Legal Opinion Letter

Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 16 No. 16 June 2, 2006

FINANCIAL INTEREST DISCLOSURES CAN PROTECT MARKETS FROM "SHORT & DISTORT" MANIPULATORS

by
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Some market actors have unfortunately observed the force of the following logic: 1) Disclosure of a Securities and Exchange Commission (SEC) investigation of a company can reliably be expected to depress the price of the company's stock; 2) if I short the stock, this is a profitable event for me; and 3) therefore, if I can induce the SEC to begin an investigation, I will almost certainly make money. In other words: *If I can move the SEC, I can move the market to my personal profit*. How should the SEC deal with the fact that other people with very large financial interest at stake, wish to use the Commission to change the price of certain stocks?

With this question in mind, consider the following scenario: While establishing a large short position in the stock of a target company, a manipulative group or its representative urges claims of accounting or financial deficiencies as "tips" to the SEC. Let us stipulate that these claims are spurious. Whether or not the claims are spurious, however, the fact that the group is pushing them on the SEC and knowledge of how the SEC staff is reacting constitute key non-public information, highly relevant to the price of the stock in question.

In our scenario the claims are spurious, so when the SEC staff asks the company about the question, it receives a reasonable explanation. That should close the matter, since there is no real problem. But the group tirelessly continues to press its claims with strident rhetoric.

Now consider the position of the SEC staff in the post-Enron era. They are well aware that such claims often reflect the financial self-interest of those making them and their intense desire to cause adverse movement in market prices. This is the so-called "short and distort" strategy. But in the post-Enron era, the political and public relations penalty for the SEC staff of missing any problem is great, however low they may view its probability. *However, there is no political or public relations penalty on the SEC for imposing great costs and market losses on the shareholders of the target company*. In this environment, the SEC staff cannot afford to take the personal and bureaucratic risk of not commencing an investigation.

An SEC investigation is therefore begun, and in compliance with the SEC's own disclosure requirements, the company publicly announces the action. As the manipulative group planned all along, the price of the company's stock drops. This means that the group has itself caused the realization of handsome profits on its short position by using the SEC's regulatory structure to manipulate the stock market. The strategy has successfully developed from "short and distort" to "short, distort, and get the SEC to support" the attack.

In short, with today's intense network of communication, the SEC cannot regulate the capital markets from an empyrean height. It is itself immersed in the markets with its own investigations as market-moving events. This effect has been magnified in the environment of the post-Enron or Sarbanes-Oxley era.

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The public rationale leading to this scenario is the watchword of the Sarbanes-Oxley requirements: disclosure. But the most essential element underlying this situation — the financial interest of the investor group and its activity with the SEC — *is not required to be disclosed at all.* Even though the group benefits by inspiring fear of an SEC investigation among stockholders of the target company, and thereby transfers wealth from the shareholders to itself, that critical fact is never has to be revealed so the market can weigh its claims accordingly.

A scenario like this is certainly not what the authors of the Sarbanes-Oxley Act had in mind and obviously should not be permitted in well-designed capital markets. Everyone should be able to agree on this point. However, situations like this are in fact one source of the informal investigations the SEC has in process, at great cost to everyone concerned. Especially great administrative and market cost is imposed on the shareholders of the target companies who are supposedly being "protected," while profits are created for the group with the undisclosed short interests.

A related scenario has become well-publicized through the allegations in the lawsuits brought by Biovail Corp. and Overstock.com Inc. These suits assert that short-selling hedge funds, having conspired with an investment research firm to produce misleading negative reports, had non-public information of the content and timing of their release. They could then time their market moves to benefit from the market price reaction.

It is well known that short sellers routinely and aggressively push views favorable to their investment positions on journalists, analysts and regulators. "We have had hedge funds twist our arms to write reports in a certain way," said one analyst. *Fair Comment or Foul?*, THE ECONOMIST, Apr. 1, 2006. But if this morphs into the use of privileged, non-disclosed, market price moving information, it is a different matter.

As another related example, consider using private knowledge that there will be a lawsuit filed, as insightfully discussed by Professor Moin Yahya. Use of the non-public information that there is an imminent lawsuit, especially when the short-selling group is itself initiating or arranging the suit to cause the resulting price movement from which it will profit, is self-evidently manipulation. "The failure of the short-seller to disclose the impending suit," Yahya writes, "…is arguably a material omission and constitutes fraud…. No rational investor would ever consent to purchasing stock from someone who was about to sue the company." *Plaintiffs, Lawyers, and Short-Sellers: The Legal Status of 'Dump and Sue'*, LGL. BACKGROUNDER (Wash. Lgl. Found.), Feb.24, 2006.

Let us return to the scenario of the group selling you stock while doing its utmost in private to cause the SEC to commence an investigation of the company. No rational investor would ever consent to purchase stock from a seller working hard to use the SEC to knock down the price of the stock.

The principle of disclosure provides a straightforward way to help address this problem: *Require that any party bringing claims of accounting or financial irregularities to the SEC publicly disclose all the short or long financial interests it has or represents in the company involved.* A simple SEC questionnaire could provide this disclosure. Appropriate penalties for failure to disclose would automatically be covered by existing federal law sanctions for making false statements.

Disclosure should be a continuing requirement for all interests acquired or disposed of while any contacts between the group and the SEC continue and/or during the life of the SEC's inquiry or investigation of the issues raised. This is because ongoing communication with the SEC can allow the group to have trading advantages based on its private knowledge of how the SEC staff is responding.

Such a disclosure requirement would reveal how much profit the group has realized while involving the SEC to move market prices. The SEC could then measure this effect. Any profits derived by effective insider information of coming SEC investigations or actions, should be treated as exactly as other profits from trading on insider information.

The good news is that this problem can be addressed with a simple and obviously appropriate requirement. This could be enacted as legislation, adopted as policy by the SEC, or implemented as a required procedure by the SEC staff. Policy makers and regulators should give such solutions their full consideration.

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ISBN 1056 3059