# CRA Insights:
## Financial Markets

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August 2010

# Implications of the SEC's new short selling restrictions for securities litigation

## In this issue

SEC Rule 201 restricts short selling activity if a stock declines at least 10% from the previous trading day's close. Historical experience indicates that while the restriction is likely to apply to a relatively small percentage of all stocks on an average day, the restriction is likely to prove relevant in a large number of securities class actions.

### Background on new regulation

On February 24, 2010, the SEC adopted Rule 201, which restricts short selling activity on days when there is a sizable decline in the price of any stock listed on a national securities exchange. The new rule states that if a stock declines at least 10% from the previous trading day's close, short sellers are prohibited from selling shares at any price less than or equal to the current national best bid for two trading days (including the current day). By not allowing short sellers to sell at or below the current national best bid while the circuit breaker is in effect, Rule 201's price test restriction will allow long sellers to sell first in a declining market for a particular security.

SEC Chairman Mary L. Schapiro attributed Rule 201's passage to calls from investors and issuers for renewed restrictions on short selling activity to foster confidence in securities markets in the wake of the financial crisis. "The rule is designed to preserve investor confidence and promote market efficiency, recognizing short selling can potentially have both a beneficial and a harmful impact on the market," said SEC Chairman Mary L. Schapiro. "It is important for the commission and the markets to have in place a measure that creates certainty about how trading restrictions will operate during periods of stress and volatility."[1]

### Academic evidence on short selling

Academic studies have generally shown that short selling enhances market efficiency by improving the process through which information is reflected in stock prices.[2]

[1] "SEC Approves Short Selling Restrictions," SEC Press Release, February 24, 2010.

[2] See, for example, Bris, Arturo, William N. Goetzmann, and Ning Zhu, "Efficiency and the Bear: Short-Sales and Markets around the World," Journal of Finance, vol. 62, no. 3, June 2007, pp. 1029-79.

Boehmer, Ekkehart, Charles M. Jones, and Xiaoyan Zhang, "Which Shorts are Informed?" Journal of Finance, vol. 63, no. 2, April 2008, pp. 491-528.

Boehmer, Ekkehart and J. (Julie) Wu, "Short Selling and the Price Discovery Process," Social Science Research Network (ssrn.com), May 4, 2010.

Other academic studies present more mixed results regarding the effect of short selling on stock price volatility as well as the incidence and severity of stock price declines.[3] Taken together, these findings suggest that short selling provides some benefits to securities markets with no obvious drawbacks. Perhaps not surprisingly, therefore, the request for comment on Rule 201 resulted in 4,300 responses on the costs and benefits of possible actions.[4]

One way that the SEC attempted to mollify critics of Rule 201's price test restriction was to highlight that a relatively small proportion of stocks would actually be affected by it. During the period between April 9, 2001 and September 30, 2009, the price test restriction would have been triggered, on an average day, for approximately 4% of all stocks.[5] For a period of lower volatility between January 1, 2004, and December 31, 2006, the price test restriction would have been triggered, on an average day, for approximately 1% of all stocks.[6]

## Implications for securities litigation

While the SEC highlighted Rule 201's potentially limited scope as a reason to justify its passage, a different picture emerges for companies that are the target of a securities class action lawsuit. Using a sample of 101 securities class actions with 10(b) allegations filed during 2009, Charles River Associates finds that Rule 201's price test restriction would have been triggered at some point during the alleged class period for 99 cases.[7] In addition, over one third of the cases experienced 10 or more class period trigger dates. Figure 1 summarizes the frequency of class period trigger dates for our sample.

**Figure 1: Number of stock price declines > 10% during class period**

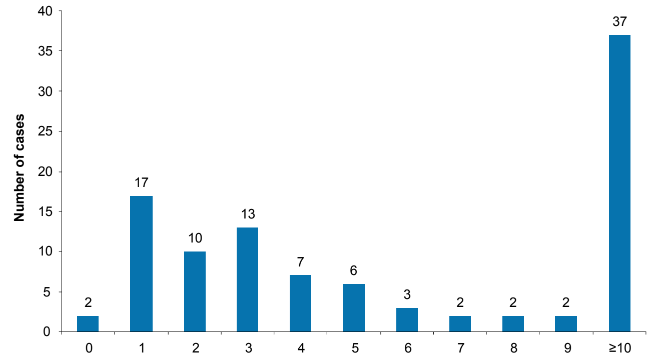
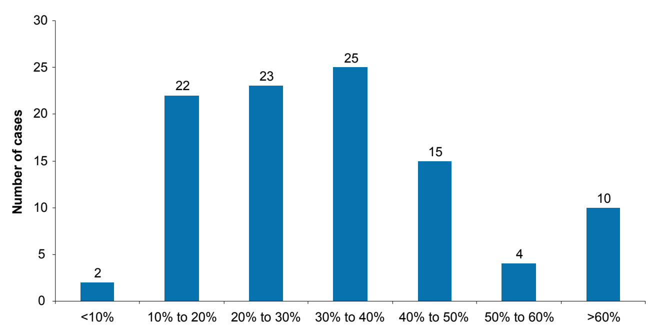



Figure 2 provides information on the magnitude of the maximum stock price decline during the alleged class period for our sample. The maximum decline ranges from less than 10% for the two companies that would not have triggered Rule 201's price test restriction to above 60% for 10 companies. Over half of our sample has a maximum decline of 30% or more.

**Figure 2: Maximum stock price decline during class period**




[3] See, for example, Bris, Arturo, William N. Goetzmann, and Ning Zhu, "Efficiency and the Bear: Short-Sales and Markets around the World," Journal of Finance, vol. 62, no. 3, June 2007, pp. 1029-79.

Diether, Karl B., Kuan-Hi Lee, and Ingrid M Werner, "It's SHO Time! Short-Sale Price Tests and Market Quality," Journal of Finance, vol. 64, no. 1, February 2009, pp. 37-74.

Shkilko, Andriy, Bonnie Van Ness, and Robert Van Ness, "Aggressive Short Selling and Price Reversals," Social Science Research Network (ssrn.com), May 14, 2009.

[4] "Speech by SEC Chairman: Statement at SEC Open Meeting – Short Sale Restrictions," Chairman Mary L. Shapiro, February 24, 2010.

[5] SEC Amendments to Regulation SHO (Release No. 34-61595), p. 11.

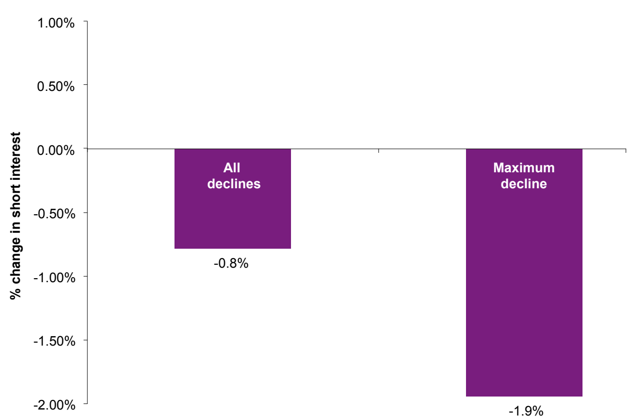
[6] SEC Amendments to Regulation SHO (Release No. 34-61595), p. 11.

[7] All analyses in this report include the first trading day after the class period.

CRA's analysis suggests that the SEC's new short selling restrictions are likely to be triggered during or immediately after the alleged class period in most securities class action lawsuits. These restrictions will likely coincide with the most significant stock price declines on days when plaintiffs allege corrective disclosures.

To investigate how Rule 201 might affect the trading behavior of short sellers in a securities litigation context, CRA analyzed changes in short interest around all class period trigger dates in our sample. As shown in Figure 3, the median change in short interest is -0.8%. Focusing only on maximum class period stock price declines as a proxy for corrective disclosures, the median change in short interest is -1.9%, which is also shown in Figure 3. While these findings suggest that short sellers actually unwind their short positions slightly around days with large class period stock price declines, it is important to note that short interest data are reported twice monthly, which masks the direction and volume of near-term short selling around specific days.

Figure 3: % change in short interest around class period stock price declines




While the findings in Figure 3 suggest relatively minor changes in the typical level of short interest around large class period stock price declines, changes in the level of short interest for individual companies range from -100% to above 100%. Thus, evaluation of the facts and circumstances on a case-by-case basis will be required to evaluate the effect of short interest and Rule 201 with respect to the issues of class certification, loss causation, and damages. As we point out above, Rule 201's price test restriction is likely to apply to only a small proportion of trading days generally, but will apply at some point in a large proportion of securities class actions.

## About our Financial Markets Practice

CRA's Financial Markets Practice provides advanced consulting services to corporate clients and attorneys. We specialize in applying the tools, principles, and findings of finance, economics, and accounting to complex litigation and business problems. Companies, law firms, and government agencies rely on CRA for high quality research and analysis, expert testimony, and comprehensive support in litigation and regulatory proceedings. Our reputation is built on exceptional client service and our ability to present innovative and pragmatic solutions to complicated challenges. For additional information about how CRA's financial experts can help you with your litigation and regulatory needs, please visit **www.crai.com/financialmarkets**.

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