. 16, 2010).

273. Medifast, Inc., Current Report (Form 8-K), at 2 (May 18, 2010); Medifast, Inc., Current Report (Form 8-K), Item 5.02(b) (Nov. 14, 2012); Medifast, Inc., Current Report (Form 8-K), Item 5.02(b) (Dec. 26, 2012); Medifast, Inc., Current Report (Form 8-K), Item 5.02(b) (Jan. 7, 2013).

274. See Medifast, Inc., Quarterly Report (Form 10-Q), at 18 (Nov. 9, 2009) ("There are currently no pending matters of a material nature related to any government investigation of the case involving Mr. Minkow, his company, its affiliates or associates. Any actions related to any government investigation pertaining to this complaint have been deemed confidential at this time."). On September 10, 2012, the FTC announced a \$3.7 million settlement with a Medifast subsidiary for allegedly violating a previous FTC settlement by making unsupported claims about Medifast's weight-loss program. Press Release, Fed. Trade Comm'n, Subsidiary of Diet Plan Marketer Medifast Inc. to Pay \$3.7 Million to Settle FTC Charges (Sept. 10, 2012), available at <http://www.ftc.gov/opa/2012/09/jasonpharm.shtm>.

275. Maxwell Murphy, *SEC Probe into Barry Minkow's Fraud Discovery Institute Continues*, Dow JONES NEWSWIRE (June 11, 2011), <http://www.advn.com/nyse/StockNews.asp?stocknews=IOC&article=43201457>.

abusive short selling is an enforcement priority.²⁷⁶ In this regard, a series of enforcement actions against “naked” short sellers and related persons for technical violations of Regulation SHO—including several actions against options market-makers—suggests that, even in the absence of proof that market participants have engaged in blatantly abusive or manipulative conduct that is characteristic of short attacks, the SEC will prosecute violations of Regulation SHO. Notably, several recent cases involve alleged “naked” short selling of stock in companies that have asserted they were victims of short attacks. With these cases, it is apparent that the SEC has chosen to use the technical requirements of Regulation SHO as a significant tool for policing potentially abusive short selling.

The SEC has brought a number of enforcement actions related to what are termed “reverse conversion” and sham “reset” transactions. Such transactions are designed to evade the locate and close-out requirements of Regulation SHO, resulting in “naked” short sales.²⁷⁷ For example, the SEC brought an ad-

276. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges optionsXpress and Five Individuals Involved in Abusive Naked Short Selling Scheme (Apr. 16, 2012) (No. 2012-66), available at <http://www.sec.gov/news/press/2012/2012-66.htm> (quoting statement by Daniel M. Hawke, Chief of the SEC Enforcement Division's Market Abuse Unit, that compliance with Regulation SHO “continues to be a high enforcement priority”).

277. The Commission has explained that a:

“reverse conversion” or “reversal,” involves selling stock short while also selling a put option and buying a call option that each have the exact same expiration date and strike price. The option combination creates what is known as a ‘synthetic long position’ that hedges the short stock sale. All three of these transactions are executed with the same counterparty—which is engaging in a “conversion.” The position is “delta neutral” to any change in the underlying stock price because whether the equity price rises or falls, the position remains hedged until the options expire, when one option will expire worthless while the other will be exercised or assigned, causing the stock to be received by the original seller and closing the short position.

Jeffrey A. Wolfson, Exchange Act Release No. 66283, 2012 WL 1024032, at *3 (Jan. 31, 2012). The Commission has further explained that a “reset” is a “sham transaction” that purports to discharge a short seller’s obligation to “purchase” the shorted security and “close out” its short position. *Id.* at *4. To accomplish a sham reset, the short seller purchases a long position in the shorted stock and simultaneously purchases “from the same counterparty a short-term, deep in-the-money put option (a so-called ‘married put,’ because the purchase of stock was paired with the put option),” or sells “a short-term, deep in-the-money call option (a so-called ‘buy write’ because the buyer buys shares and ‘writes’—or sells—a call option). This ostensible purchase of shares married with the short-term deep in-the-money option create[s] the illusion that the [short seller has] satisfied the close-out obligation of Reg. SHO Rule 203(b)(3) by ‘purchasing’ shares. But because the purchase was married to a short-term deep in-the-money option that in fact negated the purchase and returned the shares to the counterparty the next day, it was not a bona-fide purchase transaction.” *Id.* (footnote omitted). Some observers have suggested that these types of transactions may have been used in connection with abusive short selling schemes to create fictional shares for the purpose of “covering” what were in reality naked short sales. See Weiss, *supra* note 233 (stating that allegations made by Overstock in a brief filed in California state court, when read in conjunction with subsequent SEC enforcement actions against certain options market makers, suggest that prime brokers may have acquired inventory to cover customers’ short sales from options traders who created fictional shares through reverse conversions). The SEC’s Division of Market Regulation has stated unambiguously that “[n]aked short selling has no effect on an issuer’s total shares outstanding.” *Responses to Frequently Asked Questions Concerning Regulation SHO, Question 7.1*, U.S. SEC. & EXCH. COMM’N (Apr. 10, 2012), <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (refuting the belief, held by some, “that naked short sale transactions cause the number of shares trading to exceed the number of shares outstanding, which in turn allows broker-dealers to trade shares that don’t exist”).

ministrative enforcement proceeding in 2012 against optionsXpress, an online broker-dealer and clearing agency specializing in options and futures that is currently a wholly owned subsidiary of The Charles Schwab Corporation; Thomas E. Stern, an optionsXpress executive; and Jonathan I. Feldman, a retail customer of optionsXpress.²⁷⁸ The SEC alleged that optionsXpress failed to satisfy its close-out obligations under Rules 204 and 204T of Regulation SHO by repeatedly engaging in sham reset transactions that facilitated “naked” short selling by customers, including Feldman.²⁷⁹ The SEC claimed that the respondents knew, or were reckless in not knowing, that the options would be exercised and assigned on the day that they were sold, resulting in shares not being delivered on settlement.²⁸⁰ After a hearing, an SEC Administrative Law Judge (“ALJ”) rendered an initial decision finding that optionsXpress willfully violated Rules 204 and 204T of Regulation SHO by executing sham buy-write transactions, which involved the purchase of shares of a stock and the simultaneous sale of a call option for the same amount of shares—for the purpose of covering FTDs—and further finding that Feldman’s sale of deep-in-the-money calls resulting in naked short positions that were covered through buy-writes constituted fraud in violation of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rules 10b-5 and 10b-21 thereunder.²⁸¹

In a related, settled administrative proceeding, an optionsXpress trader and two optionsXpress compliance officials consented to the entry of an order finding that they caused optionsXpress’s violations of Rules 204 and 204T of Regulation SHO and ordering them to cease and desist.²⁸² The three settling respondents also agreed to cooperate with the SEC in any related investigations, litigation, and other proceedings.²⁸³

While the SEC did not allege the spreading of false rumors or other such conduct, it did assert that:

Rule 10b-21 and Rules 204 and 204T were adopted, among other things, to address abusive “naked” short selling and failures to deliver. . . .

. . . Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with short sales Failures to deliver . . . can negatively affect purchasers of stock by depriving them of the benefits of ownership, such as voting and lending, and create a misleading impression of the market for an issuer’s stock.²⁸⁴

278. optionsXpress, Inc., Securities Act Release No. 9313, 2012 WL 1264508 (Apr. 16, 2012).

279. *Id.* at *1.

280. *Id.* at *5.

281. optionsXpress, Inc., Initial Decision Release No. 490, 2013 WL 2471113, at *4, *62–78 (June 7, 2013). The ALJ also found that Stern willfully caused and aided and abetted the violations of optionsXpress and Feldman, and that optionsXpress willfully caused and aided and abetted Feldman’s violations, ordered disgorgement of ill-gotten gains, and imposed monetary and other sanctions on the respondents. *Id.* at *79–88.

282. Peter J. Bottini, Exchange Act Release No. 66814, 2012 WL 1264509 (Apr. 16, 2012).

283. *Id.* at *9.

284. optionsXpress, Inc., 2012 WL 1264508, at *4.

The SEC also claimed that the “sham reset transactions” at issue in the options-Xpress matter “impacted the market for the issuers,” accounting, for example, for “47.9% of the daily trading volume in Sears” stock between January 1, 2010, and January 31, 2010.²⁸⁵ According to the SEC, Feldman was aware that his trading had an effect on the marketplace, and his “use of buy-writes was a manipulative device and deceived the market.”²⁸⁶

Similarly, in an administrative proceeding against brothers Jeffrey A. Wolfson and Robert A. Wolfson and Golden Anchor Trading II, LLC (“Golden Anchor”), Robert Wolfson’s trading vehicle, the SEC alleged that the respondents routinely used “sham” reverse conversion and reset transactions “to circumvent Reg. SHO, allow[ing] them to generate millions of dollars in profits . . . and caus[ing] their clearing broker to have large persistent fail to deliver positions in . . . threshold securities, thus undermining an important purpose of Reg. SHO.”²⁸⁷ The SEC’s order instituting proceedings against the Wolfsons cited Regulation SHO’s proposing rule release, which explained that “naked short sellers enjoy greater leverage . . . and they may use this additional leverage to engage in trading activities that deliberately depress the price of a security.”²⁸⁸

The SEC asserted violations of Rules 203(b)(1) and 203(b)(3) under Regulation SHO. Threshold securities in which the Wolfsons allegedly traded include Fairfax and Novastar Financial, Inc. (“Novastar”), both companies that have allegedly been victims of short attacks or naked short selling.²⁸⁹ Consent orders were entered against the Wolfson respondents.²⁹⁰

In August 2009, the SEC brought a settled enforcement action against broker-dealer Hazan Capital Management, LLC (“HCM”), an options market-maker, and

285. *Id.* at *2.

286. *Id.* at *20.

287. Jeffrey A. Wolfson, Exchange Act Release No. 66283, 2012 WL 1024032 (Jan. 31, 2012).

288. *Id.* at *1–2.

289. *See id.* at *5. Fairfax is discussed in Part III.B. In June 2006, a group of Novastar investors brought a lawsuit in California state court against a number of major prime brokerage firms for allegedly manipulating the market for Novastar stock by executing short sales and intentionally failing to deliver stock to settle those positions. *See* Second Amended Complaint, *Avenius v. Banc of Am. Sec. LLC*, No. CGC-06-453422 (Cal. Super. Ct. May 29, 2008). A number of the defendants reached undisclosed settlements with the plaintiffs in May 2011. *See Avenius v. Banc of Am. Sec. LLC*, No. CGC-06-453422, slip op. at 2 (Cal. Super. Ct. May 26, 2011) (order granting certain defendants’ motions for summary judgment). On May 26, 2011, upon finding that the plaintiffs failed to raise any competent, affirmative evidence that the defendants engaged in market manipulation, the court granted summary judgment in favor of the remaining defendants. *Id.* at 5–6. The Novastar lawsuit is similar to a lawsuit against prime brokerage firms initiated by Overstock in February 2007, which is discussed in Part III.B.

290. J. Wolfson consented to the entry of an administrative order requiring him to cease and desist from violating Exchange Act Rules 203(b)(1) and 203(b)(3), suspending him from association with certain regulated entities, and ordering him to pay disgorgement of \$8,771,432, prejudgment interest of \$2,153,568, and civil penalties of \$2,500,000. Jeffrey A. Wolfson, Exchange Act Release No. 67451, 2012 WL 2914903, at *12–13 (July 17, 2012). R. Wolfson and Golden Anchor also consented to the entry of an administrative order requiring them to cease and desist from violating Exchange Act Rules 203(b)(1) and 203(b)(3), suspending R. Wolfson from association with certain regulated entities, and requiring R. Wolfson and Golden Anchor to pay, on a joint and several basis, disgorgement of \$722,589, prejudgment interest of \$177,411, and civil penalties of \$200,000. Jeffrey A. Wolfson, Exchange Act Release No. 67450, 2012 WL 2914902, at *11 (July 17, 2012).

its owner, Steven M. Hazan, for violations of Regulation SHO based on the broker-dealer's involvement in reverse conversion and reset transactions.²⁹¹ The SEC found, and the respondents neither admitted nor denied, that the respondents used reverse conversions and reset transactions to circumvent Regulation SHO.²⁹² The SEC further found, and the respondents neither admitted nor denied, that, at the time of the short sales at issue, the respondents improperly claimed the market-maker exception to the locate requirement, although the respondents were not engaged in bona fide market making.²⁹³

On the same day it brought its enforcement action against HCM, the SEC brought another settled action, based on substantially similar conduct, against TJM Proprietary Trading, LLC ("TJM"), a broker-dealer and options market-maker; John T. Burke, its principal and chief operating officer; and Michael R. Benson, a TJM trader.²⁹⁴ The SEC settlement alleged that TJM committed, and its trader willfully aided and abetted and caused, violations of Regulation SHO Rules 203(b)(1) and 203(b)(3) based on TJM's participation in reverse conversion and sham reset transactions.²⁹⁵ The SEC settlement alleged that Burke failed to supervise Benson reasonably, in violation of section 15(b)(4)(E) of the Exchange Act.²⁹⁶

Three months after it settled the TJM and HCM actions, the SEC brought yet another settled enforcement action against several entities relating to similar transactions that it alleged were violative of Regulation SHO.²⁹⁷ According to the SEC, Fat Squirrel Trading Group, LLC ("FSTG") and Rhino Trading, LLC

291. Hazan Capital Mgmt., LLC, Exchange Act Release No. 60441, 96 SEC Docket 1627 (Aug. 5, 2009), 2009 WL 2392842.

292. *Id.* at *1–2. While the enforcement order does not specifically identify HCM's counterparties or the threshold securities at issue, filings in Overstock.com's market manipulation case against a number of brokers, discussed in Part III.B, name Hazan as one of the market-makers engaged in naked short selling of Overstock.com securities during the relevant time period. *See, e.g.*, Plaintiff's Consolidated Opposition to Defendant's Motions to Seal Summary Judgment Papers, Overstock.com, Inc. v. Morgan Stanley & Co., No. CGC-07-460147 (Cal. Super. Ct. Mar. 1, 2012).

293. In settling the enforcement action, Hazan and HCM agreed to cease and desist from causing or committing violations of Rules 203(b)(1) and 203(b)(3). Hazan also agreed to a five-year bar from association with any broker or dealer, and HCM consented to a censure. Hazan Capital Mgmt., LLC, 2009 WL 2392842, at *7. Hazan and HCM also jointly and severally paid \$1,000,000 in fines and \$3,000,000 in disgorgement to NYSE Amex and NYSE Arca pursuant to a Stipulation of Facts and Consent to Penalty that Hazan and HCM entered into with those entities based on the same conduct. *See* NYSE Amex LLC Hearing Board Decisions 09-AMEX-21, 09-AMEX-22 (Aug. 4, 2009), <http://www.nyse.com/pdfs/09-AMEX-21-22%2009-ARCA-05-06.pdf>; NYSE Arca, Inc. Hearing Board Decisions 09-ARCA-5, 09-ARCA-6 (Aug. 4, 2009), <http://www.nyse.com/pdfs/09-AMEX-21-22%2009-ARCA-05-06.pdf>.

294. TJM Proprietary Trading, LLC, Exchange Act Release No. 60440, 96 SEC Docket 1622 (Aug. 5, 2009), 2009 WL 2392840.

295. *Id.* at *2.

296. *Id.* In settling the allegations, TJM, Benson, and Burke jointly and severally paid a \$250,000 fine, and TJM paid \$541,000 in disgorgement. TJM and Benson also agreed to cease and desist from committing or causing violations of Rules 203(b)(1) and 203(b)(3), and TJM was censured. Benson agreed to be suspended from associating with any broker or dealer for three months, and Burke agreed to be suspended from associating with any broker or dealer in a supervisory capacity for nine months. *Id.* at *6–7.

297. Rhino Trading, LLC, Exchange Act Release No. 60941, 97 SEC Docket 234 (Nov. 4, 2009), 2009 WL 3652431.

(“Rhino”), both registered broker-dealers and options market-makers, violated Rule 203(b)(3) by engaging in “a large volume” of reverse conversion and sham reset transactions like those effected by TJM and HCM and intended to circumvent their locate and close-out obligations in Regulation SHO threshold securities. The securities at issue included the stock of Novastar and USANA—both of which claimed to be victims of short attacks or naked short selling.²⁹⁸ As a result, the SEC alleged that Rhino and FSTG violated Rule 203(b)(3) of Regulation SHO.²⁹⁹

The SEC brought additional enforcement actions against traders based on reverse conversions and sham resets in late 2011 and early 2012. In a settled action, the SEC alleged that Gary Bell and GAS I, LLC (“GAS”), both registered broker-dealers, violated Rules 203(b)(1) and 203(b)(3) of Regulation SHO by engaging in “a large number” of reverse conversion and sham reset transactions, including transactions in the stock of Novastar.³⁰⁰ In order to settle the allegations, Bell agreed to cease and desist from committing or causing any violations of Rules 203(b)(1) and 203(b)(3), agreed to a nine-month suspension, and paid disgorgement and interest of \$1,836,094 and a civil money penalty of \$250,000.³⁰¹

The SEC has also filed enforcement actions against broker-dealers for allegedly assisting customers in effecting naked short sale transactions. For example, the SEC brought a settled enforcement action against UBS Securities, LLC (“UBS”), a registered broker-dealer and investment advisor, for alleged violations of section 17(a) of the Exchange Act and Rule 203(b) of Regulation SHO.³⁰² In that settlement, the SEC alleged that UBS traders provided and recorded “locates” for their customers in order to enable them to execute short sales, despite in many instances not having contacted a lender to confirm the availability of the shares that they purported to borrow or agreed to borrow.³⁰³ The SEC alleged that, by permitting this practice, UBS created a system in which it was not possible to trace the basis upon which a locate was actually granted, and that the basis was in many cases documented inaccurately.³⁰⁴ The SEC settlement alleged that UBS violated the recordkeeping requirements of section 17(a) of the Exchange Act and the Rule 203(b) requirement that a broker-dealer borrow, arrange to borrow, or have reasonable grounds to believe that an equity security

298. USANA is discussed in Part III.C. Novastar is discussed at *supra* note 289.

299. The SEC settlement also included allegations that Steven Peter, an FSTG trader and managing member, and Damon Rein, a trader at both FSTG and Rhino, willfully aided and abetted and caused those violations. In settling the allegations, Rhino and Rein agreed jointly and severally to pay a fine of \$150,000 and FSTG, Rein and Peter agreed jointly and severally to pay a \$30,000 fine. In addition, Rhino and FSTG agreed to pay \$350,000 and \$45,000, respectively, in disgorgement, and Rein and Peter agreed to three-month suspensions. Each of the defendants agreed to cease and desist from committing or causing violations of Rule 203(b)(3), and Rhino and FSTG were censured. *Id.* at *5–6.

300. See Gary S. Bell, Exchange Act Release No. 65941, 2011 WL 6184476, at *6 (Dec. 13, 2011).

301. *Id.* at *7.

302. UBS Sec. LLC, Exchange Act Release No. 65733, 2011 WL 5444407 (Nov. 10, 2011).

303. *Id.* at *3–4.

304. *Id.* at *4.

can be borrowed before accepting a short sale order in the equity security or effecting a short sale in the security for its own account.³⁰⁵

Broker-dealer Goldman Sachs Execution & Clearing, L.P. (“Goldman”) consented to the entry of an administrative order finding that it violated section 10(a) of the Exchange Act and caused customers to engage in naked short selling.³⁰⁶ According to the SEC, Goldman relied on certain customers’ representations that they held “long” positions in securities that they were selling, even though, for more than two years, Goldman knew that these customers had repeatedly failed to deliver securities that they had sold, and that they were purchasing stock in other offerings to cover these sales.³⁰⁷ The SEC’s order found that Goldman’s records contained information showing that Goldman was improperly lending these customers securities to accomplish this.³⁰⁸ The SEC found that Goldman could have discovered this information if it had appropriate procedures in place.³⁰⁹

These enforcement actions indicate that the SEC will continue to pursue regulatory cases against short sellers and related parties. Although recent enforcement activity may presage more aggressive SEC action against naked short sellers and those who facilitate naked short sales, there is no indication from these cases that the SEC intends to pursue short attack actions in the absence of clear evidence of scienter and of false rumors being used to depress the price of shorted securities.

V. CONCLUSION

Difficulties of proof are endemic to short attack cases. An issuer that believes it is facing a short attack has to evaluate these difficulties and their implications closely in deciding what strategies to employ in responding to a perceived attack. The SEC enforcement actions in this area show that the Commission is not likely to pursue fraud charges against a short seller or its affiliates in an alleged short attack case absent egregious conduct and persuasive evidence. This position is

305. *Id.* at *1–2. In settling the allegations, UBS agreed to retain and cooperate with an independent consultant, who would review and report to UBS and the SEC regarding UBS’s policies, procedures, and practices with respect to granting locate requests, which findings UBS agreed to adopt. UBS also agreed to a censure, to cease and desist from committing or causing violations of section 17(a) and Rule 203(b) of Regulation SHO, and paid an \$8,000,000 civil money penalty. In discussing UBS’s conduct, the SEC noted that “the impact of [UBS’s] practices was mitigated by certain factors.” *Id.* at *4. Such factors included that some clients did not actually execute short sales using the locates UBS granted, or executed short sales in amounts smaller than approved. The SEC also noted that some of the lenders may have been able to in fact lend the securities, despite the inaccurate recording of locates, allowing UBS to meet its settlement obligations, and that UBS was “generally able to meet its settlement obligations” by borrowing stock from other sources, if needed. *Id.*

306. Goldman Sachs Execution & Clearing, L.P., Exchange Act Release No. 55465, 90 SEC Docket 538 (Mar. 14, 2007), 2007 WL 763698, at *1.

307. *Id.*

308. *Id.* at *3.

309. *Id.* at *5. Goldman paid a \$1 million civil penalty as part of the settlement and agreed to cease and desist from future violations of section 10(a) and the rules thereunder, as well as Rules 200(g) and 203(a) of Regulation SHO. *Id.* at *6.

sound policy for a government agency with limited resources that must be leveraged intelligently. That position, however, also warrants caution for issuers considering reaching out to the SEC when faced with a short attack. Although the Commission continues to investigate actively in this area, and has not hesitated to file cases on relatively straightforward charges involving violations of Regulation SHO, a more aggressive enforcement position in this area should not be expected.

The civil litigation record also cautions against issuer action, absent clear evidence linking short sellers to demonstrably false statements that are clearly designed to depress the value of the issuer's securities, especially in light of the fact that perpetrators of short attacks have demonstrated success with free-speech and other defenses. Furthermore, potential recoveries are not likely to be high, and a lengthy public battle with a short seller may prove counterproductive and increase regulatory risk for an issuer. This litigation and enforcement precedent should be considered carefully by any issuer contemplating strategic action when confronted with a perceived short attack.