LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What To Know About Short-Seller Risks During Pandemic

By **Avi Weitzman, Barry Goldsmith and Jonathan Seibald**
(June 3, 2020, 4:24 PM EDT)

Avi Weitzman

Barry Goldsmith

Jonathan Seibald

As the world struggles to cope with the COVID-19 pandemic, and volatile markets are rattled by the latest virus and economic news, publicly traded companies are increasingly susceptible to fraudulent short-seller attacks. While legitimate short selling plays an important and well-recognized role in the public markets, there are a few who have abused and misused short selling to manipulate the price of public company stock.

Particularly in this volatile, skittish stock market, a lone tweet, press release or blog post from a recognized short seller can result in large stock-price declines.[1] While those abusive short sellers often claim the mantle of the First Amendment to protect their public and lobbying activities, no amount of free speech permits short sellers to adopt abusive, deceptive and manipulative practices, such as "short and distort" schemes. And some abusive short sellers will also engage in protracted, public battles, actively seeking to drive down a company's share price by instigating regulatory investigations, lobbying government officials, generating negative press coverage, and putting pressure on external auditors and other key stakeholders.

When fraudulent short sellers adopt such sophisticated manipulative schemes, public companies need to adopt an equally sophisticated and coordinated strategy to protect their shareholders and defend their reputations.

This article briefly describes the regulatory regime applicable to short sellers, as well as examples of enforcement actions brought against short sellers for running afoul of these rules. The article then describes strategies that public companies can deploy to defend themselves against sustained predatory short-seller attacks.

Short-Selling Regulatory Regime and Enforcement Actions

A short sale is the sale of borrowed stock in the hope that the stock price will fall, leading to a profit when the short seller later buys shares back in the open market at a lower price to replace the borrowed shares.

To be sure, short selling plays a legitimate and important role in the public markets. Short sellers can help ensure that securities trade at efficient prices, enhance liquidity, and expose fraud and other

wrongdoing that regulators have missed, with a notable such example being James Chanos and the Enron scandal.

Short sellers are protected by the First Amendment when they, in good faith, publicize their honestly held positions and thesis about a public company.[2] It is important for all short sellers to understand the regulatory regime surrounding short selling.

Disclosure Requirements

There are no public disclosure requirements for individual short sellers comparable to those for certain investors holding long positions. For example, certain funds and investment managers are required to file a Form 13F report disclosing their long positions within 45 days of quarter-end.[3] In some circumstances, they will also be required to make an additional public filing (a Schedule 13D form) within 10 days of acquiring more than 5% of any class of a public company's shares.[4] Short sellers are not required to make similar disclosures regarding their short positions, even if they have shorted more than 5% of a company's outstanding stock.

The Financial Industry Regulatory Authority separately has certain short reporting obligations, including, among other things, requiring broker-dealers to report total "short positions" in all customer and proprietary firm accounts twice per month.[5]

Prohibition on Manipulative Conduct

Despite the lack of broad disclosure requirements, short sellers nevertheless are subject to regulatory prohibitions against manipulative conduct, including under the anti-fraud provisions of Securities Exchange Act of 1934 Section 10(b) and Rule 10b-5. While "short selling — even in high volumes — is not, by itself, manipulative,"[6] the anti-fraud provisions prohibit short sellers from engaging in so-called "short and distort" schemes (the mirror image of a "pump and dump" scheme) by making material misrepresentations about the issuer with the intent to deceive. In other words, "[w]hile short-sellers are free to express their opinions about particular companies, they may not bolster those opinions with [knowing or reckless] false statements."[7]

Short sales are also subject to the insider trading prohibitions that courts have read into the Exchange Act's anti-fraud provisions. Before effecting a short sale, short sellers must therefore consider whether they possess material, nonpublic information about the issuer that could potentially expose them to insider trading liability.

The government has brought a number of enforcement actions against short sellers for engaging in manipulative conduct. For example, in 2018, the U.S. Securities and Exchange Commission charged hedge fund adviser Gregory Lemelson and his investment advisory firm with securities fraud for a "short-and-distort scheme"[8] based on alleged false statements they made about a pharmaceutical company "that were intended to shake investor confidence in the company," and thereby drive down the price of the company's stock and increase the value of Lemelson's short positions.[9] The case against Lemelson remains pending.

In 2011, fraud investigator Barry Minkow pled guilty to conspiracy to commit securities fraud in connection with a short and distort scheme based on his false statements about homebuilder Lennar Corp. to the public and federal law enforcement agencies, "with the intent of artificially depressing Lennar's stock price."[10] Minkow was sentenced to five years in prison and ordered to pay restitution

of almost $600 million.

Additionally, in 2008, the SEC filed a settled civil action charging trader Paul Berliner "with securities fraud and market manipulation for intentionally disseminating a false rumor" relating to a potential acquisition of Alliance Data Systems, in order to profit from his short of ADS stock.[11]

Reg SHO

Short sales are also subject to Regulation SHO, enacted in 2005 primarily to address concerns about abusive "naked" short selling, where the short seller does not arrange to borrow the shares in time to make delivery to the buyer within the standard three-day settlement period.

Among other rules, Reg SHO requires broker-dealers to locate a source of borrowable shares prior to executing a short sale order (the "locate" requirement)[12] and to acquire and deliver the securities sold short by certain specified dates (the "closeout" requirement).[13] Rule 10b-21 also expressly prohibits deceptive practices in connection with naked short sales.[14] While uncommon, the SEC has brought enforcement actions relating to improper naked short sales.[15]

Reg SHO also places certain restrictions on short selling when a stock is experiencing significant downward price pressure, in order to prevent short selling from further driving down the stock price. Rule 201, also known as the Alternative Uptick Rule, is triggered when a stock experiences a price decline of at least 10% in one day.[16] At that point, the rule, which is subject to numerous exceptions, prohibits further short selling for the remainder of that day and the following day unless the short sale price is above the current national best bid.

Strategies for Public Companies Facing Short-Seller Attacks

Activist short sellers, many well-connected and with substantial resources at their disposal, frequently deploy a multifaceted, aggressive strategy to drive down a company's share price. That strategy can include retention of outside counsel, lobbyists, industry experts, media and public relations consultants, and private investigators to advance their agenda.

These short sellers may seek evidence of misconduct involving both the target company and its senior officers and directors, including by soliciting through social media and other means potential whistleblowers who may include current or former company employees. Short-seller strategy can also include proactive engagement with regulators, elected officials, the media, external auditors, key customers and suppliers, and other company stakeholders — all designed to create a perfect storm for an attack on the company.

The risks of a downward spiral as a result of these multipronged attacks are exacerbated in today's challenging economy and volatile market. Public companies facing such sustained attacks must quickly develop and execute a crisis management plan, which may include a mix of defensive and offensive strategies, to debunk any false statements about the company, take control of the narrative, and restore investor and stakeholder confidence.

Defensive Strategies

Public companies must swiftly develop facts and relevant legal, accounting, or other analyses or white papers, supported by experts in the field as needed, to disprove false or misleading allegations. Armed

with this information, it is critical to educate the external auditor about the propriety of the company's conduct to ensure continued trust and certification of the company's financial statements.

The company should also proactively engage with the media in a sophisticated way, utilizing a public relations firm with specialized short-seller attack expertise to disseminate accurate information about the company to the public and rapidly respond to each public attack from the short sellers or their media and blogging allies.

Of course, there are instances where an initial investigation of the facts reveals that certain short-seller allegations may have merit. In those situations, and in particular where the allegations involve the company's senior management, it is critically important for the board of directors (or a subset of the board) to conduct a thorough internal investigation of those allegations to satisfy directors' Caremark duties.[17] Such investigations will help further distill fact from fiction in the short sellers' allegations, enabling the company to quickly remedy any misconduct and defend itself against any false allegations.

For short sellers who publicize their thesis against the company and a stock drop results, issuers can expect class actions and perhaps even government investigations to follow. Indeed, these lawsuits and investigations are often actively encouraged by the short sellers. Companies, armed with the facts and relevant analyses, should be prepared to aggressively respond to these lawsuits and government inquiries. In some instances, it may make sense to quickly reach out to regulators and make affirmative presentations refuting the short sellers' claims in hopes of staving off costly and distracting investigations.

Offensive Strategies

In certain cases, the company may need to go on the offensive. The company should research and identify any clearly false and misleading or reckless allegations made by the short seller or its allies about the company or its management. Where such allegations are identified, analysis of potential aberrational trading — including prescient short sales and timely options purchases — in the company's securities ahead of the dissemination of this false information is advisable. Engagement of external investigators to identify a history of short-seller misconduct may also be helpful. The company, through its counsel and public relations consultants who can coordinate efforts, can in turn provide information regarding the misconduct to regulators and the media.

Depending on the misconduct uncovered following sufficient investigation, a company may consider filing a lawsuit against the short seller asserting potential claims such as RICO, defamation, and other statutory or common law tort claims. While short sellers may wrap themselves around a "free speech" mantra and contend that the First Amendment and, where applicable, state anti-SLAPP statutes protect their conduct,[18] no such protection applies to the knowing or reckless spread of false and manipulative information.[19]

Indeed, issuers have had some success in suing those involved in alleged short and distort schemes, such as the 2013 jury verdict awarding Lennar Corp. $1 billion in damages in a defamation lawsuit relating to the manipulative short and distort scheme described earlier in this article.[20]

By developing a crisis management plan and executing that plan with the right mix of defensive and offensive strategies as facts and the situation warrant, public companies can defeat sustained predatory short-seller attacks, even in unprecedented times such as these.

Avi Weitzman is a partner at Paul Hastings LLP. Barry R. Goldsmith is a partners and M. Jonathan Seibald is an associate, at Gibson Dunn & Crutcher LLP.

[1] See Bailey Lipschultz, Citron Delivers Blow to Inovio's Surging Stock Amid Vaccine Hope, Bloomberg (Mar. 9, 2020), https://www.bloomberg.com/news/articles/2020-03-09/citron-delivers-blow-to-inovio-s-surging-stock-amid-vaccine-hope.

[2] See, e.g., USANA Health Scis., Inc. v. Minkow, 2008 WL 619287, at *1 (D. Utah Mar. 4, 2008) (striking several state law claims against short seller under state anti-SLAPP statute "designed to protect the defendant from having to litigate meritless claims aimed at chilling First Amendment expression") (quoting Batzel v. Smith, 333 F.3d 1018, 1025 (9th Cir. 2003)).

[3] 17 C.F.R. §240.13f-1.

[4] 17 C.F.R. §240.13d-1.

[5] See FINRA Rule 4560.

[6] See ATSI Commc'ns v. Shaar Fund, Ltd., 493 F. 3d 87, 101 (2d Cir. 2007).

[7] SEC Charges Hedge Fund Adviser with Short-and-Distort Scheme, Press Release, SEC (Sept. 12, 2018), https://www.sec.gov/news/press-release/2018-190.

[8] Id.

[9] Complaint ¶ 3, SEC v. Lemelson, No. 18-cv-11926 (D. Mass. Sept. 12, 2018).

[10] Barry Minkow Sentenced to Five Years' Imprisonment on Stock Manipulation Conspiracy, Press Release, United States Attorney's Office for the Southern District of Florida (July 21, 2011), https://www.justice.gov/archive/usao/fls/PressReleases/2011/110721-02.html.

[11] SEC Charges Wall Street Trader with Fraud for Spreading False Rumor, Press Release, SEC (April 24, 2008), https://www.sec.gov/litigation/litreleases/2008/lr20537.htm.

[12] 17 C.F.R. §242.203(b)(1).

[13] 17 C.F.R. §242.203(b)(3).

[14] 17 C.F.R. § 240.10b-21.

[15] See, e.g., SEC Charges Brothers With Short Selling Violations, Press Release, SEC (Jan. 31, 2012), https://www.sec.gov/news/press-release/2012-2012-22htm.

[16] 17 C.F.R. § 242.201.

[17] In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–70 (Del. Ch. 1996).

[18] See, e.g., GTX Glob. Corp. v. Left, 2007 WL 1300065, at *1 (Cal. Ct. App. May 4, 2007) (affirming grant of short seller's anti-SLAPP motion and dismissal of defamation lawsuit).

[19] See, e.g., Overstock.com, Inc. v. Gradient Analytics, Inc., 151 Cal. App. 4th 688 (2007) (affirming denial of short seller's anti-SLAPP motion where company provided prima facie evidence of falsity of short seller's statements and reckless disregard for truth).

[20] See Kris Hudson, Lennar Wins $1 Billion Award in Defamation Case, The Wall Street Journal (Dec. 3, 2013), https://www.wsj.com/articles/lennar-wins-1-billion-award-in-defamation-case-1386107443.