SHORT REPORTS, ACTIVIST SHORTS, AND CORRECTIVE DISCLOSURES

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INTRODUCTION

Short sellers—traders that make a profit by betting against a stock—play a crucial role in ensuring that our capital markets remain efficient and well-functioning.[1] This role is accentuated when short sellers help discover corporate misconduct that otherwise positively distorts a company's valuation. In other words, short sellers (sometimes referred to as "activist short sellers"[2]) help make markets efficient by uncovering fraud and by lighting a fire under the feet of corporations that might, in the absence of short sellers, engage in self-serving conduct to the detriment of shareholders' long-term interests. Exemplifying this ability is a current SEC commissioner's remark that "short sellers were among the earliest persons to identify potential problems at Enron."[3] Many others have followed in their footsteps in the decades since Enron's collapse, underscoring the positive role short sellers play in American capital markets.

This article highlights the positive role activist short sellers play in enhancing price efficiency and in facilitating private class actions brought by plaintiffs under Section 10(b) of the Securities Exchange Act of 1934. It also investigates a question that has fractured the circuit courts—can short reports be used to satisfy Rule 10b-5's loss-causation requirement? This article argues that the answer to that question should be yes, as is the case in one-third of the circuits. In defending short sellers and reviewing a key question splintering the circuits, this article proceeds in four parts.

Part II introduces "short reports"—the reports that activist short sellers create to help bring to light company misconduct—via a case study that demonstrates how short reports reveal corporate misconduct otherwise unknown to the market.

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[1] *See, e.g.*, Merritt B. Fox et al., *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y. L. SCH. L. REV. 645 (2009) (finding that an increase in short selling predicts negative news the next day and summarizing the theoretical and empirical literature on short selling and price discovery).

[2] Lisa Pham, *Why Activist Short Sellers Stir Up Controversy*, BLOOMBERG (Jan. 25, 2024, 8:39 AM), https://www.bloomberg.com/news/articles/2024-01-24/why-activist-short-selling-is-a-controversial-trading-strategy [https://perma.cc/HMT7-L7DA].

[3] Mark T. Uyeda, *Statement on Short Position and Short Activity Reporting by Institutional Investment Managers*, SEC (Oct. 13, 2023), https://www.sec.gov/news/statement/uyeda-statement-short-sale-101323 [https://perma.cc/T4U8-3YQQ]; *see also* Liz Hoffman & Justin Baer, *Justice Department Targets 'Spoofing' and 'Scalping' in Short Seller Investigation*, WALL ST. J. (Feb. 16, 2022, 2:24 PM), https://www.wsj.com/articles/justice-department-is-pursuing-wide-ranging-investigation-of-short-sellers-sources-say-11645019122 [https://perma.cc/QXK3-8UAK].

Part III surveys the scholarship analyzing the role short sellers play in the market. This Part considers the extent to which scholars, regulators, and businesspeople believe that short sellers and their participation in the market should be either incentivized or stymied. In other words, what benefits, if any, do activist short sellers confer on capital markets and how does that affect capital market regulation?

Part IV of this Article surveys the jurisprudence related to the role that activist short sellers and their reports play in private actions that bring claims under Section 10(b), which has fractured the circuit courts into three distinct groups. Most relevant to short reports is their potential to function as a "corrective disclosure." When used in this manner, short reports satisfy the "loss causation" element that plaintiffs must meet when bringing a claim under Section 10(b).[4] Courts of appeals and district courts nationwide have taken markedly different approaches to this question. One-third of the circuits categorically bar short reports from being corrective disclosures, another third permits them to function as such under certain circumstances, and the final third has no law on the matter.[5]

Part V of this Article argues that the Supreme Court should take on this issue—whether a short report can be a corrective disclosure and, if so, under what circumstances. The Court should answer the former question by rejecting a categorical rule prohibiting short reports from being corrective disclosures, as one-third of the circuits have done. As to the latter question, a holistic, multi-factor inquiry reflecting the realities and complexities of 21st century capital markets and a whistleblower-like "sparking a government investigation," should dictate the circumstances under which a short report can constitute a corrective disclosure.

I. SHORT REPORTS IN ACTION

Short reports are the moniker for a company analysis undertaken by a private party—generally an activist short seller—who intends to demonstrate that the report's target is engaged in behavior that has artificially inflated a company's value. Put plainly, short reports seek to uncover securities fraud and make a profit by doing so. To their credit, short reports have been responsible for uncovering a nontrivial amount of fraud, as discussed throughout this article. That said, short

[4] *See* Dura Pharm. v. Broudo, 544 U.S. 336, 341–42 (2005) (listing the elements of a Rule 10b-5 private damages action). For a plaintiff to prevail under Rule 10(b)-5, they must show: (1) misrepresentation of a (2) material fact that was done (3) with knowledge, and that the investor (4) relied on that misrepresentation and that (5) said misrepresentation caused the investor to lose money. 17 C.F.R. § 240.10b-5 (2023).

[5] *See infra* Part IV.

reports are also an alleged vice of their own. Critics contend that short activists simply "short and distort" stock prices, which benefits short sellers but does not facilitate capital market efficiency and price discovery more generally.[6] Critics suggest that the authors of short reports make unsubstantiated allegations against a corporation to profit from the temporary shock to the stock price. Some scholars argue[7] these distorting short reports are endemic to the trade of activist short selling, particularly when the reports are anonymous or pseudonymous, as many often are. This school—the reformists—propose that more stringent regulation of short sellers is justified.

Whether short sellers themselves should be subject to more stringent regulation is beyond the scope of this article, but literature on the effect that activist short sellers exert on capital markets is canvassed in Part III. This article will demonstrate that the short reports themselves have proven to be useful at uncovering substantial amounts of fraud and thus should be incentivized. This utility, exemplified by the case studies below, supports this Article's argument that short reports should be able to be function as "corrective disclosures" such that they—under certain circumstances, discussed more fully in Part IV—satisfy the requirement that plaintiffs pleading violations of Section 10(b) show that a given misrepresentation *caused* a fall in a stock's price, known as the "loss causation" element. Plaintiffs satisfy loss causation when a corrective disclosure reveals the truth of a defendant's misrepresentation, and that the company's stock price dropped in response to that revelation, thus loosing investors' money.[8] Short reports regularly do exactly that. As Professor John Coffee remarked, "[i]f you want to detect fraud, forget the accountants and contact your local short sellers; they are the real detectives today."[9]

While the current state of the law on whether short reports can be corrective disclosures is analyzed fully in Part IV, the following case study would benefit from a brief review of the fractured state of the law. Currently, there exist two related questions that determine whether short reports can be corrective disclosures. First, a threshold question: whether short reports can ever be considered a corrective disclosure. Second, if courts do permit these reports to

[6] Joshua Mitts, *Short and Distort*, 49 J. LEGAL STUD. 287 (2020).

[7] *Id.*

[8] 15 U.S.C. § 78u-4(e)(1) (2023); Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1209 (9th Cir. 2016).

[9] *See* John C. Coffee, Jr., *Activist Short Selling Today: The Two Sides of the Coin*, CLS BLUE SKY BLOG (July 7, 2020), https://clsbluesky.law.columbia.edu/2020/07/07/activist-short-selling-today-the-two-sides-of-the-coin/ [https://perma.cc/8P35-A8HV].

function as corrective disclosures, under what circumstances do short reports meet that standard?

The threshold question of whether short reports can be corrective disclosures divides the circuits. A corrective disclosure occurs when "information correcting the misstatement or omission that is the basis for the action is disseminated to the market."[10] Some jurisdictions, including cases from the Second,[11] Fourth,[12] Tenth,[13] and Eleventh Circuits,[14] deny a short report's ability to function as a corrective disclosure. These jurisdictions base their rejection on a dogmatic adherence to the strongest form of the efficient market theory. This economic theory holds that all publicly available information is already impounded into a company's valuation, no matter how difficult it is to find that information or draw complex conclusions from it.[15] Thus, for a short report to be a corrective disclosure, it must disclose information unknown to the market, which is distinct from repackaging and analyzing publicly available information in a way that is insightful or analytically complex. Conversely, the Third,[16] Fifth,[17] Sixth,[18] and Ninth Circuit[19] reject a strong form of the efficient market hypothesis. These circuits permit the aggregation and analysis of nominally public information to constitute a corrective disclosure if that analysis reveals information that has not yet been incorporated into the company's valuation because of the analysis' complexity.

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[10] 15 U.S.C. § 78u-4(e)(1).

[11] *In re* Omnicom Group, Inc. Sec. Litig., 597 F.3d 501, 512 (2d Cir. 2010) ("What appellant has shown is a negative characterization of already-public information.").

[12] Teacher's Ret. Sys. of La. v. Hunter, 477 F.3d 162, 187–88 (4th Cir. 2007) (explaining negative characterization of previously known information cannot constitute a corrective disclosure).

[13] *In re* PolarityTE, Inc., Sec. Litig., No. 2:18-CV-00510, 2020 WL 6873798 (D. Utah Nov. 22, 2020).

[14] Meyer v. Greene, 710 F.3d 1189 (11th Cir. 2013).

[15] Donald Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 3-4 (1978); Christopher Paul Saari, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV., 1031, 1041-54 (1977).

[16] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).

[17] Pub. Emps. Ret. Sys. v. Amedisys, Inc., 769 F.3d 313 (5th Cir. 2014).

[18] Norfolk Cnty. Ret. Sys. v. Cmty. Health Sys., Inc., 877 F.3d 687 (6th Cir. 2017).

[19] *In re* BofI Holding, Inc. Sec. Litig., 977 F.3d 781 (9th Cir. 2020).

The second question, under what circumstances a short report constitutes a corrective disclosure, is analyzed holistically in Part IV. The basic question now is whether the report was sufficiently persuasive and complex such that plaintiffs can show that it affected the market. To inform this analysis, courts generally rely on the complexity of the information reviewed,[20] whether the report was anonymous,[21] and whether the author disclaimed the report's accuracy,[22] among other factors. If a short report meets this standard, courts adopting this theory hold that the report satisfies a Rule 10b-5 plaintiff's requirement to demonstrate loss causation.

A. Luckin Coffee

No company tragedy arc better demonstrates the benefits short sellers can provide market participants than Luckin Coffee. Luckin Coffee, a Chinese coffee company, arrived on public markets in 2019. Luckin Coffee was and continues to compete heartily against Starbucks, recently surpassing it in annual sales in China.[23] However, its trajectory has not always been straight.

Luckin's success story that brought it to public markets in 2019 would be short-lived. In January 2020, less than a year after Luckin went public, Muddy Waters, an activist short-selling hedge fund led by Carson Block, issued a short report explaining that "a new generation of Chinese Fraud 2.0 has emerged,"[24] and Luckin was caught in the crosshairs.[25] Shortly after Muddy Waters released its

[20] *Amedisys*, 769 F.3d at 323 ("[I]t is plausible that complex economic data understandable only through expert analysis may not be readily digestible by the marketplace.").

[21] *In re BofI Holding*, 977 F.3d at 797.

[22] *Id.*

[23] *Luckin Surpasses Starbucks in China Annual Sales For First Time*, BLOOMBERG (Feb. 23, 2024), https://www.bloomberg.com/news/articles/2024-02-23/luckin-surpasses-starbucks-in-china-annual-sales-for-first-time [https://perma.cc/5XMZ-3SMD].

[24] *Luckin Coffee: Fraud and Fundamentally Broken Business*, MUDDY WATERS (Jan. 9, 2020), https://cdn.gmtresearch.com/public-ckfinder/Short-sellers/Unknown%20author/Luckin%20Coffee_Anonymous.pdf [https://perma.cc/8MY3-YFV3].

[25] Jing Yang, *Coffee's for Closers: How a Short Seller's Warning Helped Take Down Luckin Coffee,* WALL ST. J. (June 29, 2020), https://www.wsj.com/articles/coffees-for-closers-how-a-short-sellers-warning-helped-take-down-luckin-coffee-11593423002, [https://perma.cc/GX65-4MBW].

report, Luckin Coffee admitted that much of its 2019 sales data was fabricated.[26] Consequently, its shares collapsed, and the company was delisted from stock exchanges shortly thereafter. As a result of admitting to intentional fabrication of over $300 million in sales, Luckin agreed to a $180 million settlement with the SEC.[27]

The proof that Luckin Coffee was ridden with fraud was an 89-page report published by Muddy Waters.[28] Muddy Waters gathered extensive evidence by deploying hundreds of individuals to monitor Luckin Coffee locations in China.[29] By carefully monitoring these locations, Muddy Waters deduced that Luckin had grossly inflated their revenues, severely underreported their costs, and more.[30] Besides these "smoking guns," there were plenty of other red flags: the company's co-founder had previously been sentenced to prison for fraud, insiders cashed out enormous amounts of their stock holdings, and some of its board members also were board members of "very questionable Chinese companies listed in the US that have incurred significant losses on their public investors."[31]

Shockingly, none of this misconduct was unveiled until Muddy Waters conducted its investigation. Muddy Waters can even be credited with prompting enforcement actions by the SEC.[32] While Chinese authorities reportedly considered bringing criminal charges against Luckin's chairman, Lu Zhengyao, none were ultimately brought,[33] and some of those same executives are once again back in the coffee business.[34] Although an array of impressive, well-credentialed

[26] Jing Yang, *Luckin, Rival to Starbucks in China, Says Employees Fabricated 2019 Sales; Stock Plummets*, WALL ST. J. (Apr. 2, 2020), https://www.wsj.com/articles/luckin-coffee-accuses-operating-chief-of-financial-misconduct-11585840274?mod=article_inline [https://perma.cc/4MQB-VZB4].

[27] Press Release, *Luckin Coffee Agrees to Pay $180 Million Penalty to Settle Accounting Fraud Charges*, SEC (Dec. 16, 2020), https://www.sec.gov/news/press-release/2020-319 [https://perma.cc/Z2FJ-HA4F].

[28] MUDDY WATERS, *supra* note 23.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] Press Release, *supra* note 27.

[33] Shen Xinyue & Lin Jinbing, *Luckin Boss to Face Fraud Charges in China: Source*, NIKKEI (June 8, 2020, 18:37 JST), https://asia.nikkei.com/Spotlight/Caixin/Luckin-boss-to-face-fraud-charges-in-China-source [https://perma.cc/UW4W-4VD4].

[34] Ye Zhanhang, *Ousted Luckin Founder Charts Comeback With New Coffee Business*, SIXTH TONE (Oct. 24, 2022), https://www.sixthtone.com/news/1011475 [https://perma.cc/UKH7-QN7W].

investors backed the company, none of them realized that Luckin had grossly overstated its key financial data. Unfortunately, some federal courts would not permit Muddy Waters' Luckin Coffee-focused short report to be leveraged by private plaintiffs suing the company for its fraud. The courts reasoned that Muddy Waters' short report merely repackaged information that was already publicly available in a way that revealed insights into the market, rather than revealing new information. And, even if the courts would permit public information repackaged in a useful way to be a corrective disclosure, plaintiffs must be careful to satisfy the Private Securities Litigation Reform Act's (PSLRA) exacting pleading standards.[35]

II. SHORT SELLERS: HEROES OR VILLAINS?

Short reports and the individuals and entities behind them have garnered the attention of capital markets scholars and regulators in recent years. "Here, we face a paradox: Sometimes, [short sellers] are the hero of the story, and sometimes the villain."[36] Whether such reports are made by heroes or villains, they are on the upswing, both in the United States[37] and abroad.[38] While more recent data on the number of short activism events is unavailable, from 2009 to 2011 there was on average of 48 "short events" per year.[39] From 2014 to 2016, there was an average of 166 such events per year, a 246 percent increase.[40] Exemplifying this upswing

[35] *See In re* Parmalat Sec. Litig., 414 F. Supp. 2d 428, 432 (S.D.N.Y. 2006) ("[To satisfy Rule 9(b) particularity, a plaintiff must specify] what [deceptive] acts were performed, which defendants performed them, when the [deceptive] acts were performed and what effect the scheme had on the securities at issue.").

[36] Coffee, *supra* note 9.

[37] Jeff Katz & Annie Hancock, *Short Activism: The Rise in Anonymous Online Short Attacks*, HARV. L. SCH. F. CORP. GOV. (Nov. 27, 2017), https://corpgov.law.harvard.edu/2017/11/27/short-activism-the-rise-in-anonymous-online-short-attacks/ [https://perma.cc/6AHB-NC9Y].

[38] Rikard Stenberg et al., *Short-Selling Activism—A New Challenge for Companies Listed in Sweden*, WHITE & CASE (Dec. 20, 2022), https://www.whitecase.com/insight-alert/short-selling-activism-new-challenge-companies-listed-sweden [https://perma.cc/5PPK-NDR8]; Mark Desjardine and Rodolphe Durand, *Activist Hedge Funds: Good for Some, Bad for Others?*, HEC PARIS (Mar. 26, 2021), https://www.hec.edu/en/knowledge/articles/activist-hedge-funds-good-some-bad-others [https://perma.cc/A3X6-PPYW].

[39] Peter Molk and Frank Partnoy, *The Long-Term Effects of Short Selling and Negative Activism*, 2022 U. ILL. L. REV. 1, 65 (2022).

[40] *Id.*

is the recent creation of a short activist hedge fund that was created in October of 2023 by a group of investigative journalists.[41] The group plans to trade on market-moving news unearthed by its own investigative reporting, based on compilation and analysis of exclusively public information.[42] Of course, this new fund's work is legal to the extent that they are not themselves manipulating the market, but the question relevant to this article is whether the investigative work done by that fund will be able to aid plaintiffs bringing suits under Rule 10b-5 after the journalists, inevitably, unveils material corporate misconduct that negatively affects the company's stock price.

In response to this increase in short-selling behavior and calls from industry for greater regulatory scrutiny of short activists, the DOJ and the SEC launched a probe into more than thirty activist short-selling funds.[43] Academics hotly debate whether short sellers and short reports are beneficial to capital markets and whether more regulatory scrutiny is justified.[44] And Wall Street is not without its share of opinions on this issue, as public corporations face the brunt of short reports' investigations and ultimately may be subject to the private litigation and government enforcement that those reports cause. This Part of the article canvasses literature on the subject and outlines the positions on both sides of the short-seller debate.

A. The Case Against Short Sellers

The case against activist short sellers and the reports they create adopts the form of the following syllogism. Activist short sellers have an enormous profit incentive to "find" misconduct perpetrated by the companies that they have short positions in. This profit incentive leads short sellers to make unsubstantiated allegations about fraud they have "discovered," thereby causing a company's stock price to fall. The short seller then closes their position shortly after making the allegations and reaps a handsome profit, with the stock generally reverting back to its prior price and price trajectory. Thus, activist short sellers and their often-

[41] Kate Duguid et al., FINANCIAL TIMES, *US Media Veterans Back New Trading Firm With Financial News Arm* (Oct. 31, 2023), https://www.ft.com/content/8550d1fe-569b-479c-b5b3-622716eda167 [https://perma.cc/3QZ4-M4S9].

[42] *Id*.

[43] Katia Porzecanski & Tom Schoenberg, *Vast DOJ Probe Looks at Almost 30 Short-Selling Firms and Allies*, BLOOMBERG LAW (Feb. 4, 2022), https://news.bloomberglaw.com/securities-law/vast-doj-probe-looks-at-almost-30-short-selling-firms-and-allies [https://perma.cc/9WUA-PVHA].

[44] *Compare* Mitts, *supra* note 6, *with* Molk & Partnoy, *supra* note 39.

unsubstantiated allegations merely distort prices rather than aid the market in accurately valuing a company, thereby harming capital markets.

i. From Academia

Professor Joshua Mitts has been at the helm of short-selling reform. His scholarship focuses in particular on "pseudonymous attacks," which he calculates have caused over $20.1 billion in mispricing, "wreak[ing] havoc in financial markets."[45] Others focus on named short sellers, arguing that their claims are often unsubstantiated and if they are, that there are too few legal avenues to hold them accountable.[46]

Professor Mitts' work has compared options activity in the days before a report is released with a stock's historical options trading data. Mitts describes that there is a sharp increase in overall options trading activity in the days before a report is published, which is consistent with manipulation.[47] Then, the report is published and the price drops, but is frequently followed by a reversal once the market determines that the report was unsubstantiated.[48] This phenomenon, which looks like scalping, thus justifies greater regulatory scrutiny of pseudonymous short sellers.[49] Enhanced regulatory scrutiny is particularly justified, according to Mitts, because existing securities laws are not well-suited to police market manipulation of the type Mitts suggests is endemic to pseudonymous short reports. For instance, while Section 9(a) of the 1934 Exchange Act prohibits manipulating the price of a security, it comes with an intent requirement that is likely not satisfied by the circumstantial trading data that Mitts uses to support his thesis that pseudonymous reports are often manipulative.[50]

Professor Mitts suggests that there are even more difficulties in bringing an action under Rule 10b-5 against short sellers.[51] First, pseudonymous attacks often state opinions and cannot be targeted as unlawful material misstatements of fact.[52]

[45] Mitts, *supra* note 6, at 287–88.

[46] QUINN EMANUEL, *"That Is Not an Opinion": How to Sue Short Sellers* (June 25, 2021), https://www.quinnemanuel.com/the-firm/publications/that-is-not-an-opinion-how-to-sue-short-sellers/ [https://perma.cc/TPU8-WG3P].

[47] Mitts, *supra* note 6, at 289.

[48] *Id.* at 287–88.

[49] *Id.* at 291.

[50] *Id.* at 330–31.

[51] *Id.* at 331.

[52] *E.g.*, QUINN EMANUEL, *Updating the Offensive Playbook: Recent Developments in Short Seller Litigation* (2022), https://www.quinnemanuel.com/media/glkhpyza/client-alert-recent-developments-in-short-seller-litigation.pdf [https://perma.cc/4QNX-LXY7].

And second, like market manipulation claims, Rule 10b-5 also requires that the SEC demonstrate the pseudonymous author acted with intent to make a material misstatement of fact.[53]

To remedy these shortcomings, Mitts suggests that the SEC engage in rulemaking to accomplish various goals. First, Mitts proposes requiring intermediaries hosting pseudonymous blogs to maintain identifying information for the account to ease the enforcement burden on the SEC.[54] And as to the 10b-5 claims, Mitts and a group of law professors requested rulemaking "that would clarify that rapidly closing a short position after publishing (or commissioning) a report, without having specifically disclosed an intent to do so, can constitute fraudulent scalping in violation of Rule 10b-5."[55] Moreover, this group suggests that the SEC create a safe harbor allowing short sellers to "clos[e] a position at a price equal to or lower than a valuation stated, expressly or impliedly, by a short seller [in their report]."[56] In other words, if the short seller is correct, then they can use the safe harbor and avoid legal liability.

Even short reports that are not pseudonymous or anonymous and backed by well-credentialed investors can be highly manipulative while still falling outside the ambit of securities laws. For instance, a short report and a lengthy PowerPoint released by Harry Markopolos—the first person to publicly proclaim Bernie Madoff was running a Ponzi scheme—in August 2019 alleged that General Electric was "a bigger fraud than Enron."[57] General Electric's stock plunged 21 percent over the next month and Markpolos made significant returns on his short position. This was the case even though General Electric promptly proved the claims inaccurate and unfounded,[58] and the stock recovered all of its Markopolos-induced losses within two months.

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[53] Mitts, *supra* note 6, at 331.

[54] *See id.* at 295–96.

[55] Securities Law Professors, *Petition for Rulemaking on Short and Distort*, SEC (Feb. 12, 2020), www.sec.gov/rules/petitions/2020/petn4-758.pdf [https://perma.cc/GVC3-523S].

[56] *Id.*

[57] Jesse Pound, *Read the Full Report From the Madoff Whistleblower Accusing GE of an Enron-like Fraud*, CNBC (Aug. 15, 2019),[https://perma.cc/J23C-8PBS].

[58] *See, e.g.,* GE, *GE Addresses Claims by Harry Markopolos*, (Aug. 15, 2019), https://www.ge.com/news/press-releases/ge-addresses-claims-harry-markopolos [https://perma.cc/U6E5-8STS]; Al Root, *Wall Street Is Shrugging Off Allegations of GE Accounting Fraud*, BARRONS (Sep. 4, 2019), https://www.barrons.com/articles/wall-street-comfortable-with-ges-accounting-shrugs-off-markopolos-report51567525632 [https://perma.cc./2N7B-SWU5].

This event prompted many scholars to argue that the Markopolos-GE event "demonstrates that we need to rethink the current legal treatment of short selling and 'negative activism'."[59] In the event's aftermath, Professor John Coffee Jr. suggested that "[t]he SEC could make clear that a short seller who has published critical negative research and announced its short position must disclose immediately when it closes out its short position,"[60] informing the market that the short seller no longer holds their position. Professor Coffee's position has since been adopted by scores of academics.[61] This would seemingly allow markets to make the inference that the stock has reached a value that the short seller believes fairly represents the company's valuation, which is information that would be useful to the market in assessing the short report's legitimacy and whether to continue trading in light of its contents. Some, like Professor Mitts, have gone further, proposing a 10-day holding periods for all short activists once they make their research public.[62] This lock-up period forces activist short sellers to "ride the consequences" of their research, according to Mitts, which should incentivize activists to publish short reports of higher quality, thereby facilitating price discovery and market efficiency more effectively than the status quo.[63]

ii. From Government

Capitol Hill has vilified short sellers in recent years, particularly in light of media frenzies like that related to GameStop stock's meteoric rise that was caused by a short squeeze, costing some hedge funds billions.[64] Representative Jeff Fortenberry claimed "Big Hedge . . . has made trillions shorting great American

[59] John C. Coffee Jr., *Markopolos, G.E. and Short Selling as Negative Activism*, N.Y. L .J., Sept. 18, 2019, https://www.law.com/newyorklawjournal/2019/09/18/markopolos-g-e-and-short-selling-as-negative-activism/?slreturn=20230407122133 [https://perma.cc/6L6B-4XXN].

[60] *Id.*

[61] *See* John C. Coffee Jr. et al., *Petition for Rulemaking on Short and Distort* 3 (Colum. L. Sch. Scholarship Archive, Working Paper No. 2623, 2020).

[62] Dealbook Newsletter, *Are Activist Short Sellers Misunderstood?*, N.Y. TIMES (Feb. 12, 2022), https://www.nytimes.com/2022/02/12/business/dealbook/are-activist-short-sellers-misunderstood.html [https://perma.cc/9FWH-8GQ3].

[63] *Id.*

[64] Gregory Zuckerman, *The GameStop Short Squeeze Shows an Ugly Side of the Investing World*, WALL ST. J. (Jan. 27, 2021), https://www.wsj.com/articles/gamestop-stock-short-squeeze-ugly-side-11611750250 [https://perma.cc/4AK9-TNPR].

companies facing a rough patch . . . Now they are getting a comeuppance."[65] Representative Ro Khanna negatively portrays short sellers, opining that "[s]ome people go get fancy degrees, know the right people, and spend all day in front of their computers short selling . . . and it's a form of manipulation that has hurt our country."[66] In the wake of these comments, Congress proposed the Short Sale Transparency and Market Fairness Act, which would have imposed enhanced disclosure requirements for certain short positions.[67] The bill, however, has not made progress.

The SEC, however, has. The Commission has taken these calls for reform seriously by proposing rules to enhance the transparency of short positions in equity securities in February of 2022.[68] The SEC's recent proposed rulemaking on short sellers had two parts. The first part, Proposed Rule 13f-2, intended to "make aggregate data about large short positions available to the public for individual equity securities" which would "provide the public and market participants with more visibility into the behavior of large short sellers."[69] Alongside this was a second part, Proposed Rule 205, which "which would establish a new 'buy to cover' order marking requirement for broker-dealers."[70] In October of 2023, the SEC finalized their rulemaking and adopted Proposed Rule 13f-2, but declined to adopt Proposed Rule 205.[71]

The SEC designed Rule 13f-2 to induce transparency about the individuals and entities holding short positions and how much they hold by requiring that a form—Form SHO—be submitted once certain thresholds are met. Its obligations apply only to "institutional investment managers," a definition triggered depending on

[65] Lisa Lerer & Astead W. Herndon, *When Ted Cruz and A.O.C. Agree: Yes, the Politics of GameStop Are Confusing*, N.Y. TIMES (Feb. 18, 2021), https://www.nytimes.com/2021/01/31/us/politics/gamestop-robinhood-democrats-republicans.html [https://perma.cc/5C36-EX7A].

[66] *Id.*

[67] H.R. 4618, 117th Cong. (2021) ("Short Sale Transparency and Market Fairness Act").

[68] *Short Position and Short Activity Reporting by Institutional Investment Managers*, Exchange Act Release No. 34-94313, 17 C.F.R. pt. 240, 242, and 249 (Feb. 25, 2022) (hereinafter, "Short Position Proposed Rule").

[69] Press Release, *SEC Proposes Short Sale Disclosure Rule, Order Marking Requirement, and CAT Amendments*, SEC (Feb. 25, 2022), https://www.sec.gov/news/press-release/2022-32 [https://perma.cc/U2AW-RMYS].

[70] *Id.*

[71] Short Position and Short Activity Reporting by Institutional Investment Managers, Exchange Act Release No. 34-98738, 17 C.F.R pt. 240, 249, at 11 (Oct. 13, 2023) (hereinafter, "Short Position Final Rule").

the nature and quantity of the underlying short position. Managers must report their short positions on Form SHO if they hold a monthly average gross short position of at least $10 million of an equity security registered under Section 12[72] of the Exchange Act.[73] Alternatively, a Form SHO filing is required if managers hold a monthly average short position equal to or greater than 2.5 percent of the shares outstanding.[74] Managers holding short positions in non-reporting companies must disclose their positions under Form SHO if the gross short position exceeds $500,000 at the end of any trading day during the calendar month.[75]

Procedurally, the SEC would require managers meeting these reporting thresholds to making a Form SHO filing on EDGAR[76] during the final fourteen calendar days of a month.[77] This data would then be published by the end of the following month, giving submitting institutions buffer time before their positions became public. The SEC believes that this delay proves sufficient to protect Form SHO filers from short squeezes, copycat traders, and other manipulative trading practices that could ensue if short positions are made public.

Disclosure under Form SHO, however, does not combat the typical short seller behavior that modern critics tend to focus on. To combat the activities of this group, the SEC issued Proposed Rule 205, which establishes the "buy-to-cover" reporting requirement for broker-dealers.[78] This would require broker-dealers to mark any purchase as "'buy to cover' if the purchaser has any short position in the same security at the time the purchase order is entered."[79] This would have allowed the SEC to more readily uncover abusive trading practices like short squeezes[80]

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[72] *See* 15 U.S.C. § 78l (publicly traded companies and other sufficiently large privately held companies are required to register under Section 12 of the Exchange Act.)

[73] Short Position Final Rule, *supra* note 70, at 54–55 (the proposed rule prescribed that Form SHO disclosure would be triggered if the amount was greater than $10 million at the end of trading hours on any market day, but the SEC amended it in its final rule).

[74] *Id.* at 57.

[75] *Id.*

[76] EDGAR is the database where companies submit required filings with the SEC and stands for "Electronic Data Gathering, Analysis, and Retrieval system" *See About EDGAR*, U.S. SEC. & EXCH. COMM'N. (last modified Apr. 6, 2023), https://www.sec.gov/edgar/about [https://perma.cc/E2X5-SCYA].

[77] Short Position Final Rule, *supra* note 71, at 87.

[78] Press Release, *supra* note 69.

[79] *Id.*

[80] *See* Mark J. Loewenstein*, Short Squeeze, Game Stop, the Common Law and a Call for Regulation*, 50 SEC. REGUL. L.J. 1 (2022) (describing the Game Stop short squeeze and arguing such incidents should be regulated so as to reoccur).

and gain insight into short selling more generally, all with an eye toward preserving and enhancing the fairness and efficiency of the market.[81]

Proposed Rule 205 would have applied to broker-dealers, but "[i]ndividuals who buy and sell securities for themselves generally are considered traders and not dealers."[82] This rule, then, would have encapsulated trading practices only by companies like Hindenburg, which specialize in short selling, but would not apply to individual traders such as the pseudonymous individual traders critiqued by Professor Joshua Mitts.[83] Considering that scholarship critical of short sellers has focused on individual anonymous and pseudonymous authors,[84] Proposed Rule 205 would not have effectively targeted the short-selling practices that scholars have recently decried. Other commentators also were skeptical that Proposed Rule 205 would have helped the SEC curb abusive short squeezes, which is one reason the SEC proposed the rule in the first instance.[85] Ultimately, the SEC declined to adopt Proposed Rule 205 on account of "potential operational issues" and steep compliance costs.[86]

To be sure, the finality of these rules is not guaranteed. On December 12, 2023, three hedge fund associations sued the SEC over its final rules, arguing that they are contradictory to each other.[87] The group brought suit in the Fifth Circuit Court of Appeals, a circuit notoriously hostile to the SEC, which recently ruled that the SEC's administrative law judges were unconstitutional,[88] a decision affirmed by the Supreme Court,[89] and that its rulemaking on stock repurchases was invalid.[90] The Fifth Circuit will have to determine whether the SEC's rules are, in fact, contradictory. The short-seller disclosure rule, as reviewed, delays disclosure of short sellers' positions by a month, thus protecting them from copycat traders.

[81] *See* Zuckerman, supra note 64.

[82] *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM'N. (last modified Dec. 12, 2016), https://www.sec.gov/about/reports-publications/investor-publications/guide-broker-dealer-registration [https://perma.cc/5LWG-WZHE].

[83] *Id*.

[84] Mitts, *supra note* 6.

[85] Short Position Final Rule, *supra* note 71, at 120–21.

[86] *Id.* at 119–123.

[87] Hal Scott & John Gulliver, *The SEC Contradicts Itself*, WALL ST. J. (Dec. 14, 2023), https://www.wsj.com/articles/the-sec-contradicts-itself-short-selling-disclosure-rule-c8c91131 [https://perma.cc/X66D-2UZS].

[88] Jarkesy v. Sec. & Exch. Comm'n, 34 F.4th 446 (5th Cir. 2022).

[89] Jarkesy v. Sec. & Exch. Comm'n, 603 U.S. ___ (2024).

[90] Chamber of Com. of the U.S. v. Sec. & Exch. Comm'n, 85 F.4th 760, 780 (5th Cir. 2023).

However, a second rule finalized on the same day requires securities lenders to disclose the total dollar amount and number of loans for each stock, which does not sufficiently obscure short seller position data.[91] According to the hedge fund associations, the rules adopt conflicting stances on investor privacy and market transparency, rendering them contradictory and susceptible to challenge under the Administrative Procedure Act.[92]

These proposed and finalized (for now) rules lay the groundwork for potential SEC and DOJ investigations into short-seller activity. Yet, even in the absence of these rules, these agencies have already been tackling short-selling misconduct. For instance, the SEC and DOJ launched a probe into short sellers that began sometime in 2021.[93] Over thirty short-selling firms were targeted in that raid, and Andrew Left, the head of short-selling firm Citron Research, had his home raided by the FBI in 2021 pursuant to the SEC's investigation, which resulted in federal criminal charges in July of 2024.[94] Other activity that was apparently a part of the probe occurred September 2022, when the DOJ subpoenaed short-selling firms, requesting information about how they short blue-chip stocks.[95] The recently finalized regulations and the indictment of Andrew Left will likely catalyze further investigations into short sellers. If nothing else, it underscores the SEC's and DOJ's desire to oversee the short-selling space.

The call to reform, which has been on the upswing for the better part of the last five years, has not borne fruit. However, recent demand from the banking industry, particularly after the short-lived banking crisis that forced multiple banks

[91] Scott & Gulliver, *supra* note 87; Carolina Mandl & Michelle Price, *Hedge Fund Groups Sue SEC in Bid to Vacate Short Selling Rules*, REUTERS (Dec. 12, 2023), https://www.reuters.com/markets/us/hedge-fund-groups-sue-us-sec-bid-vacate-short-selling-rules-2023-12-12/ [https://perma.cc/5X7L-7STU].

[92] Scott & Gulliver, *supra* note 87.

[93] Porzecanski & Schoenberg, *supra* note 43.

[94] Sam Klebanov, *The Big Short Seller Probe: Who Are The Investors on the DOJ's List?*, B2 (March 3, 2022), https://www.businessofbusiness.com/articles/the-big-short-seller-probe-who-are-the-investors-on-the-dojs-list/ [perma.cc/Y279-993S]. Since the raid, Andrew Left has been indicted on federal criminal charges related to market manipulation and securities fraud. *See* Dave Michaels & Justin Baer, *U.S. Accuses Prominent Short Seller Andrew Left of Fraud*, WALL ST. J. (July 26, 2024), https://www.wsj.com/finance/stocks/u-s-accuses-prominent-short-seller-andrew-left-of-fraud-0161e42f [https://perma.cc/7D37-8H7X].

[95] Matt Robinson & Tom Schoenberg, *DOJ Short-Selling Probe Eyes Bets on Amazon, Microsoft and JPMorgan*, BLOOMBERG (Sept. 12, 2022), https://www.bloomberg.com/news/articles/2022-09-12/doj-short-selling-probe-eyes-bets-on-amazon-microsoft-jpmorgan#xj4y7vzkg [perma.cc/SJX6-RPA5].

into bankruptcy during the Spring of 2023, informed and likely catalyzed the recent finalized rulemaking on short sellers. In May of 2023, JPMorgan CEO Jamie Dimon and the American Bankers Association called for the SEC to act against market manipulation and other abusive short-selling practices.[96] These critics maintain that short sellers exacerbated the crisis by spreading unsubstantiated rumors about regional banks' financial health, or otherwise propagated bad news to an extent "that appears disconnected from underlying financial realities."[97] If true, the practice would drive the price of these stocks downward, creating a potential death spiral that would hasten any given banks' collapse.[98] While some have called on the SEC to ban short selling of certain stocks entirely in light of these allegations,[99] SEC staffers report that the last time the SEC banned short selling—during the 2008 Financial Crisis—it exacerbated the uncertainty of financial markets and ultimately hurt the banks that the regulations were trying to protect.[100]

With a round of final rulemaking under the SEC's belt, and no apparent forward progress in the halls of Congress, the field for short-seller regulation has been set. For the near future, the regulatory scrutiny on short sellers will come via enforcement action, not by statute or rule.

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[96] Andrew Ross Sorkin et al., *Calls to Investigate Short Sellers Intensify as Bank Crisis Deepens*, N.Y. TIMES (May 12, 2023), https://www.nytimes.com/2023/05/12/business/dealbook/jamie-dimon-short-sellers-banks.html [perma.cc/8HFK-6HYE].

[97] Letter from Rob Nichols, President and CEO, Am. Bankers Ass'n., to Gary Gensler, Chairman, Sec. Exch. Comm'n. (May 4, 2023), https://www.aba.com/-/media/documents/letters-to-congress-and-regulators/sec-gary-gensler-05042023.pdf?rev=0a2e6cc287d74dcb838b830853b95918 [perma.cc/C4QH-W243].

[98] These critiques echo many of those made by bank executives in the throes of the Great Recession. For instance, Lehman Brothers CEO Dick Fuld blamed the collapse of the renowned bank on a plague of short selling during the crisis. *See* Heidi N. Moore, *Dick Fuld's Vendetta Against Short-Sellers—and Goldman Sachs*, WALL ST. J. (Oct. 7, 2008), https://www.wsj.com/articles/BL-DLB-3598 [perma.cc/YH88-CKJU].

[99] Eleanor Terrett & Charlie Gasparino, *SEC Staff Throw Cold Water on Calls for Ban on Short Selling of Bank Stocks*, FOX BUS. (May 8, 2023), https://www.foxbusiness.com/markets/renewed-calls-short-stelling-ban-pressure-sec-gensler [perma.cc/BGH9-HQU8]; Chris Prentice, *U.S. Prosecutors Look at Short Selling in Bank Shares – Source*, US NEWS (May 10, 2023), https://www.usnews.com/news/top-news/articles/2023-05-10/u-s-prosecutors-look-at-short-selling-in-bank-shares-source [perma.cc/YNS5-J96N].

[100] Terrett & Gasparino, *supra* note 99; Prentice, *supra* note 99.

B, The Case for Short Sellers

A coin always has two sides.[101] In favor of short sellers are the latest scandals uncovered by short reports, as the Luckin Coffee case study epitomizes, which demonstrate that "[i]f you want to detect fraud, forget the accountants and contact your local short sellers; they are the real detectives today."[102] While this may be due to the resource constraints of government enforcement, it is also due to the fact that "[w]hen the fraud is really egregious, we often find that the regulator has been captured by the fraudster."[103] The sentiment that regulators simply lack the bandwidth to effectively enforce the securities laws, particularly when companies are predominantly located abroad,[104] and are subject to regulatory capture are just some of the reasons to rely more on private enforcement, like short activists. While the purpose of this paper is not to settle the debate on whether short selling is beneficial to capital markets in its current form, this Part demonstrates that short sellers create numerous positive externalities and should be encouraged within a proper regulatory framework.

i. From Academia

Academia has not been silent regarding the benefits that short sellers, whose work is often dubbed "negative activism," confer on capital markets. Recently, Professors Peter Molk and Frank Partnoy have shown various reasons to be dubious of the claims against short sellers. By and large, the professors argue that short sellers are revealing legitimate fraud, demonstrated by the fact that companies targeted by short activists persistently underperform the market. Far from throwing mud at a clean company, short activism on average reveals legitimate reasons to doubt a company's price. This same long-term underperformance persists in operational performance for companies targeted by short activists, further indicating that the shorts are discovering something that the market ought to know, not merely taking advantage of short-term price

[101] *See* Coffee, *supra* note 9.

[102] *See id.*

[103] *See id.*

[104] For instance, Muddy Waters, one of the most successful and well-known short hedge funds, primarily targets China. The firm even owes its name to a Chinese proverb: "muddy waters makes it easy to catch fish." *See* Michelle Celarier, *The Rage of Carson Block*, INST. INVESTOR (Apr. 19, 2021), https://www.institutionalinvestor.com/article/2bswvw9n02kg7ksdcd62o/corner-office/the-rage-of-carson-block [perma.cc/W36G-4GPA].

distortions.[105] Oftentimes, short activism also spurs regulatory action that otherwise would not have occurred. These general findings—that short activism correlates with companies underperforming both in stock price and operational performance, and that short activism helps unveil corporate misconduct that warrants regulatory intervention—create the broad strokes of the case against regulating short sellers more stringently.

Some academics have drawn insights from abroad, as many foreign countries regulate short sellers more rigorously than the United States, with some even imposing outright bans.[106] For instance, the United Kingdom requires that short sellers disclose individual short positions above a certain threshold, whereas the United States merely requires that the aggregate short position of any given firm be disclosed, leaving their specific short positions undisclosed. The United Kingdom's system is similar to the new governance framework imposed by Rule 13f-2, the finalized SEC rule described earlier,[107] and the Brokaw Act, which was introduced by the Senate Banking Committee in August 2017.[108]

Academics have shown that mandatory disclosure regimes like that adopted in Rule 13f-2 may harm capital markets and reduce price efficiency.[109] Professors John Heater, Ye Liu, Qin Tan and Frank Zhang have investigated the effect mandatory disclosure has on the market and showed that it causes "herding behavior" leading to persistently high short-interest for stocks subject to the mandatory disclosure regime, which thus causes a short-term artificial depression in stock price.[110] Moreover, mandatory disclosure regimes are relatively easy to subvert; actors in markets subject to mandatory disclosure rules accumulate their positions just below the disclosure thresholds so that they do not have to disclose their positions and to prevent "copy-cat" traders.[111] Lastly, the obvious outcome is that disclosure regimes reduce the amount of short positions firms take.[112] Whether

[105] Molk & Partnoy, *supra* note 39, at 1.

[106] Larry Swedroe, *Short Sellers Are Informed Investors*, ALPHA ARCHITECT (July 21, 2022), https://alphaarchitect.com/2022/07/short-sellers-are-informed-investors/ [perma.cc/FJH5-RC9J].

[107] Press Release, *supra* note 69.

[108] *See* S. 1744, 115th Cong. (2017).

[109] John Heater et al., *Mandatory Short Selling Disclosure Could Lead to Investor Herding Behavior*, CLS BLUE SKY BLOG (Sept. 23, 2021), https://clsbluesky.law.columbia.edu/2021/09/23/mandatory-short-selling-disclosure-could-lead-to-investor-herding-behavior/ [perma.cc/9KUD-XFBC].

[110] *Id.* at 5–6.

[111] *Id.*

[112] *Id.*

that is a poor outcome depends on how one perceives short sellers in general. As Professor Partnoy said, "[i]f your view is that short sellers are helping the market and are helping to bring information about overpriced companies to the market, the last thing you want to do is regulate them more."[113] Conversely, if you want less short selling, enhanced regulation is needed.

The Committee on Capital Markets Regulation, an academic think-tank dedicated to financial regulatory policy issues, has likewise shown skepticism at mandatory disclosure regimes for short sellers in their 2018 letter titled *Short Selling's Positive Impact on Markets and the Consequences of Short-Sale Restrictions*.[114] They note that those advocating for mandatory disclosure of short positions support their position by noting that there are mandatory disclosure requirements for long positions. From this, disclosure advocates conclude that disclosing short positions would be appropriate, so that long and short positions are treated equally. However, the rationale for the two differs.[115] Long positions must be disclosed because the market needs to know who is, or might be, in control of the company; no similar rationale exists for short positions. More broadly, the Committee's letter describes the benefits of short selling as threefold: it enhances price efficiency, increases market liquidity, and instigates positive corporate governance reforms.[116]All of these benefits, however, would be hampered by regulating short sellers more stridently.

The Committee on Capital Markets Regulation relies on the work of Boehmer and Wu, academics that empirically confirmed short selling's positive effect on price efficiency. These academics note that, rather than cause volatility and distortion, short selling *improves* price accuracy.[117] And this makes sense, says Boehmer and Wu, because short sellers are rational and thus trade only on value-relevant information, which pushes mispriced stocks closer to their fundamental value.[118] Overall, the Committee concludes that mandatory disclosure ought be

[113] Michelle Celarier, *Are Activist Short Sellers Misunderstood?*, N.Y. TIMES (Feb. 12, 2022), https://www.nytimes.com/2022/02/12/business/dealbook/are-activist-short-sellers-misunderstood.html [perma.cc/W36G-4GPA].

[114] *Short Selling's Positive Impact on Marks and the Consequences of Short-Sale Restrictions*, COMM. ON CAP. MARKETS. REGUL., (Sept. 2018), https://capmktsreg.org/wp-content/uploads/2022/11/CCMR-Statement-on-Short-Selling-1.pdf [pema.cc/9QXH-KA8N].

[115] *Id.* at 1.

[116] *Id.* at 3.

[117] Ekkehart Boehmer & Juan (Julie) Wu, *Short Selling and the Price Discovery Process*, 26 REV. FIN. STUDIES 287, 287 (2012).

[118] *Id.* at 288.

avoided because "the empirical evidence from recent academic studies strongly supports the more positive view of short selling's impact on price efficiency." This position has resounding support; a 2020 study by the World Federation of Exchanges, a global industry group, concluded "the evidence almost unanimously points towards short-selling bans being disruptive for the orderly functioning of markets, as they are found to reduce liquidity, increase price inefficiency and hamper price discovery."[119] Arguably, as the Economist said: "short-sellers are savvy investors who help to keep the market's exuberance in check."[120] As such, this school argues short sellers should be regulated only with a light hand and a deft touch.

ii. From Wall Street

Even the titans of finance recognize that short selling can benefit markets. None other than Warren Buffett remarked at the 2006 Berkshire Hathaway annual shareholder meeting that "[t]here's nothing evil, per se, about—in my view—about selling things short . . . [s]hort sellers—the situations in which there have been huge short interests very often—very often have been later revealed to be frauds or semi-frauds."[121] Of course, the most spirited of short-selling defenses emanating from Wall Street come from the short activists themselves.

In 2022, Carson Block, founder of Muddy Waters Capital, authored a white paper confronting the claims levied by Professor Joshua Mitts against short activists.[122] Block's paper, titled *Distorting the Shorts*, tackles Mitts' arguments about the problem of pseudonymous short sellers by arguing that Mitts' data is incomplete. Further, Block argues that if a complete data set were considered, Mitts' conclusions on the effect pseudonymous authors have on price action would not be accurate. Lastly, Block makes a strident critique of a case study offered by

[119] Stefano Alderighi & Pedro Gurrola-Perez, *What Does Academic Research Say About Short-Selling Bans?* 2, (World Fed'n Exch., Working Paper, Apr. 29, 2020), https://ssrn.com/abstract=3775704 [perma.cc/F2LD-P3QR].

[120] *Short-Sellers are Good for Markets*, ECONOMIST (Oct. 11, 2018), https://www.economist.com/finance-and-economics/2018/10/11/short-sellers-are-good-for-markets [perma.cc/8TN4-SZE8].

[121] Tae Kim, *Experts—Including Warren Buffett—Say Short Selling Can Be Beneficial for Markets*, CNBC (Oct. 5, 2018), https://www.cnbc.com/2018/10/05/experts-including-warren-buffett--say-short-selling-can-be-beneficial-for-markets.html [perma.cc/MZV9-NDG2].

[122] Carson Block, *Distorting the Shorts* 1 (S&P Global, Working Paper, Feb. 23, 2022), https://ssrn.com/abstract=4041541 [perma.cc/8R9U-8GW8].

Mitts that supports Mitts' theory that pseudonymous authors taking short positions have materially significant effects on a stock's price.[123]

Block demonstrates that Mitts' dataset is incomplete by showing that only 21 to 40 percent of the authors analyzed by Mitts in his study were in fact taking short positions on the stocks they wrote about.[124] In other words, in Mitts' study on pseudonymous short sellers, "a sizeable majority were not actually short."[125] Mitts responded to Block's refutation of his dataset, having no issue with Block's characterization of it, by noting that he was overinclusive because he assumed that some of the authors "could by lying" about not having short positions.[126] Block contends that had Mitts considered a dataset that consisted only of short sellers, he would have found that their effect on price action was minimal and hardly distorting.[127] Notably, Block also thoroughly investigated the anecdotal claim that Mitts used to support his theory. In *Short and Distort*, Mitts pointed to a pseudonymous short activist by the name of "SkyTides," suggesting that SkyTides distorted the price of the company by publishing a critical article on a company named Insulet, which caused the company's stock to fall over 7 percent, only for it to recover shortly thereafter.[128] In an oral presentation of his work, Mitts pointed to the sudden decline in Insulet's stock price immediately before the pseudonymous article was published as proof-positive that someone took out a short position (presumably the author, SkyTides), thus depressing the company's stock price.[129] Upon further investigation, however, Block showed that SkyTides took out a short position of less than $2,500[130]—hardly enough to move a company's stock price, let alone distort it.

Proof that bolsters Wall Street's case for short sellers can also be found in the pudding. In addition to the fraud of Luckin Coffee, described above, and the cases described below in Part IV, short sellers are responsible for other notable takedowns of fraud-ridden corporate giants. Jim Chanos was the vanguard of the Enron investigation after he suspected that their accounting practices were

[123] *Id.* at 12–14.
[124] *Id.* at 5–6.
[125] *Id.* at 6.
[126] Celarier, *supra* note 113.
[127] Block, *supra* note 122, at 20.
[128] *Id*. at 14–15.
[129] Columbia Business School, *Short and Distort*, YOUTUBE (June 11, 2019), https://www.youtube.com/watch?v=bfTtO2ZZkSs [perma.cc/3HB3-9VDR].
[130] Block, *supra* note 122, at 17.

misleading.[131] Short sellers sounded the alarms about Lehman Brothers and the systemic risk mortgage-backed securities posed to the finance industry, a collective position popularly known as the "Big Short."[132] And even more recently, a short seller exposed an opioid crisis scandal by investigating Insys Therapeutics because he believed the company "was improperly influencing doctors to prescribe a powerful nasal spray containing fentanyl that play a role in the death of at least two patients."[133] That investigation led to federal prison time for the company's executives.[134] As Warren Buffett said, "the situations in which there have been huge short interests very often—very often have been later revealed to be frauds or semi-frauds."[135] That may be reason enough to heed the call from Wall Street to continue supporting short activism.

iii. From Government

Suffice it to say, the supporters of short activists on Capitol Hill are very rare. Indeed, short sellers have been maligned by politicians for centuries, acting as the scapegoat for virtually every fiscal crisis since the dawn of finance.[136] Generally, any admission of short selling's benefits by legislators is quickly followed by their concerns. Importantly, legislators understand the key role short selling serves in a well-functioning capital market ecosystem. For instance, in a hearing before the House Committee on Financial Services, Congressman Andy Barr related to the founder of Melvin Capital, the hedge fund on the losing end of the GameStop short frenzy, the "important role" shorting plays in our national markets.[137] The Congressman's concern, which he thought should be the focus of regulators, was naked shorting—the practice of shorting a stock without having access to the underlying shares.

[131] Kate Kelly & Mathew Goldstein, *Wall Street's Most Reviled Investors Worry About Their Fate*, N.Y. TIMES (Feb. 8, 2021), https://www.nytimes.com/2021/02/08/business/wall-street-short-sellers-game-stop.html [perma.cc/857B-5JGV].

[132] *See* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

[133] Kelly & Goldstein, *supra* note 131.

[134] *Id*.

[135] Kim, *supra* note 121.

[136] Ryan Kailath, *Wall Street Short Sellers: Hated for Centuries*, NPR (Feb. 15, 2021), https://www.npr.org/2021/02/15/966877259/wall-street-short-sellers-hated-for-centuries [perma.cc/NL8K-XTNG].

[137] *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Virtual Hearing Before the H. Comm. on Fin. Services*, 117th Cong. 108-114 (Feb. 18, 2021) (statement of Andy Barr, Congressman).

The SEC, too, has recently described benefits that short sellers confer. Commissioner Mark Uyeda, in a recent statement, noted: "[s]hort sales can play a vitally important role in setting a fair price for securities, which is perhaps the greatest protection for investors in the market."[138] Further, he argues, "[s]hort selling as a trading strategy can result in economic rewards for conducting research into the value of a security, thereby encouraging such research. Why should anyone make the effort to conduct research if there will no individualized reward for such efforts?"[139] Nevertheless, Commissioner Uyeda is part of the minority that supports short selling.

That Congress has advocated against short sellers is unsurprising. There are few political considerations that would weigh in favor of a politician allying themselves with short sellers, who are generally wealthy traders on Wall Street. The SEC, however, has stated that short sellers positively affect the two interrelated concepts of liquidity and price transparency.[140] As discussed above, short sellers increase price transparency by revealing information about a company that helps move that company's stock toward its actual value. If this function did not exist, it would theoretically lead to a higher incidence of mispriced stocks, or stocks that are mispriced to a greater degree.[141] As a result, the market ends up with a higher bid-ask spread, which reduces overall trading in the stock, and therefore, liquidity.[142] To the extent short sellers effectuate price transparency and liquidity, there is a strong case to ensure regulation does not negate these positive effects.

III. FEDERAL COURTS ARE IN DISARRAY ABOUT IF AND WHEN A SHORT REPORT CAN BE A CORRECTIVE DISCLOSURE.

Short selling regulations are, as reviewed, the subject of an ongoing and vibrant debate that has spanned centuries. Short sellers and the reports they create can help make markets more efficient by enhancing price discovery and increasing liquidity, among other positive externalities.[143] Of course, as discussed, these short reports—particularly when anonymous—are often described as extortionate. Critics contend these reports distort stock prices in the short term so the author can take advantage of a temporary decline, only for the price to revert to its previous trend—a sign the report failed to provide the market with any material information.

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[138] Uyeda, *supra* note 3.

[139] *Id*.

[140] Short Position Proposed Rule, *supra* note 68.

[141] COMM. ON CAP. MARKETS. REGUL., *supra* note 114, at 4.

[142] *See id*. at 6.

[143] *See* Uyeda, *supra* note 3; *infra* Part B.i.

This Article now moves from the short selling policy debate and turns toward reviewing the law of short selling. Like the policy debate, the law of short selling is splintered, as federal courts are in disarray over the relationship between short reports and whether they can be considered a "corrective disclosure" that satisfies Rule 10b-5's loss-causation requirement. One-third of the circuits categorically bar short reports from being corrective disclosures, one-third permit them under certain circumstances, and the final third remains silent on the matter.

As described above, one of the many elements that a Rule 10b-5 plaintiff must adequately plead is loss causation. In 2005, the Supreme Court, in *Dura Pharmaceuticals v. Broudo*, held that Rule 10b-5 plaintiffs must prove there was a causal connection between the alleged misrepresentations and the subsequent decline in the stock price.[144] The loss-causation requirement is met by corrective disclosures—disclosures that contain "information correcting the misstatement or omission that is the basis for the action" and are "disseminated to the market."[145] Corrective disclosures often take the form of the company itself making a disclosure, as such a disclosure generally provides new, "insider," information to the market. To illustrate this point, a corrective disclosure that satisfies Rule 10b-5's loss-causation requirement could look like a company disclosing its accounting was incorrect and its liabilities are materially higher, or it misrepresented its sales revenue.[146]

Recently, plaintiffs have frequently resorted to short reports like the one that uncovered Luckin Coffee's fraud to function as corrective disclosures that satisfy Rule 10b-5's loss-causation requirement. However, courts are split on whether short reports can be used to satisfy that requirement. And even if courts do permit short reports to be corrective disclosures as a threshold matter, they are split on the circumstances under which short reports in fact constitute corrective disclosures, and thus satisfy loss causation. This Part of the article unravels how courts have viewed the relationship between short reports and loss causation by analyzing whether a short report can be a corrective disclosure and if they can, the applicable circumstances.

A. Can a Short Report Ever Be a Corrective Disclosure?

The threshold question that courts must first consider when reviewing a short report is if a short report can *ever* be a corrective disclosure, regardless of if that report is authored by an anonymous or pseudonymous author or is attributed to a

[144] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 347 (2005).
[145] 15 U.S.C. § 78u-4(e)(1).
[146] Meyer v. Greene, 710 F.3d 1189, 1196 (11th Cir. 2013).

discoverable author. The fundamental question that undergirds this inquiry is how intensely a court applies the efficient market theory, an economic theory granted judicial imprimatur in 1988 by the Supreme Court in *Basic v. Levinson.* [147] The efficient market theory holds that the price of a stock in an "open and developed" market reflects all material, public information at any given time because the market is efficient—i.e., it incorporates all public information, all the time, no matter what.[148]

If the market is as efficient as the theory suggests, a position that some circuits adopt, then reports based on public information cannot be corrective disclosures. This is because when a corrective disclosure is based on public information, the strong form of the efficient market theory holds that such information is already reflected by the stock's price, regardless of how complex the revelation is. And because the stock price reflects the "public information" that the report is based on, then a short report cannot have "caused" any decline in price, even if a stock's value in fact fell and remained depressed in response to the report's release.

Another version of the efficient market theory adopts a more modest, pragmatic approach. The modest form of the efficient market theory rejects the heroic presumption that the market is all-knowing of all public information at all times. Rather, it holds that while most publicly available information is reflected by a stock's price, there are circumstances where nominally publicly available information is not reflected in a stock's price because it is difficult to access or analyze.

The strong form of the efficient market theory takes *Basic*'s premise—that the market reflects all material, publicly available information—where it was never intended to be taken, turning a theory describing a hypothetical world into a doctrine holding back securities plaintiffs in the real world. *Basic* created a presumption that plaintiffs employ to satisfy Rule 10b-5's reliance requirement. The *Basic* presumption, dubbed the "fraud-on-the-market" theory, assumes that a securities plaintiff relied on the defendant's misstatement, even if they cannot show actual reliance.[149] This theory enables plaintiffs to circumvent the requirement to plead particularized facts showing they relied on the material

[147] Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988) (establishing that securities class action plaintiffs presumptively relied on a material misstatement, even if they cannot in fact show that they did so).

[148] *Id.* at 241–48.

[149] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 268 (3d Cir. 2005).

misstatement that formed the basis of the action under Rule 10b-5.[150] The fraud-on-the-market theory assumes a plaintiff relies on a company's misstatement as a corollary to owning company stock. Without this presumption, each Rule 10b-5 plaintiff would have to demonstrate that they relied on the misstatement, which would all but scuttle the mine run of suits brought under Rule 10b-5.[151]

The *Basic* Court, however, did not endow efficient market theory with Delphic power. Rather, the Court based their opinion on "common sense and probability."[152] And it is common sense and probability that should guide courts in determining whether reports based on publicly available information can function as corrective disclosures, not "theories which may or may not prove accurate upon further consideration."[153] As Professor Ann Lipton aptly noted, "[t]he 'modest' presumption that public information is reflected in market prices does not extend to all possible conclusions that could be drawn from that public information, let alone conclusions that require special effort, expertise, and investigation."[154]

Courts that categorically prohibit short reports from being corrective disclosures take *Basic*'s adoption of the efficient market presumption and turn it from a theory underlying the Supreme Court's opinion into doctrine divorced from both reality and the economic theory from which it derives.[155] Such courts hold that plaintiffs must take the bitterness of the efficient market theory with the sweet.[156] The sweet is, as mentioned, that the fraud-on-the-market theory permits plaintiffs to take advantage of the presumption that they relied on a material misstatement without having to plead particularized facts demonstrating that they did. The bitter part is that when taken to an extreme untethered to market reality,

[150] Yaron Nili, *Supreme Court Upholds Fraud-On-The-Market Presumption in Halliburton*, HARV. L. SCH. F. CORP. GOVERNANCE (June 24, 2014), https://corpgov.law.harvard.edu/2014/06/24/supreme-court-upholds-fraud-on-the-market-presumption-in-halliburton [perma.cc/QP8N-DB2A].

[151] *See* Robert N. Rapp, *Plausible Cause: Exploring the Limits of Loss Causation In Pleading and Proving Market Fraud Claims Under Securities Exchange Act §10(b) and SEC Rule 10b-5*, 41 OHIO NORTHERN UNI. L. REV. 389, 397–98 (2015).

[152] *Levinson*, 485 U.S. at 246.

[153] *Id.* at 254 (J. White, concurring).

[154] Ann Lipton, *A Terrible Injustice Has Been Corrected*, BUS. L. PROF BLOG (Oct. 10, 2020), https://lawprofessors.typepad.com/business_law/2020/10/a-terrible-injustice-has-been-corrected.html [perma.cc/E8AQ-5BV9].

[155] *See* Langevoort, *supra* note 15 (describing how the legal world has misapplied the efficient market theory).

[156] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 271 (3d Cir. 2005) ("An efficient market for good news [for plaintiffs] is an efficient market for bad news [for plaintiffs].").

the efficient market can be used to rule out from being corrective disclosures those reports based on publicly available information. The next Part of this Article details the implications these respective conceptions of the efficient market theory have on plaintiffs attempting to use short reports to satisfy Rule 10b-5's loss-causation requirement.

i. Courts Categorically Prohibiting Short Reports From Being Corrective Disclosures

Four circuits prohibit short reports from being corrective disclosures under any circumstances. These circuits represent the strongest form of the efficient market and conceptualize it as all-knowing and constantly impounding public information, no matter how far flung that information might be. Using this theory, courts refuse to permit short reports to be corrective disclosures able to satisfy loss causation if those reports are based on publicly available information. This is because those reports cannot be said to have caused any sort of loss assuming the information, being public, was already incorporated into the market price, which is the basis of the efficient market theory.

The leading decision articulating the efficient market theory's implications on short reports' ability to function as corrective disclosures is the Eleventh Circuit's decision in *Meyer v. Greene. Meyer* constitutes a case regarding a claim brought under Rule 10b-5 based on the fraud perpetrated by the St. Joe Company. There, David Einhorn, founder of the hedge fund Greenlight Capital,[157] delivered a 139-slide presentation on apparent misrepresentations made by the St. Joe Company, one of the largest publicly traded Floridian real estate development companies.[158] Einhorn outlined various defects in St. Joe's business in his presentation, most of which related to St. Joe improperly accounting the valuations of their properties for not marking them to market properly.[159] This was because St. Joe was hit hard by the financial crisis, which reduced the value of Floridian properties at a rate

[157] FORBES, *David Einhorn* (last visited September 28, 2023), https://www.forbes.com/profile/david-einhorn/?sh=1f7760806743 [perma.cc/C4B6-E8EC].

[158] Gregory White, *Here Are the Details Behind David Einhorn's Latest Big Short*, BUS. INSIDER (Oct. 13, 2010), https://www.businessinsider.com/david-einhorn-joe-2010-10 [perma.cc/2H7U-MVZK]; St. Joe Co., Securities Act Release No. 9967, Exchange Act Release No. 76275, 2015 WL 6467959 (Oct. 27, 2015) (describing St. Joe's size).

[159] St. Joe Company, Exchange Act Release No. 76275, 2015 WL 6467959 (Oct. 27, 2015).

greater than the national average.[160] Yet, St. Joe executives never marked the value of their assets to reasonable prices, let alone market prices. Rather, they made only modest write downs, leaving assets at inflated levels that rendered the company balance sheet entirely misleading to investors.[161]

Einhorn went to great lengths to prove St. Joe had improperly inflated its asset prices, like by travelling through many of St. Joe's residential properties and conducting his own property valuations. One of the most damning examples of St. Joe's failure to adequately price their assets was the community of Windmark, which St. Joe valued at around $280 million.[162] Upon inspection by Einhorn, however, he discovered that the community was essentially a "ghost town."[163] Einhorn valued the properties at around $39 million—a price 90 percent lower than what St. Joe's accounting reported.[164]

Einhorn also demonstrated that St. Joe was not properly valuing its assets by cross-referencing St. Joe's property sales with the book value of similar lots. In one such example, in 2009, St. Joe valued the community of Rivertown, consisting of 185 lots, at roughly $75 million—about $400,000 per lot.[165] However, Einhorn found deeds from 2007, predating the financial crisis, that showed St. Joe sold some of these lots for an average price of $72,133, more than 75 percent less than St. Joe's valuation.[166] Einhorn also found deeds from 2009 showing that St. Joe sold more lots in the community for an average of $31,250 per lot, a 57 percent decline in value in just two years, which was attributable to the financial crisis.[167] Einhorn argued that if all of the remaining lots were similarly valued—at around $31,000—then the real value of Rivertown was not $75 million, as St. Joe reported

[160] Gregory White, *Here's David Einhorn's Epic Takedown of St. Joe Company*, BUS. INSIDER (Oct. 15, 2010), https://www.businessinsider.com/david-einhorn-presentation-joe-2010-10#-37 [perma.cc/BAT8-AXGX]. From Q1 2007 to Q1 2010, the Home Price Index fell roughly 11 percent. Over the same period, the Home Price Index fell for Florida alone fell 35 percent. *See id.* at Slide 36.

[161] Press Release, SEC, Developer, Former Top Execs Charged for Improper Accounting of Real Estate Assets During Financial Crisis (Oct. 27, 2015), https://www.sec.gov/news/press-release/2015-247 [perma.cc/9S43-SUY5].

[162] Tom Lauricella, *Einhorn's New Short: St. Joe*, WALL ST. J. (Oct. 13, 2010), https://www.wsj.com/articles/SB10001424052748703673604575550393057211062 [perma.cc/V2JC-VZB3].

[163] *Id*.

[164] *Id*.

[165] *See* White, *supra* note 158 at Slides 52–63.

[166] *See id.* at Slide 55.

[167] *See id.* at Slide 56.

on its 2009 10-K, but rather somewhere closer to $6 million—a price over 90 percent below what St. Joe claimed the property was worth.[168]

Einhorn's 2010 short report began his battle against St. Joe, which continued for years. In 2015, Einhorn would be vindicated when the SEC announced it would be charging St. Joe, its executives, and its accountants for materially overstating its earnings and assets in 2009 and 2010—exactly what Einhorn informed the market five years earlier. In fact, the SEC would go on to all but completely replicate Einhorn's own analyses to show that St. Joe failed to use the appropriate generally accepted accounting principles when determining the value of its properties, and thus inflated the value of its assets during this time period.[169] Eventually, St. Joe would settle with the SEC. In that settlement, the SEC described St. Joe's failures as "persist[ing] until the very day of the short-seller presentation," and only after Einhorn exposed St. Joe did its auditors request "all of St. Joe's economic models for its real estate developments in connection with [its real estate developments]."[170] Einhorn and his presentation were referenced six times. If not for Einhorn's investigation, the SEC may have never discovered St. Joe's misconduct.[171]

Neither the SEC nor St. Joe's company insiders realized St. Joe was engaging in this misconduct before Einhorn released his short report. Moreover, the SEC noted in its charging documents that "St. Joe and its senior executives . . . deprived investors of critical information with which to make informed investment decisions."[172] Nevertheless, when plaintiffs brought claims based on St. Joe's fraud in the Eleventh Circuit, it paradoxically described the Einhorn presentation—which precisely mirrored the SEC's findings of accounting fraud—as not "revelatory of any fraud."[173] Despite obviously revealing fraud, and doing so in a way that apparently no market participant had yet done, the Eleventh Circuit held that because the Einhorn short report "[merely repackaged] already-public information" it was "simply insufficient to constitute a corrective disclosure."[174]

[168] *See id.* at Slides 62–63.

[169] *See* St. Joe Co., Securities Act Release No. 9967, Exchange Act Release No. 76275, 2015 WL 6467959 (Oct. 27, 2015).

[170] *Id.* at *8.

[171] *See* Julian La Roche, *Hedge Fund Manager David Einhorn Has Scored the Ultimate Victory*, BUS. INSIDER (Oct. 28, 2015, 10:43 AM), https://www.businessinsider.com/einhorn-st-joe-short-gets-shout-out-from-the-sec-2015-10 [https://perma.cc/RT88-STEL].

[172] Press Release, *supra* note 161.

[173] Meyer v. Greene, 710 F.3d 1189, 1199 (11th Cir. 2013).

[174] *Id.*

Thus, even though Einhorn's keen eye and diligent investigation revealed St. Joe's fraud to the investing public, government regulators, and even the company's own lawyers—which was demonstrated by the 19.6 percent drop in St. Joe's stock price in the days after the report[175]—plaintiffs could not use Einhorn's investigation in the private action to satisfy Rule 10b-5's loss-causation requirement because it was based on information that was nominally publicly available.[176]

Numerous courts have followed the Eleventh Circuit's zealous commitment to the strong form of the efficiency market theory by adopting a categorical rule that bars short reports from being a corrective disclosure. These courts thus adopt a theory that gives judicial imprimatur to a level of market efficiency that "exists only in the idealized frictionless world of the imagination."[177]

The Fourth Circuit, for instance, considered a case where the plaintiff, a former executive of a company, alleged that the company's current executives had engaged in self-dealing. The plaintiff claimed that the current executives authorized fraudulent company expenditures because the expenditures went to a company that a current executive had a beneficial interest in.[178] This transaction (but not the fact that the executive had a conflict of interest) was disclosed in a public company filing. Accordingly, the Fourth Circuit described the complaint as "merely attribut[ing] an improper purpose to the previously disclosed facts," and held that the connection between the spending and the conflict of interest could not be a corrective disclosure.[179] The Fourth Circuit further extended this holding in a later case, noting: "[c]orrective disclosures must present facts to the market that are new, that is, publicly revealed for the first time."[180] The Fourth Circuit, like the Eleventh Circuit, turned the efficient market theory into an ironclad rule.

The Second Circuit has likewise categorically barred short reports from functioning as corrective disclosures. In *In re Omnicom Group*, the Second Circuit considered whether investigative reporting done by the Wall Street Journal amounted to a corrective disclosure.[181] There, the Wall Street Journal published

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[175] Jonathan Stempel, *St. Joe Investors Lose in Court; Einhorn Had Shorted Stock*, REUTERS (Feb. 25, 2013, 12:21 PM), https://www.reuters.com/article/us-stjoe-einhorn-ruling/st-joe-investors-lose-in-court-einhorn-had-shorted-stock-idUSBRE91O11C20130225 [https://perma.cc/XN2N-B73J].

[176] *Meyer*, 710 F.3d at 1199.

[177] *See* A. CRAIG MACKINLAY ET AL., THE ECONOMETRICS OF FINANCIAL MARKETS 24 (1997).

[178] Tchrs.' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 187 (4th Cir. 2007).

[179] *Id.*

[180] *See* Katyle v. Penn Nat'l Gaming, Inc., 637 F.3d 462, 473 (4th Cir. 2011).

[181] *In re* Omnicom Grp., Inc. Sec. Litig., 597 F.3d 501, 511 (2d Cir. 2010).

articles describing the fallout among board members that ultimately led to a board member's resignation over suspect accounting practices.[182] To support its investigation, the Journal interviewed two accounting professors who suggested various accounting practices Omnicom undertook were fraudulent and designed to hide losses.[183] When plaintiffs sued Omnicom and argued that the Wall Street Journal's reporting was a corrective disclosure, the Second Circuit rebuffed. The Second Circuit described the Wall Street Journal articles as merely "a negative characterization of already-public information," which meant that it could not be a corrective disclosure satisfying Rule 10b-5's loss-causation requirement.

Notably, the Second Circuit's holding in *Omnicom* was based on reporting that was not incredibly sophisticated. Indeed, compared to more complex reports many short activists create, the Journal's reporting was surface level. All this considered, it is not apparent whether *Omnicom*'s holding would apply to a more sophisticated short report, like the one published about Luckin Coffee's[184] and St. Joe's[185] fraudulent practices. Specifically, the Second Circuit's holding relied on the fact that "no hard fact in the June 12 article suggested that the avoidance of the write-down was improper,"[186] which suggests that a more complex report, even one based on public information, could be considered a corrective disclosure.

However, the Southern District of New York read *Omnicom* for all it was worth in *Lau v. Opera Limited* and rejected a short report's ability to function as a corrective disclosure on the grounds that it merely contained an analysis of already public information, not new information.[187] In *Lau*, the Southern District of New York confronted whether a short report authored by a leading short activist hedge fund, Hindenburg Research, constituted a corrective disclosure. In its report, Hindenburg described allegedly deceptive lending practices that the defendant-company, Opera, engaged in in Africa and India and noted that Opera's apps violated Google Play's terms and conditions.[188] Hindenburg's report spanned dozens of pages, contained voluminous evidence, and revealed facts about Opera's operating procedures in foreign countries that were broadly unknown, despite being information nominally available to the public.

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[182] *Id.* at 505.

[183] *Id.* at 506–07. Notably, this conduct occurred immediately after Enron. Like Enron, Omnicom's accountancy was the now-defunct Arthur Andersen.

[184] *See supra* Part II.A.

[185] *See supra* Part IV.A.i.

[186] *In Re Omnicom Grp.*, 597 F.3d at 512.

[187] Lau v. Opera Ltd., 527 F. Supp. 3d 537, 559 (S.D. N.Y. 2021).

[188] *Id.* at 550.

The *Lau* Court dismissed the report summarily, noting that "the Hindenburg report cannot constitute a corrective disclosure sufficient to allege loss causation because it merely analyzed the public data to which the defendants directed investors."[189] There was no discussion about how the report's complexity came into play and the Southern District dismissed the effect the Hindenburg report had on the market, and predicated its holding solely on the fact that the report was based on nominally public information. Thus, even though the stock fell nearly 20 percent in the days after the report's release and remained depressed for the next six months, the Southern District of New York refused to permit Hindenburg's report to satisfy 10b-5's causation requirement,.[190]

That a stock's price can fall, and remain depressed, after a complex report reveals damning information about a company, and yet still be held to not have satisfied loss causation reveals the tension between the efficient market that exists in theory and the one inhabited by real investors. In *Basic*, the case that sanctified the efficient market theory, the Supreme Court emphasized that the theory and its subsequent application in the realm of securities laws was to be informed by logic and common sense.[191] Had the Southern District considered common sense, like whether the market's reaction to the Hindenburg report supported its holding, it would have humored a different outcome. Thus, *Opera* and the Southern District reveal the grand irony of applying the strong form of the efficient market theory to Rule 10b-5's loss-causation requirement: by invoking it, courts ignore market realities when determining whether a report caused a loss in that market.

One district court ruling from Utah imposes categorical bars on short reports' ability to function as corrective disclosures, portraying the current standard for the Tenth Circuit. The value of the company in *In re PolarityTE,*[192] Polarity, was tied to the issuance of a patent for its signature skin-healing technology.[193] Polarity then bought a public company and merged with it so that it could quickly benefit from public market capital—a reverse merger.[194] However, shortly before the merger, the United States Patent and Trade Office (USPTO) issued a non-final rejection of the patent, noting that the patent was "obvious" and "failed the written description

[189] *Id.* at 561.

[190] Amended Complaint for Violation of Federal Securities Laws, Brown v. Opera Ltd., (S.D. N.Y. 2020) (No. 1:20-cv-00674-JGK), 2020 WL 4048159, at ¶156.

[191] *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

[192] *In re* PolarityTE, Inc., Sec. Litig., No. 2:18-cv-00510, 2020 WL 6873798 (D. Utah Nov. 22, 2020).

[193] *Id.* at *1.

[194] *Id.*

requirement."[195] The USPTO later issued a "final rejection of the patent."[196] On the heels of this information, Citron Research—a short activist hedge fund—published a short report describing how Polarity had misled its investors regarding the patent status of its technology. The report emphasized how the Patent Office's final rejection damaged the company's value.[197] After the report was released, Polarity's stock fell 31 percent.[198] Polarity issued its own report that attempted to downplay Citron's warnings to no avail, and the stock fell a further 12 percent.[199]

The District of Utah engaged in a brief discussion of whether Citron's short report could constitute a corrective disclosure. There, the Court allied with the Second and Eleventh Circuit's case law that imposes a categorical bar on the ability of short reports based on publicly available information from functioning as a corrective disclosures.[200] It further cited a case from the District of Colorado that was affirmed by the Tenth Circuit that doubted whether a "publication . . . which relied exclusively on publicly-available information . . . can constitute the type of corrective disclosure" sufficient to satisfy loss causation.[201] The Court concluded its analysis by describing the efficient market theory and the fact it requires assuming all publicly available information, like the public rejection of a patent, to be reflected in a company's stock price. Consequently, the plaintiffs' claims were dismissed, as Citron's report did not meet the requirements of being a corrective disclosure.

The Second, Fourth, Tenth and Eleventh Circuits thus stand together in adopting a version of the efficient market theory that is easily administrable but divorced from market reality.[202] In taking the efficient market for all its worth, these circuits hold the short reports that often accompany these shorting events, no matter their complexity, are per se barred from functioning as a corrective disclosure and thus cannot be used by plaintiffs to show that corporate misconduct caused their losses.

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[195] *Id.* at *2.

[196] *Id.*

[197] *Id.*

[198] *Id.*

[199] *Id.*

[200] *Id.* at *6.

[201] *Id.* (citing Hampton v. Root9B Techs., Inc., 2016 WL 9735744, at *6 n.6 (D. Colo. Sept. 21, 2016), *aff'd*, 897 F.3d 1291 (10th Cir. 2018)).

[202] Langevoort, *supra* note 15; Sunita Surana, *Informational Efficiency in the Context of Securities Litigation: What Have We Learned?*, 2021 U. ILL. L. REV. ONLINE 334, 335.

ii. Courts Permitting Short Reports to be Corrective Disclosures

Four circuits do permit short reports and other reports based on nominally public information to function as corrective disclosures. These circuits take a more pragmatic approach to efficient market theory, as they understand that even if information is nominally public, it does not necessarily follow that it is reflected into a company's share price.[203] This is justified because sophisticated analyses of public information can be conducted, and conclusions stemming from them can escape even the most sophisticated trader's eye, let alone reasonable investors. Thus, such analyses and their conclusions so too often escape the attention of the efficient market, and therefore can be used to satisfy loss causation.

In an elaborate opinion which has created a rich line of jurisprudence on corrective disclosures, the Ninth Circuit in *In re BofI* held that reports based on public information can constitute a corrective disclosure under certain circumstances, even if they come in the form of blogs on websites like Seeking Alpha, a financial and stock market analysis platform.[204] Some blogs could be considered as equivalent to "short reports" because, like more traditional short reports, they attempt to reveal the shortcomings and potential malfeasance of a certain company.

Blogs like this were at the center of the *In re BofI* litigation. There, shareholders argued a series of eight Seeking Alpha blog posts published between August 2015 and February 2016 were corrective disclosures, because they allegedly revealed material misstatements at Bank of the Internet (BOFI) (now rebranded as Axos Financial). [205] The basic misconduct unveiled by the blogs was that BOFI's senior leadership was engaging in self-dealing and likely violating various banking and securities laws.

On August 1, 2015, BOFI's stock traded at $30.82.[206] By mid-February 2016, after all of the blog posts had been published, the stock traded at $14.55[207]—a 53

[203] Lipton, *supra* note 154 (describing this presumption as more modest and realistic than the alternative).

[204] SEEKING ALPHA, https://seekingalpha.com/ (last visited Apr. 13, 2024) [https://perma.cc/G6V5-LNNG].

[205] Bank of the Internet has since changed its name to Axos Financial, trading under the New York Stock Exchange ticker "AX."

[206] AXOS FINANCIAL, INC. (AX), https://finance.yahoo.com/quote/AX/history?period1=1438387200&period2=1441065600&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true, (last visited Apr. 13, 2024) [https://perma.cc/KX3B-JU9N].

[207] *Id.*

percent decline in just over six months—while the broader market remained mostly flat. These blog posts, like Muddy Waters' analysis of Luckin Coffee and Einhorn's presentation on the St. Joe Company, were based solely on publicly available information. The eight posts, seven of which were authored by the pseudonymous author "Aurelius" and the other by "Real Talk Investments" together span over 25,000 words.[208] The blogs questioned BOFI's underwriting standards,[209] suggested that its internal controls were suspect and did not adequately guard it from potential fraud which violated securities laws,[210] and argued that BOFI fell short of banking compliance laws.[211] Ultimately, the district court found, and the Ninth Circuit agreed, that BOFI had made material misstatements on these exact issues.[212]

The blogs substantiated their allegations by cross-referencing various publicly available documents. For instance, "Aurelius" showed that BOFI made an undisclosed loan of $31.9 million to a company called "Propel" at a favorable 5.5 percent interest rate.[213] This was problematic because "Aurelius" showed that a man by the name of Paul Grinberg, the chair of BOFI's audit committee (the part of BOFI charged with disclosing said loan), was also the Executive Vice President

[208] The blogs in question are paywalled but are on file with the author.

[209] Aurelius, *BofI: Boiler Rooms, Bad Loans, and Off-Balance Sheet Maneuvers Underpin Poorly Understood Risks*, SEEKING ALPHA (November 10, 2015, 1:37 PM ET), https://seekingalpha.com/author/aurelius [perma.cc/D9HT-JK3P]; Aurelius, *BofI: Chairman Contradict's CEO's Assertions Regarding External Auditor's 'Without Merit' Finding*, SEEKING ALPHA (November 30, 2015, 2:29 PM ET), https://seekingalpha.com/author/aurelius [perma.cc/D9HT-JK3P].

[210] Aurelius, *BofI: Undisclosed Related Party Dealings Found to Infect Audit Committee*, SEEKING ALPHA (Jan. 6, 2016, 8:10 AM ET), https://seekingalpha.com/author/aurelius ("[T]hese findings have enormous implications for the integrity of BOFI's . . . internal controls.") [perma.cc/D9HT-JK3P].

[211] Aurelius, *Recent BOFI Court Filing Confirms Existence of Undisclosed Subpoenas and Nonpublic Government Investigations*, SEEKING ALPHA (November 5, 2015, 2:57 PM ET), https://seekingalpha.com/author/aurelius [perma.cc/D9HT-JK3P]; Aurelius, *BofI: Boiler Rooms, Bad Loans, and Off-Balance Sheet Maneuvers Underpin Poorly Understood Risks*, SEEKING ALPHA (November 10, 2015, 1:37 PM ET), https://seekingalpha.com/author/aurelius [perma.cc/D9HT-JK3P]; Aurelius, *BofI: Undisclosed Related Party Dealings Found to Infect Audit Committee*, SEEKING ALPHA (Jan. 6, 2016, 8:10 AM ET), https://seekingalpha.com/author/aurelius [perma.cc/D9HT-JK3P].

[212] *In re* BofI Holding, Inc. Sec. Litig., 977 F.3d 781, 789 (9th Cir. 2020).

[213] Aurelius, *supra* note 207.

and Chairman of "Propel," the company on the receiving end of the $31.9 million loan.

When "Aurelius" discovered financing documents submitted to the Delaware Secretary of State that confirmed BOFI financed Propel with an unspecified amount of money on May 2, 2014, "Aurelius" concluded that Grinberg likely engaged in self-dealing. To prove the loan was for $31.9 million, "Aurelius" found that a 10-K filed by Propel's parent company referenced a $31.9 million financing agreement entered into on May 2, 2014—the same date as the BOFI financing document filed in Delaware. "Aurelius" then found public filings in Florida and Massachusetts that listed Grinberg as a director of Propel to tie Grinberg to this deal.[214] None of this information was disclosed in BOFI's SEC disclosures, representing a violation of regulation S-K and an indictment of BOFI's internal controls.

However, the Ninth Circuit ultimately held that "Aurelius"' blogs were not corrective disclosures, despite the fact the blogs uncovered what the Ninth Circuit also later deemed to be material misstatements. According to the Ninth Circuit, the determinative question was: "can we plausibly infer that the [Seeking Alpha posts] provided new information to the market that was not yet reflected in the company's stock price?"[215] In its analysis, the Court said: "[t]he fact that the underlying data was publicly available is certainly one factor to consider. But other factors include the complexity of the data and its relationship to the alleged misstatements, as in *Amedisys* and *Gilead*, and the great effort needed to locate and analyze it."[216] The basic thrust of determining whether information is new in the loss-causation context requires that shareholders bringing the suit "allege particular facts plausibly suggesting that other market participants had not done the same analysis, *rather than could not*."[217]

Despite ultimately answering that the posts *did* reveal new information,[218] the Ninth Circuit rejected their ability to function as a corrective disclosure. Because the posts were pseudonymously authored by those with a financial stake in them as short sellers, and because the authors made a boilerplate disclaimer on the report's accuracy, investors would have taken them with "a healthy grain of salt," not traded on the information in them, and thus the blogs could not be even the

[214] *Id.*

[215] *In re BofI Holding,* 977 F.3d at 795.

[216] *Id.* at 796.

[217] *Id.* at 794 (emphasis added).

[218] *Id.* at 797 ("The time and effort it took to compile this information make it plausible that the posts provided new information to the market, even though all of the underlying data was publicly available.").

partial cause[219] of BOFI's stock price decline.[220] Accordingly, they could not be used by the plaintiffs to satisfy loss-causation.

The Ninth Circuit added an additional wrinkle. Besides requiring the information be new, the Court held that it also must be plausible that the market perceived the information as revealing the falsity of BOFI's prior misstatements. In other words, the report must also be reliable. This is because the fundamental question is one of causation, and if the reports were unreliable and thus not relied on by investors, they could not be used to show loss causation. And at least in the case of BOFI, because the posts were pseudonymous, had a disclosure disclaiming the accuracy of the statements, and were issued by authors with a financial incentive to convince others to sell, the posts were considered unreliable. Accordingly, while posts like those in *In re BOFI* could theoretically satisfy the loss-causation requirement by acting as a corrective disclosure, they must plausibly reveal new information that the market relies on, which is difficult to do when the reports are anonymous.

Subsequent developments in the Ninth Circuit have further delineated when a report can function as a corrective disclosure. In *Nektar Therapeutics*, the Ninth Circuit again considered how pseudonymous reports claiming to reveal corporate fraud interact with a Rule 10b-5 plaintiff's requirement to plead loss causation.[221] There, shareholders sued a drug development company after it allegedly misled them by touting the results of Phase 1 drug trials that were not in fact as successful as the company led them to believe. Shortly after the release of the Phase 1 results, an anonymous short seller drafted their own report suggesting that the Phase 1 results relied on outliers, rendering the results misleading.[222] Despite disclaiming the report's accuracy, a disclaimer often made by short reports, Nektar's stock fell seven percent upon its release.[223]

The *Nektar Therapeutics* Court reiterated its basic holdings from *In re BofI*: a short-seller report that is based on publicly available information can be a corrective disclosure when it reveals new information and investors perceive the

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[219] *Id.* ("A corrective disclosure need not reveal the full scope of the defendant's fraud in one fell swoop; the true facts concealed by the defendant's misstatements may be revealed over time through a series of partial disclosures."); *see also* Pub. Emps. Ret. Sys. of Miss. v. Amedisys, Inc., 769 F.3d 313, 322–24 (5th Cir. 2014).; *In re* Williams Sec. Litig. —WCG Subclass, 558 F.3d 1130, 1137–38 (10th Cir. 2009).

[220] *In re BofI Holding,* 977 F.3d at 797.

[221] *In re* Nektar Therapeutics Sec. Litig., 34 F.4th 828 (9th Cir. 2022).

[222] *Id.* at 833–34.

[223] *Id.* at 834.

report as reliable in revealing material misstatements.[224] As in *In re BofI*, the *Nektar Therapeutics* Court held that the short report failed to rise to the level of a corrective disclosure. Although the report analyzed "disparate sources and connected data in ways that were not plainly obvious . . . it is not plausible that the market would perceive the [report] as revealing false statements because the nature of the report means that investors would have taken its contents with a healthy grain of salt."[225] The *Nektar Therapeutics* Court did not foreclose the possibility of an anonymous short report to functioning as a corrective disclosure, but it did emphasize the "high bar that plaintiffs must meet" when relying on such reports.[226]

The Third Circuit likewise permits short reports to satisfy loss causation, with the leading case being *In re Merck*.[227] In that case, a Wall Street Journal reporter undertook a scrutinizing analysis of Merck's SEC-required public disclosures. Merck is a leading pharmaceutical company—one of the top five largest in the world.[228] In its S-1 filing, Merck related that it had recognized revenue from a certain business segment but failed to state how much this revenue was.[229] To uncover how much revenue this segment generated and where the revenue was coming from, one needed to employ only basic arithmetic by cross-referencing a few numbers disclosed in Merck's public filings. Merck's stock price remained steady for the two months following disclosure of this S-1. However, during this period, a Wall Street Journal reporter did that math and determined that this business segment was recognizing revenue from co-payments to the tune of five billion dollars.[230] However, Merck was not supposed to be recognizing co-payment revenue in this way, which meant it had overinflated its net revenues by at least five billion dollars.[231] The day the reporter published these findings, Merck's stock dropped four percent.[232] Within three weeks, it had fallen nearly

[224] *Id.* at 840.
[225] *Id.*
[226] *Id.* at 839.
[227] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).
[228] Angus Liu et al., *The Top 10 Most Profitable Pharma Companies in 2021*, FIERCE PHARMA (June 14, 2022, 10:00 AM), https://www.fiercepharma.com/special-reports/top-10-most-profitable-pharma-companies-2021 [https://perma.cc/PMF5-LY9D].
[229] *In re Merck & Co.*, 432 F.3d at 264.
[230] *Id.*
[231] *Id.*
[232] *Id.*

twenty percent.[233] A class action brought by shareholders under Rule 10b-5 promptly followed.[234]

The Third Circuit held that the Wall Street Journal's report did not amount to a corrective disclosure and therefore could not satisfy loss causation. The Court, however, focused on the simplicity of the math underlying the report. "The calculation from Merck's S–1 was somewhat [] complex—it required some close reading and an assumption as to the amount of the co-payment. But the added, albeit minimal, arithmetic complexity of the calculation hardly undermines faith in an efficient market."[235] In addition to the simplicity of the calculations underlying the alleged corrective disclosure, the Court emphasized how large Merck was. Because of this, the Third Circuit felt that "it is simply too much for us to say that every analyst following Merck, one of the largest companies in the world, was in the dark."[236] In the end, the Court "decline[d] to decide how many mathematical calculations are too many or how strained assumptions must be" for an investigative report to constitute a corrective disclosure,[237] teeing up a recent district court case from the circuit that establishes the very boundaries the Third Circuit passed on drawing in *Merck*.

In *Aurora Cannabis*, the District of New Jersey confronted a case where a cannabis company entered into an alleged sham transaction that materially inflated Aurora's financial metrics.[238] In an attempt to plead loss causation, the plaintiffs cited four separate reports.[239] Two of these were reports from the company itself, one was a report done by Yahoo Finance, and the final report was done by an investment analyst working for a cannabis research group known as the Cannalysts.[240] The Court ruled the company reports did not amount to corrective disclosures.[241] As to the other two reports, the defendants argued that they could not function as a corrective disclosure because they were based on publicly available information.[242]

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233 *Id.*

234 *Id.* at 265.

235 *Id.* at 270.

236 *Id.*

237 *Id.* at 271.

238 *In re* Aurora Cannabis Inc. Sec. Litig., No. 19-cv-20588, 2023 WL 5508831, at *1 (D. N.J. Aug. 24, 2023).

239 *Id.* at *2.

240 *Id.*

241 *Id.* at *4–5.

242 *Id.* at *6.

The Court disagreed with the defendant's argument as to the two remaining reports. Rather, the Court held that loss causation was adequately plead because the Cannalyst report and the Yahoo report qualified as corrective disclosures.[243] This is because those reports did not "merely elucidate the magnitude of a previously disclosed metric, and it involved more than a 'reporter simply [doing] the math' or 'performing one subtraction and one multiplication' from information in a single public filing."[244] Indeed, "each provided new information as to the seriousness and extent of the Company's alleged fraud."[245] This was the case even though Third Circuit previously conceded that it had "one of the clearest commitment to the efficient market hypothesis,"[246] which should have theoretically doomed the plaintiff's argument that the reports based on publicly available information could satisfy loss causation.[247]

The Fifth Circuit has taken a tack similar to that of the Third. It too considers the sophistication behind a report's analysis before determining whether plaintiffs can use it to plead loss causation. In *Amedisys*, the Fifth Circuit considered the case of a company that committed extensive Medicare fraud.[248] The company ordered medically unnecessary visits for their patients "in order to hit the most lucrative Medicare reimbursement thresholds."[249] Eventually, financial investigators caught on to this tactic and published reports calling out Amedisys's misconduct. For instance, in 2010, the Wall Street Journal hired a Yale professor of healthcare finance to prove that Amedisys was ordering medically unnecessary visits. After the article was published, the company's stock fell nearly seven percent.[250] However, the District Court dismissed the plaintiffs' claims, holding that the article was "based on publicly available Medicare records, and as such, does not reveal any new information to the marketplace" and therefore could not be used to show loss causation.[251]

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[243] *Id.*

[244] *Id.* (quoting *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 270–71 (3d Cir. 2005)).

[245] *Id.* at *6.

[246] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 269 (3d Cir. 2005) (quotations omitted).

[247] For a discussion about the extent to which efficient market theory can be imported into securities fraud claims, see Langevoort, *supra* note 15.

[248] Pub. Emps. Ret. Sys. of Miss. v. Amedisys, Inc., 769 F.3d 313 (5th Cir. 2014).

[249] *Id.* at 317.

[250] *Id.* at 318.

[251] *Id.* at 323.

The Fifth Circuit reversed. Specifically, the Fifth Circuit rejected the district court's finding that simply because a report is based on public information that it cannot be a corrective disclosure. The "WSJ Article [cannot] be justifiably pushed aside simply because the data it was based upon may have been technically available to the public, given that the raw data itself had little to no probative value in its native state."[252] Rather than bar reports based on public information from being corrective disclosures, the Fifth Circuit takes a pragmatic approach and considers whether there are factors indicating that the reports contents were not yet picked up by the "efficient market." Whether the data requires expert analysis to uncover its meaning and whether other experts in the field deem the report technically complex are some such factors.[253]

The Sixth Circuit has also joined in refusing to categorically prohibit reports based on public information from classification as corrective disclosures. In *Norfolk County Retirement*, the largest for-profit healthcare system in the United States—Community Health Systems—allegedly provided in-patient treatment for illnesses and symptoms that should have been treated as an out-patient visit.[254] This allowed Community to bill much higher rates to Medicare. To determine whether a patient should be treated as in or outpatient, the medical provider working for Community used a guide created by Community called the "Blue Book."[255] The Blue Book essentially directed its providers to commit Medicare fraud by encouraging medically unnecessary visits to their patients.[256] The company never referenced this guide in public despite it being the reason for Community's strong earnings.

Eventually, one of Community's competitors issued a report containing expert analyses showing that there were suspiciously high rates of inpatient visits at Community healthcare facilities and revealed the existence of Community's Blue Book.[257] These experts based their findings on publicly available admissions data. From these analyses, experts in the healthcare industry concluded "that Community not only admitted more inpatients than other hospitals but did so in a manner that was clinically improper"[258] and that the practice "served to overstate [Community's] growth statistics, revenues, and profits, and has created a

[252] *Id.*

[253] *Id.* (noting the expert that noted the analysis required technically complex work).

[254] Norfolk Cnty. Ret. Sys. v. Cmty. Health Sys., Inc., 877 F.3d 687 (6th Cir. 2017).

[255] *Id.* at 690 (not to be confused with the Bluebook that governs technical citations in legal writing).

[256] *Id.*

[257] *Id*. at 691.

[258] *Id.* at 697.

substantial undisclosed financial and legal liability[.]"[259] The plaintiffs in the case attempted to use these reports to satisfy loss causation in their 10b-5 suit, but the district court dismissed the case because the reports allegedly did not satisfy loss causation.[260] Plaintiffs appealed.

At the Sixth Circuit, Community argued that because the reports revealing the alleged fraud were based on publicly available data, they could not be used to satisfy loss causation. The "Blue Book," for instance, "was copyrighted and thus presumably available for inspection at the Library of Congress."[261] Further, Community argued that because the reports used publicly available admissions data, they could not be corrective disclosures. Many circuits, like those discussed in Part IV.A.i, would hold that the strong form of the efficient market prohibits these reports from constituting corrective disclosures because the information was nominally publicly available even if it were not practically so.

The Sixth Circuit refused to adopt the categorical rule barring publicly available information from being the basis for a corrective disclosure. Rather, the Court adopted a functional analysis that nearly completely disregarded whether the information was publicly available, instead focusing on if the information's substance was new to the market.[262] As to the revelation of the Blue Book, the Court did not care that it was nominally publicly available because investors "had no greater reason to travel to Washington to inspect the Blue Book than they had to inspect, say, Community's articles of incorporation."[263] And as to the publicly available admissions data underlying the report, the Court turned the standard corrective disclosure analysis on its head, focusing on whether the report disclosed "plausibly new" information, not whether the report was based on public information. And because learning that Community was improperly inflating its inpatient admissions was "plausibly new" information for the market, indicated by a 35 percent stock price decline immediately after the report's publication, the Sixth Circuit allowed the expert analyses to serve as corrective disclosures.[264]

These courts represent the four circuits that permit reports based on publicly available information to function as corrective disclosures. The Third Circuit conducts an analysis that focuses on the report's technical complexity to determine whether a report "provided new information as to the seriousness and extent of the

[259] *Id.* at 691.
[260] *Id*. at 693.
[261] *Id.* at 697.
[262] *Id.* at 695.
[263] *Id.* at 697.
[264] *Id*.

Company's alleged fraud."[265] The Fifth Circuit likewise heavily weighs the report's technical complexity in determining whether it can be a corrective disclosure,[266] as does the Sixth.[267] The Ninth Circuit's opinions in *In re BofI* and *Nektar Therapeutics* are the leading commentary in the space and tie together the case law this article has reviewed. There, the Ninth Circuit adopted a two-part inquiry: first, is the report sufficiently complex that it revealed new information to the market? And second, if it does reveal new information, would market participants rely on the report given its author, any conflicts of interest, and the report's complexity.[268]

While these circuits adopt a broadly similar approach in that they reject the strong form of the efficient market theory—unlike the Second, Fourth, Tenth, and Eleventh Circuits—some circuits weigh factors more heavily than others, or not at all. Thus, in addition to there being a circuit split about the threshold question of whether short reports based on public information can be a corrective disclosure, there is also circuit split on which factors should be considered and how heavily they should feature in determining whether a report can be a corrective disclosure. The next Part of this article explores those factors and reviews whether and how heavily they are weighed by different circuits.

B. Under What Circumstances Can a Short Report Be a Corrective Disclosure?

As discussed, some courts do permit short reports to be a corrective disclosure capable of satisfying Rule 10b-5's loss-causation element. However, courts diverge on the issue of under what circumstances a short report may be deemed to qualify as a corrective disclosure. Courts have failed to adopt a clear standard because permitting a report based on publicly available information to be a corrective disclosure runs headlong into the efficient market hypothesis. Loss causation must "demonstrate[] that the fraudulent misrepresentation actually caused the loss suffered,"[269] yet the efficient market holds that all publicly available information is already reflected in a stock's price. For a short report to cause a stock price to fall, the report therefore must be outside the scope of the efficient market. In essence, then, courts are assessing which combination of

[265] *In re* Aurora Cannabis Inc. Sec. Litig., No. 19-cv-20588, 2023 WL 5508831, at *6 (D.N.J. Aug. 24, 2023).

[266] *See* Pub. Emps. Ret. Sys. of Miss. v. Amedisys, Inc., 769 F.3d 313 (5th Cir. 2014).

[267] *See Norfolk Cnty. Ret. Sys.*, 877 F.3d at 697.

[268] *See also In re* Nektar Therapeutics Sec. Litig., 34 F.4th 828, 840 (9th Cir. 2022).

[269] Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 173 (3d Cir. 2001).

factors must be present for a report to have escaped the efficient market's grasp, and which factors must be present to show that the market relied on the report.

Some common factors arise throughout the line of cases permitting short reports to be corrective disclosures. From these factors, a two-step inquiry has emerged.[270] The first set of factors deals with the report's substance. That is, is the short report the product of basic arithmetic or is it the product of elaborate technical analysis that is well-beyond the grasp of the average investor, and is it reasonable to assume that Wall Street analysts did not already internalize the substance of the report? If the answer to these questions is yes, it is likely that the report is revealing information that has not already been incorporated by the efficient market.

The second set of factors relates to the report's author. This inquiry determines whether the market would have deemed the report sufficiently credible to inform their trading. A report authored by a person or entity lacking credibility will not be relied on by the market, and the report thus cannot be used to show loss causation. Questions relating to this determination ask whether the author is pseudonymous or anonymous. And, does the author have a financial interest in the report's contents or has the author disclaimed the report's accuracy? If the answers to these questions are yes, then the report is less credible. If the report is less credible, then it is less likely that the market relied on it, which means that it is less likely that the report caused the price decline under review, and it therefore cannot be used to satisfy loss causation.

i. The Short Report Must be Complex

The circuits permitting a short report to satisfy loss causation agree that such reports must be complex. Although this standard eschews precise definition, the thrust of the analysis relates to whether the report reveals information that has not yet been incorporated into the stock's price by the efficient market. What factors can be combined to reach this level of complexity is circumstantial and fact intensive. In *Merck*, the Third Circuit held that a Wall Street Journal article in which the investigation consisted of making one assumption and engaging in basic arithmetic did not reveal new information to the market, largely because the

[270] It is worth noting that it is unclear whether these steps are subject only to Fed. R. Civ. P. 8's "plausibility" pleading standard, or rather Fed. R. Civ. P. 9(b)'s "particularity" pleading standard. There exists a circuit split on this issue as well and the Supreme Court denied certiorari in a case that presented the opportunity to address that question. *See* Petition for Writ of Certiorari, Amedisys, Inc. v. Public Employees' Retirement System of Mississippi, 2015 WL 1478006 (2015) (No. 14-1200) (cert. denied).

investigation was on one of the largest companies in the world.[271] Thus, whether information in a report based on publicly available information is "new" can be a function of both the report's complexity and the size of the company being targeted. This makes sense in light of the efficient market hypothesis as it is widely understood that "[t]he markets for some securities are more efficient than the markets for others."[272] Thus, overcoming the efficient market presumption in the loss-causation analysis takes greater degrees of sophistication when the company is larger because it trades in a relatively more efficient market to begin with.

However, company size aside, the circuits do not agree on what level of complexity is necessary. The Wall Street Journal's basic arithmetic in *Merck* was insufficient, while the *Aurora Cannabis* Court interpreted *Merck* to allow a report based on public information that revealed "new information as to the seriousness and extent of the company's fraud" to function as a corrective disclosure.[273] There, *Aurora Cannabis* merely required that the short report be derived from more than one public filing, and involve more than basic arithmetic, but provided little precedential guidance.[274]

The Fifth Circuit did permit a Wall Street Journal report to be classified as a corrective disclosure when a professor of healthcare finance authored it. It held that the report's complexity made it plausible that "the efficient market was not aware of the hidden meaning of the Medicare data that required expert analysis, especially where the data itself is only available to a narrow segment of the public and not the public at large."[275] This finding was bolstered by the declaration of a Ph.D. healthcare economist who told the Court that "it is highly unlikely that anyone other than a specialized Medicare researcher would have possessed the knowledge required to successfully obtain and manage the underlying data presented in the WSJ analysis."[276] The Sixth Circuit too noted that a short report that employed expert healthcare consulting firms and their analyses made the short

[271] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 271 (3d Cir. 2005).

[272] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2409 (2014) ("*Basic*'s presumption of reliance thus does not rest on a 'binary' view of market efficiency. Indeed, in making the presumption rebuttable, *Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.").

[273] *In re* Aurora Cannabis Inc. Sec. Litig., No. 19-cv-20588, 2023 WL 5508831, at *6 (D.N.J. Aug. 24, 2023) (quoting Hall v. Johnson & Johnson, No. 18-1833, 2019 WL 7207491, at *27 (D.N.J. Dec. 27, 2019).

[274] *In re Aurora*, 2023 WL 5508831, at *6.

[275] Pub. Emps. Ret. Sys. V. Amedisys, Inc., 769 F.3d 313, 323 (5th Cir. 2014).

[276] Brief for Plaintiffs-Appellants at 36–37, Pub. Emps. Ret. Sys. V. Amedisys, Inc., 769 F.3d 313 (5th Cir. 2014) (No. 13-30580).

report more likely to be a corrective disclosure, especially because the consultants corroborated each other's findings.[277] Future plaintiffs would benefit from bolstering their reports with expert declarations and analyses that establish the short report in question reveals insights "beyond the ken of most investors."[278]

The Ninth Circuit has found two different short reports as complex enough to have been beyond the ken of the efficient market. In *In re BofI*, the Ninth Circuit found that the following set of circumstances was sufficient to constitute a revelation of new information to the market: "the posts required extensive and tedious research involving the analysis of far-flung bits and pieces of data;"[279] the authors scoured "hundreds of Uniform Commercial Code filings, bankruptcy court documents, and other companies' registration documents;"[280] and the authors discovered novel investigative leads that BOFI tried to conceal from the market.[281] And in *Nektar Therapeutics*, the Ninth Circuit held that a report that "pulled together disparate sources" and made nonobvious insights by cross-checking statements made by Nektar at various conferences was a report that "probably" provided the market with novel information.[282] Thus, the Ninth Circuit cases give credit where a short report generates its conclusions by cross-referencing various documents, even if they are publicly filed. The more "far-flung" the bits of evidence and the more engaged the research, the more likely it is to be a corrective disclosure.

Taking these cases together, patterns emerge. A short report provides new information to the market when the report reflects a high degree of technical sophistication, which must be relatively higher when the company is well-established and likely already highly scrutinized by market participants. When a report cross-references various public filings to investigate a lead and make a plausible claim, such a report is more likely to be sufficiently sophisticated. The more tedious the investigation, the more likely the report is to provide new information. And when the analysis is more quantitative in nature, that analysis must be more than mere arithmetic for it to be a corrective disclosure. Plaintiffs must show that the report is beyond the capabilities of most investors, which can be bolstered by submitting expert declarations confirming that the corrective disclosure is indeed complex.

[277] Norfolk Cnty. Ret. Sys. V. Cmty. Health Sys., Inc., 877 F.3d 687, 697–698 (6th Cir. 2017).

[278] *Id.*

[279] *In re* BofI Holding, Inc. Sec. Litig., 977 F.3d at 797 (9th Cir. 2020).

[280] *Id.*

[281] *Id.*

[282] *In re* Nektar Therapeutics Sec. Litig., 34 F.4th 828, 840 (9th Cir. 2022).

ii. The Short Report Must Induce Reliance

Even if a short report is complex enough to provide the market with new information, the report itself must also be trustworthy enough to have induced the market to rely on it. If it does not, then it cannot be said to have "caused" any subsequent price drop, and thus cannot satisfy Rule 10b-5's loss-causation requirement. As with complexity, the circuits are split on when an author or report is sufficiently credible to induce reliance. Because the Ninth Circuit is the only circuit to have dealt with anonymous and pseudonymous reports, the current understanding of this step of the inquiry is informed largely by that circuit.

In both *In re BofI* and *Nektar Therapeutics*, the Ninth Circuit refused to permit an anonymous short report to be used as a corrective disclosure despite finding the report provided the market with new information. This was because the Court found the market would have taken the reports with a grain of salt given that the authors were anonymous, had a noted financial interest in their reports, and publicly disclaimed the accuracy of their writings. This is sensible, but likely overstates how the market perceives the credibility of an analyst with a financial interest that disclaims the accuracy of their claims.[283] Nevertheless, the Ninth Circuit has not yet created a per se bar on anonymous reports from being corrective disclosures even if the case law's inertia trends steadily in that direction.[284]

The Sixth Circuit, by contrast, adopts a relatively pure "fraud-on-the-market" approach to ascertaining reliance. This is the idea that "when a corrective disclosure reveals the fraud to the public and the [company's share] price subsequently drops," it constitutes a prima facie case of loss causation.[285] This theory was again adopted in *Norfolk County Retirement*, wherein the Sixth Circuit noted that the "disclosures—and the speed at which Community's share price fell after them—make it at least plausible that the disclosures had something to do with the Funds' losses."[286] No other circuit has imported such a practical fraud-on-the-market theory to loss causation when reviewing whether a short report constitutes a corrective disclosure.

[283] That the Ninth Circuit overstates these factors is explored thoroughly in Part V.B, below.

[284] *Nektar Therapeutics*, 34 F.4th at 839 (noting that plaintiffs have a high bar when they rely on self-interested, anonymous short sellers).

[285] *In re* KBC Asset Mgmt. N.V., 572 F. App'x 356, 360 (6th Cir. 2014) (quoting *In re* Williams Sec. Litig.-WCG Subclass, 558 F.3d 1130, 1137 (10th Cir. 2009)).

[286] Norfolk Cnty. Ret. Sys. v. Cmty. Health Sys., Inc., 877 F.3d 687, 696 (6th Cir. 2017).

Thus, the circumstances under which a short report can be a corrective disclosure relies on two different inquiries, in the circuits that permit them. First, whether the report reveals new information and second, whether the report induced market activity. As surveyed, when a report reveals new information is indeterminate and highly contextual. And the second step, which is often implicated by anonymous reports, requires showing that investors would not take the report with a grain of salt. The circuits do not agree on what is required to meet these standards, and the Supreme Court should take it upon itself to set forth a clear test that determines when a short report can be considered a corrective disclosure.

IV. LOOKING AHEAD: THE SUPREME COURT SHOULD ADOPT TWO TESTS TO DETERMINE WHEN A SHORT REPORT IS A CORRECTIVE DISCLOSURE

The analysis in Part IV of this Article exposes clear fault lines in the jurisprudence related to short reports' ability to constitute a corrective disclosure. Courts are split on the threshold question of whether a short report can ever constitute a corrective disclosure. In addition, those federal courts permitting short reports to constitute corrective disclosures have likewise been unable to consolidate around a standard under which a short report can do so. Such a breach between federal courts renders the issue ripe for Supreme Court review.

As a threshold matter, short reports should be able to constitute a corrective disclosure under certain circumstances, as demonstrated by the Third, Fifth, Sixth, and Ninth Circuits. As the Luckin Coffee case study elucidates, such reports often reveal fraud to the government, the marketplace, and even to the company itself. Titans of finance, like Warren Buffett, and the deans of securities law, like Professor John Coffee, have likewise noted the beneficial role that short sellers and their investigations can have on capital markets. And SEC Commissioner Uyeda has described that short sellers help curb abusive pump-and-dump schemes and other upside manipulators, which benefits the market as a whole.[287] Given this, such research should be encouraged, because "[w]hy should anyone make the effort to conduct research if there will be no individualized reward for such efforts?"[288] With this in mind, there clearly exists a strong policy rationale for permitting short reports to satisfy the loss-causation requirement under certain circumstances.

Moreover, the efficient market that exists in circuits prohibiting reports based on publicly available information is a market that exists only in theory. Indeed, the

[287] Uyeda, *supra* note 3.
[288] *Id.*

Supreme Court has described,[289] and reaffirmed,[290] that the efficient market hypothesis is "modest," not talismanic. The modest theory that the Supreme Court has adopted is not the flawless one that some courts believe exist, as "[t]he notion of perfect efficiency is an unrealistic benchmark that is unlikely to hold in practice."[291] Thus, the circuits that adhere to the strongest form of the efficient market theory are not just being unrealistic but are also deviating from the Supreme Court's own description of what the efficient market demands. Accordingly, it cannot be said—as some courts have contended—that because the reports contain publicly available information, that these reports are categorically excluded from being a corrective disclosure.

Courts should roll up their sleeves and review the facts to determine if a given report constitutes a correct disclosure, while also taking to heart modest assumptions that reflect the reality of 21st century capital markets. This Part of the Article suggests two alternative tests that the Court could adopt to address what factual circumstances give rise to a short report capable of qualifying as a corrective disclosure: the multifactor test and the "sparking a government investigation" test.

A. The Multifactor Test

The multifactor test should, as its name suggests, consider a variety of factors to determine if a short report constitutes a corrective disclosure and therefore satisfies loss causation. This test is already deployed to varying degrees by circuits rejecting a dogmatic commitment to the efficient market theory. However, these circuits inappropriately weigh certain factors.

When determining whether a short report constitutes a corrective disclosure, technical complexity should be the focal point of the analysis—which is already largely the case. Because the efficient market exists, albeit to varying degrees, the larger the company, the more insightful and sophisticated a report should be before a court considers it a corrective disclosure.[292] The more widely watched a company, the more sophisticated a report might need to be. By contrast, a startup with hardly an analyst reviewing the company should require a comparatively less complex report to be a corrective disclosure. This essentially forces courts to consider a given stock's "relative efficiency," which is likely "a more useful concept than the all-or-nothing view taken by much of the traditional market-

[289] Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988).

[290] Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 272 (2014).

[291] Surana, *supra* note 202 at 335.

[292] *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).

efficiency literature,"[293] as relative efficiency is realistic; the all-or-nothing approach "exists only in the idealized frictionless world of the imagination."[294] Indeed, expecting courts to undertake this relativistic comparison is not asking too much; academics have released comprehensive lists ranking the relative efficiencies of stocks on the Nasdaq and New York Stock Exchange.[295]

When courts deploy this multifactor analysis to draw an inference on whether a report was sufficiently complex to be a corrective disclosure, they should inform their analysis with how the market reacted to that report. When reviewing claims brought under Rule 10b-5, courts should not ignore the marketplaces that they are helping remain fair and efficient. To be sure, courts should not attempt their own financial econometrics analysis for claims like this. Nevertheless, common sense can go a long way in determining whether a given report caused a loss to ensue by revealing fraud to the market. A dramatic and sustained drop in a company's stock price in response to a report militates toward finding that the report is a corrective disclosure; by contrast, a minimal drop or a quick rebound indicates that the report seemingly failed to reveal novel or reliable information. In sum, the inquiry into whether a report was sufficiently complex should be undertaken with an eye toward ensuring the report did indeed relate news to the market that the market had yet to internalize (i.e., the information is new) and in a way that would cause the market to react (i.e., the information was reliable).

Some factors considered by federal courts should receive lesser weight. The Ninth Circuit, for instance, considers anonymity and financial interests as reasons militating against finding the report to be a corrective disclosure. The Ninth Circuit's position essentially contends that authors sullied by a financial interest or remain anonymous are less reputable, and therefore their reports are less likely to induce the market to react.[296] Accordingly, such reports are less likely to *cause* a price decline. This position is in error, however, as the presence of a financial interest in one's writing is not probative of a given report's ability to induce reliance, nor is whether an author remains anonymous. Every analyst that issues what could be a short report likely has a financial interest in that report. And rather than focusing on who wrote the article, courts should be focused on its contents. Thus, discounting anonymity and financial interest in this balancing test would be

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[293] *See* JOHN Y. CAMPBELL ET AL., THE ECONOMETRICS OF FINANCIAL MARKETS 24 (1997).

[294] *Id.*

[295] Bharat Bhole et al., *Benchmarking Market Efficiency Indicators for Securities Litigation*, 2020 U. ILL. L. REV. ONLINE 96 (2020).

[296] *In re BofI Holding*, Inc. Secs. Lit., 977 F.3d 781 (9th Cir. 2020).

sensible because neither necessarily correlates with a report's legitimacy or its ability to relay fraud unknown to the market.

Indeed, the Sixth Circuit does not consider these factors, nor should other courts. In *Norfolk County*, the Sixth Circuit made no qualms about the fact that two separate and obvious financial interests may have infected the report.[297] There, the short report was issued by a competitor of the company that was the short report's target, which would be equivalent to Nike drafting a short report about Adidas. Moreover, the short report issued by the competitor was bolstered by expert analyses from healthcare consultancies that were hired by the short report's author.[298] Considering where the money was coming from, it is hardly surprising that the consultancies created reports bolstering the short report's claims. However, the Sixth Circuit—correctly—did not hold these facts against the plaintiffs, and instead focused on the substance of the revelation to determine whether the market would rely on the report—rather than the report's author or the existence of financial interests.

Moreover, the Ninth Circuit's insistence on disclaiming a report's accuracy, which short report authors often do, overexaggerates the reason for and effect of this boilerplate recitation. In both *In re BofI* and *Nektar Therapeutics*, the Ninth Circuit noted: "disclaimers from the authors stating that they made 'no representation as to the accuracy or completeness of the information set forth in this article'" weighed heavily against finding the short reports were corrective disclosures. This recitation is generally a disclaimer stating that the author does not guarantee the accuracy of their claims and that the report represents only the author's opinion. However, disclaimers like these provide important protection if authors are threatened with defamation suits. The global law firm Quinn Emmanuel notes that a short report's words are actionable in a defamation claim only when the report's statements can be construed as statements of fact rather than opinion.[299] Quinn Emanuel specifically points out disclaimer language like that at issue in *In re BofI* and *Nektar*, which suggests the disclaimers are a tactic to preempt a lawsuit more than they are representative of an author's lack of faith in their work. While the First Amendment repercussions of short reports are beyond the scope of this Article, courts should perceive a boilerplate disclaimer as a defensive strategy by short report authors to preempt litigation rather than as a true lack of faith in the author's analysis.

[297] Norfolk Cnty. Ret. Sys. v. Cmty. Health Sys., Inc., 877 F.3d 687 (6th Cir. 2017).
[298] *Id.* at 697.
[299] QUINN EMANUEL, *supra* note 46.

Lastly, that a report is authored anonymously should receive little weight in determining whether the market relied on the report. As Professor Mitts has demonstrated, traders do in fact rely on pseudonymous and anonymous reports.[300] To be sure, anonymity should be considered when determining whether a report induced markets to trade on it. But the Ninth Circuit, the only circuit to confront anonymous or pseudonymous reports, has essentially barred such reports from functioning as corrective disclosures because "reasonable investors" would have "taken [the report's] contents with a healthy grain of salt."[301] The relative weight of this factor should be less than that given to it by the Ninth Circuit.

Thus, the multifactor test should focus foremost on the report's complexity and the novelty of its insights, which can be deduced in part by how quick, dramatic, and sustained a fall in stock price is in the days, weeks, and months after a report is issued. That said, some factors courts have used to discount a report should be granted less weight. Although anonymity and financial interest could make it more difficult for a report to cause a stock to decline in price, courts weigh them too heavily in their analyses in the current corrective disclosure jurisprudence.

B. Sparking a Government Investigation Test

To be sure, circuits that maintain a zealous dedication to the efficient market will rebuff the multifactor test. However, they should nevertheless find that short reports presumptively satisfy a Rule 10b-5 plaintiff's requirement to plead loss causation when they spark a government investigation. For instance, in *Meyer v. Greene*, a short report unveiled systemic fraud being perpetrated by the St. Joe Company. The short activist found so much fraud, in fact, that it spurred the SEC to pursue an enforcement action against St. Joe, reflected by the fact that the SEC referenced the short report multiple times in their own court filings. Despite this, the Eleventh Circuit refused to permit that report to satisfy loss causation. Luckin Coffee's fraud was likewise brought to light, largely, by a short report. Shortly after Muddy Waters detailed Luckin Coffee's fraud, the SEC opened an investigation and Chinese authorities considered bringing criminal charges.[302] However, despite revealing steep fraud, the Southern District of New York would not have let Muddy Waters' report be considered a corrective disclosure had it

[300] Mitts, *supra* note 6.
[301] *In re BofI Holding*, 977 F.3d at 797.
[302] Xinyue et al., *supra* note 33.

been able to consider that question before Muddy Waters entered into a settlement agreement with the SEC.[303]

That a report can spark a government investigation but be said to not have disclosed material information to the market is a difficult position to defend. A report that sparks a government investigation should be credited in private litigation with the rebuttable presumption that it satisfies loss causation, which would deputize short activists in the quest to uncover market fraud. While short activists already do this to some extent, exemplified by the Luckin Coffee case study and the decisions reviewed in Part IV, creating a greater incentive for them to do so by increasing the value their reports can generate would be beneficial for fighting fraud and, therefore, would help create a market that is more fair and efficient for regular investors.[304] It would also act as a prophylactic against future misconduct and aid those who are suing companies for past misconduct, rendering it more likely that aggrieved investors are made whole. Moreover, permitting short reports that spark government investigations to satisfy loss causation would parallel other parts of American regulatory enforcement, like the whistleblower statute, that rewards those who help the government combat fraud. Lastly, one scholar—Alexander Platt—has recently suggested that the SEC should more stringently regulate whistleblower attorneys' fees and awards, because Platt suggests private attorneys create efficiency, accountability and constitutional concerns for the SEC's whistleblower program.[305] However, if the SEC accepts Platt's critiques and reforms its whistleblower program accordingly, and thus reduces the net incentive for whistleblowers to file complaints with the SEC, an appropriate balance would allow suits that spark government investigations to be viable private actions in federal courts. This would address Platt's critique regarding the efficiency and agency capture issues posed by the whistleblower program, as more actions would be filed in federal court rather than with the SEC. This would also transfer part of the cost of the whistleblower programs from the SEC to civil defendants without necessarily reducing the overall incentive to investigate and report corporate misconduct. However, if the whistleblower

[303] Bernstein Litowitz Berger & Grossmann LLP, *In re Luckin Coffee Inc. Securities Litigation,* (Mar. 17, 2024, 1:50 PM), https://www.blbglaw.com/cases-investigations/luckin-coffee [https://perma.cc/B287-FWL9].

[304] *See* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497 (1997) ("The class action thereby has an important deterrent feature which give [sic] it a quasipublic character; it can thus be seen as an extension of the state's enforcement arm and an expression of society's will.").

[305] Alexander Platt, *The Whistleblower Industrial Complex*, 40 Yale J. Reg. 690, 695, 758 (2023).

program were reformed in a way that reduces the incentive to blow the whistle while the efficient market also stops such actions from being viable 10b-5 cases in federal court, the SEC could be creating a suboptimal enforcement regime.

CONCLUSION

Short activists and the reports that they create are indisputably valuable. While there is a vibrant debate about regulating short sellers on the margins, it is widely accepted that they are necessary to ensure that well-functioning capital markets remain well-functioning. This policy debate is relevant to the legal debate currently dividing the circuits. One-third of the circuits prohibit reports like this from being able to prove loss causation in a private action under Rule 10b-5 merely because they are based on publicly available information. One-third of the circuits, however, reject this position and permit reports based on publicly available information to satisfy loss causation, but remain divided on how exactly to arrive at that conclusion. The remaining third of circuits have not spoken on the issue. Given the lively debate around short selling and a matryoshka doll of circuit splits, the time is ripe for the Supreme Court to determine whether and when a report based on publicly available information can satisfy loss causation. In essence, the question is: how strong is the efficient market? Is it omnipresent, ubiquitous, and all-knowing? Or is it pragmatic? In the context of loss causation, the Supreme Court's own opinions suggest the latter. It would be salutary for them to confirm as much.