When Does Short Selling Become Manipulation?

The recent financial crisis has focused the media and regulators on allegations of manipulative short selling in the stocks of financial services firms. The Securities and Exchange Commission (“SEC”), in addition to a range of regulatory responses, has made investigations into the possible manipulation of financial stocks through short selling schemes a top enforcement priority. Director of Enforcement Linda Thomsen has vowed to subject to “the full force of the law” anyone who engages in “abusive short selling, market manipulation, and false rumor mongering....” Similarly, New York Attorney General Andrew Cuomo has compared short sellers in the current market turmoil to “looters after a hurricane,” and promised to intensify his own investigation of short selling abuses.

Thus, as market losses have hit record levels, the SEC and other authorities appear poised to take strong action against anyone who unlawfully profits from those losses through manipulative short selling schemes. However, proving that short sales were part of a market manipulation may not be easy, and persons or entities caught up in short selling investigations may have strong defenses. Both the SEC and the federal courts have consistently recognized that even aggressive, high volume short selling can be a legitimate trading strategy with important benefits for pricing efficiency.

Short sellers can sometimes become convenient bogeymen for company executives, most notably during periods when share values are under pressure from economic forces or from management’s own failures. Indeed, the SEC has taken action in the past against persons who justified their own manipulative activities or other unlawful conduct by claiming the need to combat short sellers.

Thus, in pursuing investigations, the SEC and other authorities will need to carefully differentiate between legitimate short selling and short selling that unlawfully manipulates stock prices. The distinction is not always clear, particularly in light of recent case law. Although short sellers who engage in other patently manipulative or deceptive activities may present a straightforward case for enforcement action, recent

1 See, e.g., “SEC Moves to Curb Short-Selling – Controversial Step Comes Amid Claims That Financial Stocks Were Manipulated,” The Wall Street Journal (July 16, 2008) at A1. A short sale is defined as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.” 17 C.F.R. § 240.3b-3. Generally speaking, in a short sale, the seller borrows the securities for delivery to the purchaser (typically from a broker-dealer or institutional investor), and later returns equivalent securities to the lender by purchasing securities on the open market, or by using other securities it already owns. See Short Sales (Proposed Rule), SEC Rel. No. 34-48709, 2003 SEC LEXIS 2594 at *8-*9 (Oct. 28, 2003) (“SHO Proposing Release”).
4 See, e.g., SHO Proposing Release at *15-*16 (Oct. 28, 2003); Sullivan & Long, Inc. v. Scattered Corp., 47 F.3d 857 (7th Cir. 1995).
Market Manipulation Generally

Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) prohibits the use of “any manipulative or deceptive device or contrivance” in contravention of SEC rules. The term “manipulative” is “virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”

Classically, manipulation includes “practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” However, one issue that has occasionally surfaced in the litigated cases is whether real (i.e., non-fictitious) trading can be considered manipulative if undertaken with the intent to affect stock price – so-called “open-market” manipulation. In United States v. Mulheren, the Second Circuit Court of Appeals expressed “misgivings” about this theory without deciding the issue. However, the SEC has historically taken the position that real trading can be charged as market manipulation if undertaken for the purpose of artificially affecting securities prices. “A manipulation may be accomplished without wash sales, matched orders, or other fictitious devices. Actual buying with the design to create activity, prevent price falls, or raise prices for the purpose of inducing others to buy is to distort the character of the market as a reflection of the combined judgments of buyers and sellers, and to make of it a stage-managed performance.”

In Markowski v. SEC, the District of Columbia Circuit Court of Appeals sided with the SEC on the theory of open-market manipulation, upholding the Commission’s determination that the chairman and head trader of a broker-dealer manipulated the market for a stock through “real transactions” with “real customers.” The court relied on section 9(a)(2) of the Exchange Act, a manipulation-specific provision (unlike the general antifraud prohibition found in section 10(b)) that prohibits transactions in exchange-traded securities (or in connection with swap agreements relating to such securities) “creating actual or apparent active trading in such market for a stock through ‘real transactions’ with ‘real customers.’”

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References:
6 Effective October 17, 2008, the SEC adopted new rule 10b-21, a “naked” short selling antifraud rule. In a “naked” short sale, the seller does not borrow or arrange to borrow securities in time to make delivery to the purchaser during the standard three-day settlement period. Rule 10b-21 was intended specifically to address “abusive naked short selling,” in which the short seller intentionally deceives other participants about its intention or ability to deliver shares. Thus, rule 10b-21 provides that it shall constitute a “manipulative or deceptive device” under section 10(b) “for any person to submit 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.” See Naked Short Selling Antifraud Rule, SEC Rel. No. 34-58774, 2008 SEC LEXIS 2318 at *2-*3 (Oct. 14, 2008). In cases involving other conduct, as well as in cases where the conduct predates rule 10b-21, whether short selling is deemed to be manipulative or deceptive depends on an analysis under the general antifraud provisions of the federal securities laws. This article discusses the application of the general antifraud provisions to manipulations involving short selling, without reference to new rule 10b-21.
11 938 F.2d 364, 368-69 (2d Cir. 1991). The court assumed that a defendant could be convicted of violating section 10(b) and rule 10b-5 where the purpose of his transaction was solely to affect the price of a security, but determined that the Government failed to meet its burden of proving manipulative intent. Id.
14 274 F.3d at 528.
or sale of such security by others.” The court found that section 9(a)(2) reflected Congress’ determination that “‘manipulation’ can be illegal solely because of the actor’s purpose,” without the need for activities such as wash sales or matched orders. Therefore the court determined that the SEC’s inclusion of such conduct within the phrase “manipulative … device” in section 10(b) was reasonable.16

The Benefits of Short Selling

Even amid the current market turmoil, and while enacting curbs on short selling, the SEC has been careful to acknowledge the important benefits of short selling for the health of the financial markets. These include “contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations.”17 In particular, short selling enhances pricing efficiency by helping to move overvalued stocks toward their true values.18 As the SEC has written:

Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security’s price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.19

The case of Sullivan & Long, Inc. v. Scattered Corp.20 provides an example of how even highly aggressive short selling that depresses a stock’s price may be viewed as a positive market influence. In February 1993, LTV Corporation, which was in bankruptcy, announced a plan of reorganization pursuant to which common stockholders would receive new shares that were estimated to be worth approximately 3-4 cents, compared with their existing shares that were trading at the time for more than 30 cents. After the announcement, Scattered Corp., a market maker in LTV stock, began an aggressive campaign of “naked” short selling, ultimately selling 170 million LTV shares short as compared with the total of 122 million shares outstanding.21 The plaintiffs were purchasers on the other side of Scattered’s short sales. Scattered “hoped to take advantage of these people” as a result of confusion in the market surrounding the true value of the old LTV shares.22

The plaintiffs argued that Scattered manipulated the market for LTV stock by “flooding” it with short sales to keep the price low. However, the Seventh Circuit Court of Appeals affirmed the lower court’s dismissal of the case. Judge Posner, writing for the court, observed that Scattered “merely had a better understanding of the information about the reorganization than the investors with whom it traded … The effect of trading on an information advantage [provided there is no abuse of inside information] is to dispel, by penalizing, ignorance and to bring market values into closer, quicker conformity with economic reality.”23

Judge Posner noted that the “central objective” of the anti-manipulation prohibitions of the federal securities laws is “to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities.

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16 274 F.3d at 529. Although section 9(a)(2) applies only to exchange-traded securities, activities that violate section 9(a) (2) have been held to also violate section 10(b) when engaged in with respect to an over the counter security. See SEC v. Resch-Cassin & Co., Inc., 362 F. Supp. 964 (S.D.N.Y. 1973).
19 SHO Proposing Release at *15-*16.
20 47 F.3d 857 (7th Cir. 1995).
21 Scattered’s “naked” short selling without having located shares for delivery did not violate the rules of either the SEC or the Chicago Stock Exchange (where Scattered was a member) at the time. See SHO Proposing Release at *23-*29; 47 F.3d at 861.
22 47 F.3d at 860.
23 Id. at 860.
In this case, rather than Scattered creating artificially low prices, LTV’s stock price after the announcement of the reorganization was “artificially high because [it] so greatly exceeded the stock’s true value, which was only 3 to 4 cents. Far from launching a balloon, Scattered’s short sales punctured a balloon, bringing prices down to earth where they belonged.”

Having determined that Scattered’s conduct was not the type the securities laws were intended to prevent, the court quickly dispensed with the plaintiffs’ specific legal arguments under sections 9(a)(2) and 10(b) of the Exchange Act. Judge Posner wrote that the “essence of the offense” under section 9(a)(2) is “creating a false impression of supply or demand.”

Contrasting Scattered’s conduct with the example of a case involving wash sales, Judge Posner observed that “[o]n the other side of all of Scattered’s transactions were real buyers, betting against Scattered, however foolishly, that the price of LTV stock would rise.” The Seventh Circuit thus called into question the theory of “open-market” manipulation, at least for cases involving aggressive short selling without other deceptive conduct. This is further discussed below. Similarly, the court dismissed the plaintiffs’ section 10(b) claim because Scattered had not engaged in any deception.

Short Selling as Part of a Manipulative Scheme

It is useful to draw a distinction between two sets of circumstances in which short selling may cross the line from legitimate trading strategy to manipulation. In the first, short selling does not itself affect stock prices, but is instead one element of a manipulative scheme. These cases can be relatively clear-cut because other elements of the scheme are often patently manipulative or deceptive. In the second, aggressive short selling is itself the core activity that is alleged to “artificially” drive down the price of a security. As the Seventh Circuit’s decision in Scattered Corp. illustrated, whether and under what circumstances such short selling can be said to constitute an unlawful market manipulation is a far more difficult question.

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24 Id. at 861.
25 Id. at 862.
26 Id. at 864.
27 Id. at 864.
28 Id.
29 United States v. Russo
30 74 F.3d at 1391.
the money generated through the short sales, the appellants would not have been able to keep large blocks of [the subject stocks] off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of [the stocks].

Accordingly, the court found that the defendants’ short sales “were sufficiently connected to the manipulation scheme to constitute a violation of Section 10(b) and Rule 10b-5.”

The SEC’s recent enforcement action charging securities fraud and market manipulation against a short seller who profited by intentionally disseminating a false rumor that caused a company’s stock price to drop may also be viewed as a case where short selling is one element of a scheme that has at its core other manipulative conduct. Similar to a classic “pump and dump” scheme, in which the “pump” manipulates a stock’s price upward and the “dump,” or sale of shares into the unsuspecting market, is the means of profiting from manipulative activity, a “distort and short” scheme (as SEC Chairman Cox has termed it) involves the use of a false rumor or other false information to intentionally manipulate the target stock’s price downward, coupled with short selling to make unlawful trading profits. The short selling in such a case is a critical part of the scheme, but it is the false rumor or other false information injected into the market that leads to an “artificial” price for the security. The SEC has made such conduct a focus of its current investigations into short selling and market manipulation.

Manipulation Where Short Selling Depresses Stock Prices

As discussed above, in Scattered Corp., the Seventh Circuit dismissed claims that the defendant had engaged in market manipulation through a massive short selling campaign that depressed the price of LTV stock. The court found that the defendant did not create a “false impression of supply or demand” — the “essence” of market manipulation — where it merely sold shares to “real buyers” who were betting that the price of LTV stock would rise.

In GFL Advantage Fund, Ltd. v. Colkitt, the Third Circuit Court of Appeals followed the Seventh Circuit and held that aggressive short selling, unaccompanied by other deceptive conduct, will not support a claim for market manipulation. The plaintiff provided financing to the defendant’s companies and received notes that could be exchanged for stock at a discount to the stock’s average closing price during the five days before each of the exchange requests. Thereafter, and in conjunction with its exchange requests, the plaintiff began aggressive short selling in the stock of the defendant’s companies. The plaintiff filed suit when the defendant refused to honor the exchange requests. In response, the defendant argued that the plaintiff had engaged in a manipulative scheme to depress the companies’ stock prices in order to exchange the notes for larger quantities of artificially low-priced shares.

The Third Circuit rejected this defense, and affirmed summary judgment for the plaintiff, upon finding that the defendant produced no evidence that the defendant’s conduct went beyond short selling. Citing the Seventh Circuit’s decision in Scattered Corp., the court first observed that even if aggressive short selling contributed to a decline in the stocks’ prices, this was not evidence that the prices were depressed artificially. “[I]ncreasing the supply of stocks by selling them on the open-market in legitimate transactions to real buyers does not artificially affect prices and therefore cannot be manipulative.” The court rejected the defendant’s argument that he only needed to show that the plaintiff engaged in short selling for the undisclosed purpose of artificially depressing share prices. The court held that to make out a claim of market manipulation, the defendant needed to show, in addition to manipulative purpose, that the plaintiff “engaged in deceptive or manipulative conduct by...
injecting inaccurate information into the marketplace or creating a false impression of supply and demand for the security.” By requiring a showing of manipulative intent plus other deceptive conduct, the Third Circuit effectively rejected the theory that aggressive and high volume open-market short selling can by itself be considered manipulative if combined with manipulative intent.

Last year, in the case of *ATSI Communications, Inc. v. The Shaar Fund, Ltd.*, the Second Circuit Court of Appeals joined the Seventh and Third Circuits in holding that “short selling – even in high volumes – is not by itself manipulative.” The case involved allegations that the defendant, a purchaser of “floorless convertible” preferred stock in the plaintiff company, aggressively sold the plaintiff’s common stock short for the purpose of creating a “death spiral” in the stock price, which enabled the defendant to cover its short sales with discounted common shares obtained at progressively lower prices upon conversion of the preferred. The Second Circuit, citing the Seventh and Third Circuit precedents, held that “to be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security.”

A recent decision from the Southern District of New York denying a motion to dismiss the SEC’s complaint in a case involving short selling in connection with convertible securities illustrates the distinction the Second Circuit has drawn between legitimate, if aggressive, short selling, and manipulative short selling. In *SEC v. Badian*, the SEC alleged that the defendants engaged in massive short selling in order to manipulate downward the price of stock in Sedona Corporation for the purpose of ensuring that a client of one of the defendants would receive an increased number of Sedona shares when it exercised conversion rights under a debenture that the client held. The short sales were conducted in accounts of the client and covered with conversion shares, notwithstanding that the debenture agreement specifically prohibited the investor from making any short sales of Sedona common stock. However, in order to disguise the client’s role in the short sales, the defendants engaged in wash sales and matched orders, and falsely marked the short sales as “long” on the broker’s records.

In holding that the complaint satisfactorily pled market manipulation, the court emphasized the SEC’s allegations that the defendants “conceal[ed] the identity of [the client], whose covenant against short sales had been disclosed to investors, from the market as the seller and creat[ed] the false appearance that individual investors were selling large amounts of Sedona stock.” Further, the wash sales and matched orders “were allegedly intended to conceal [the client’s] participation in this scheme to manipulate the market for Sedona stock by producing the false appearance that the accounts with short positions were purchasing the shares in the open-market, rather than covering their short positions with shares obtained through the Debenture conversion.” Thus, although the court did not specifically reference the Second Circuit’s test for determining when short selling becomes manipulative (i.e., when it is combined with “…something more to create a false impression of how market participants value a security”), both the SEC’s pleadings and the court’s opinion appear to have conformed to the Second Circuit’s requirements.

Does the Second Circuit’s opinion in *ATSI Communications* close the final door on an argument that aggressive, but undisguised, open-market short selling can constitute market manipulation? Not necessarily. Recent cases from the Southern District of New York have put differing glosses on the Second Circuit’s requirement that “something more” is required to turn short selling into manipulation.

41 Id. at 207. The court also found that the defendant had failed to provide evidence that the plaintiff engaged in short selling for the purpose of depressing the stocks’ prices. Id. at 211-212.
42 493 F.3d 87 (2d Cir. 2007).
43 Id. at 101.
44 Id. (emphasis added).
46 The debenture entitled the client to convert all or any portion of the debenture into Sedona common stock on preestablished conversion dates at a discounted price to the volume average weighted price of Sedona common stock during the five trading days before the conversion date.
47 2008 U.S. Dist. LEXIS 64661 at *12.
48 Id. at *13.
In *Nanopierce Technologies, Inc. v. Southridge Capital Management*, the court held that *ATSI Communications* required granting summary judgment to defendants against the plaintiff’s claims that the defendants manipulated the plaintiff’s stock price downward through aggressive and high volume sales of shares in order to take advantage of reset provisions in a “death-spiral financing” agreement that entitled the defendants to additional shares in the event of stock price declines. The court held that, after *ATSI Communications*, death-spiral financing is not “inherently manipulative,” and that the “inten[t] to manipulate and drive down Nanopierce’s stock price through short selling and other techniques, in order to obtain additional shares of stock and control Nanopierce,” among other alleged conduct, “cannot form the basis for market manipulation…. ” In reaching its conclusion, the court also relied on the Third Circuit’s holding in *GFL Advantage Fund*, “a case endorsed by the Second Circuit in *ATSI*,” that “increasing the supply of stocks by selling them on the open market in legitimate transactions to real buyers does not artificially affect prices and therefore cannot be manipulative.”

However, in a recent case involving commodities manipulation, another court in the Southern District of New York applied *ATSI Communications* differently. In *In re Amaranth Natural Gas Commodities Litigation*, the plaintiffs alleged, among other things, that the defendants sold large quantities of certain natural gas futures contracts during the last half-hour of trading with the intent to depress the settlement prices of those contracts. This enabled the defendants to profit from large short positions that the defendants held in swaps relating to the contracts.

Relying on the Second Circuit’s decision in *ATSI Communications*, the court held that commodities manipulation, like securities manipulation, requires “something more” than merely entering into futures contracts or swaps. There must be “some additional factor that causes the dissemination of false or misleading information.” However, the court decided, manipulative intent meets this test:

But the additional factor need not be a misstatement or omission. The “something more” is anything that distinguishes a transaction made for legitimate economic purposes from an attempted manipulation. Because every transaction signals that the buyer and seller have legitimate economic motives for the transaction, if either party lacks that motivation, the signal is inaccurate. Thus, a legitimate transaction combined with an improper motive is commodities manipulation.

Due to the difficulty of distinguishing between legitimate trading strategies and deliberate attempts to manipulate the market, the court cautioned that “[i]n close cases there should be no liability.” Because rule 9(b) applies to such allegations, “plaintiffs face a substantial hurdle in alleging that a legitimate transaction plus scienter constitutes commodities fraud.” In the *Amaranth* case, the size and timing of the transactions (all in the last hour of trading) provided the evidence of intent that, in the court’s view, transformed legitimate sales into manipulation. In a case not characterized by such unusual trading patterns, a court would have to look to other factors to find evidence of manipulative

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50 *Id.* at *47-*48.
51 *Id.* at *49.
52 *Id.*, citing *GFL Advantage Fund Ltd.*, 272 F.3d at 210 (emphasis in original).
54 *Id.* at *47-*48.
55 *Id.* In a separate case involving enforcement litigation instituted by the Commodity Futures Trading Commission against Amaranth, another court in the Southern District of New York took a different tack to similarly conclude that open-market sales combined with manipulative intent establishes commodities manipulation. Rather than following, and then interpreting, the Second Circuit’s holding in *ATSI Communications* that “something more” is required that conveys false information about the value of a security, the court in the Amaranth enforcement litigation distinguished *ATSI Communications* based on differences between the Exchange Act and the Commodity Exchange Act, 7 U.S.C. § 1 et seq. (“CEA”). See CFTC v. Amaranth Advisors, LLC, 554 F. Supp. 2d 523 (S.D.N.Y. 2008), reconsidered denied, 2008 U.S. Dist. LEXIS 45638 (2008). The court reasoned that, because the CEA addresses fraud and manipulation in separate sections of the statute (unlike section 10(b) of the Exchange Act, under which manipulation is treated as one variant of fraud), fraudulent conduct is not an element of a claim for commodities manipulation.
56 *Id.* at *49.
57 *Id.*
58 *Id* at *50, *64-*65.
intent. Further, the defendant should not be liable for manipulation if there is any legitimate economic motive for short sales, even if part of the defendant’s purpose is to affect prices.\(^5\)

**Conclusion**

The Second, Third, and Seventh Circuit Courts of Appeals have each held that aggressive short selling will not by itself support a claim for market manipulation under the federal securities laws. For short selling to be considered manipulative, the short seller must do something more to inject false information into the marketplace, or to create a false impression of the true market for the security being sold.

A court ordinarily will have no trouble finding this test to be satisfied where short selling is one component of a scheme that has at its heart other manipulative or deceptive conduct. Absent such conduct, however, a critical question becomes whether open-market, high volume short selling that has price-depressive effects may be charged as stock manipulation based solely on evidence of the short seller’s intent. With deference to the importance of short selling for the health of the financial markets and for legitimate trading strategies, the Third and Seventh Circuits appear to have concluded that intent alone is not enough when short selling involves “real transactions” between “real” buyers and sellers. However, the Second Circuit’s opinion in *ATSI Communications* has opened the door to conflicting interpretations in the lower federal courts of the Second Circuit, and the possibility that short selling alone, if accompanied by intent to affect stock prices, could be charged as an “open-market” manipulation.

Given the existing case precedents, one key focus of the SEC’s manipulation investigations relating to short selling will likely be whether short sellers have engaged in any other manipulative or deceptive conduct. Such cases will be the strongest, factually and legally, for possible enforcement action.\(^6\) At the same time, the SEC has a long record of bringing cases based on “open-market” manipulation, and would likely consider doing so in future cases involving short selling if the staff believes there is clear evidence of manipulative intent and lack of independent economic purpose for short sales.

\(^5\) See SEC v. Masri, 523 F. Supp. 2d 361 (S.D.N.Y. 2007). In *Masri*, the SEC alleged market manipulation by “marking the close” – i.e., purchases timed for the end of the day for the purpose of increasing the closing price of a security. The court held that intent alone can render an otherwise legitimate open market transaction manipulative, but that “in order to impose liability for an open market transaction, the SEC must prove that but for the manipulative intent, the defendant would not have conducted the transaction. … [I]f a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is ‘artificially’ affecting the price of the security or injecting inaccurate information into the market, which is the principal concern about manipulative conduct.” Id. at 372-73 (emphasis added).

\(^6\) See, e.g., SEC v. Robert Todd Beardsley, Litigation Rel. No. 20814 (Nov. 19, 2008), available at www.sec.gov/litigation/litreleases/2008/320814.htm (manipulative short selling scheme charged where defendants violated the “uptick” rule, failed to mark orders as short sales “in order to create the false appearance that their orders were long,” and traded through nominee accounts).