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SEC Moves to Curb Short Selling

By: Kara Scannell and
Jenny Strasburg

The Wall Street Journal
July 12, 2008

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SEC Moves to Curb Short Selling

Controversial Step Comes Amid Claims That Financial Stocks Were Manipulate

BY KARA SCANNELL
AND JENNY STRASBURG

WASHINGTON—The Securities and Exchange Commission took unprecedented action against short sellers on Tuesday, acting on a widespread concern that negative bets against bank and brokerage stocks might be exacerbating the financial sector's woes.

In a dramatic emergency order, the SEC said it would immediately move to curb improper short selling in the stocks of struggling mortgage giants Fannie Mae and Freddie Mac, as well as those of 17 financial firms, including Goldman Sachs Group Inc., Lehman Brothers Holdings Inc., Morgan Stanley and Merrill Lynch & Co.

The plan, which is expected to go into effect on Monday, will expire in 30 days. But the SEC will also begin considering whether to extend the new requirements to all stocks traded in the U.S. The actions represent one of the most extensive attempts by a government agency in recent years to control short selling.

It's far from clear whether the move, which sparked a barrage of criticism, will curb the activity of short sellers. While its aim is to

Reuters

GLOOMY PROGNOSIS: Treasury Secretary Henry Paulson, SEC Chairman Christopher Cox and Fed Chairman Ben Bernanke, before Congress Tuesday. New data and Fed projections signal tough sailing for U.S. economy. **Page A3.**

curb abuses, it also would add an additional layer of bureaucracy to legitimate transactions.

Some critics say the move is simply an attempt by the SEC to show that it is taking action when it is under pressure for not doing enough to police markets. SEC Chairman Christopher Cox, in particular, has come under fire for not being a more visible figure at a volatile time.

Short selling is a legitimate trading strategy in which traders aim to profit from falling stock prices. Shorting can act as a corrective force at times of rampant bullishness in markets, its defenders say. But it has long been controversial because it pits investors, notably hedge funds, against companies that are eager to see their share prices high.

Richard Baker, the former Louisiana congressman who is now president of the Managed Funds Association in Washington, the biggest hedge-fund industry group, said the SEC's emergency action "is aberrant, it's unusual, and it may be wi out precedent. I was a little s prised by the scope of this, speed with which the decis was made, and the potential c sequences to market functi ing." The MFA will seek me ings with regulators to disc their reasoning, he said.

The regulatory action is great symbolic importance Wall Street, which has co plained long and hard ab what they suspect is manipu tive trading in their stoc which have been pummeled t year. Bear Stearns Cos. implo in March and now is part of Morgan Chase & Co.; Lehma shares have plunged this y The financial firms placed un the SEC's protective umbr have been some of the hard hit in recent trading.

The chief executives at Lehn and Bear Stearns have made p vate calls in recent months among others, Goldman Sa Group Inc. CEO Lloyd Blankfei raise questions about whet Goldman was helping to fuel, e indirectly, pressure on their fir shares, according to people fa iar with the matter. (Please see lated article on Page C1.) Short

Please turn to page

SEC Makes a Controversial Effort to Restrict Short Selling

Continued from Page One
terest, or the amount of short positions outstanding, is at an all-time high, at 18 trillion shares, for NYSE Euronext listed stocks.

The battle between regulators and short sellers has a long history—dating back at least to the South Sea Bubble of the early 18th century—and short sellers have usually won. It's hard to prove that short sellers manipulate markets or that they perpetuate false rumors that pummel stocks.

In a short sale, a trader borrows stock and then sells it, in hopes it will later fall in price. If it does, the short seller then buys the stock in the open market at the lower price, returns what was borrowed, and pockets the difference.

The SEC said Tuesday's move aims to stop "unlawful manipulation through 'naked' short selling." Naked shorting refers to the practice of selling stock short without taking steps to borrow it.

Critics say short sellers band together and sell shares of a company all at once, overwhelming the market and driving its stock price down. That can set off a chain reaction, with shareholders getting nervous and selling. Critics say the short sellers then close out their bets at tidy profits. In practice, this is extremely difficult to do with big companies whose stocks are heavily traded, although smaller companies are more vulnerable.

Under current rules, a short seller must first locate shares to borrow, but does not have to enter into a contract with the share lender. Often, more than one trader is able to borrow the same shares, creating a multiplier effect in the size of the total short position.

Under the emergency order, a short seller would be required to have an actual agreement to borrow the shares. The new move would effectively take shares out of the market for borrowing, which could reduce the amount of stock available for selling short.

The SEC has started clamping down on short selling, indicating it is worried about the im-

short selling to drive down shares of Bear Stearns earlier this year. Lehman is engaged in a public fight with certain short sellers, which has also prompted an SEC investigation.

On Sunday, the SEC said it would crack down on firms or individuals that illegally spread false rumors. In its various short-selling investigations, the SEC has sent subpoenas to more than 50 hedge funds, some as recently as Monday.

Critics of the SEC's move Tuesday asked why certain financial firms were being protected—but not the broader market—especially when many of those firms are also active short sellers.

"For heaven's sakes, they're the very ones we believe have been doing this...to thousands of public companies," said James "Wes" Christian, a lawyer with Texas law firm Christian, Smith & Jewell, who represents companies who have filed lawsuits relating to short selling.

An SEC official said the agency focused on financial firms that were of a significant size. "Drastic falls [in stock prices] can end up destroying confidence in the firm altogether, which is not true for bricks-and-mortar industrial companies," the official said.

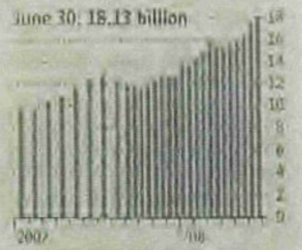
Evading Restrictions

It's unclear to what extent the emergency action will reduce short selling in the stipulated stocks. The financial companies have large "public floats," meaning many shares are available in the market for short sellers to borrow. James Angel, an associate finance professor at Georgetown University, said that if the rules were extended to other stocks, the biggest impact would be on thinly traded stocks that are hardest to borrow.

Charles M. Jones, a finance professor at New York's Columbia University, says there are numerous ways to evade restrictions on short selling. Traders are free to short U.S. stocks in overseas markets, unhindered

High Volume

NYSE short selling positions, in billions of shares



Note: NYSE began reporting short interest twice a month in September 2007

Source: WSJ Market Data Group

that could end up silencing investors who are among the first to point out problems at troubled companies.

"What do I think is really going on here?" he asked. "I think that regulators are very, very concerned about the collapse of the stocks of major U.S. financial institutions and are grasping at straws as to what to do about it." Mr. Tilson's hedge fund has had short positions on banks and brokerage firms, including Lehman, Washington Mutual Inc. and Wachovia Corp., as well as big bond insurers.

Some market observers say the SEC's elimination of the so-called up-tick rule in 2007 has contributed to the current market volatility, and they want the agency to reinstate that rule instead of taking the emergency action.

The up-tick rule barred short sellers from selling unless the stock price was rising, which had the effect of cushioning the market impact of such selling. It was a symbolic barrier against the kind of short selling that could cause stocks to fall precipitously.

Mr. Cox said the SEC was open to implementing some kind of similar price test, but he didn't elaborate.

For nearly as long as stock markets have existed, authorities have tried to restrict short selling. And for as long as they have tried, they have failed. In

short selling. The law remained in force for more than 150 years, even though, as financial historian Charles Duguid noted in 1901, "it was at no time seriously operative."

'Silly but Harmless'

On Apr. 10, 1792, the New York state legislature banned short selling. Five weeks later, two dozen stockbrokers banded together to sign the Buttonwood Agreement, which created what became the New York Stock Exchange, where short selling occurred with abandon. Last month, Pakistan banned short selling on the Karachi Stock Exchange for a month, after declines. In the 1990s, Hong Kong temporarily banned short sales, and the Malaysian finance ministry proposed that anyone caught short selling should be punished by caning. Neither measure prevented

those markets from falling during or after the 1998 Asian crisis.

Efforts to restrict short selling are "silly but harmless," says short-selling expert Owen Lamont, formerly a finance professor at Yale and now a money manager at DKR Fusion in Boston. Mr. Lamont adds that the SEC initiative "might have some impact on investors' faith in the system. But I don't see how it could possibly stabilize the markets in a fundamental way."

Other legal experts predicted the new SEC program would have minimal impact. "In the near term, short sellers may see some marginal increase in their cost of borrowing, as brokers adjust their operations," said Laurel FitzPatrick, a partner at the law firm Ropes & Gray LLP, who advises hedge funds on trading and other regulatory issues. "Ultimately, neither this rule, nor

the SEC's indications that they are looking to bring enforcement cases against sellers spreading rumors, will reduce short selling if sellers believe a stock is overvalued."

The SEC announcement didn't bolster shares of Fannie Mae or Freddie Mac, which fell 27% and 26%, respectively, on Tuesday.

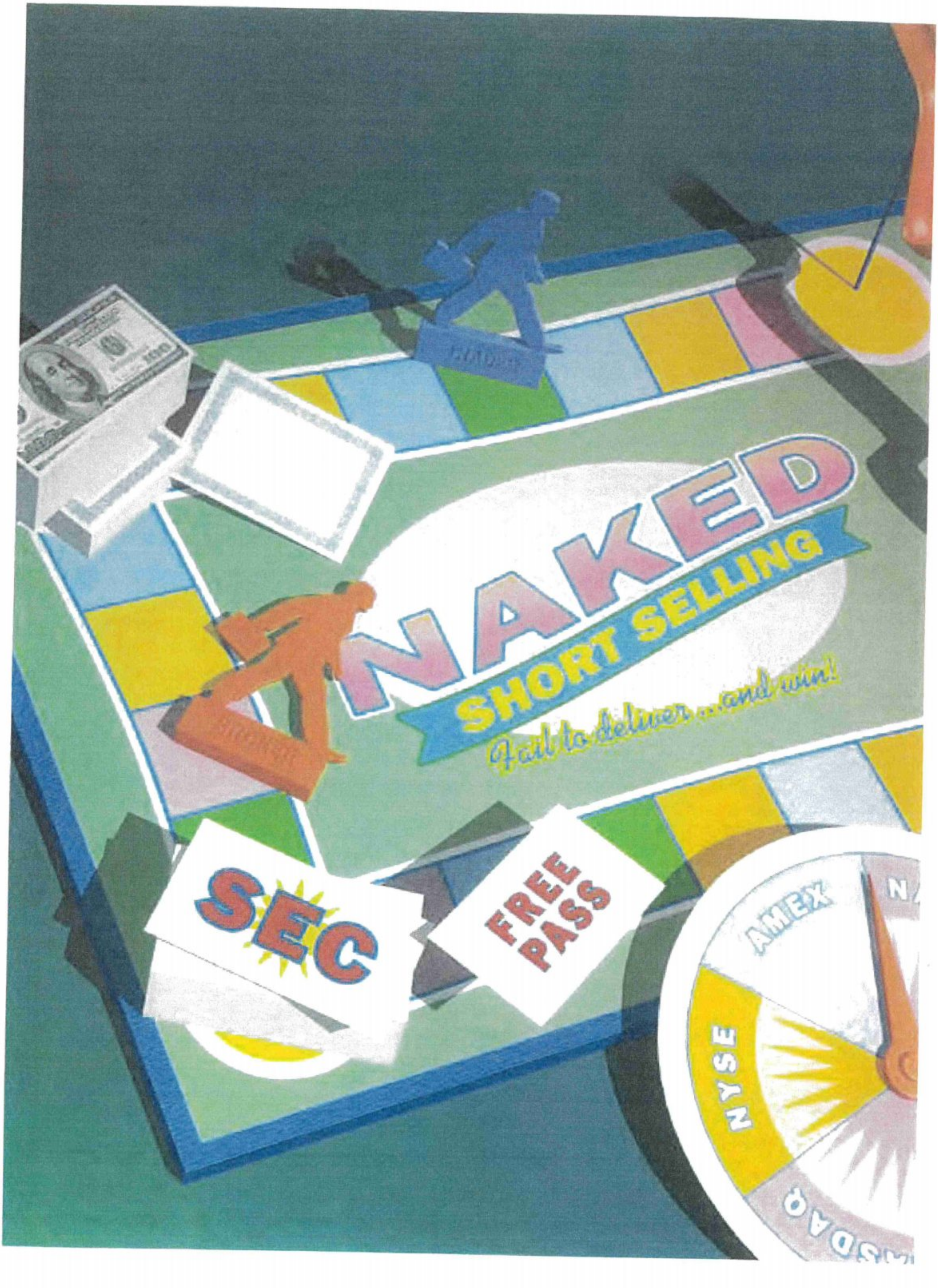
Short sellers have been targeting Fannie and Freddie more aggressively than they were a year ago. At the end of June, there were 138.7 million shares shorted of Fannie, compared with 17.2 million for June 2007. For Freddie, the figures were 82.8 million shares, versus 12.5 million a year ago.

—*Jason Zweig and Randall Smith contributed to this article.*

Games Short Sellers Play

By: Bob Drummond

BLOOMBERG, Volume 15
September, 2006


NAKED
SHORT SELLING
Fail to deliver ...and win!
SEC
FREE PASS
AMEX
NYSE

Games Short Sellers Play

Traders who sell shares they don't own—and haven't even borrowed—are driving down prices. More than 425 companies a month may be the victims of these schemes.

By Bob Drummond

Movie Gallery Inc. shares fell 20 percent on Feb. 3, their biggest nosedive in almost a decade. At the time, there didn't seem to be a reason for the jaw-dropping rout. Analysts who follow Dothan, Alabama–based Movie Gallery, the second-largest video rental chain in the U.S., speculated that investors were spooked after a large money manager cut its stake or that they were worried sales figures wouldn't meet expectations.

Another possible factor surfaced two weeks later, and it had nothing to do with financial performance. On Feb. 17, the Nasdaq Stock Market added Movie Gallery to a list of stocks considered, under a new U.S. Securities and Exchange Commission regulation, to be at risk for manipulation by naked short sellers. In naked shorting, traders who hope to profit from falling prices sell shares without borrowing stock. Using that strategy, naked short sellers can drive down prices by flooding the market with orders to sell shares they don't have.

"These people are lying, they're cheating and they're stealing," says Wes Christian, a Houston lawyer who represents Internet discount retailer Overstock.com Inc. and more than a dozen other companies that say their stocks were pummeled by naked shorting. "This is, in our opinion, the biggest commercial fraud in U.S. history."

Movie Gallery Chief Financial Officer Thomas Johnson says he has asked the SEC to investigate whether naked short sellers helped undercut the stock. "I'm throwing out the towel, saying 'Help me,'" Johnson, 43, says. "There are rules designed to deal with this, and people are still managing to do these naked short sales. It's extremely frustrating. It's like being on the front line and people are shooting you from every direction."

In traditional short selling, traders rely on a strategy that's the mirror opposite of the time-honored adage to buy low and sell high. Short sellers borrow stock through a broker

ILLUSTRATION BY ELIOT BERGMAN

and hope to profit by selling shares high and later buying them back at lower prices to repay the loan. Naked short sellers do the same thing, with one difference: They don't borrow any shares. Naked short selling isn't illegal in most cases, unless authorities can prove fraud, such as a scheme to manipulate stock prices.

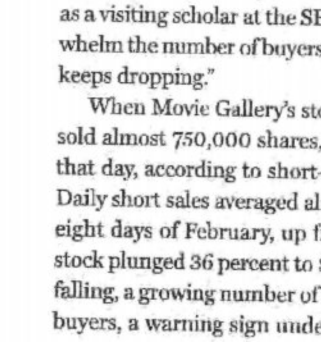
The threat to investors arises because traders in naked short sales aren't limited by the number of shares available to borrow. If a naked short seller doesn't intend to borrow stock, he can pump a theoretically unlimited volume of sales into the market, driving down a company's shares. Instead of hoping a stock will fall, like a traditional short seller, an unscrupulous naked short seller may be able to help make it happen.

Overstock.com CEO Patrick Byrne says naked short sales warp the market price of companies.

"If they don't have to borrow shares, there's nothing that keeps someone from selling and selling and hammering the market with sell orders," says Leslie Boni, a former University of New Mexico finance professor who studied naked short selling as a visiting scholar at the SEC in 2003 and '04. "They can overwhelm the number of buyers, and as the buyers dry up, the price keeps dropping."

When Movie Gallery's stock crashed on Feb. 3, short sellers sold almost 750,000 shares, or 11 percent of the shares traded that day, according to short-sale records compiled by Nasdaq. Daily short sales averaged almost 370,000 shares over the first eight days of February, up from 70,000 on Jan. 31, while the stock plunged 36 percent to $3.47 from $5.45. As the stock was falling, a growing number of sellers weren't delivering shares to buyers, a warning sign under SEC rules of possible naked short selling.

Nasdaq put Movie Gallery on its list of companies at risk of manipulation because from trades through Feb. 8, those undelivered shares topped 160,000, or 0.5 percent of Movie Gallery's total shares. When companies surpass that threshold, SEC rules impose restrictions on further short selling.



'These people are lying, they're cheating and they're stealing,' a plaintiffs lawyer says.

Patrick Byrne, chief executive officer of Salt Lake City–based Overstock.com, has been the most vocal executive charging that abusive short-selling schemes are draining the lifeblood from many companies. "I've been pouring kerosene on myself and setting myself on fire because I think there are global, systematic issues with naked short selling," Byrne, 43, says. "It's warping the market price of some small-cap companies and destroying American entrepreneurship."

As of July 10, Overstock.com had been on Nasdaq's list of potential naked-short-selling targets every day since April 22, 2005, and its shares had fallen 45 percent over that period.

Investors who specialize in selling short say naked shorting is rare and complaints from supposed victims are overblown. "The phrase I would use would be red herring," says Jim Chanos, 48, who runs Kynikos Associates Ltd., a New York–based hedge fund firm known for short selling. He says he's never used naked short selling as a technique. "It sounds ominous, it sounds nefarious and, by and large, it's a nonissue in the marketplace," he says.

Wall Street traders have long thought that most complaints about naked short selling come from executives at poorly managed companies looking for a scapegoat when investors sour on their stocks, says Peter Chepucavage, a securities lawyer who has worked for the SEC and is now at Plexus Consulting Group LLC in Washington. "The Street's view is that this never was a real problem, and that these guys are whiners," he says.

Phillip Marcum, CEO of Denver-based Metretek Technologies Inc., says he doesn't need excuses for his company's performance and generally doesn't give short sellers a second thought.

DOUGLAS PIZAC/AP-WIDE WORLD

"We're a real company, with real investors and real revenue," says Marcum, 62, whose company sells commercial electricity-backup systems and meters to measure gas-well production. Metretek shares quintupled in the 12 months through the end of March, when the company announced a $28 million sale of additional stock.

Still, the American Stock Exchange on April 10 put Metretek on its list of potential naked-shorting targets because of an increase in shares that weren't delivered to buyers. On March 30, Metretek's shares fell almost 7 percent as sales rocketed to 169,000 shares from a daily average of 11,000 a week earlier.

"You can't control somebody who shorts stock," Marcum says. "But they've got to play by the rules. It seems to me, there ought to be severe penalties if you sell short without borrowing the stock. Can't they find out who's doing this and do something about these people?"

The short answer is no. The SEC puts most of its restrictions on brokerages, not naked short sellers. In one exception, SEC rules forbid naked short sales in connection with stock offerings. The SEC and exchanges have been investigating possible fraud in those instances. "This is an area where we have seen problems, and you can expect enforcement actions," said Susan Merrill, the New York Stock Exchange's regulation enforcement chief, speaking to a securities industry conference in June.

In the past three years, the SEC has imposed a total of just under $24 million in penalties in five cases alleging that traders and investment firms illegally covered naked short sales using shares from stock offerings. Four cases were settled without admissions or denials of wrongdoing; the fifth is pending.

The reason company executives and short sellers debate the scope of naked short selling is partly because there aren't statistics that specifically measure such transactions. New York-based Depository Trust & Clearing Corp., which processes the vast majority of U.S. trading, does keep track of how much stock has been sold and not delivered on schedule to the purchasers. On an average day in March, those unsettled trades amounted to more than 750 million shares in almost 2,700 stocks, exchange-traded funds and other securities, according to Depository Trust & Clearing data obtained from the SEC through Freedom of Information Act requests.

Because there are innocuous reasons why stock may not get to the purchaser on time, such as paperwork delays, it's impossible to tell how many of those shares, known as failures to deliver, can be blamed on naked short sales, Depository Trust & Clearing spokesman Stuart Goldstein says. "We're not in a position to know why trades fail," he says.

Failed deliveries of shares to buyers do provide the foundation for an SEC rule designed to blunt potential market manipulation. The measure is part of a broader package of short-selling rules known as Regulation SHO, for Short Sales. The rule, called Reg SHO, was approved unanimously in 2004 after almost five years of consideration under three SEC chairmen.

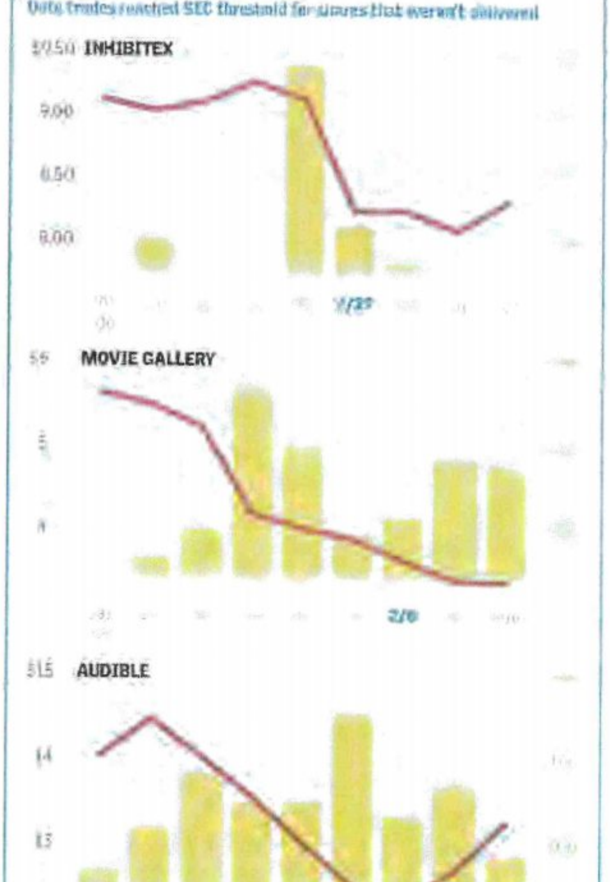
While Reg SHO doesn't outlaw naked short sales per se, it targets companies with enough failed deliveries to raise concerns about naked short selling, and it restricts further short sales of those stocks. Reg SHO's short-selling restrictions took effect in January 2005.

Reg SHO's naked-shorting provisions were designed to create a single SEC standard to replace individual rules that previously were set by each exchange. Supplanting exchange rules with one regulation meant the SEC, and not just market regulators, could police enforcement, says lawyer Chepucavage, 58, who helped draft Reg SHO. "There was a belief that the markets weren't aggressive enough in enforcing the rules," he says. "They tended to treat them as traffic ticket–type cases."

Under the SEC rule, Nasdaq, the NYSE, the American Stock Exchange and smaller markets must get daily reports

The plunge

Naked short sales may have driven down share prices before stock exchanges recognized that buyers weren't getting the shares they had bought.



Sources: Bloomberg, Nasdaq

from Depository Trust & Clearing about failed deliveries. When an exchange finds that a company has accumulated unsettled trades equal to at least 10,000 shares and 0.5 percent of outstanding stock for five consecutive trading days, it's subject to stricter requirements for future short sales. Exchanges keep the companies on these lists until failed deliveries fall back below the 0.5 percent level for five straight trading days.

Once a stock is on a list, Reg SHO requires any new short sales to be settled within 13 trading days, about 2½ calendar weeks. If shares haven't been delivered by that time, the brokerage involved in the sale must buy stock for delivery to the buyer.

Naked short sellers face no limit in flooding the market with stock sales without borrowing shares.

If it doesn't, Reg SHO forbids the broker from handling additional short sales of that company's shares unless it makes binding arrangements to borrow the necessary stock. During June, more than 425 companies were on an exchange list.

For the first year after the restrictions took effect in January 2005, the markets' lists suggest that Reg SHO cut down potential naked shorting. This year, the number of possible naked short sales has increased. From February through May, the average lists reported more stocks than in any month since August 2005. The number of new companies that surpassed Reg SHO's thresholds for the first time also jumped in February, to an average of 18.5 from as few as 15 in October 2005.

Depository Trust & Clearing's statistics on total failed deliveries of shares to buyers show a similar trajectory: In February and March, more than 700 million shares that were sold were not delivered to buyers on an average day, the highest levels since December 2004, the month before Reg SHO took effect.

Shares of Inhibitex Inc., a biotech drug developer in Atlanta's northern suburb of Alpharetta, plummeted 9.8 percent on Feb. 27, their biggest one-day drop in more than 14 months and the worst showing among more than 160 stocks in the Nasdaq Biotech Index. Nasdaq short sale records show that, during the two days ended on Feb. 27, short sellers traded almost 410,000 shares, up from fewer than 9,500 over the two preceding days. Enough traders failed to deliver stock over Reg SHO's limit for five straight days, so Nasdaq put Inhibitex on its list on March 8. Company executives didn't return calls seeking comment.

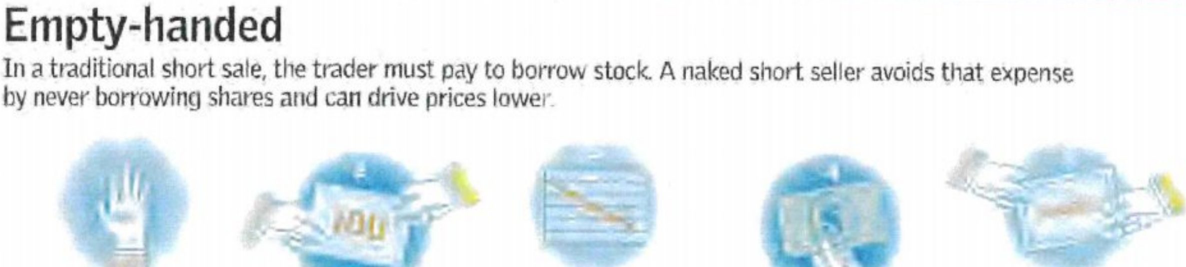
Audible Inc., which sells audio newspapers and books on the Web, had delivery failures that broke Reg SHO's threshold from trading on Jan. 4. Over five days, short sales had averaged 309,000 shares, almost triple the level for the preceding week. Audible, based in Wayne, New Jersey, ranked last in the 279-member Russell 2000 Technology Index during that stretch, falling 15.5 percent. "When you're manipulating the stock, you're taking away from investors, the business itself and our employees," says David Joseph, 37, an Audible vice president.

These apparent short sale jumps were allowed by a snag in Reg SHO. Under the rule, delivery deadlines apply only to short sales made after a company appears on one of the markets' lists. Naked shorting before that point, including the trades that put a company over the rule's thresholds in the first place, can remain unsettled indefinitely. "It's a loophole which allows an unlimited number of fails against anybody," says Robert Shapiro, an economist and former U.S. undersecretary of commerce, who is a consultant for Christian and other lawyers representing alleged victims of naked shorting.

On July 12, the SEC voted unanimously to propose changes to short sale regulations that would remove that clause and set deadlines for settling trades before a stock is added to

Empty-handed

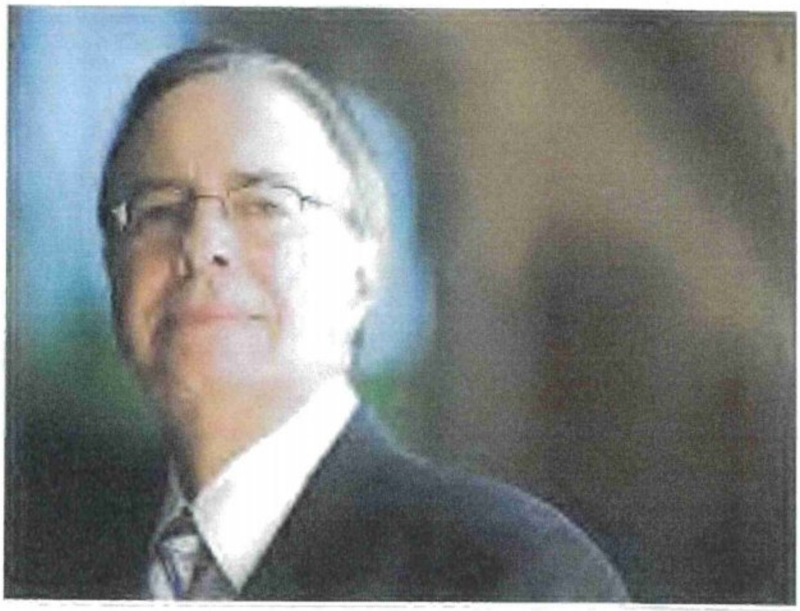
In a traditional short sale, the trader must pay to borrow stock. A naked short seller avoids that expense by never borrowing shares and can drive prices lower.



Source: Bloomberg

a threshold list. "There are still persistent failures to deliver in the marketplace, and some of that is undoubtedly attributable to loopholes in our rule," SEC Chairman Christopher Cox said.

The hole in the rule helps explain why some companies have stayed on the threshold lists for months or longer. As of July 17, New York–based Martha Stewart Living Omnimedia Inc., popular with short sellers since its eponymous founder's March 2004 trial and prison sentence for lying to federal investigators probing insider trading, had been on the NYSE's threshold list 383 times, or every day since Reg SHO took effect more than 18 months earlier.



Metretek CEO **Phillip Marcum** says severe penalties could stop naked short selling.

Taser International Inc. had a 379-day streak on Nasdaq's list that ended on July 11. The stun gun manufacturer based in Scottsdale, Arizona, had faced an SEC probe of its accounting and product safety claims, and its shares fell 78 percent in 2005. The SEC ended its inquiry in May without bringing any charges. Krispy Kreme Doughnuts Inc., a onetime Wall Street favorite that fell from grace as the SEC investigated its accounting in 2004, was on the NYSE list for almost 18 months. Shares of the Winston-Salem, North Carolina–based company plunged 54 percent in 2005.

Taser and Krispy Kreme are typical examples of companies pounced on by short sellers after setbacks threaten stock prices. "There's no doubt some companies have issues other than stock manipulation," Christian says. "But they should be allowed to succeed or fail on their own and not because of manipulative market conditions. This is not just attributable to whining companies that couldn't make it."

The stakes in the debate were raised when an alliance of lawyers, including Christian, 53, and fellow Houston litigator John O'Quinn—a billionaire from fees in a $206 billion tobacco industry settlement—joined forces to represent companies alleging fraud in naked shorting. The group has already filed 14 lawsuits against short sellers, brokers and Depository Trust & Clearing and plans at least 20, Christian says.

A short sale begins, like other trades, when investors tell their brokers they want to sell stock. Reg SHO says a broker must check to make sure a brokerage or institutional investor has stock it's willing to loan the short seller in time for settlement, which for most U.S. stock transactions takes place three business days after a trade. After confirming the availability of stock loans, brokers send a sell order to the appropriate exchange, where shares are sold to investors who want to buy the stock. There's no law requiring short sellers to actually borrow shares.

In a traditional short sale, buyers receive actual shares in a company. In a naked short sale, buyers effectively get an IOU promising that stock will be delivered at a later date.

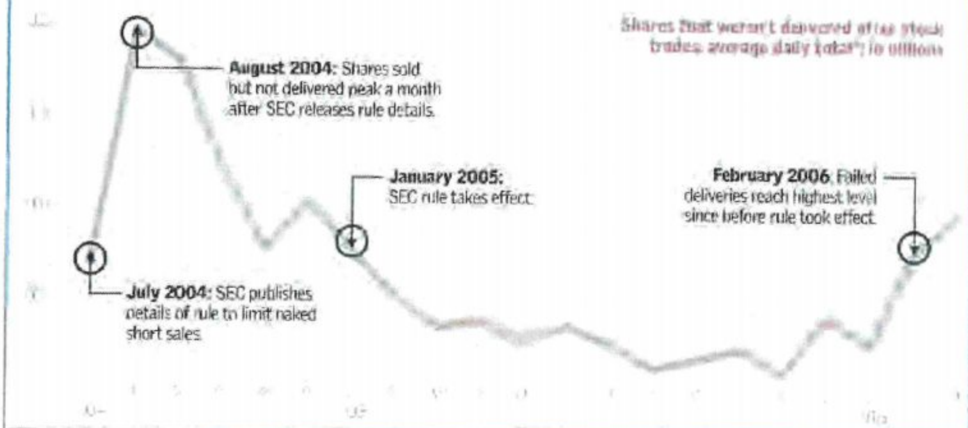
When naked short sellers target a company, the results can be devastating, says David Vey, chairman of King of Prussia,

Leslie Boni, a former visiting scholar at the SEC, says naked short sellers can drive down stock prices by pumping the market with sell orders.

DAVID STRICK; RAY NG (TOP)

Beating the rules

Shares that traders failed to deliver soared in the months before new SEC restrictions on short sales took effect.



*Figures represent shares from all trades that weren't delivered at settlement. Data counts only securities with at least 10,000 total failures to deliver.
Source: Depository Trust & Clearing data, released by the SEC under the Freedom of Information Act

Pennsylvania-based Sedona Corp., which sells software programs that help banks manage customer databases. "It's demoralizing when you're working hard and someone else is staying awake at night trying to figure out how to take your money," Vey says. In 2003, the SEC filed a suit alleging that a single naked short seller, Rhino Advisors Inc., a New York–based investment firm, accounted for 40 percent of all Sedona transactions during 21 days in March 2001. The short sales came after the company sold debt securities that could be converted into shares. The stock plunged from a high of $1.50 to as little as 72 cents in that period. Rhino settled the case in 2003 for $1 million without admitting or denying wrongdoing.

That kind of drubbing makes it difficult to attract new investors and capital and leaves potential customers wary, Vey says. "You have to prove credibility and some kind of staying power," he says. "People don't want to buy your product if they're worried you're not going to be here in two years." On July 10, Sedona shares closed at 21 cents in over-the-counter trading.

Depository Trust & Clearing's Goldstein, 55, says failed deliveries represent only a tiny fraction of U.S. stock trading, and naked short selling is one of many explanations for settlement delays. At the end of 2005, about 23,000 trades hadn't settled compared with about 26 million transactions on a typical day last year, Depository Trust & Clearing says. "We're not saying there is no problem, but to suggest the sky is falling might be a bit overdone," Goldstein says.

While there's more than one reason shares might not be delivered to buyers, Depository Trust & Clearing statistics for the days immediately after the SEC announced it would have new rules show that there could have been hundreds of millions of naked short sales. In eight trading days after the SEC released details of the new rule on July 28, 2004, failures to deliver skyrocketed 70 percent to more than 1 billion shares. They kept rising and, within a month, topped 2 billion shares.

The size and suddenness of that surge suggests it was caused by a rush of naked short sales rather than a rash of bookkeeping snags, Chepucavage says. "One might speculate that people were getting their naked short sales in before the rule took effect," he says. The rule's dependence on threshold lists was aimed at weeding out most of the clerical delays in stock sales that didn't produce shares at settlement, says Boni, 49, who's now a managing director at UNX Inc., a brokerage in Burbank, California.

Short sales and stock price movements for companies added to the SEC's lists, in some cases, recall an old saying: Just because you're paranoid doesn't mean that someone's not out to get you.

In April, Z-Trim Holdings Inc., which makes a calorie-free fat substitute for processed foods, hired lawyers Christian and O'Quinn to investigate whether naked short sellers sold shares of the company, which is based in the Chicago suburb of Mundelein. Reg SHO data show that Z-Trim, then known as Circle Group Holdings Inc., was placed on the American Stock Exchange's threshold list on March 3, 2005, reflecting failed deliveries from trading through Feb. 22. Over five trading days, daily short sales climbed to almost 40,000 shares on Feb. 22, from 3,300 a week earlier, while Circle Group's stock fell 24 percent to 76 cents from $1.

'Naked short selling has been a bogeyman,' one CEO says. 'Everybody thought it was out there.'

"Stock manipulators can cause huge losses for real people who invested real money," Z-Trim CEO Gregory Halpern says. The company retained lawyers to try to protect its investors, he says. "We aren't sitting here complaining that our stock was manipulated, woe is me," Halpern, 48, says. "But having been thrust into that battle, we're going to fight like hell, because we have a responsibility to our shareholders."

For Dallas-based business software maker I2 Technologies Inc., threshold-busting trades occurred on Sept. 30, 2005, when short sales more than doubled to 51,000 shares from 21,000 the previous day. I2's shares fell 10.1 percent to $18.64 from $20.73. That was the stock's worst day in almost eight months and the third-biggest decline in the 575-member Nasdaq Computer Index. Company executives declined to comment.

Meanwhile, companies continue to see shares tumble under possible pressure from naked short sales. A month after Movie Gallery's stock collapsed in February, the company's investors had an even worse day, on March 8, after the company met with lenders about revising restrictions regarding loans. Over two days, shares fell more than 34 percent, while short sales averaged 2.5 million shares—up from an average of 300,000 during the previous week. Trading on March 8 created enough failed deliveries that Movie Gallery was again added to Nasdaq's threshold list.

Cromwell Coulson, CEO of New York–based Pink Sheets LLC, which runs a market for over-the-counter stocks, says making more information public about short sales is a key to fighting abuses, particularly for investors and executives in small companies. For example, under a new NASD rule, Nasdaq's threshold lists in July started including failures to deliver for shares of some small, over-the-counter companies that weren't covered by Reg SHO. Nasdaq also began including OTC Bulletin Board and Pink Sheets companies in monthly short-interest reports in July.

"Naked short selling has been a bogeyman; it was like Bigfoot," Coulson, 40, says. "Everybody thought it was out there, but nobody knew for sure."

Sedona's Vey says regulators at the SEC and each stock market need to hit some abusive traders with multimillion-dollar fines. "They need to make a few examples out of people," he says. Until penalties are big enough to take the profit out of stock manipulation, he says, all the rules and procedures in the world will make no difference.

BOB DRUMMOND is a senior writer at Bloomberg News in Washington.
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BLOOMBERG TOOLS

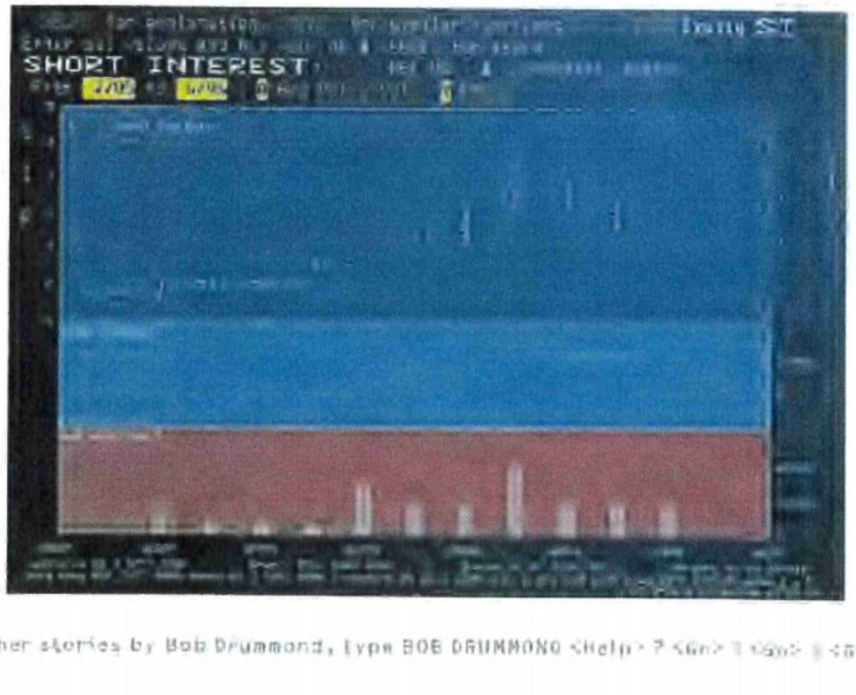
Tracking Short Interest

You can use the Short Interest (SI) function to track short positions in a selected stock that's traded on the American Stock Exchange, the Nasdaq Stock Market, the New York Stock Exchange or the Toronto Stock Exchange. For example, to track short interest on Metretek Technologies, type MEK US <Equity> SI <Go>, as shown below. The top graph shows the short interest ratio, which is the short interest—the total number of shares sold short that have not yet been repurchased—divided by the average daily volume over the selected period. SI also graphs short interest and average daily trading volume data.

For news stories related to short interest, type NI SHI <Go>. Type NI THRESHOLD <Go> for daily lists of Amex, Nasdaq and NYSE "threshold securities," stocks that have cumulative unsettled trades of 10,000 or more shares that are worth 0.5 percent or more of the shares outstanding for five consecutive trading days. Type SIUSNASD <Index> GP <Go> for a graph of an index that tracks Nasdaq short interest.

You can use the Bloomberg Law Search (BBLS) function to search for cases related to naked short selling. Type BBLS <Go>, and click on United States under Sources. Click on Courts and then on All Courts to select it. Enter *NAKED SHORT* in the ENTER TERMS field, and click on the Search button.

JON ASMUNDSSON



'Not MY Stock': The Latest Way to Fight Shorts

By: Kara Scannell

THE WALL STREET JOURNAL
August 2, 2006

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WEDNESDAY, AUGUST 2, 2006 C1

Tracking the Numbers / *Street Sleuth*

'Not MY Stock': The Latest Way To Fight Shorts

By Kara Scannell

SOME EXECUTIVES are reaching for an odd tactic in an expanding battle against short sellers, who profit when share prices fall.

The executives—at smaller companies that often don't trade on big exchanges—are pushing shareholders to lock away their physical stock certificates so the short sellers can't get their hands on the shares.

Stock trading rarely involves the actual exchange of physical stock certificates anymore, because Wall Street trades and tracks most stocks electronically. But in a perhaps quixotic effort, the executives hope they can short-circuit the short sellers by rounding up stock certificates and taking them out of the electronic loop.

Short sellers borrow shares and sell them, hoping the share price will fall, allowing them to profit by replacing the borrowed shares with less costly ones bought later. The activity is legal, and many investors and scholars argue it helps share prices to adjust to changes in a company's outlook.

But a number of executives—at companies like **Fairfax Financial Holdings Ltd.**, a Canadian insurance company, and **Overstock.com Inc.**, a U.S. Internet company—argue short sellers are manipulating their shares. They are challenging the shorts with lawsuits, private investigations and publicity campaigns.

Few companies have been able to prove improper trading, but the stock-certificate effort is a sign the battle between short sellers and aggrieved executives is widening. By getting shareholders to take physical possession of their stock, the executives hope, brokers won't be able to lend the shares out to short sellers.

"The problem is shorting has gotten to be so popular that there's no accountability," says Wes Christian, a partner at Christian, Smith & Jewell LLP, a Houston law firm that says it is working for 20 companies—including Overstock and Sedona Corp.—against short sellers.

Peter Fiorillo, founder of **Rx Processing Corp.**, a Tampa, Fla., provider of laboratory tests, says he became suspicious about activity in his company's shares in February, when 85,000 Rx shares traded at 0.0001 cent, well below the one cent where it had been trading. He suspected short sellers were involved.

"You see somebody print 0.0001, and you

Please Turn to Page C3, Column 1

Tracking the Numbers / Street Sleuth

Executives Turn to a Long Shot to Fend Off Shorts

Continued From Page C1

know that they're not real trades," he says. The shares trade as pink sheets, part of an unregulated stock-quote service populated by many small companies, and don't change hands on an exchange like the New York Stock Exchange or Nasdaq.

The following month, he issued a news release recommending shareholders of Rx Processing ask their brokers to deliver physical certificates. "This action limits interbrokerage borrowing and market manipulation," he said in the release.

Company executives complain that some traders sell borrowed shares that don't even exist, a practice known as naked short selling, which is typically illegal. These executives argue that if short sellers can't find stock to borrow and sell, it will be harder for them to short the shares.

Moreover, if fewer shares are in the hands of brokers to lend out, some short sellers might be forced to return borrowed shares, relieving downward pressure on share prices.

James Angel, an associate professor of finance at Georgetown University in Washington, calls the executives' efforts a fruitless attempt to "go back to the early 20th century." Mr. Angel says chief executives blame short sellers, when in fact short sellers are often first to identify companies with problems.

"Much the same as when the hyenas are targeting a pack of zebras," he says, "they're likely going to get the weak ones."

It isn't clear just how many executives are asking shareholders to go paper. It is even less clear how many are succeeding.

At Rx Processing, fewer than 15 stockholders followed the CEO's advice and requested certificates. That amounted to about 500,000 shares, less than 6% of the nine million shares outstanding.

Mr. Fiorillo says he is unlikely to push the effort further. Now, he hopes to leave the murky over-the-counter market by going private, reorganizing and trying for a Nasdaq listing that would bring more market surveillance.

Holding physical shares can be costly. Investors often have to pay a brokerage as much as $25 to receive a paper certificate. The Securities Industry Association, Wall Street's main lobbying group, has tried to get rid of paper certificates for years, estimating it costs the industry more than $250 million.

Most companies involved in the current campaign have risky, thinly traded penny stocks not listed on the NYSE or Nasdaq. These companies often don't meet corporate-governance standards or financial requirements to trade on the big exchanges.

Some of these companies have tried to grab control of their shares by offering stock or cash dividends that require a shareholder to redeem their securities to get a new class of stock or cash dividend.

Riverbank Investment Corp., a small Wilmington, Del. broker, announced a cash dividend last month hoping to "trigger a short-squeeze forcing naked shorting to be covered," it said in a news release. Primeholdings.com Inc., a Salt Lake City holding company for Internet businesses, said last fall it planned to issue a stock dividend for the same reason.

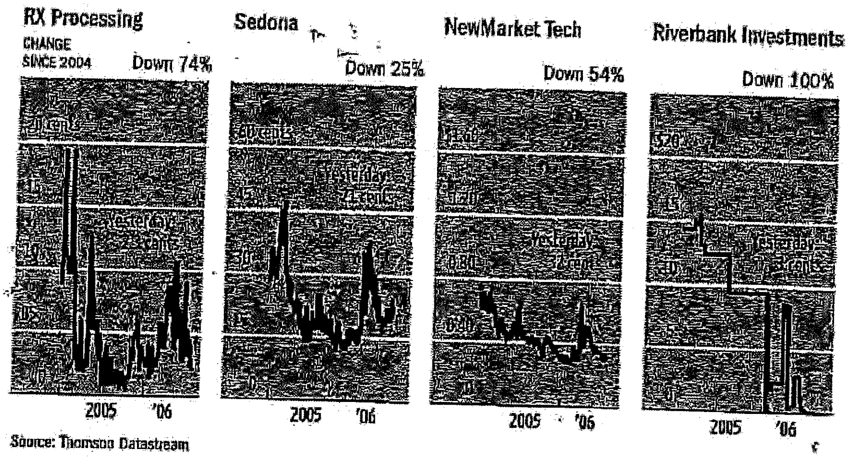
Philip Verges, chief executive of communications company NewMarket Technology Inc. suspected two years ago that naked short sellers drove his company's stock price lower on the OTC Bulletin Board and urged investors to demand stock certificates. "Do not take no for an answer," he wrote in a letter to shareholders.

Yet only a handful of NewMarket shareholders responded, and the company abandoned the effort. "We started thinking it was not going to help," said Rick Lutz, head of investor relations for NewMarket.

The company has applied for a listing on the American Stock Exchange. It is awaiting approval.

Short Sights

Some companies trading on the Pink Sheets that claim their share prices have been manipulated by short-sellers:



Source: Thomson Datastream

The Secret Lives of Short Sellers.

The Rise of Hedge Funds and Indie Research Raises New Questions About a Shadowy World.

By: Jane Sassen

BUSINESS WEEK, Volume 10
April 10, 2006

BURGER KING IPO: NOT SO JUICY (P. 30) | **BEST FUND MANAGERS** (P. 88)

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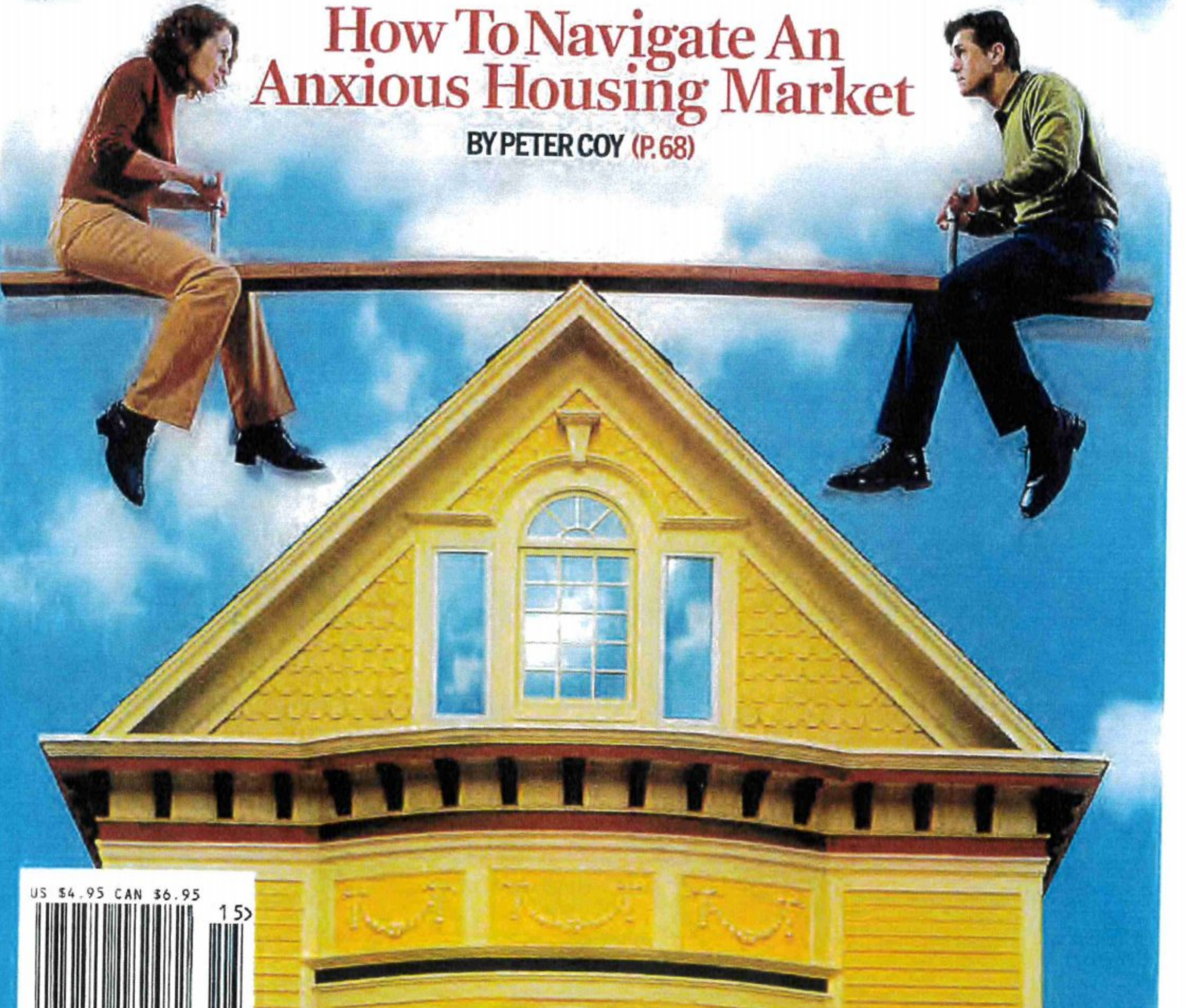
Buyer (and seller) Beware

How To Navigate An Anxious Housing Market

BY PETER COY (P. 68)



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The Secret Lives Of Short-Sellers

The rise of hedge funds and indie research raises new questions about a shadowy world

BY JANE SASSEEN

SITTING IN A CONFERence room in a Manhattan office, the researcher explains how he digs up financial information, often of the damning variety, for hedge funds and other big investors. His clients need the intelligence because they frequently sell short, meaning they bet on shares falling. "Look at the Web as a giant fish pond," he says, on the condition that he not be quoted by name. "We try to develop bait that will hook someone who knows more than anyone else."

On another day, not far away, a private investigator hired by the other side can't resist a little boast, which, of course, is not to be attributed to him. He has been employed by several companies to help prove that a group of short-selling hedge funds are fraudulently collaborating with analysts and journalists to push down stocks. He claims he has planted moles at funds and sent phony book authors to interview unsuspecting targets. "It's amazing how people just open up," he says with a grin.

SPY VS. SPY

ONCE AGAIN, the War of the Short-Sellers is surging. This time there are new twists to both public hostilities and shadowy spy-vs.-spy activity. Helping to drive the controversy is the proliferation of a breed of independent researcher prone to greater skepticism than traditional Wall Street analysts. The growing influence of these little-known characters is a by-product of the Enron-era corporate scandals, as well as New York Attorney General Eliot Spitzer's campaign against the overly rosy analysis produced by many Wall Street firms.

Businesses targeted by shorts are fighting back more aggressively with undercover investigations and lawsuits. Biovail Corp., a Canadian drug company, and online retailer Overstock.com Inc. claim that hedge funds run by two of the most powerful traders on Wall Street, Steven A. Cohen and David Rocker, have engaged in fraud to drive down share prices. (Those allegations have been vociferously denied.) Public relations campaigns related to the suits have drawn intense media interest, with CBS's *60 Minutes* featuring a sympathetic segment on Biovail. The Securities & Exchange Commission, meanwhile, is investigating allegations about abusive short-selling concerning the two companies, as well as potential underlying problems at both.

> Targets of shorts are fighting back with tougher tactics

Criticism of short-sellers is as old as stock trading. The technique involves selling borrowed shares in hopes that prices fall so the shares can be bought back more cheaply before being returned. Some aggrieved executives accuse shorts of crushing shares with whisper campaigns. But shorts often expose hidden corporate weaknesses and have sounded early alarms about Enron, Tyco, Krispy Kreme, and many other debacles.

Pending suits by Biovail and Overstock allege a wider conspiracy than has been claimed in the past. One reason these complaints have resonated loudly is growing unease over the number and clout of hedge funds, the secretive, lightly regulated investment pools that frequently sell short. Since 2000 the number of funds has soared from 3,873 to 8,661, according to Hedge Fund Research Inc., while assets have more than doubled, to $1.1 trillion. "The perception is they're a bunch of cowboys, willing to do whatever it takes to get their returns," says Richard Leggett, CEO and president of the Center for Financial Research & Analysis, a forensic accounting firm whose clients include hedge funds, mutual funds, and regulators.

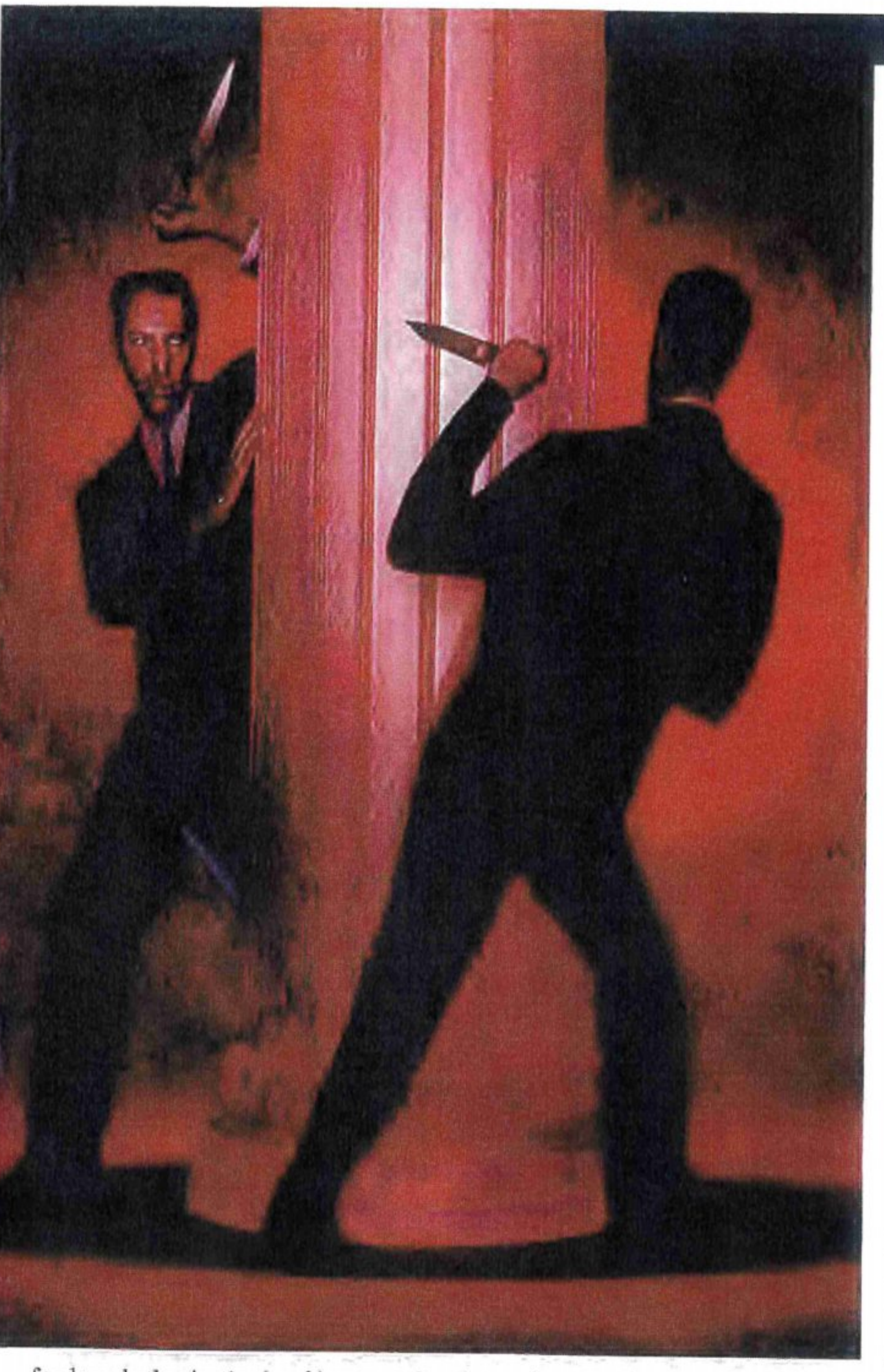
Short-selling has become much more prevalent. Hedge funds dedicated strictly to the technique, such as those run by famed short-seller James S. Chanos of Kynikos Associates LP, had $603 million in assets in 2001, according to HFR; by 2005, assets in all short-only funds had grown to $3.3 billion. Many of the thousands of hedge funds that primarily focus on "long" investing, betting that shares will rise, also short at times. Short sales on NASDAQ hit a record high of 6.2 billion shares for the month ending Mar. 15.

RABID FOR RESEARCH

THE GROWTH IN hedge funds has fueled a shift in stock research. To keep up returns, and to justify earning the highest fees on Wall Street, hedge funds have turned away from much of the research broadly distributed by investment banks. It's a commodity now. "The hedge funds will pay, but they value research that's not widely read," says Frank A. Fernandez, research director for the Securities Industry Assn., a trade group.

That trend has accelerated since Spitzer's 2002 probe of Wall Street research. One of the New York State prosecutor's goals was to jump-start the independent research industry as a counterweight to the management-friendly research big investment banks did. The settlement of the Spitzer probe also ended the practice of analysts being paid to help win banking deals from the companies they covered, leading Wall Street to cut research spending.

All that has opened the door to new, high-priced independent competitors. Two specialized categories have benefited the most: "forensic" firms, which look for suspicious accounting, and "direct research" outfits, which arrange confidential interviews with industry sources paid to answer questions posed by hedge



MATT MAHURIN

funds and other institutional investors. It all adds up to more research highlighting potential problems with company financial statements or operations, and much of it is in the hands of hedge funds that sell short. Traders and analysts sometimes pass along such reports to the media, and that has led to harder-hitting coverage of some companies.

Biovail, in its suit filed last month in state court in Essex County, N.J., alleges that Cohen's powerful hedge fund group, the $8 billion SAC Capital Advisors, conspired to create false reports about the company's financial health with independent stock research firm Gradient Analytics Inc. of Scottsdale, Ariz. Biovail alleges that Gradient let the Stamford (Conn.)-based SAC "ghost-write" negative reports, which Gradient sent to other clients and journalists as its own analysis after SAC had sold Biovail shares short.

Overstock has filed a similar suit in state court in Marin County, Calif., alleging that Gradient worked with Rocker's fund to push its stock down.

SAC dismisses the charges as false and says Biovail's stock fell due to regulatory problems and its repeated failure to meet earnings targets. Gradient co-founder Carr Bettis says its research is based entirely on its analysts' views, and claims that it allowed clients to sell short ahead of reports are "absolutely false." Rocker Partners LP also denies any wrongdoing, calling the allegations "frivolous."

Critics of the shorts say recent government investigations of other funds demonstrate that abuses do exist. The SEC has brought a string of enforcement actions against smaller hedge funds that sold stock short in connection with deals known as private investments in public equities, or PIPEs. On Mar. 14, three hedge funds and their portfolio manager, Jeffrey Thorp, agreed to pay $15.8 million to settle fraud and insider-trading charges related to 23 PIPEs deals. Thorp allegedly obtained unregistered shares in the private placements and shorted the stock. He then used the unregistered shares to cover those short positions, a violation of federal securities law. The defendants settled without admitting or denying charges. SEC officials say they are investigating two-dozen hedge fund players involved in such deals.

THE SILENCERS

STILL, DEFENDERS OF short-selling argue that corporate critics are usually trying to divert attention from their own internal problems. Moreover, they want to silence analysts who publish critical research and discourage journalists from writing about the issues raised. "One of the more disturbing aspects of this is if they don't like what you say, then they'll use shareholder money to sue you for calling attention to their shortcomings," says Chanos, the short-seller who issued early warnings about Enron.

John O'Quinn, a plaintiffs' lawyer in Houston who has won multimillion-dollar settlements against manufacturers of cigarettes, breast implants, and diet drugs, is at the center of the escalation of the hostilities. He has coordinated an effort by a consortium of law firms over the past several years to develop cases concerning allegedly manipulative short-selling. Overstock turned to this group to press its suit in California, and Wes Christian, the day-to-day manager of O'Quinn's legal campaign, says his team has helped Biovail with its case. "When we've turned up things related to other companies, we've made sure that information got to them," says Patrick M. Byrne, Overstock's president. In this carefully orchestrated campaign, O'Quinn's group has filed lawsuits related to about nine companies in half a dozen states, Christian says. With other analyst firms and big-name funds targeted, more litigation is in the works. ■

–With Amy Borrus in Washington and Emily Thornton in New York

Watch Out, They Bite!

How Hedge Funds Tied to Embattled Broker Refco Used "Naked Short Selling" to Plunder Small Companies.

By: Daniel Kadlec

TIME: INSIDE BUSINESS
November 14, 2005


NOVEMBER 14, 2005
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Watch Out, They Bite!

HOW HEDGE FUNDS TIED TO EMBATTLED BROKER REFCO USED "NAKED SHORT SELLING" TO PLUNDER SMALL COMPANIES

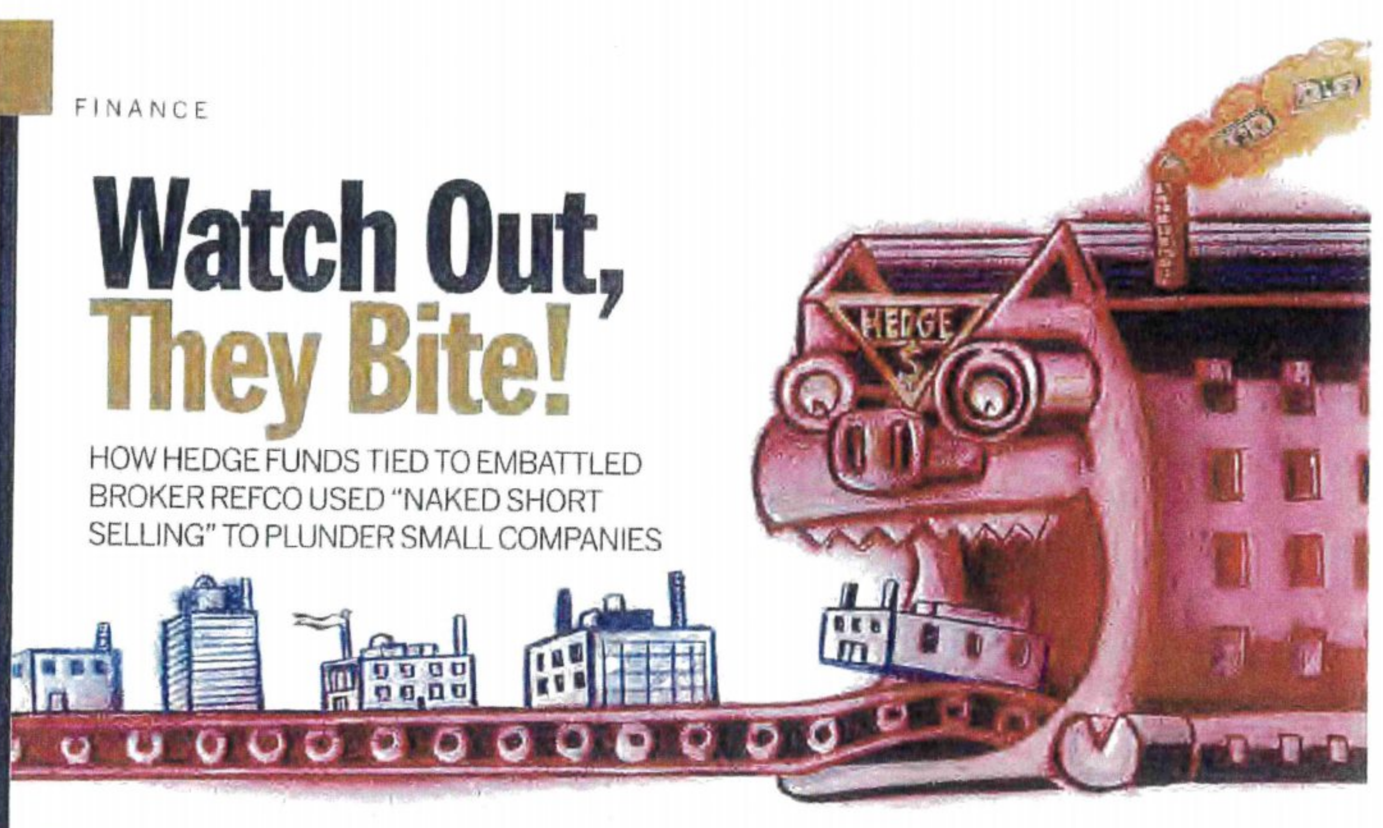


ILLUSTRATION FOR TIME BY PETER KUPER

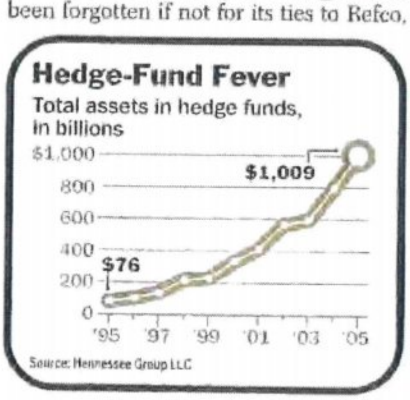
BY DANIEL KADLEC

Thomas Badian was expecting a package, just not this one. Standing in his doorway, smiling, he opened the envelope a courier handed to him. Then he froze, and the color drained from his face. It was over: after two years overseas, the former New York City hedge-fund operator had been located. Badian slammed the door of his posh Vienna, Austria, apartment in the heart of the city's embassy quarter—but not before being officially served with a civil lawsuit linking him to the beleaguered U.S. commodities firm Refco and tying him and Refco to a type of fraud that some argue has destroyed thousands of companies and bilked investors out of billions of dollars.

The boyish-looking Badian, 36, of East European descent, seems an unlikely key figure in a high-stakes Wall Street intrigue. Yet long-standing criminal and civil charges place Badian at the center of a scheme to lend Arizona software developer Sedona much needed operating capital, then trigger the collapse of its stock and profit from the company's demise. This pattern is also alleged in the civil suit handed to Badian on Aug. 8 in his apartment in Austria—only this time the mark was pet-supplies company Pet Quarters, based in Lonoke, Ark.

Three years ago, Badian paid a $1 million fine to settle a Securities and Exchange Commission (SEC) charge that he had manipulated Sedona's shares. Related criminal charges were filed a few months later, but by then Badian had fled. His whereabouts were recently given to U.S. Attorney Michael Garcia in New York City, whose office is handling the criminal case. Garcia's office said only that the case remains open.

Yet the Badian episode might have been forgotten if not for its ties to Refco,

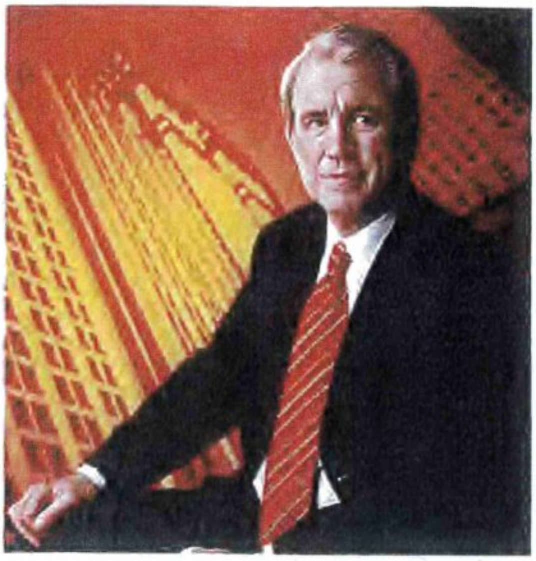


which last month admitted to reporting false results after hiding $430 million of uncollectible debt. Refco CEO Phillip Bennett was charged with fraud, and his company sank into bankruptcy protection within days. It turns out, plaintiff lawyers say, that Badian had been making some of his Sedona trades through Refco, which has acknowledged an SEC investigation.

Looking the other way while clients manipulated the shares of small companies through what's known as naked short selling appears to have been yet another questionable way of doing business at Refco. Short selling is legal: you borrow stock, then sell it and hope to buy it back at a lower price, profiting from the difference. But naked short selling is illegal, barring certain exceptions for brokers trying to maintain an orderly market. In naked short selling, you execute the sale without borrowing the stock. The SEC noted in a report last year the "pervasiveness" of the practice. When not caught, this kind of selling has no limits and allows a seller to drive down a stock.

Brokers are required to ask a client the nature of a stock sale. If it's a short sale, the broker must ascertain if the client has been able to borrow the stock. "I have seen evidence that links Badian and/or Refco to more than 50 stocks that were driven into the ground," says Wes Christian, part of a legal team headed by billionaire Texas tobacco litigator John

Leading the case against Badian and other hedge funds: litigator John O'Quinn



O'Quinn, who is amassing a case against Badian, other hedge funds and now possibly Refco. Refco declined to comment. Badian didn't come to the door when a TIME reporter rang his bell. His lawyer in the civil cases, Perrie Weiner, says that the suits against Badian have "not a shred of merit" and that courts have consistently dismissed such cases.

After high-profile alleged frauds like Refco's and another this summer at hedge fund Bayou Management, where managers shut down the firm without notice, the call for strict oversight is growing. Largely unregulated investment pools for institutions and the wealthy, hedge funds make big bets—up or down—on stocks, bonds, commodities and currencies. Officials are investigating trading records at 35 institutions as part of their probe into naked short selling. And starting in February, hedge-fund advisers must register with the SEC.

Usually the victims of hedge-fund excesses are their rich customers, who lose when the hedge fund makes a bad bet. But through naked short selling, hedge funds can stir up trouble for any publicly traded firm. In the case of Pet Quarters, the suit alleges that Badian's hedge fund lent the firm sorely needed operating capital on terms that allowed the hedge fund to convert the debt to shares at any time. Through naked short selling, Badian then pushed Pet Quarters stock from $4 to just pennies. Badian balanced his massive short selling with cheap shares obtained after he converted the loan to stock.

Meanwhile, with its stock sinking, Pet Quarters couldn't raise the funds it needed to keep operating, and shut down. CEO Steve Dempsey and an executive who had invested with him wound up filing for personal bankruptcy. "There was nothing wrong with our business," says Dempsey. "We fell prey to the perfect crime." Weiner counters that "most of these companies" that blame short sellers when their stock falls are financially "barely skating by."

SEC data show that such relatively big firms as Overstock.com and Martha Stewart Living Omnimedia have been targets too. Overstock CEO Patrick Byrne has launched a crusade against naked short selling, charging that an unnamed criminal "mastermind" is conspiring against his company. Byrne says the attacks have "put limits on the amount of capital we can raise, how fast we can grow and how many people we can employ." His company's stock, at $76 in January, has tumbled into the low $30s. Byrne filed an unfair-practices suit in August against Rocker Partners, which specializes in short selling. Rocker says the suit is "frivolous" and blames Overstock's disappointing results for the stock slide.

But small companies are especially vulnerable because even modest trading can move the stock. Naked short selling "has got to push the price down," says James Angel, associate professor of finance at Georgetown University. He says the rate of short selling has nearly doubled in the past five years, to 36% of all trades. In the same period, assets held in hedge funds, which are active short sellers, more than doubled, to more than $1 trillion.

ILLEGAL NAKED SHORT SELLING HAS COST INVESTORS $100 BILLION AND DRIVEN 1,000 COMPANIES INTO THE GROUND

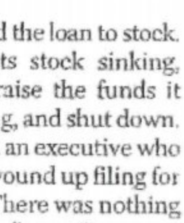
Illegal naked short selling, according to Robert Shapiro, a former Under Secretary of Commerce, has cost investors $100 billion and driven 1,000 companies into the ground. Shapiro is on O'Quinn's legal team, which has brought 16 cases against hedge funds and other traders. For their part, the hedge funds say that they have done nothing illegal, that the stocks they sell short ultimately drop because the companies are not doing well.

Papers filed in the Sedona case offer a rare glimpse into the cut-throat nature of naked short selling. Federal prosecutors, in a case that remains open against Thomas Badian but has been dropped against his brother Andreas, charge in the complaint that Andreas ordered brokers to sell Sedona shares short with "unbridled levels of aggression." After the stock had "collapsed," according to the complaint, he congratulated the brokers on a "good job" and instructed them to be "merciless" in selling the stock a day later.

Around that time, Thomas Badian was living the high life. Registered in his name was a two-seat 1998 Aston Martin. "He told me he liked to put the top down and take a long drive," recalls Pet Quarters' Dempsey. "I asked him if he'd like to drive out to Humboldt [Pa.] to take a look at our distribution center. For a guy who had just loaned us money, he seemed strangely detached. He never did make the drive." He had other plans for Pet Quarters. Just not the ones Dempsey had imagined.

—With reporting by Bethany Bell/Vienna

SHANNON STAPLETON—REUTERS; ADAM ROUNTREE—AP



A Refco broker is consoled in the futures trading pit after Refco filed for bankruptcy protection; former Refco CEO Phillip Bennett, below

The Curious Incident of the Shares that Didn't Exist

By: Helen Avery & Peter Koh

SEC Seeks to Curb Naked Ambition

By: Helen Avery

Stung by the German Connection.

By: Peter Koh

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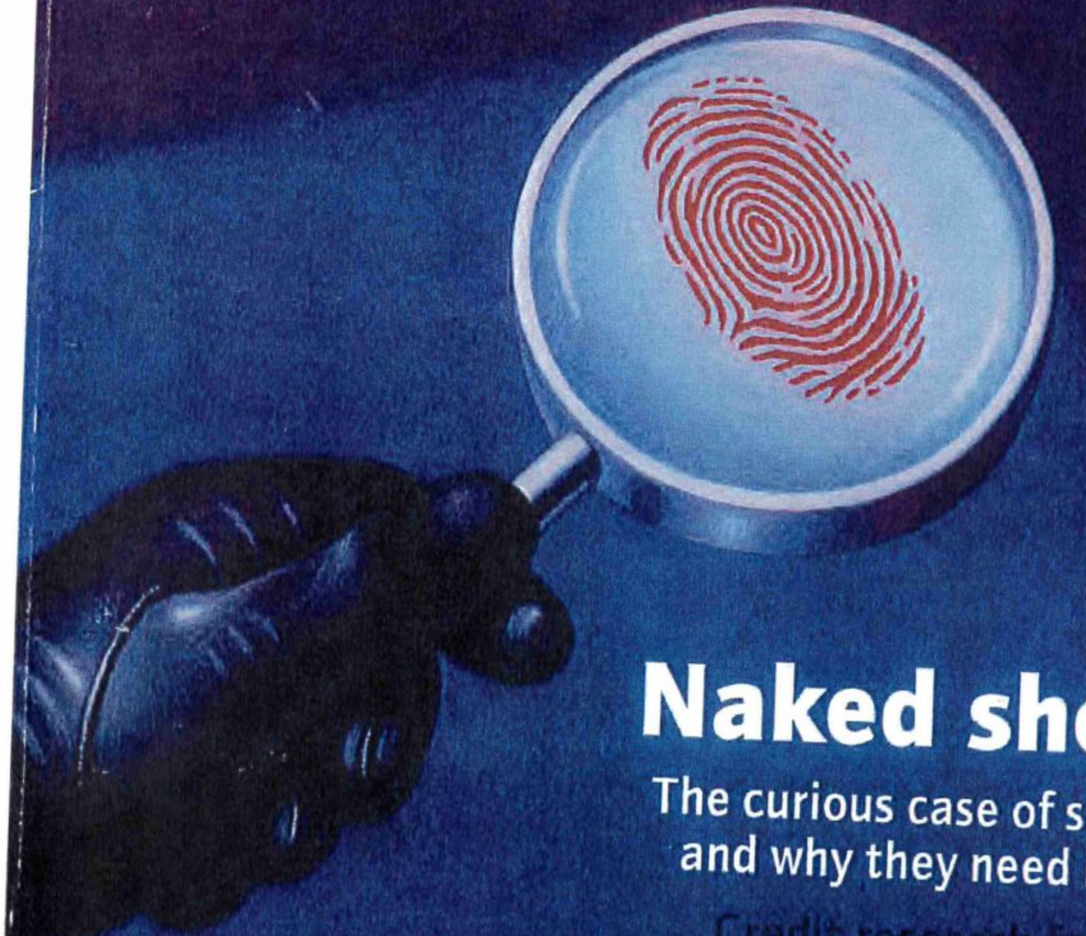

Naked shorting

The curious case of surplus shares and why they need investigation

Credit research faces upheaval as banks seek a new model

EBS's reach for the buy side poses challenge for FX traders

Ukraine tries to play catch-up with the rest of central Europe

The curious incident of the shares that didn't exist

Shareholders and executives in some of the US's smallest listed companies believe their share prices have been forced down by illegal naked shorting. This has led to a number of lawsuits, claiming unscrupulous behaviour by brokers and market-makers exploiting loopholes in the central clearing system. Those implicated dismiss the allegations as rubbish. What's going on? *Helen Avery and Peter Koh report*

IN FEBRUARY THIS year, Michigan-based entrepreneur Robert Simpson decided to see what would happen if he bought the entire stock of one company.

Using a single broker, within a couple of days Simpson had paid a little over $5,000 for 1,285,050 shares in OTC bulletin board property development company Global Links. According to Simpson, these shares were delivered into his account shortly afterwards. Yet the following day 37,044,500 Global Links shares were traded on the bulletin board. The next day, 22,471,000 shares were traded. On neither day had Simpson traded a single Global Link share, he insists.

And events surrounding Simpson's investments became yet more confusing. Global Links had only ever issued 1,158,064 shares. Simpson had managed to acquire 126,986 shares that did not exist. How he had managed to be sold more shares than were in issuance is exactly the question Simpson hoped his foray would raise.

Simpson is CEO of OTC bulletin board company Zann Corp, a provider of advanced technology products for niche markets, and has experienced an inexplicable excess shares situation over the past two and-a-half years. Since November 2003, Zann's stock price has plummeted over 98%. This, Simpson claims, makes no sense since his company has performed relatively well. The reason for this extreme underperformance, Simpson believes, is that his company has been subject to severe naked short selling – where stocks are short sold without having been borrowed before the time of settlement, if at all.

Law suits pending

Simpson's case is not a one-off. About 20 lawsuits are pending in the US, brought by investors and companies that claim to be the victims of naked short sellers. Many of the companies affected are those whose shares are traded on the Nasdaq's OTC bulletin board. More than 3,300 companies are traded on the lightly regulated platform. They are small cap, often start-up companies and they tend to be thinly traded, although they do have to make intermittent filings with the SEC. They are by definition high-risk investments. Other companies affected are those on the Pink Sheets – a daily publication compiled by the National Quotation Bureau containing price quotations for OTC stocks. These companies are considered riskier still and do not have to file with the SEC.

Indeed, some of these 'penny-stock' companies have turned out to be extremely risky. Many are legitimate companies, offering products which tend to include software, technology, and healthcare solutions. Global Links' CEO Frank Dobrucki points out, for example, that his company has millions of dollars in real estate assets.

Others offer no products or services at all – they are just shells.

Many are struggling young companies which are just starting out, perhaps on the way to the big board of the New York Stock Exchange. Consultant C Austin Burrell notes that "companies such as Microsoft, Intel, Dell, Oracle and Cisco started out on the Pink Sheets." As he says: "In 1975 Microsoft had three employees, and revenues of $16,005. These companies can grow into major corporations if given a chance."

But with volatility expected, and odds against their success, such stocks can be prime targets for naked shorting. The SEC's new short sales regulation, which came into effect in January, attempts to stop this. But for the 20 or so companies and their shareholders with lawsuits pending, this regulation has come too late. Three of the cases claim that the naked shorting problem started as far back as 1981, and were facilitated by alleged inefficiencies at the US Depository Trust & Clearing Corporation (DTCC). If their claims are correct, it would suggest a serious flaw in the infrastructure of US securities markets.

Systemic problem

The stock borrow programme at the DTCC, they allege, enables the naked shorting of shares to the extent that the number of shares in circulation of some companies is now several times in excess of that issued. Even companies listed on the NYSE, could have been affected. As Wes Christian, partner in law firm, Christian, Smith & Jewell in Houston, and lead lawyer on several of the cases, explains: "With the revelation of the Regulation SHO Threshold Securities list and the Leslie Boni report, published in November 2004 [see glossary on page 39], it is now crystal clear that this problem of naked short selling is systemic in Wall Street, and virtually impacts every business sector on every exchange including numerous billion-dollar companies listed on the NYSE and other companies listed on the Amex."

Burrell, who worked as an options trader before establishing himself as a consultant to small IT, healthcare, and generalist companies – the type that would be listed on the OTC bulletin boards – has researched the problem. His conservative estimate is that more than 1,000 companies presently have shares in circulation in excess of their floats, and that for at least 500 this number exceeds the number outstanding (the float plus shares that are not available on the market) – in some cases many times that number. If the claims are correct, this could mean that these companies have been susceptible to artificial deflation of their share price, and, even, that investors might be holding shares that do not exist.

David Lott, president of Limelight Media, a provider of digital media networks, is not

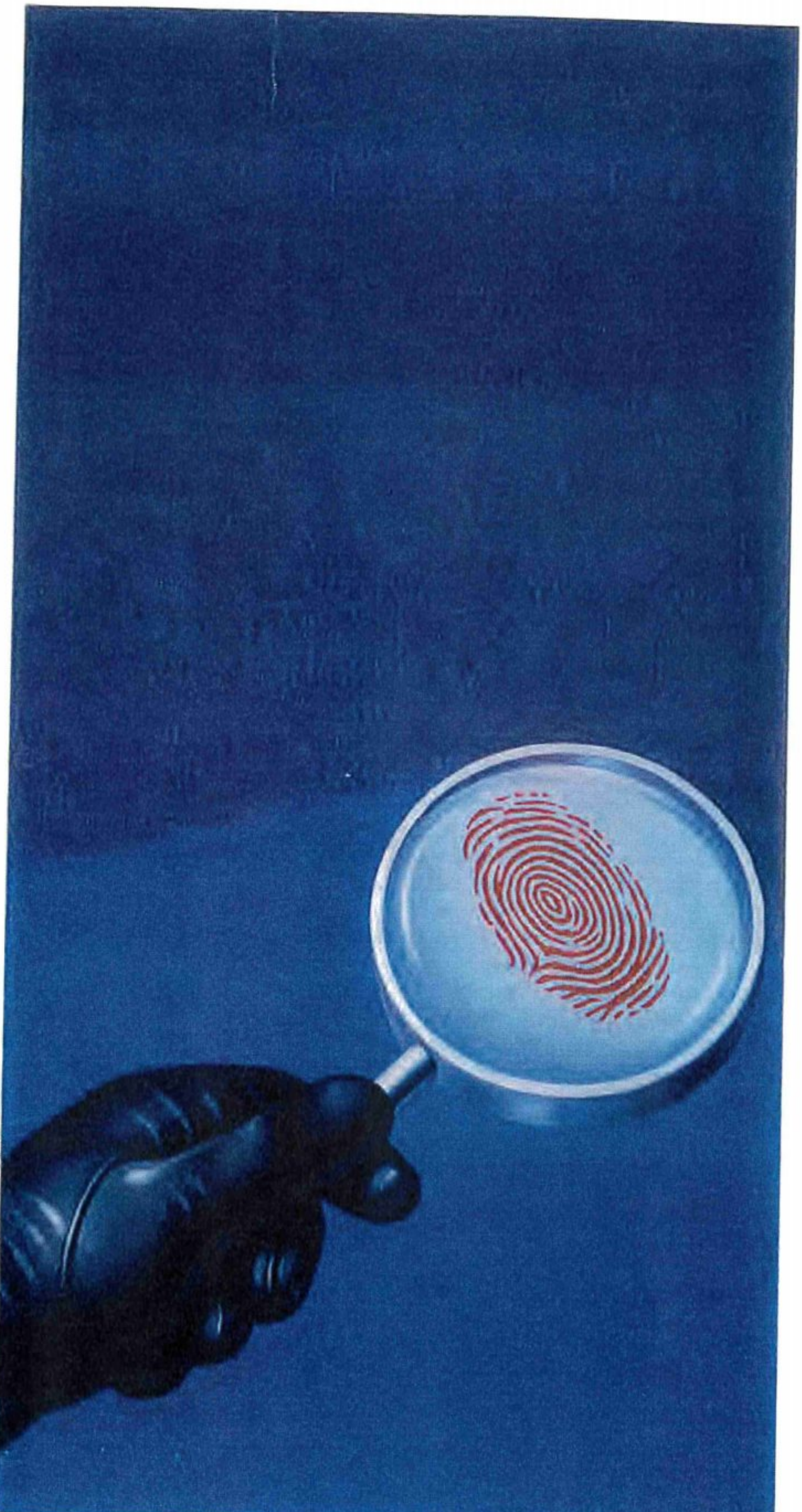

ILLUSTRATION BY CHRISTOPHER ZACHAROW/CORBIS

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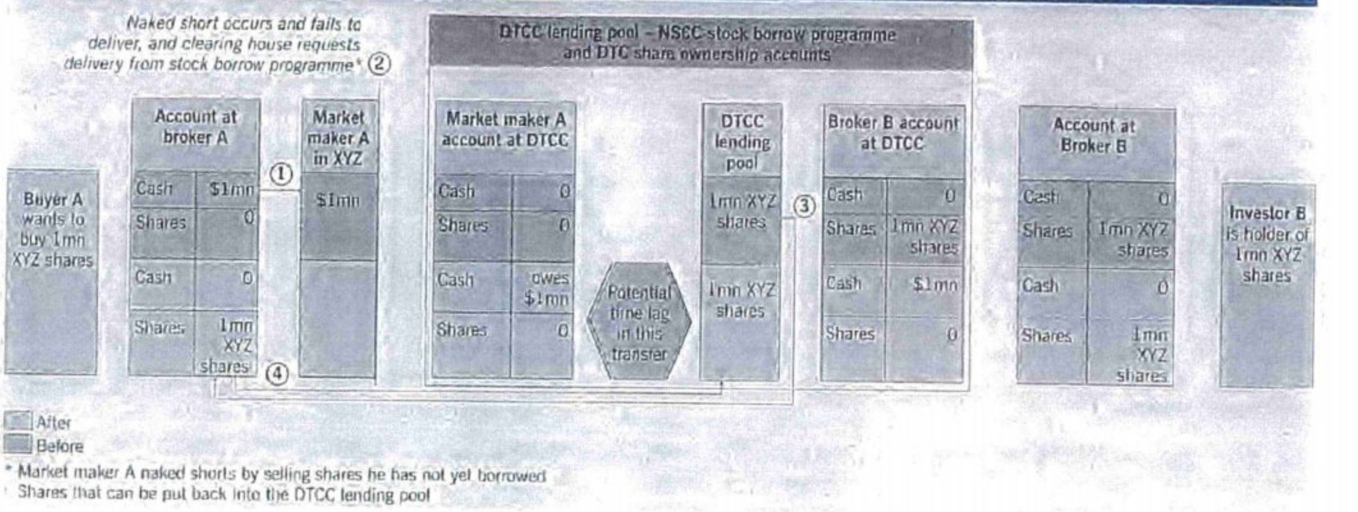
Simplified diagram to show how the DTCC's stock borrow programme allegedly works
The self-replenishing pool theory



* Market maker A naked shorts by selling shares he has not yet borrowed
' Shares that can be put back into the DTCC lending pool

surprised by Burrell's findings. His company is listed on the OTC bulletin board, and he believes more shares are held by investors than are outstanding. "It's my company, and I have an understanding of how much stock the large shareholders own. I know we have about 700 shareholders. I called 20 of them in December last year to ask how many shares they were holding. Those 20 alone owned more shares than there had been in the float."

It is possible that it is not just small OTC bulletin board companies that are affected. Patrick Byrne is the president of Nasdaq-listed Overstock.com, a discount shopping website, with a market capitalization of almost $900 million. He claims to have been informed by "someone in the know" that his company has "hundreds of thousands of shares in circulation above the outstanding amount".

That there could be more shares in circulation than a company has issued seems incredible, and some market participants are sceptical about the allegations. One charge is that companies that are performing badly are using the excuse of naked shorting to explain their plummeting share price to shareholders. Hal Stewart Scott, visiting professor of public and international affairs at Princeton University, says: "Short selling cannot create more shares or dilute equity – at most it can lead to securities failing to be delivered which is a clearing risk, and the clearing house still makes good on the trade... My bottom line on short selling is that issuers and investors do not like shares to go down which occurs when there is a lot of selling." The majority of cases where naked shorting is alleged have involved small, risky companies of little present value, which only adds to the doubts. Says James Brigagliano, an assistant director in the SEC's division of market regulation: "When you look at some of the complaints from issuers, you have to ask yourself is naked shorting really the problem here? Some of these companies have had serious financial and regulatory issues that may have been the cause for their stock price falling."

Share duplication

But what if loopholes in the DTCC's stock borrow programme did allow for shares to be lent out that had already been sold, and borrowers were never forced to return them? This, seemingly, would result in two people holding the same shares. And this is what the claimants.

One source, who has studied the stock borrow programme for more than 20 years, claims that the problem of duplication of shares was not foreseen when the DTCC subsidiaries, the National Securities Clearing Corporation (NSCC) and Depository Trust Company (DTC) were established but that a series of loopholes afforded by the system and the programme have resulted in it arising.

The DTC and NSCC were created as a response to a paperwork crisis on Wall Street in the late 1960s. Each time a trade was made, physical share certificates were hand delivered by runners who collected cheques from the buying broker to take back to the selling broker. As volumes increased, this became an unacceptably slow trade settlement procedure. In a bid to speed the process up, Congress passed legislation in 1971 for two new service organizations whose objectives were the speeding up of clearance and settlement in the national marketplace. The DTC was then established as the nation's principal securities depository, whose aims were to convert the paper certificates to electronic book entries; and to immobilize those certificates, keeping them in a vault at the DTC. And the NSCC provided clearance and settlement services. It all made sense.

No less sensible was the idea of further speeding up the trade settlement process by creating a stock borrow programme, approved by the SEC in 1981. This enabled the creation of a massive lending pool of shares from brokers' client margin accounts (brokerage accounts in which the broker lends the customer cash to purchase securities. The loan in the account is collateralized by securities and cash).

The brokers would buy securities from a specialist broker (a market-maker) who can short sell them the stock, and if there was a fail to deliver beyond the permitted trade plus three-day (T+3) settlement rule, which occasionally happened, at request of the buy-in from a member, the NSCC could

Glossary

Naked short selling Naked short selling, while not defined in the federal securities laws or SRO rules, generally refers to selling short without having borrowed the securities to make delivery.

Illegal naked short selling Naked short selling becomes illegal if conducted by anyone other than a "bona fide market maker", or if it is conducted by "bona fide market maker" with the intention of manipulating stock price downwards.

Stock borrow programme The DTCC programme authorised by the SEC in 1981 that allows broker/dealers to put money in clients' margin accounts into a central lending pool at the NSCC. Participants can request to buy-in stock from this pool if their order fails to deliver.

Fail to deliver Shares from a seller's brokerage account are supposed to be transferred to the account of the buyer's brokerage in return for payment by the third day following the transaction (t+3). If this does not happen the selling brokerage registers a fail to deliver. The market maker or short seller has failed to deliver.

Margin account stock Stock held in a margin account can come from money lent by the broker. The loan in the account is collateralised by securities and cash.

Market maker Market makers are broker dealers that accept the risk of holding a particular number of shares in a particular stock in order to facilitate trading. Market makers quote both bid and offer prices for a guaranteed number of shares. Once an order is received, the market maker immediately sell from its own inventory or seeks an offsetting order.

OTC Bulletin Board The OTCBB is a quotation medium for subscribing members, not an issuer listing service. OTCBB securities are traded by market makers that enter quotes and trade reports through a closed computer network. Unlike the Nasdaq Stock Market the OTCBB does not impose listing standards, provide automated trade executions, maintain relationships with quoted issuers, or impose the same obligations on market makers. OTCBB companies have to file quarterly with the SEC.

Pink Sheets Established prior to the OTC BB, the Pink Sheets are a daily publication compiled by the National Quotation Bureau containing price quotations for OTC stocks. These companies do not have to file with the SEC.

DTCC The Depository Trust and Clearing Corporation operates the DTC, the NSCC and the FICC (Fixed Income Clearing Corporation).

DTC The Depository Trust Company (DTC), retains custody of nearly all US share certificates. Its centralised system allows for shares to be transferred between accounts electronically rather than physically. The DTC is a clearing company incorporated as a limited-purpose trust company and an integral part of the US Federal Reserve System.

pull out the required shares from the DTC pool and allow the trade to clear, speeding up the trade process. Changes in ownership were then passed on to the DTC. To avoid confusion, all shares held at the DTC are in street name only – they take the name of the broker's account in which they end up. The NSCC charges a 30-cent fee for delivery of stock, and holds the money that is now with the market-maker as collateral.

What the DTC failed to put in place, claim the defendants, were sufficient incentives to return the stock borrowed from the programme. The source says: "The DTCC never monitored the length of time brokers or market-makers were taking to close out the position. You might not close the position for months or years, and no-one was onto you. It was the perfect loophole for the bad guys. Who cared if you didn't own what you sold – the DTCC would make good on your delivery." When asked whether, before the new short selling regulation came into force, there was no time limit for the return to the stock borrow programme of shares that had been borrowed, a DTCC spokesperson replied: "Essentially that's accurate."

The benefits of the system were similar to other stock loan programmes. Those lending the shares are credited with the full market value of securities borrowed, so they can earn overnight interest on that value by investing the cash. Today, more than 350 brokers participate in the stock borrow programme directly.

"The system means transactions are executed much more efficiently, but it is ripe for a fraudulent and manipulative undertaking," says Christian. If the DTCC is providing the delivery of the share, and is not checking how long the borrower takes to return it, positions can remain open forever, the theory goes.

Failure to deliver

It is hard to ascribe the blame for this to those who set up the programme. The theory was good. The buying investor has his share delivered quickly. The broker gets his commission. The market-maker gets commission from the broker. If the market-maker fails to deliver and there is a buy-in, he will get his collateral back from the DTCC when he returns the borrowed shares – and if he is lucky the share price might have dropped and he won't have to pay back as much. If he is extra lucky, no-one will even ask for a buy-in. The broker whose shares have been taken out of the lending pool and lent on, receives the market value of those shares to earn interest on, until the market-maker closes the position. The DTCC earns 30 cents per delivery of stock which, since it is a not-for-profit organization, is passed back to its members – the brokers and market-makers.

But what about the company? If no one is forced to buy-in its shares, and people don't, its stock price will fall. If there is no delivery and there is no buy-in, then what was initially a buy-and-sell transaction ends up as just a sell. The opinion seems to be that the companies affected are so small or unviable that they have it coming to them. As a spokesperson at the DTCC says: "Some of these firms have no value. People may leave those things out there because there's nothing to be gained from pursuing them." Then why did people want to invest in them? Surely, the only reason not to order a buy-in when stock doesn't turn up is when that company's stock is worthless. This could mean that market abusers are able to manipulate these small companies' share prices to such an extent that no investors would want to buy-in, leaving them able to keep the investors' original money – illegal naked shorting.

Furthermore, claimants contend that the

NSCC The National Securities Clearing Corporation (NSCC), is the central counterparty for nearly all broker-to-broker equity, corporate bond, municipal bond, exchange-traded fund and unit trust trades in the US. It provides centralized clearing, settlement and information services.

National Coalition Against Naked Shorting (NCANS) A coalition of investors created by "Bob O' Brien" (a shareholder in NYSE-listed NovaStar Financial). The coalition published a $50,000 advertisement in the Washington Post in February this year calling attention to continued naked shorting. Patrick Byrne, CEO of Nasdaq-listed company Overstock.com and some small investors who believe they are victims of naked shorters contributed with O'Brien to the cost of the advertisement.

Freiverkehr A regulated unofficial market administered by a German exchange. A market maker can apply to trade any security that's traded on a recognised exchange anywhere in the world with minimal restrictions and conditions. Securities are not technically listed, so no issuer approval is needed for trading to take place.

Regulation SHO This regulation was adopted by the SEC on July 28 2004 and came into effect on January 3 2005. The regulation modifies the rules for short sales in the US with the objective of restricting naked short selling and supplants other conflicting short sale restrictions.

Rule 200 defines ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt."

Regulation SHO also requires short sellers in all equity securities to locate securities to borrow before selling, and also imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred (Rule 203). Equity and options market makers are exempt from these requirements when conducting bona fide market making. There are no penalties for violating Regulation SHO.

Threshold Securities List The Threshold Securities List is published daily by the major stock exchanges in the US – the NYSE, Amex, Nasdaq, OTC Bulletin Board and Pink Sheets, of companies whose shares show significant and persistent fails. Any stock traded on these organisations with total fails of at least 0.5% of shares outstanding and 10,000 shares that persist for five consecutive days is a "Threshold" stock.

NASD Rule 3370 NASD Rule 3370 requires US broker/dealers to make an affirmative determination that they will receive delivery of a security or be able to borrow that security on behalf of their clients prior to the settlement date, before accepting any short sale order. The rule was extended on April 1 2004 to include non-member broker/dealers too.

investor, if he did order a buy-in, might not even end up with a real share in his account. Such allegations "can only be described as nonsense", asserts the DTCC.

The lending pool

But one claimant attempts to explain just how this situation could arise (see diagram on page 34). Buyer A who has an account in street name (in an electronic book format) with Broker A, requests Broker A to buy 1 million shares in XYZ Corporation, which are trading at $1 per share. Broker A (through his clearing house) gives a buy order to Market-Maker A in XYZ – if he is not a market-maker in XYZ himself. (A market maker is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price).

Market-Maker A confirms to Broker A that the trade has been done without first locating the shares and so Broker A takes the $1 million from Buyer A and passes it to Market-Maker A. When the trade fails to deliver on T+3 because Market-Maker A has not located the required amount of XYZ shares, the buyer can order a buy-in from Market-Maker A, who can request the use of the DTCC's stock borrow programme.

The DTCC sees that in its lending pool Broker B has one million XYZ shares. The DTCC takes the $1 million as collateral from Market-Maker A and registers this as owing in his account. The DTCC then pays Broker B $1 million and borrows Broker B's 1 million XYZ shares "temporarily". The DTCC then puts the 1 million XYZ shares into Buyer A's account with Broker A through a clearing house. Meanwhile, Broker B now has $1 million in his DTCC cash account to earn interest on until the DTCC returns the 1 million XYZ shares, once they have been returned by Market-Maker A. The crucial issue is how and where Broker B got these shares to put in the lending pool. The XYZ shares actually belong to Investor B who has an account with Broker B and does not know that his shares have been lent out.

In theory, Investor B need never know what has happened to his shares, as Market-Maker A should find a seller of XYZ shares and return the shares to the DTCC. The DTCC would then put back those shares into Broker B's lending pool. However, the source claims that the DTCC does not keep track of how long these loans are outstanding. As a result Market-Maker A is under no pressure to return the borrowed shares unless it wants its $1 million back from the DTCC. So when it is time for clients to receive their monthly statements from Broker A and Broker B, Buyer A's account will say he owns 1 million shares in XYZ, and Investor B's account says he owns 1 million shares in XYZ. The trouble is they are owners of the same shares.

Incentives

The DTCC counters that "the NSCC only borrows shares from a lending member if the lending member has the shares on deposit in its account at the DTC (and voluntarily offers them for participation in the programme)." Point 4 in the diagram, however, shows how this could result in the shares being put back in and lent out again – a self-replenishing pool.

The source explains: "There has been a buyer, so there should be 1 million fewer shares of XYZ than before. The lending pool should now say that zero shares of XYZ are available for lending. But Broker A can put the 1 million XYZ shares he has showing in Buyer A's account back into the lending pool with the DTCC. The incentive is there after all as he could end up with their market value to earn interest on, if the DTCC has to lend those shares on."

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But while the DTCC does not explain exactly how this cannot be so, it insists: "The assertion that the same shares are lent over and over again with each new recipient acquiring ownership of the same shares is either an intentional misrepresentation of the system, or a profoundly ignorant characterization."

Devastating results

If the source is correct, however, the result could be devastating for companies, particularly if they are small, illiquid and cash-strapped, as are many of those listed on the OTC bulletin board. If Company XYZ has bad news, the amount of readily sellable shares is much bigger than it ought to be – Buyer A and Investor B could sell the same shares. XYZ's share price will go down disproportionately, and XYZ might have to issue more shares to raise capital, further diluting the shares. The stock price goes down. This makes it harder to receive financing. The stock price goes down again as the company cannot grow. Investors are less inclined to buy-in.

And so begins a spiral that could ultimately result in XYZ going bankrupt and Market-Maker A getting back the $1 million collateral being held in the DTCC account. The only losers are XYZ and its shareholders, among which are Buyer A and Investor B. A different source estimates that thousands of companies have been bankrupted in this way. He backs up his claim by pointing out that in 1999 there were twice as many OTC bulletin board companies as today – although the majority of the casualties would have been technology companies wiped out when the equity bubble burst in 2000. Says Global Links' Dobrucki: "The company and its shareholders have the right to expect a fair playing field. When illegal trading occurs, the company cannot meet its goals, and shareholder equity is diluted."

If the stock borrow programme does have shares in excess of some companies' floats, the DTCC says it doesn't know about it. "We would not know [if there are excess shares in the programme], and that's a supposition [by those who allege it]... We're not involved at the trading end. This is a trading issue." A spokesman points out the DTCC operates on behalf of its members, not the issuers, and further passes the buck by saying that, regarding fails-to-deliver, "regulatory oversight and responsibility resides with the self-regulatory organisations (the exchanges and penny-stock platforms) and the SEC."

However, the claimants in the outstanding cases against the DTCC maintain that, as the DTCC has the records of all shares in the programme, if there are more shares in existence than issued, it must be aware of this.

This is the state of affairs alleged by OTC bulletin board microelectronics firm Nanopierce Technologies and two of its shareholders, who are suing the DTCC and its subsidiaries the DTC and the NSCC. The plaintiffs blame the stock borrow programme for allowing the manipulation of Nanopierce's share price by various sellers who failed to deliver Nanopierce shares. Among the numerous claims, the plaintiffs allege that the defendants were aware that there was excess stock being held in Nanopierce. The DTCC says one cases have already been dismissed, and that is has filed motions to dismiss all cuurent cases against it. The motions will be heard over the next few weeks, it adds.

Furthermore, the DTCC says it will tell an issuer what amount of its stock brokers are holding with the DTCC, so the company itself would know as much as the DTCC. What it does not tell companies, however, is how much of their stock is on loan. The DTCC would not confirm why.

To what extent the brokers who bought the shares on the clients' behalf know that the shares are not real has been questioned in some of the lawsuits. Some sceptics point out that stock held in a margin account is not necessarily owned by the account holder anyway. In order to ensure actual ownership, some companies have advised their shareholders to request delivery of physical share certificates from their brokers. By law, brokers are required to deliver physical certificates upon client request – a service for which they charge about $40. In turn, they ask the DTCC to deliver the certificates, which it should have in its vaults. But getting hold of these share certificates is proving difficult for some investors.

Demanding delivery

Says Global Links' Dobrucki, "I received many phone calls and email messages from stockholders asking why they cannot get delivery of their stock. I received several email messages from shareholders, which were sent by their brokers indicating that share certificates could not be issued at this time because (a) the company is going through a reorganization and that the 'company' was not issuing shares at this time; (b) the transfer agent was not issuing shares at this time; and (c) that the company is in a 'chill' mode and that shares cannot be issued at this time. None of these answers are true.

"If you purchased shares in Global Links, you have the right to demand delivery of your shares. If the shares simply do not exist, then the problem of naked short selling will come to the surface. The broker that sold you the shares has to provide delivery of your shares. Exchange Act, Rule 10a-2 requires delivery of shares sold to our stockholders."

"It's obvious that some brokers will get greedy and throw as many shares as possible in the stock borrow programme"

The DTCC says that there should be no problem in getting certificates, and that they will be at the transfer agent or at the DTC. One spokesperson for the DTCC says: "I don't know where that comes from. People can get their certificates." He says it can be time-consuming and costly, however, so brokers tend to suggest to investors that they don't attempt to do it. But what if an investor wants his certificate and pays $40 to get it? "You can get it," he says. So if everyone who owns stock asks for their share certificate tomorrow, will there be enough share certificates to go round? "This is an unlikely occurence and would paralyze our capital market system, even worse than the paperwork crisis that shut down the markets in the early 1970s. But because there is some legal naked short selling, the answer is probably not. There can be shortages," says the DTCC spokesperson.

In a response to this non-delivery of physical share certificates, some shareholders are taking their brokers to court.

Alan Sporn, former president and major shareholder of OTC bulletin board company Trident Systems, is suing a group of brokers who, he claims, utilized a number of techniques, including the stock borrow program, to undermine the price of Trident's stock. This attack on the value of the company's stock virtually destroyed the company, both in terms of raising capital for growth, and indepressing the value of the shareholders' investments to virtually nothing, claims Sporn.

Trident purchased a number of companies that primarily dealt in administering self-administered health and benefit plans, each with solid contracts and good potential for success, he says. The result of the short sales was the rescission of all the purchases, and the demise of three of the subsidiaries, claims Sporn. The share price of Trident Systems fell from $20 to 7 cents in four months, and Sporn's attorney Steve Young estimates that there were 2.3 million uncovered short positions in Trident – almost as many as the amount of unrestricted shares trading at the time. The case is still pending before the United States Court of Appeals for the Ninth Circuit in San Francisco.

There are other alleged instances of shares being multiplied. It is claimed that brokers are throwing more than just margin account stock into the DTCC's stock borrow programme. As per the margin rules of the Federal Reserves Regulation T, only shares held in a margin account can be put into the lending pool. It is not permitted for shares held in cash, excess margin, retirement and institutional accounts to be used in the stock borrow programme. In the case brought by Sporn, it is claimed that Trident Systems is an OTC bulletin board company ineligible to have its shares held in a margin account. "In the case of Trident, the shares were unmarginable," says Young, yet "around 50 brokers were trading Trident shares." One industry expert says: "It's obvious that some brokers will get greedy and throw in as many shares as possible to the stock borrow programme, as they make money from it when it is lent out."

Further implicated in the multiplication of shares/naked shorting saga are the market-makers themselves. Robert Simpson does not hold his broker at fault. Instead he believes the market-makers to be responsible alongside the DTCC, as it is the market-maker that agrees the sell.

Market makers at fault

It might be particularly hard to prove that the market-maker is at fault. Market-makers are allowed to naked short. They are supposed to keep the system liquid and so can lend shares without borrowing them first. Where naked shorting becomes illegal is when those market-makers do not intend to cover those positions and/or manipulate the stock price down to make financial gain, or when individuals other than "bona fide market-makers" undertake naked shorting (see page 41). One source stresses that "the majority of naked shorters are the good guys" and that most market-makers will return the shares to the DTCC and collect their collateral.

And as the DTCC points out, of the $400 billion-worth of transactions processed daily in 2004, fails to deliver had an average daily value of only $6 billion. Of these, it claims, some will be a result of simple mistakes, such as "failure by an investor to deliver physical certificates to his broker within two days of a trade; failure to properly sign the back of a physical certificate; sale of a certificate that later is found to have been reported stolen or lost etc."

The success of all the cases is open to question. As one specialist says: "It would be hard to imagine these smaller companies and investors having any impact on the way the stock borrow programme is run even if they win their cases. What it needs is hedge funds and institutional investors to get behind the cause and start demanding their share certificates. Brokers will not want to lose their best clients, and will be buying-in where they can. Then we will know if there are excess shares out there."

It's a confusing tale, and it will be up to the courts to decide just where Robert Simpson and other claimants' excess shares have come from. But if one thing has been proved already, it is that naked shorting, whether intentional or unintentional, is commonplace.

Defendants may well dismiss the companies affected as shams, but if larger companies are inspired to investigate their own stock sales, and investors begin to question the validity of the shares in their margin accounts, who knows what they may uncover? The SEC had better hope its new short sales regulation is having an effect. [see next story]

Strategic failures

Academic research into delivery failures in the US cash equity and options market support the idea that prior to Reg SHO, market makers deliberately failed to deliver securities in a strategic way.

Leslie Boni, an economist at the University of New Mexico, wrote a paper entitled "Strategic delivery failures in US equity markets" while a visiting financial economist at the SEC last autumn. Boni found that most US equity issues experience at least a small percentage of failures-to-deliver every day. On average failed shares account for just 0.15% of the outstanding shares of listed companies and 0.91% of unlisted shares. Some 42% of listed stock issues and 47% of unlisted stock issues, have persistent fails of five days or more.

Any clearing member with a failure to receive position has the option of asking the NSCC to force a "buy in" on its position. Buy-ins, however are rarely requested. In a 2003 paper, Wharton and University of North Carolina economists found that options market makers with cash equity failures-to-deliver were only bought-in in 86 of the 69,063 transactions examine, or just 0.12% of cases.

Academics argue that persistent fails are primarily due to market makers strategically failing to deliver because the data show that the likelihood of persistent fails in a stock increases with its borrowing cost. Persistent fails, they note, are also more likely when a stock is illiquid. The likelihood of persistent fails in a security also increases if it has options listed because option market makers can hold short stock positions for longer than equity market makers.

SEC seeks to curb naked ambition

The SEC has amended legislation in a belated effort to clamp down on naked short selling. But it remains under pressure from a lobby group that ranges from senators to lawyers, and management to shareholders, who believe the new rules are having little effect. • *Helen Avery reports*

ON JANUARY 24 this year, Anthony Elgindy was convicted in Brooklyn Federal Court on charges relating to a naked shorting scam that affected more than 100 penny-stock companies. Between 1999 and 2002, Elgindy had been running a subscription website for hedge funds and brokers that invested in shares traded over the counter or on the pink sheets.

On the website, Elgindy established a message board where he posted price-sensitive, non-public information provided by an FBI agent, Jeffrey Royer, on the penny-stock companies and their executives. Elgindy and his subscribers could then naked short the company's stock, before information was made public, making thousands if not millions of dollars in the process. "The whole purpose was to discredit the companies," alleges one source familiar with the trial. "Some attorneys were also involved in the scam, issuing class action lawsuits against the companies to hit them harder, make them unable to get financing, and eventually forcing them to be delisted." Elgindy's attorney has said there will be an appeal.

Donaldson: the SEC chairman is under mounting pressure to prove that new rules on naked short selling are working

PHOTO BY LARRY WONDER/REUTERS

Comparison of locate, delivery and close-out requirements
Pre- and post-regulation SHO

	Pre-regulation SHO	*Post-regulation SHO*
Locate requirements	There must be arrangements or acceptable assurances that the stock can be borrowed and delivered on the settlement date before short selling. Exempt: equity market makers, options market makers, hedgers and arbitrageurs	There must be arrangements or acceptable assurances that the stock can be borrowed and delivered on the settlement date before short selling. Exempt: equity market makers and options market makers
Forced delivery	Any clearing member with a failure to-receive position has the right to request the NSCC to force delivery ("buy-in") the position	No change
Mandatory close-out requirements	Nasdaq stocks with fails of at least 0.5% of shares outstanding and 10,000 shares that persist for 10 days or more, must be closed out. Exempt: equity market makers, options market makers, hedgers and arbitrageurs	NYSE, Amex, Nasdaq, OTCBB and Pink Sheet stocks with total fails of at least 0.5% of shares outstanding and 10,000 shares that persist for five consecutive days ("Threshold" stocks), must be closed out if positions fail for at least 10 days. Exempt: pre-existing fail positions and new short sales that are options market makers' hedges for pre-existing option positions
Other deterrents	NASD rules prohibit further short selling by those with fails-to-deliver in a security for at least 60 days	Those with fails of at least 10 days in "Threshold" stocks cannot make further short sales until fail positions are closed out, unless the stock has already been borrowed (or borrowing has been arranged)

Source: "Strategic delivery failures in US equity markets", Leslie Boni, University of New Mexico

Royer was also convicted, and says he will appeal, while others alleged to be involved in the scam are currently being investigated. Yet just two months after Elgindy and Royer's convictions, some former subscribers to Elgindy's website can be found on a new message board, sharing price-sensitive information on penny-stock companies, and betting on companies' downfalls.

Crackdown

Cracking down on illegal naked shorting, where stocks are sold with no intention of borrowing the necessary securities to deliver, has stepped up in the SEC's list of things to do. Last August, the regulator passed long-awaited new short sales regulations (Reg SHO) that came into effect in January. Before that time the short sale rules had not been updated since 1938. But a series of events in the late 1990s and early 2000s meant the SEC could no longer put off calls for an update. There had been an increasing number of complaints from issuers and investors about alleged naked short selling; press reports questioning links between decreasing stock prices and naked short selling; and the settlement by the SEC of a case involving alleged massive naked short selling of the stock of software applications and services provider Sedona Corporation, a Nasdaq small cap company. The action alleged that the defendants engaged in massive short selling that flooded the market with Sedona stock, and consequently depressed its price. Can the SEC stop the illegal naked shorters? Not everyone is convinced Reg SHO is enough.

Last month, Utah senator Bob Bennett told SEC chairman William Donaldson as much at a hearing on the state of the securities industry. He pointed to Robert Simpson's (see main story) discovery of excess Global Links shares, saying: "You put out a new rule in January to deal with naked short selling and it is not working.... I have constituents who say trading since the rule was adopted in our stock has exceeded the available float by four or five times on a daily basis. This [the Simpson case] indicates that people are still selling short shares they don't have and are clearly never going to acquire."

There are two features of the regulation that the SEC hopes will lead to a decrease in illegal naked shorting. The first is the introduction of a set of standard rules that govern when a security can be sold short. (Before Reg SHO, US stock exchanges and the National Association of Securities Dealers had their own sets of rules.) Broker/dealers who do not act in a market-making capacity are required to have either borrowed the security, to have entered into an arrangement to borrow the security at the time they short sell, or at least to have "reasonable grounds" to believe that the security can be borrowed so that it can be delivered. "Bona fide" market-makers, who are allowed to naked short as it ensures a liquid market when demand is unexpected, are exempt from these rules.

The problem of this new locate rule, however, is a question of semantics, say critics. The definition of "reasonable grounds" and "bona fide market makers" are open to interpretation. As Glenn Bagwell, an attorney in North Carolina, pointed out in the SEC's comment period for the rule: "Who determines what 'reasonable grounds' might be? What if the broker is relying upon its ability to 'borrow' shares... held... at the DTC? 'Reasonable grounds' is not an objective standard and there are too many dishonest market participants who will take advantage of this proposed subjectivity to allow it." It's an important point. If the stock borrow programme can, on request, borrow the securities on the short seller's behalf and the short seller knows this, then he can claim 'reasonable grounds' to have known the security could be borrowed and delivered.

Room for abuse

Bagwell adds that the SEC should enforce the distinction between 'bona fide market-making activity' and the naked short-selling-based trading strategy that many market-makers currently employ on a daily basis. "Again, if the SEC gives these industry players 'wiggle room', many will abuse it as they do today," he says.

The second section of the rule aimed to prevent naked shorting is the introduction of a Threshold Securities List. The DTCC now provides information to the New York Stock Exchange, Nasdaq, Amex, OTC Bulleting Board and Pink Sheets, which in turn publish daily a report of their listed companies where for five consecutive settlement days there have been aggregate fails-to-deliver of 10,000 shares or more, and if the level of fails is equal to at least 0.5% of the company's total shares outstanding. Once this stretches to 13 consecutive days, the broker/dealer or his >

clearing house must order a "buy-in" to close out the position.

Whoever was responsible for the short sale and subsequent fail-to-deliver, the market-maker or the broker/dealer has to buy in the securities. If he is unable to buy-in the securities to cover his short position, then he must no longer short sell shares in that company without having borrowed the shares upfront until the time that he covers his position. This process is designed to prevent continued open-ended fail-to-deliver transactions, with the onus being put on the broker/dealers and clearing houses to pressure the short seller.

Mandatory buy-ins

Just how effective this list and the forced buy-ins are has led to debate. As of March 15 there were 223 companies on the threshold list for the five exchanges, and 151 on the threshold list of the OTC bulletin boards and pink sheets. In theory, mandatory buy-ins for companies on the list for 13 consecutive days should result in companies dropping off the list shortly after. Some companies, however, have remained on the list since its formal inception on January 3. Merrill Lynch publishes a report daily showing every company on the threshold on the NYSE, Amex, Nasdaq National Market, and Nasdaq small cap market, and the length of time they have been on the list. As of March 15, 11 Amex-listed companies had been on the list since inception – 45 days. Of these, 12 had remained on Nasdaq, and 13 had remained on the Nasdaq Small Cap. 14 NYSE-listed companies had remained on the list. These included Krispy Kreme Doughnuts, Martha Stewart Living Omnimedia, Novastar Financial and Delta Airlines.

A spokesman for Delta Airlines said the company was "keeping an eye on the situation." When mortgage lender NovaStar Financial was asked whether the company was being naked shorted, the spokesman said it could not comment, and concentrated only on increasing investor return through solid company management.

One man who claims to be certain that NovaStar is being naked shorted calls himself Bob O' Brien. Advised by lawyers not to use his real name, O'Brien, who claims to be a retired investor and long-term shareholder of NovaStar, established a website in the autumn of 2003 dedicated solely to investors in the company. "I wanted to create a central archive of the good information on NovaStar that appeared on Yahoo message board posters, by people who are hugely knowledgeable on the sector and the market. During short attacks, the boards would be clogged by nay-sayers. Over time it became obvious to me that the trading volume on 'attack' days far exceeded what could reasonably trade given the size of the float, so I suspected naked shorting was at play. When the Reg SHO Threshold list came out in preliminary form on December 3, my suspicions were confirmed – NovaStar was on it. It has been on it every day since. So it's not a question of whether the stock is naked shorted, but to what level."

Susan Petersen, a special counsel in the SEC's division of market regulation, says that it does not make public the exact amount of fails-to-deliver as it would potentially have negative effects on investors and broker/dealers by revealing trading strategies.

What is telling, points out O'Brien, is that since the list officially was published in January, the price of Novastar's shares has declined well over 30% [at times] – surprising if there was buying pressure from the fails being covered.

O'Brien, who also runs the National Coalition Against Naked Shorting, is responsible for the placement of a full-page advert in the Washington Post in February, drawing the attention of George W Bush and SEC chairman William Donaldson to the unresolved issue of naked shorting. One significant financial contributor to the advert was Patrick Byrne, CEO and president of Nasdaq-listed Overstock.com, a discount shopping website, with a market capitalization of almost $900 million. His company has been on the threshold securities list 32 out of the 45 days, and its share price has fallen 32.6%. "I don't care about our stock price – I am a value investor, but as a CEO I have shareholders who do care about our stock price," he says. "And I do care if criminals are illegally manipulating our stock price [through naked shorting]."

Byrne is convinced naked shorting explains why Overstock.com is still on the threshold list. "People would say the fails to deliver are not all naked shorting, that they're simple hold-ups, but that is quibbling. The SEC set the threshold to ensure that companies with honest fails to deliver would not be included. In our case the threshold is already 100,000 (0.5% of our 20 million shares outstanding) to ensure that companies with honest fails to deliver would not be included. We have passed the threshold and we've stayed on it. That says enough."

Rolling over fails

On March 15, 102 companies on Merrill Lynch's published Threshold Securities list had been there more than 13 days. But critics claim that the list itself is not an accurate reflection of companies that have been naked shorted. They argue that many more companies than appear on the list are being affected, but on the thirteenth day when the naked shorter is forced to buy-in, he contacts another market-maker and rolls over the short to him.

As Senator Bennett explained to Donaldson: "I am told the way it works it that one brokerage house sells short, has 13 days under your rules to acquire the shares, and after that 13-day period hands that transaction off to another brokerage house and they keep moving it around and nobody ever has to settle and they use the 13-day rule. That's clearly something that needs work."

Jamie Brigagliano, an assistant director in the SEC's division of market regulation agrees that it could happen, but points out that the rule states that you cannot enter into a close-out that you know is a sham. "It shouldn't be okay [to roll over fails], and we're not aware of it happening." Brigagliano says the SEC will be conducting examinations for compliance with Reg SHO, and those exams will confirm if it is happening.

Indeed, if forced buy-ins were occurring for companies on the Threshold List, their stock prices should be reflecting it. Mary Ann Bartels, global equity trading strategist at Merrill Lynch in New York, says: "Certain stocks have been affected [since the list] but stocks as a whole have not had much upward bias. We thought there would be upward pressure, particularly for small-cap stocks, as well as an increase in borrowing costs. These borrowing costs have gone up a little, but not many stocks have had major upward pressure on price." On March 15, 25 out of the 44 NYSE companies listed on the Threshold List had

Toxic funding

Manipulation of the stock prices of small, start-up companies can manifest itself in several ways. Genuine start-up companies are in need of investment, and illegal naked shorters can use their vulnerability and inexperience as a means of making money. Wes Christian, partner with law firm Christian, Smith & Jewell says there tends to be two or three ways that these investors will loan a company money, and simultaneously short them out of existence using complicated financial arrangements – so-called toxic funding, or 'death-spiral financing'.

These financial scams involve a ring of investors who convince a small start-up company that they are interested in their company, product or idea. They can offer to loan the start-up $5 million, with a second-tranche promised of $25 million if the stock doesn't fall below, say $1. It sounds reasonable when your company's stock price is currently about $7. The ring of investors then begins to sell the company's shares, short-selling, slandering the company's name – anything to bring the share price down to below that $1 and avoid paying the $25 million. Once other investors see the start of a 'death spiral', they tend to jump ship, adding to the downward pressure on company stock. The ring of toxic financiers can then demand conversions into shares, which will allow them to cover their short positions at a large profit, or, if the company has gone bankrupt, not cover at all. It is even possible, that the money loaned initially came from short selling by the toxic financiers. The company, essentially, was loaned its own money.

Universal example

Universal Express is a group of product and service providers to the US private postal industry. During the six months ended December 31, 2004 it had operating revenues of $579,787, and among its strategic partners are Ford Motor Company and American Airlines. Over seven years ago, however, it was the target of toxic financiers. In December 1997, Universal Express entered into, what it thought was a legitimate investment banking agreement with Select Capital Advisors. These arrangements included the creditors' right to convert debt instruments to free trading shares of the company's common stock. This was alongside long-term conventional financing which would satisfy the short-term financing, the investment bankers assured. By January 1998, this long-term financing had not arrived, and Universal Express began to notice a substantial increase in the company's daily stock sale volume. Chris Gunderson, the company's general counsel, suspended all conversions. From January 16 to February 9, Universal Express had issued and outstanding three million shares of its common stock, but during this brief period, 70 million shares or so were traded in the open market. In April that year Universal Express commenced a civil action in the 11th judicial circuit court of Florida against some of the employees of Select Capital Advisors for fraud and deceit. The final judgement was entered in Universal Express's favour for $389 million. In a follow-up judgement against remaining conspirators, Universal Express was awarded a further $137 million in April 2003.

produced negative returns since being on the list. These include UK utility United Utilities, with a market capitalisation of $8.3 billion, and Portuguese electric company, Energias de Portugal (EDP), which has a market capitalisation of $8.9 billion. Scott Peterson, a spokesman at NYSE, says it is too early to tell whether the threshold list indicates naked shorting is occurring, but says the exchange will conduct a process of targeted exams and fieldwork from April 1 to May 31. "After that we should be able to determine if there has been abusive short selling of NYSE listed securities or not," he says.

Cautious optimism

Bartel adds: "The lack of upward bias of stocks on the Threshold Securities list doesn't necessarily mean the Reg SHO is not working. It could mean there wasn't a lot of dollar volume, or a borrow was located or part of the naked shorts were those that were grandfathered in."

The situation of grandfathering in those naked shorts before January 3 by the SEC has prompted complaints by some of the companies affected. Reg SHO only applies to trades executed from January 3 onwards, so all fails-to-deliver, potentially as a result of naked shorting, for companies before that date are exempt from the buy-in rules. This could mean that companies that have been on the list from its inception have so much in excess of the 10,000 fails to deliver reported on January 3, that when there are buy-ins on those trades, it still does not take them below the 10,000 threshold. And as those positions before January 3 are not subject to the new forced buy-in rule, it is no wonder that there is no upward pressure on stock prices.

David Lott, CEO of Limelight Media disagrees with this grandfathering. His company has appeared on the OTC Threshold List since inception, and he says the management believes that the company's public stock has been a victim of shorting practices. "The grandfathering should not have happened. I think the shorts should have been covered. It is the only way to maintain a fair market."

The SEC's Brigagliano says the commission made a choice. "We were concerned about generating volatility where there were large pre-existing open positions, and we wanted to start afresh with new regulation, not re-write history."

He says the SEC is "cautiously optimistic that the new regulation is having a positive impact. "It's a bit premature to really assess the effectiveness of the rule, but some data we have indicates that there may have been some positive impact already. Some data shows that aggregate fails-to-deliver have declined since January 3. But we don't want to jump to conclusions."

If anything, the Reg SHO is an admission by the SEC that there is a naked shorting problem. It will not be until it has conducted examinations, that the extent of the problem will be revealed, and the rules may have to be re-considered. One academic says: "It's the beginning at least of the SEC addressing the issues of illegal naked shorting. There's a lot that needs to be sorted out, such as the duplication of shares, but I think they will get there." >

Stung by the German connection

Thousands of US stocks are being traded on a little-known Berlin exchange, without the knowledge of many of the companies involved. Have the naked short sellers exported their practice overseas?

Peter Koh *reports*

A YEAR AGO Ted Noble, chief financial officer at Advanced ID Corporation, a Calgary-based microchip-tracking company, received some surprising news.

"We were congratulated by a third party who saw that our shares were trading on the Berlin Stock Exchange," he recalls. "That came as news to us because we'd not done anything to get listed in Germany. I talked to a few people and we couldn't figure out whether it was good or bad."

Noble soon found out when his company's shares started behaving oddly on the US OTC bulletin board. "April 29 [2004] was a slow day, and only about 10,000 of our shares had traded. Then 370,000 shares traded in the last 20 minutes before the close. It knocked our stock price down from 58 cents to 41 cents, before closing nearly 20% down at 48 cents. That was very unusual for our stock. I'd never seen anything like it."

Noble was not the only interested party shocked by what had happened. "We had a number of very angry shareholders calling us, wanting to know what was going on. But there hadn't been any negative news about the company, so we couldn't explain it."

Noble went in search of more information. "I looked back at days with irregular trading activity and the pattern was always the same. Just before the end of the day, someone would come in and batter our stock down. There was a big short going on and we just suspected that Berlin might have something to do with it. We acted quickly to delist and the problem just went away after that."

Advanced ID Corporation is hardly an isolated case. Over the past 10 months, over 250 US-listed micro-cap companies have stopped their shares from trading on the Berlin Stock Exchange's Freiverkehr (unofficial) market because they fear that trading overseas is being exploited to circumvent US naked shorting restrictions. Many more are scrambling to do the same but they might not be so lucky.

On the threshold

Wireless Age Communications, a Toronto-based high-tech telecommunications equipment manufacturer listed on the US OTC bulletin board, is the latest. On March 10 2005, the company announced that it had hired lawyers to try to halt trading of its shares on the Berlin Stock Exchange and to prevent the trading of its shares on any international exchange, after the company found itself on the Nasdaq Threshold Securities List, indicating that the company had been naked shorted.

A month before, on February 16, Greg Manning Auctions, a New Jersey-based auction house, filed a complaint with the National Association of Securities Dealers (NASD) regarding possible manipulation of the company's share price through naked short selling. Greg Manning also announced that it was seeking to halt trading of its shares in Berlin. In its statement, CEO, president and first vice-chairman, Greg Manning said: "We believe this listing is part of an effort by certain individuals or firms to circumvent NASD and SEC restrictions against short selling."

US companies fear that exemptions for international arbitrage trades in the SEC's Regulation SHO, which came into effect this January, and the fact that foreign brokers are not subject to US delivery requirements, makes it possible for traders to get away with naked short selling in the US.

Hard evidence that this is happening is difficult to come by but anecdotal evidence abounds.

Companies are astounded that their permission was never sought before their shares began trading in Berlin. But under German rules, their permission is not necessary. Any stock traded on any recognized exchange in the world can be traded in Germany, provided that certain minimum criteria are met.

All that is needed for a company's shares to begin trading is for a broker to nominate it. The broker then buys the shares from the home market, quotes them in euros and trades them in Germany. Officially, the idea behind the system is to make it more affordable for German investors to trade foreign stocks, by avoiding the very high costs associated with cross-border clearing and settlement. In total 5,275 US securities trade on the Berlin Stock Exchange.

Some market experts in Germany, however, see the Freiverkehr system as one primarily designed to prop up the regional exchanges by giving them something to trade. Although many companies have managed to stop their shares from trading on the Freiverkehr over the past year, this came down to the good will of the German brokers and the exchange. There is no legal argument available to these companies to order a cessation of trading. In fact it might not even be possible once shares in a company are owned by German investors.

"There is really no way of 'delisting' from the Freiverkehr," says Oliver Kessler, a partner at international law firm Lovells in Frankfurt. "The only thing a company can do to try to achieve a 'delisting' is to fail to meet the preconditions for inclusion, which it may be able to do by failing to provide any information requested of them by the exchange."

Suspicious nominations

Many companies are suspicious about why about 1,000 OTC bulletin board companies were nominated for trading in Germany shortly after a long-running problem with Canadian brokers had been resolved and the NASD extended its Rule 3370 to include non-member broker dealers in April 2004.

German brokers however, have legitimate reasons for applying to trade overseas stocks in large numbers. "We have a lot of competition here," says Holger Timm, CEO of Berliner Freiverkehr, one of the major brokers on the Berlin exchange. "The different stock exchanges are in competition with each other as are all the market-makers. Bulletin board companies are more interesting for us because we get better margins. We trade big caps too but don't make as much money on these."

Timm thinks the US companies have been jumping to the wrong conclusions. "The whole story that trading in Germany is damaging the share prices of these companies is complete nonsense," he says. "We have been doing this for 20 years. It cannot hurt these companies if German investors want to buy their shares."

However, Timm says that after news began to surface of US companies' concerns about being naked shorted through Freiverkehr trading, he received a telephone call from a man claiming to represent hedge funds interested in doing just that. "An individual claiming to be a consultant for some hedge funds asked me how to do it [naked short selling]. I said there was no way, but he insisted that there must be and that he wanted to know the secret."

"We believe that listing is part of an effort to circumvent NASD and SEC restrictions against short selling"

Freiverkehr brokers cannot lend stock but as market makers, can short sell, so long as their books are covered within two days. If there is not enough liquidity in Germany to complete a trade, the German market-maker would go to a market-maker in the US to get it done. According to brokers, naked short selling is not possible in Germany because of the strict settlement requirements.

Although every trade is automatically reported directly to the federal regulator BaFin, experts on the German securities market describe regulation of the Freiverkehr as "insignificant". Many rules simply do not apply. While an ordinance was recently introduced to cover market manipulation, the rules are very broad and enforcement experience is lacking.

Retail investors that buy on the Freiverkehr via their brokers tend to stick to foreign blue chips. The companies that have complained, however, are all micro-caps worth less than $50 million. They are predominantly early stage biotech, defence technology and internet companies.

"What could be happening is that market manipulators in the US are so short on some of their positions that they are trying to cover some of their naked short positions overseas," says Rich Kaiser, CEO of Yes International, an investor relations consultancy that has helped 15 US companies to get their shares off the Freiverkehr.

"The Berlin Stock Exchange is probably being used as a conduit but the scheme works by exploiting flaws in the US trading system, particularly at the DTCC [see main story]. If they trade on overseas exchanges through offshore accounts, the trades take longer to settle and become harder to trace."

The SEC and the NASD visited Germany in June last year to meet with the Berlin Stock Exchange, the state regulator and BaFin. Though the SEC refuses to confirm the visit, the Berlin Stock Exchange confirmed the parties met to investigate the naked short selling claims.

In a statement issued last year Jörg Walter, managing director of Berlin-Bremen Stock Exchange, said: "We checked all OTC bulletin board stocks and focused on stocks of companies which had complained about illegal short selling activities on Berlin-Bremen Stock Exchange. We came to the conclusion that in none of these cases was there an indication that short selling actually took place on our exchange. In some cases stock prices went up due to a majority of buy orders. In some other cases our investigations revealed that stocks were either not yet introduced to trading on our exchange or that there was no trading activity at all during the relevant period although the companies had explicitly blamed trading on the Berlin-Bremen Stock Exchange for falling stock prices."

After returning from Germany in July 2004 however, the NASD took the unusual step of reminding its members of the extension to Rule 3370 and the guidelines governing the international arbitrage exemption, which came into effect just three months before.

Complaints from US companies keep emerging. "It looks to me like it's a good way for lawyers in the US to make money," says Thomas Posovatz, speaker of the management board at MWB Wertpapierhandelshaus, a Freiverkehr broker.

Department of Commerce and secret service representatives at the US embassy in Berlin are now also believed to be investigating the situation. The US embassy in Berlin declined to comment when contacted. ■

Wall Street's Next Nightmare?

Flamboyant Litigator JohnO'Quinn is Gunning for Another Bonanza: The Entire Trading System in Penny Stocks

By: Rob Wherry

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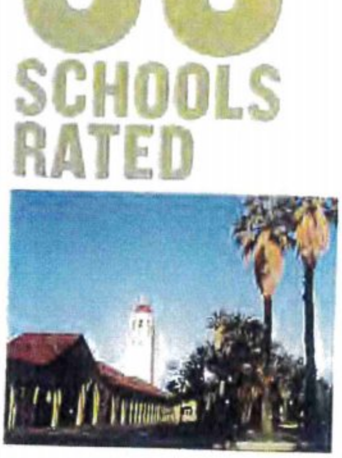

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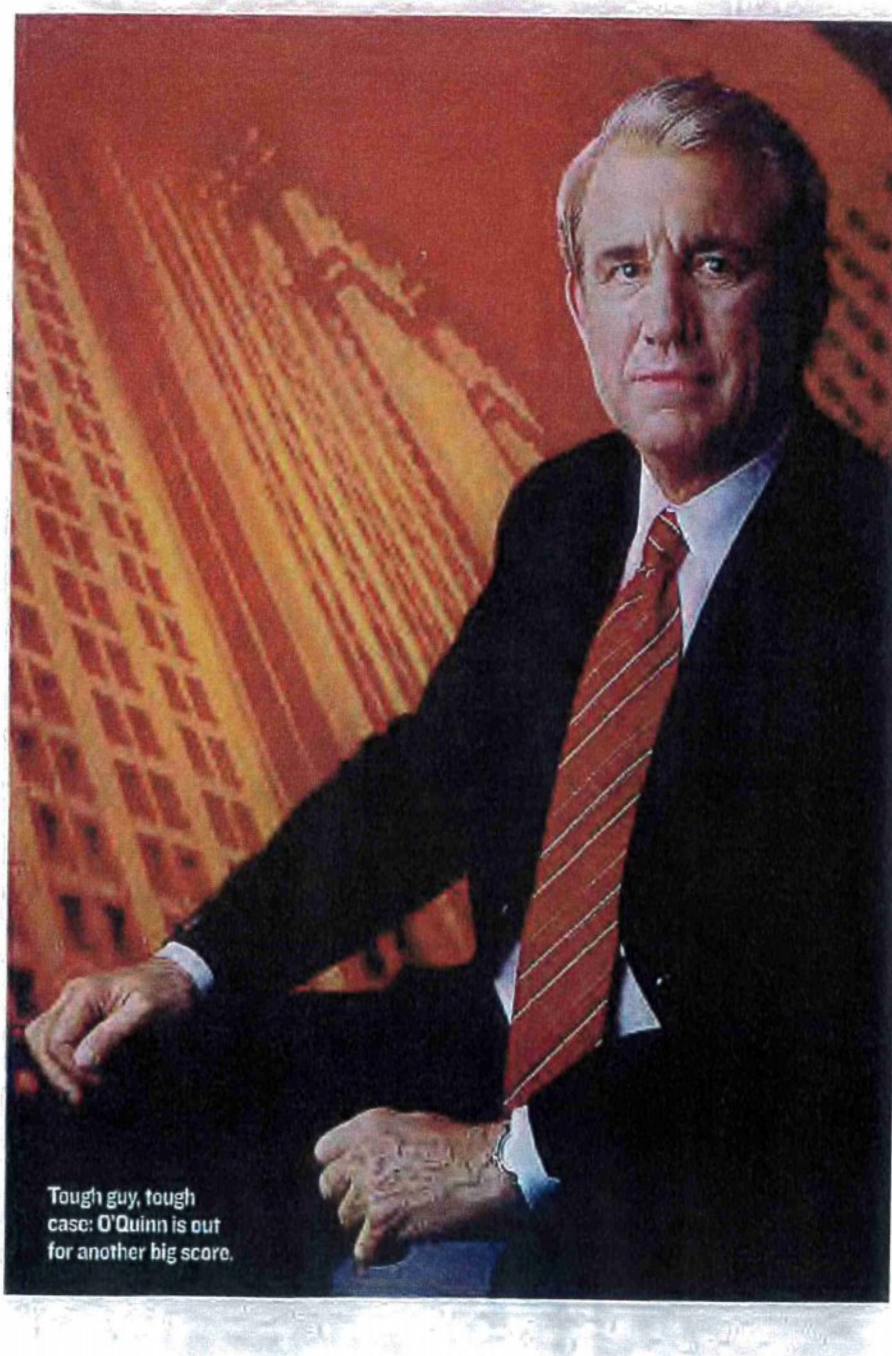
Wall Street's Next Nightmare?

Flamboyant litigator John O'Quinn is gunning for another bonanza: the entire trading system in penny stocks | BY ROB WHERRY

FROM HIS 23RD-FLOOR SUITE OF offices in Houston's Lyric Centre, John M. O'Quinn is plotting what he hopes will be his next multibillion-dollar jackpot. Not that the 62-year-old senior partner of O'Quinn, Laminack & Pirtle needs the dough; FORBES estimates his law firm has won $1.5 billion in fees from the makers of silicon breast implants and cigarettes. This time he's aiming at Wall Street. O'Quinn has a hand in 15 lawsuits alleging that various brokerages (including Ameritrade and E-Trade) and marketmakers like Knight have destroyed his clients by helping to sell the companies' shares short in a scheme to run the stock prices into the ground. The damage is daunting: O'Quinn says 1,000 companies have lost at least $100 billion in market capitalization. "If you short a stock for the sole purpose of killing the value," he says, "that's a threat to the view that we have an honest market."

The fuss is over naked shorting, a practice that's been around for decades and that is sometimes legal. Normal short-selling involves borrowing real certificates for stock, selling the stock, buying new shares at a later date, and using the new certificates to replace the ones borrowed. Naked short-selling differs in that no real certificates change hands. Instead, the short-seller creates a paper entry showing that it owes shares to the stock buyer and will get around to delivering them later.

Naked short-selling is legal if done by a marketmaker in a temporary arrangement; it's normal for a marketmaker to be net short for a day or two and then close out the position by buying real shares



Tough guy, tough case: O'Quinn is out for another big score.

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PAM FRANCIS FOR FORBES

later. Naked shorting can be illegal if done with the conscious intention of leaving the short position as a paper entry indefinitely.

It's often hard to tell the legal variety of shorting from the illegal. Nowadays most stock available for trading is held in book-entry form, and thus takes the form of electronic blips on the books of a stock-clearing company. Depository Trust & Clearing Corp.'s subsidiary is one of the leaders in the clearing business. In the normal course of business DTCC tolerates so-called failed-to-deliver entries of shares offered for sale by, say, brokers. This means the seller doesn't have the certificates on hand but promises to be good for them eventually. Is the clearing firm too tolerant of failed-to-delivers, thereby facilitating illegal naked shorting by brokers (or their customers)? That's the allegation in the lawsuits.

O'Quinn and his top lawyer on these cases, James W. Christian, senior partner with Houston-based Christian, Smith & Jewell, claim that over the last three years billions of uncovered naked shares were sold; that marketmakers (and/or their clients) took profits after waiting for share prices to fall before buying in—if at all; and that brokerages allowed fictitious shares to be traded two, three and four times over, in possible violation of Securities & Exchange Commission rules. Defendants deny the charges and have tried to dismiss some of the cases.

"It's the perfect murder," says O'Quinn, who is quick to smell collusion. "We've got a situation where the cop can't arrest the suspect because it causes too many problems for the police department."

But in this case the police seem to be getting involved. Last February the SEC levied a $1 million civil penalty against Rhino Advisors, a small New York City investment house, and its president, Thomas Badian, for using offshore accounts to short the stock of Sedona Corp., a King of Prussia, Pa. software maker and an O'Quinn client. (Rhino and Badian didn't admit or deny any wrongdoing.) Just last month Louisiana's attorney general issued a subpoena on behalf of that state's Sedona shareholders against UBS PaineWebber. (He's seeking information on failed stock deliveries, among other things.) In a separate civil suit Sedona wants a hefty $2 billion in damages against 17 defendants, including Credit Suisse First Boston's Pershing clearing unit and Westminster Securities, alleging their naked shorting knocked Sedona's share price so low that several big vendors shied away from doing business with it. New York's Attorney General, Eliot Spitzer, is interested in the case.

Still, a tobacco-size payoff for O'Quinn is not in the bank. The case of Universal Express, a Manhattan-based logistics firm (and not an O'Quinn client), illustrates one reason it's hard to collect. In 2001 it received a $389 million award levied against three Florida defendants found liable for fraud and stock manipulation, including naked short-selling. But Universal is having a tough time seeing a penny: It says the assets are in offshore accounts.

Before anyone can collect, plaintiffs have to prove fraud or manipulation—and that's tough. It's not enough to show a sliding stock price, wild discrepancies in daily volume or even a disparity between a company's authorized number of outstanding common and the number of shares traded. The key lies in demonstrating manipulation of the entire trading system.

"These claims divert attention away from the real problems: failed business plans, poor management, little revenue and no prospects," says Michael S. Rosenblum, a Los Angeles lawyer who has represented some of the defendants in these cases.

A lot of O'Quinn and Christian's success will rest on whether they can demonstrate hanky-panky within the DTCC's stock-lending pool. These are shares set aside to assist members that come up short during the day. Marketmakers, for example, borrow them and promise to make good on the missing certificates—eventually. But here's where it gets fuzzy. The SEC's Rule 15c3-3 allows for "temporary lags" in possession of the shares, "provided that the broker or dealer takes timely steps in good faith to establish ... control." And therein lies an area of ambiguity larger than Texas.

Temporary, shmemporary, says Nutek, a Las Vegas holding company that includes a data processing and market survey firm. Last year its stock price fell from a high of 13 cents a share to 4 cents. Scrambling to raise equity capital (it made $732,000 on sales of $6.6 million in 2002), it issued at depressed prices at least 35 million more shares than it intended to, which it blames in large part on naked shorting. Earlier this year Nutek and its shareholders filed suit against 12 brokers for failure to deliver the shares. The brokerages proposed a settlement to deliver the certificates but only a few shareholders have received them. Now Nutek has hired Michael Morrison, a Reno lawyer affiliated with O'Quinn, to pursue a civil action.

"The cop can't arrest the suspect; there are too many problems for the police department."

Endovasc, an early-stage drug development firm in Montgomery, Tex., is bringing similar charges against marketmakers, including Knight. The suit alleges, among other things, the company's stock was oversold by at least 1 million shares in October 2002. Christian will try to prove the marketmakers profited by letting the open positions sit for months and then buying in, if at all, at a cheaper price. During 2002 Endovasc's stock went from a split-adjusted $7.50 a share to 65 cents. It's an easy stock to be bearish about: Endovasc has lost $5.4 million on revenues of $293,000 over the nine months ended Mar. 31.

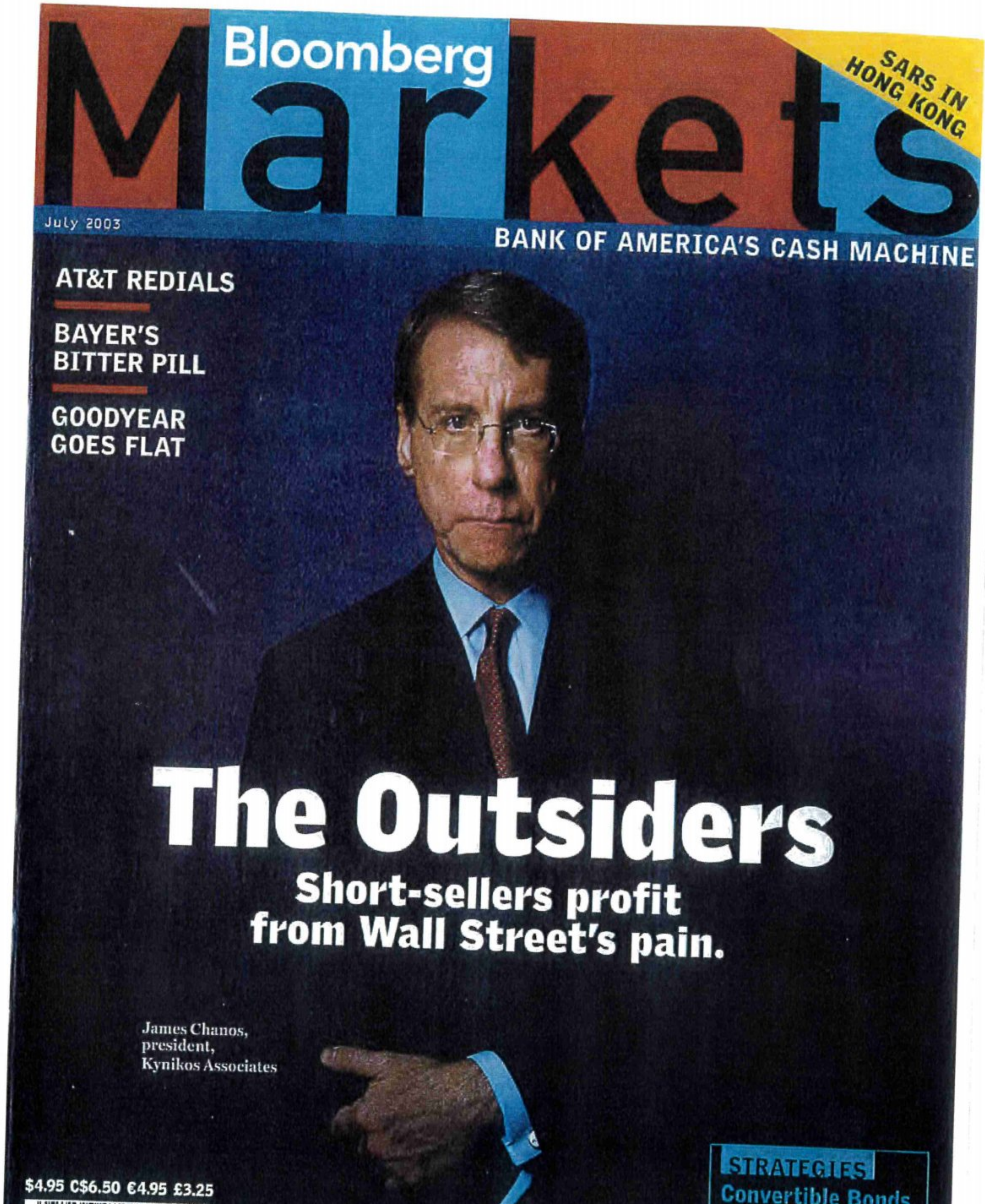
Which raises the question of whether some of O'Quinn's clients are really worth rescuing. Amazon Natural Treasures, which was a Las Vegas-based maker of herbal supplements in the 1990s, sued DTCC, arguing its clearing firm improperly allowed unregistered shares to be sold on the open market. The case was settled. In the meantime Amazon's fortunes sank. The last time it filed a complete 10-K, Amazon reported a loss of $4.8 million on sales of $392,000. That was for 1998.

What's really making these stocks go down: the way the trades are cleared—or how the managers run the firms? F

The Outsiders

By: Edward Robinson

BLOOMBERG MARKETS
July 2003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James Chanos, president, Kynikos Associates
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PHOTOGRAPH BY HENRY LEUTWYLER

The Dean

James Chanos
President of Kynikos Associates Ltd., New York

AGE 45

HOT CALL In November 2000, he said Enron's off-balance-sheet chicanery would pound the stock; in 2002, he explained Enron to Congress.

The Outsiders

Short-sellers, never a popular breed on Wall Street, have flourished during the bear market.

By Edward Robinson

Manuel Asensio, a self-described "hostile, adversarial short-seller," went on trial for defamation in Philadelphia last year—and so did short-selling itself. Hemispherx Biopharma Inc., a Philadelphia-based biopharmaceutical company, had accused Asensio of damaging its reputation in a 1998 research report. Asensio, president of New York investment firm Asensio & Co., had claimed the company was defrauding investors and that its top drug was "medically useless."

Under cross-examination on Feb. 14, 2002, Asensio called his adversaries "corrupt," and when Judge Albert Sheppard admonished him to stop, the short-seller lashed out at him, too. "Let's have a fair trial," Asensio told Sheppard in front of the jury.

"That's what I'm trying to do," the judge replied.

"No, your honor, you're not doing that," Asensio shot back. "You're totally biased, and it's obvious."

After four weeks, the jury delivered an 11-to-1 verdict that found Asensio was not liable for defamation. Judge Sheppard says he'll never forget the stormy trial. "Sometimes they come in and it's not just a case," the judge says. "It's a cause."

For Asensio's cause—making money from plunging stock valuations—these have been the best of times. As most equity investors struggled to stem losses last year, short-selling stock funds produced a 32 percent return net of management fees, according to Van Hedge Fund Advisors International Inc., a Nashville, Tennessee–based research firm that compiles an index of 11 such funds. With a 64 percent total return from Jan. 1, 2000, to Dec. 31, 2002, the index beat the Standard & Poor's 500 Index's minus 40 percent return by 104 percentage points. "Short-selling used to be like Japanese cars: un-American," says Harry Strunk, president of Aspen Grove Capital Management LLC, a Palm

Beach, Florida-based consultant to short-sellers. "Now the bear market has kicked short-selling into higher gear."

Shorting a stock is usually a straightforward transaction: An investor borrows shares from a broker, sells them and later buys new shares in the marketplace to repay the broker. If the share price slid in the interim, the short-seller pockets the difference as profit; if the stock rose, the investor can suffer steep losses to cover the position. The practice has drawn scrutiny from regulators and often infuriates both the companies involved and investors who bet on rising stocks—called "longs" by the shorts. "Your activities are mean, shameful and loathsome," Alberto Vilar, president of New York-based Amerindo Investment Advisors Inc., wrote to Asensio in 1998 after the short-seller criticized Amerindo for investing in Avant Corp., a software maker Asensio was shorting at the time. "They are motivated by appalling avarice and greed, and they will not be permitted to go unanswered."

Says Asensio, "We promote a contrarian view—and we're proud of it."

The Firebrand

Manuel Asensio
President of Asensio & Co., New York

AGE 48

HOT CALL In 2002, a jury cleared him of accusations that he defamed a biotechnology company he'd shorted four years earlier.

A short-seller needs a thick skin, says James Chanos, president of Kynikos Associates Ltd., a New York-based firm with more than $1 billion in assets that specializes in short-selling. "Every day, you are barraged with negative reinforcement. CEOs, investor relations and PR people are constantly saying you are wrong," says Chanos, who named his firm after the Greek word for *cynic*. "You will never be the most popular guy at the party if you say the emperor has no clothes."

Short-sellers have been one of the most-maligned tribes in the financial world for four centuries, says Edward Chancellor, author of *Devil Take the Hindmost: A History of Financial Speculation* (Farrar, Straus & Giroux, 1999). The practice got its start in 1609, when Isaac Le Maire, a Flemish merchant, led other short-sellers in a bid to drive down the price of the Dutch East India Company's shares, says Chancellor. Complaining that the bears were harming innocent stockholders, including "widows and orphans," in 1610 the company persuaded the Dutch government to outlaw short-selling. Two hundred years later, Napoleon also banned the practice. During Wall Street's crash of 1929, short-seller Ben Smith hired bodyguards because of threats from angry investors. The government of Malaysia currently bans short-selling, punishing offenders with fines of up to 1 million ringgits ($263,000) and with prison sentences of up to 10 years.

In their defense, short-sellers say they attempt to keep the stock market honest by sniffing out companies with rotten accounting, shoddy business plans and debt-heavy balance sheets—or all of the above. "We are a check on the false optimism of the markets," says David Tice, president of David W. Tice & Associates Inc., a Dallas-based research and asset management firm that engages in short-selling. "We are not cheering for the economy to go down and for people to get hurt. We believe in symmetry: What goes up must come down."

Like their counterparts on the long side, short-sellers have an array of investing styles. Chanos, 45, plows through foot-high stacks of newsletters, examines analysis by his own research staff and reads 10-K filings to find companies to short. Comcast Corp.'s and Cox Communications Corp.'s financial reports were recently on his desk. Chanos also mixes easily with the financial world's elite. Every summer, he attends a lobster luncheon in Southampton, New York, cohosted by Jack Nash, cofounder of Odyssey Partners LP, and Byron Wien, director of investment strategy at Morgan Stanley.

JEFFERY SALTER

There he presents his short-selling ideas to financier Carl Icahn, billionaire George Soros, real estate investor Mortimer Zuckerman and other heavyweights. In November 2000, Chanos predicted that the stock of Enron Corp.—the now bankrupt, Houston-based energy trader—would fall due to questionable accounting and off-balance-sheet liability. "Everybody listens to Chanos," says Wien.

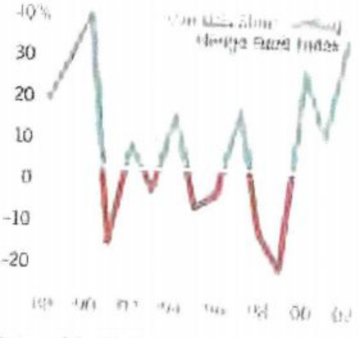
Tice, 48, studies historical boom-and-bust cycles and macroeconomic patterns to help guide his investment choices. Last year, he shorted credit card issuers American Express Co. and Capital One Financial Corp. in his Prudent Bear mutual fund because, he says, he believes consumer debt is rising to unsustainable levels, according to the fund's annual report. Tice, a native of Iowa City, Iowa, says the U.S. could be entering an 18-year "super-bear market," a mirror response to the most-recent bull market, which lasted from 1982 to 1999. "There will be rallies, but it's going to be an ugly 20 years," he says. The Prudent Bear Fund notched a 63 percent return last year by short-selling and going long on the stocks of precious-metal mining companies like Newmont Mining Corp.

Steve Leuthold, chairman of Leuthold Weeden Capital Management LLC, an equity research and asset management firm in Minneapolis, puts his faith in mathematics to find stocks ripe for short-selling. He uses a quantitative system called AdvantHedge, which scores companies based on such measures as earnings disappointments and insider selling. Leuthold, 64, who grows heirloom potatoes at his summer home in Maine, taps out his monthly newsletters *Equity Strategies* and *Perception for the Professional* on a Smith Corona Galaxie Twelve typewriter instead of a computer. "I just bought a cell phone," he says with a shrug. Since its inception on June 19, 2000, Leuthold's Grizzly Short Fund has outperformed the S&P 500 by 43 percentage points.

Asensio, 48, who holds a bachelor of science degree from the Wharton School of the University of Pennsylvania and an MBA from Harvard University, prefers a more aggressive approach. Now calling himself an "investor advocate," he hunts for companies he believes are defrauding investors, and he publishes reports about them on his Web site, even as he's shorting their stocks. While Asensio discloses in his reports that he's a short-seller, he doesn't report specific short positions.

The practice of shorting doesn't violate antifraud securities laws so long as an investor doesn't make knowingly false statements to drive down a stock, says Steven Thel, a securities law professor at Fordham University in New York. Likewise, such reports are not defamatory so long as the opinions are based on accurate facts, says Sandra Baron, executive director of the Libel Defense Resource Center Inc. in New York. "We can put out a negative opinion whenever we want," says Asensio, a native of Havana, Cuba, who on his periodic visits to the island nation, likes to take photographs of murals

BEAR RUN



featuring Che Guevara and other revolutionary icons.

Asensio's fervor hasn't stopped companies like Hemispherx from suing him. In 2002, he faced more than $1 billion in legal liability. Asensio is such a lightning rod that a band of critics runs a Web site called AsensioExposed.com that's devoted to tracking his legal scrums. "Dissing the courts" is the headline on one of the site's pages.

In Washington, D.C., a battle is developing that could affect short-sellers of all stripes. This past spring, Washington law firm Patton Boggs LLP began lobbying the U.S. Securities and Exchange Commission and members of Congress to consider introducing new rules or legislation that would regulate short-sellers, says Lanny Davis, one of the firm's partners and special counsel to President Bill Clinton from 1996 to '98. Davis is representing four companies, including Allied Capital Corp., a Washington-based private equity firm. "This is not about criticism of short-selling or hedge funds; it's about confronting a calculated campaign of false information for personal

The Perma Bear

David Tice
President of David W. Tice & Associates Inc., Dallas

AGE 48

HOT CALL In December 1999, he predicted that the U.S. stock market bubble would pop, ushering in a bear market; now he says it could last 18 years.

NANCY NEWBERRY

profit," says Davis. "The only answer is to turn on the lights and confront the short-sellers."

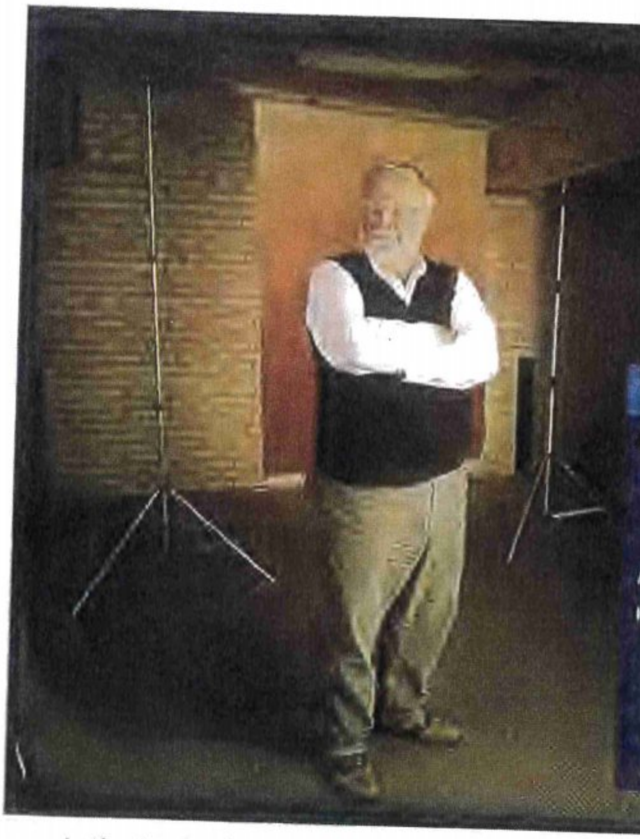
Davis's clients, who've dubbed themselves the Full Disclosure Coalition, want the government to require that short-sellers report their positions to the SEC; long investors must do so when their equity stakes exceed 5 percent. Today, stock exchanges disclose the total short interest in equities and not individual positions. Davis says more transparency would help companies identify short-sellers who may be manipulating their stock.

On April 10, SEC Chairman William Donaldson told the U.S. Senate Banking Committee that the commission was reviewing short-selling as part of its larger investigation into whether hedge funds require regulation. SEC spokesman John Heine declined to say whether that review would address a new disclosure rule for short-sellers. The SEC's counterpart in the United Kingdom, the Financial Services Authority, is also evaluating a similar rule, says FSA spokesman David Eacott.

Short-sellers are girding to fight the lobbying campaign. "You tell Lanny Davis that I will meet him anytime and anywhere to debate this issue," says Chanos. He argues that securities laws already restrict their trading. The so-called uptick rule—a regulation introduced in 1938 to protect companies from short-sellers' ganging up on them—bars investors from shorting a stock while its price is dropping. Investors can short a stock only after it moves upward. Chanos also says that unlike long investors, short-sellers lack standing as shareholders who can sue companies for securities fraud, because they don't hold equity or debt. "I would be happy to endorse disclosure if shorts could bring suit against corporations for malfeasance," he says.

Meanwhile, John O'Quinn—a Houston plaintiffs lawyer who's won billions in settlements and verdicts against companies that make cigarettes, breast implants and other products—has filed 10 securities fraud lawsuits in federal courts against investment firms, claiming their short-selling pushed companies to the edge of bankruptcy. Among O'Quinn's clients are Internet Law Library Inc., a Houston-based research firm, and Sedona Corp., a software maker in King of Prussia, Pennsylvania. James Christian, a Houston lawyer who works with O'Quinn, says they plan to file more than a hundred such suits. "These guys kill companies," says Christian.

Michael Rosenblum, a Los Angeles attorney representing several defendants in these cases, counters: "These claims are frivolous. Most of these companies have never turned a profit, and they blame shorting as a way of deflecting their own failures."



The Professor

Steve Leuthold
CEO of Leuthold Weeden Capital Management LLC, Minneapolis

AGE 64

HOT CALL Using a mathematical scoring system to short stocks, Leuthold has beaten the S&P 500 by 43 percentage points since 2000.

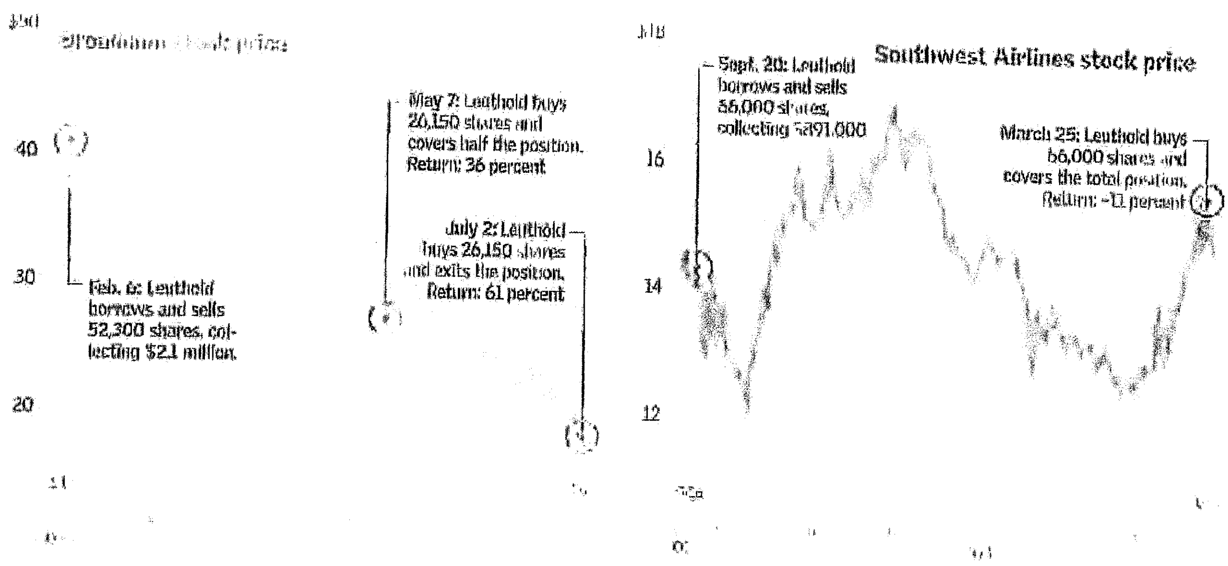
Companies that publicly attack short-sellers usually do more damage to themselves, says Owen Lamont, an associate professor of finance at the University of Chicago who authored a study last year called Going Down Fighting: Short-Sellers vs. Firms. Lamont concluded that the stocks of companies that fight short-sellers lose 2 percent more a month than other companies the following year largely because the bears unearth problems that eventually pound the stock. "Companies who complain the loudest are usually guilty," says Lamont. "If you are innocent, the best strategy is not to complain."

That's just what executives at OmniVision Technologies Inc.—a Sunnyvale, California-based manufacturer of semiconductors for digital cameras—have done. Short interest in its stock soared to 11.6 million shares in April—half of its outstanding shares—from 3.8 million shares in December, according to Bloomberg data. Short-sellers are betting that investors have overestimated consumer demand for the technology and that the stock is overvalued; last year it rose 51 percent to $13.57, from $8.98. "It doesn't make any sense to criticize the shorts, because once you start playing their game, you become a slave to it and they win," says Steve Rowley, OmniVision's worldwide marketing manager. For shorts, OmniVision, which earned $4.6 million on $30.5 million in sales in its fiscal quarter ended on Jan. 31, has become a white-knuckle ride: Its stock was up 111 percent this year as of May 9.

Whatever their risk, some companies have waged public

LAYNE KENNEDY

A WINNER—AND A LOSER



campaigns against short-sellers in the past 12 months. Allied Capital, the Washington private equity firm; MBIA Inc., a bond insurer; and Federal Agricultural Mortgage Corp., a rural-housing underwriter known as Farmer Mac, all have disputed short-sellers' reports in press releases and conference calls with investors.

MBIA entered the fray last July after New York hedge fund Gotham Partners Management Co. issued a 62-page research report claiming that MBIA was not properly accounting for losses in its portfolio of collateralized debt obligations. "Gotham believes that the company's AAA credit rating is undeserved," stated a press release accompanying the report.

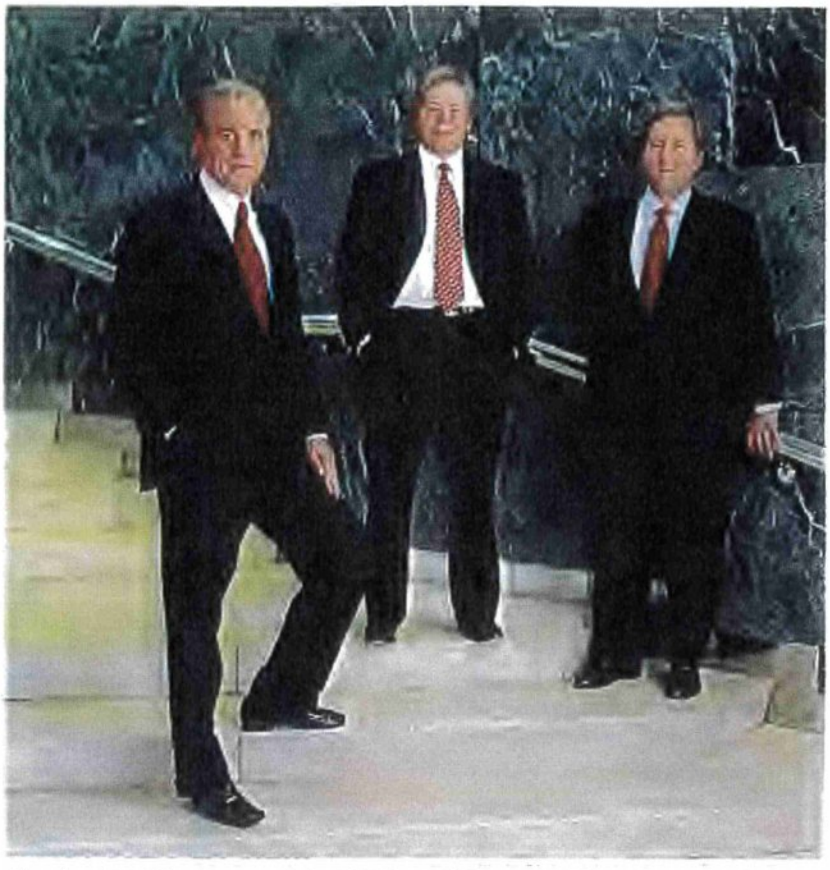
MBIA CEO Joseph Brown fired back by calling Gotham's report a "negative advocacy piece" designed to drive down the company's stock. "Many of the points raised in the Gotham report are patently wrong," Brown said in a statement on Dec. 9. New York Attorney General Eliot Spitzer is investigating Gotham in connection with MBIA and Farmer Mac, says Brad Maione, a spokesman in the attorney general's office. "We stand behind our research reports and continue to believe in the opinions we reached," says Andrew Brimmer, a Gotham spokesman.

Antishort sentiment hasn't made Chanos shy about sharing his opinions of companies and industries. Roy Furman, vice chairman of New York investment bank Jefferies Group Inc., recalls a presentation Chanos made in August 2000 at Byron Wien's annual Southampton luncheon. Chanos said the telecommunications industry, buckling under overcapacity in fiber optics and unsustainable growth rates, was about to bust. "The prediction was so dire and horrendous, you almost couldn't react to it," says Furman. "It was a dark vision, but he was right."

Chanos—whose angular face, dark suits and starched dress shirts make him look more like a hard-nosed prosecutor than a money manager—savors his role as an advocate for short-selling. On Feb. 6, 2002, he was invited to testify to the U.S. House Committee on Energy and Commerce as part of its investigation of Enron's collapse. It was a rare—and fleeting—opportunity to come in from the cold and explain the role short-sellers claim to play in uncovering corporate wrongdoing. "After Enron and other corporate accounting scandals became front-page news, there was a sense that shorts were doing the important work in the market," says Chanos, who has an Enron stock certificate hanging above a credenza in his midtown Manhattan office. "Now, we're wearing the black hats again. I guess things are back to normal." Chanos shorted Enron from November 2000—when its stock averaged $79.14 per share—through December 2001, when it traded at 60 cents.

Chanos's offices are adorned with replicas of ancient Greek pottery and abstract expressionist paintings. Books bearing titles like *When Stocks Crash Nicely* and *Debt & Delusion* line the shelves in his conference room, and one entire wall is a whiteboard on which he diagrams financial transactions such as Enron's web of off-balance-sheet partnerships. He's fond of dining next door at Michael's, the West 55th Street power lunch mecca for media executives like Barry Diller, CEO of USA Interactive, and celebrities like actor Michael Caine.

Chanos became a short-seller in 1982, when he was an analyst at Gilford Securities Inc., a Chicago investment firm. He put a sell rating on Cincinnati-based insurer Baldwin-United Corp. and recommended shorting the stock. For the next three months, Baldwin-United executives and Wall Street analysts who rated the company a buy assailed him as wrong—and reckless. When Baldwin-United's stock more than



Houston plaintiffs attorneys **John O'Quinn** and **James Christian**, here with client **Hunter Carr**, center, have filed 10 fraud suits against short-sellers.

doubled in value that autumn, Chanos says, his fledgling career was on the line.

Chanos says he was confident in his call because he'd obtained records from Arkansas insurance regulators that expressed concern about Baldwin-United's solvency. Within months, Baldwin-United's financial structure collapsed, the stock plunged and in September 1983, the company declared bankruptcy. Investors began calling Chanos to ask what other stocks he didn't like, and he's been a short-seller ever since.

Total meltdowns like Enron and Baldwin-United are the exception, Chanos says. Usually, he shorts a company because its financial status or market position isn't clear. For example, he's now shorting cable television operators like Cablevision Systems Corp., Comcast and Cox. The reason: He thinks Rupert Murdoch's News Corp. will succeed in buying DirecTV Holdings LLC, the satellite television provider owned by General Motors Corp.'s Hughes Electronics unit. Chanos says News Corp. will probably add to its satellite offering a digital recording feature pioneered by TiVo Inc. The feature will enable viewers to skip commercials and watch shows at their leisure. That move, he says, should force cable companies to spend millions to replace set-top boxes with new ones featuring digital recording so they can compete. And that's only one of many capital expenditures that will dog cable industry stocks, he says.

Like all investors, Chanos sometimes succumbs to unforeseen market forces. In 1995, he began shorting America Online Inc. because, he says, he believed it was improperly accounting for its revenue and cash flow. As the Internet boom took off, AOL's stock soared more than fivefold from 1995 to the end of '97. Chanos couldn't hang in any longer and started covering his positions. "We lost a ton of money on AOL," he says. The SEC is investigating accounting methods at the Internet service provider, now a division of AOL Time Warner Inc. The company's stock has fallen 62 percent since Jan. 1, 2000, closing at $13.02 on May 9.

In Minneapolis, a thousand miles from Chanos's offices, Leuthold says he's figured out how to sidestep such big losses on shorted stocks: expel emotion and bias from the stock-picking process and adhere to strict quantitative discipline. Leuthold counts among his most prized possessions a folder stuffed with hand-drawn charts of stock indexes. On a recent day in his office, he carefully unfolds a chart made of sheets of graph paper taped together that shows the historic bull market in Nasdaq Stock Market shares from 1991 to the present. He's marked its trajectory every day with a ballpoint pen. Clad in a fleece vest and sporting a white beard, Leuthold looks more like a sea captain charting old voyages than a professional investor pointing out historic rises and drops on his Nasdaq graph. "We can transmit data faster than ever electronically, but human nature hasn't changed," says Leuthold. "The markets are still driven by fear and greed."

Leuthold unveiled his short-stock scoring system, dubbed AdvantHedge, 11 years ago. Along with Chuck Zender, Grizzly's comanager, and Michael Schurmann, the fund's senior analyst, Leuthold sorts through 1,100 companies to find 50 to short. The system is based on 14 criteria, including a stock's strength relative to the S&P 500, its 12-month trailing price-earnings ratio, bankruptcy risk, short interest and the likelihood of future earnings disappointments. Every company has to have a market capitalization of at least $1 billion and an average daily trading volume of at least $6 million. The Grizzly annual reports warn investors that they'll lose money in bull markets. Rather than boast about his recent gains, Leuthold points out that in 1997, he lost just 4 percent, while the S&P 500 was up 31 percent. "That was victory," he says.

In 2002, the system flagged Broadcom Corp.—an Irvine, California-based maker of semiconductors for broadband

PAM FRANCIS

applications—because it scored poorly on the earnings disappointment analysis, which measures inventory buildup, rising receivables and other variables. Leuthold shorted 52,300 shares on Feb. 6, 2002, at an average price of $40.37. On May 7, with Broadcom trading at $24.72, Leuthold covered half the position for a 36 percent gain; on July 2, he covered the rest at $15.35 per share for a 61 percent return.

The system does make mistakes. Last autumn, Leuthold's team marked Southwest Airlines Co. for shorting—due mainly to the woes of the global airline industry. Leuthold, who says he has great respect for the carrier, obeyed the rules and did not veto the choice. In this case, his gut was right. Leuthold shorted 66,000 shares of Southwest stock at an average price of $13.50 on Sept. 20, 2002, and covered on March 25, 2003, at $15.05 for a loss of 11.4 percent.

If a shorted stock posts a 30 percent profit, Leuthold and Zender will take half of their money off the table. If a stock posts a 25 percent loss, the bet is automatically scaled back. Leuthold says those rules separate him from so-called terminal shorts, who ride fraudulent companies into the ground. "We catch some of those once in a while, but we are trying to find the right time to short a Colgate or a GM or an IBM," he says. "And we're quantitative—we're not making judgments about the companies."

Manuel Asensio makes such judgments all the time. On a recent day in his office on the east side of Manhattan, Asensio leans back in his chair, hands clasped behind his head, and listens on his telephone headset to a fellow bear pitching a pharmaceutical company ripe for shorting. "Yeah, I hear you on the cash flow issue, but I don't think that's good enough," says Asensio. "Get back to me."

Asensio wears his hair closely cropped and hasn't shaken the Brooklyn accent out of his baritone voice. He moved to Brooklyn's Borough Park neighborhood from Latin America when he was six. The front door of his office bears no sign, and vintage World War II-era propaganda posters hang on the walls inside. "Enemy ears are listening" reads one depicting caricatures of Hitler and Mussolini with oversize ears.

Asensio has run afoul of regulators. In November 2000, the National Association of Securities Dealers fined Asensio's firm $75,000 for violating its fair advertising rules. According to the NASD, Asensio and his firm posted seven research reports on his Web site that failed to disclose the risks of short-selling and included misleading stock-performance graphs. Under the settlement, Asensio and his firm did not admit or deny wrongdoing. "We paid them the same way you would pay a hit man who comes to your door," says Asensio.

Asensio's battle with Hemispherx has been particularly bitter. Asensio says he examined the company because it was taken public as an over-the-counter stock by Stratton Oakmont Inc., a Lake Success, New York–based brokerage that was expelled from the securities industry in December 1996 for defrauding investors and that liquidated under court order. At the time of Hemispherx's initial public offering in November 1995, Stratton Oakmont was operating under an SEC order to cease making "baseless price predictions" for over-the-counter securities it was recommending, according to SEC records. Asensio also shorted other companies Stratton Oakmont took public.

On Sept. 9, 1998, Hemispherx's stock hit a 52-week high of $12.50. On Sept. 22, Asensio posted a report on his Web site that said Hemispherx's $321 million market capitalization was based primarily on Ampligen, a drug the company said it planned to sell for treating chronic fatigue syndrome. Asensio said that for 18 years, Hemispherx had pitched Ampligen as a treatment for HIV infection, hepatitis and venereal warts, among other diseases and maladies. The U.S. Food and Drug Administration had not approved Ampligen for commercial use, according to an FDA letter to the company.

Asensio says he was convinced that Hemispherx and its CEO and chief scientist, physician William Carter, were hyping Ampligen in a stock scam. "Hemispherx is promoting futile projects simply in order to enable insiders to sell their otherwise worthless stock to the public," Asensio said in a press release accompanying his report. The stock fell 37 percent in the four days afterward. From Aug. 28 to Sept. 21, Asensio shorted 102,500 Hemispherx shares, according to court records. Assuming he bought the shares at their average trading price in that period—$9.86—Asensio would've reaped a return of 49 percent if he covered on Sept. 25. He doesn't disclose his positions.

'We paid them the same way you would pay a hit man who comes to your door,' says Manuel Asensio.

Carter says Asensio defamed his company. "Here was an individual without any scientific background or training making hysterical statements about Hemispherx and Ampligen," says Carter. "It was a massive set of falsifications."

Hemispherx sued the short-seller in federal court in Philadelphia for $80 million in damages, accusing him of fraud, defamation and violating the Racketeer Influenced and Corrupt Organizations Act. In March 2000, the court dismissed the fraud and RICO counts, and the defamation case was moved to state court. That July, the FDA ordered Hemispherx to cease promoting Ampligen in press releases and on its Web site as "safe and effective" because such promotion was in violation of federal laws barring promotion of unapproved drugs, according to an FDA "warning letter." The FDA had issued Hemispherx one such prior warning in October 1998. As Asensio headed toward trial, he says, he felt the momentum was on his side.

Then, in November 2001, Judge Sheppard ruled that Asensio could use neither the FDA action nor the Stratton Oakmont connection because the information was not relevant to Asensio's defense and would prejudice the jury against Hemispherx. Asensio was outraged. "Manuel's feeling was that, 'If you are going to call me to trial for my research and for what I said, let me tell you what I based my opinions on,'" says Fredric Goldfein, Asensio's trial lawyer.

During his testimony, Asensio repeatedly tried to interject references to the barred evidence, according to trial transcripts. Hemispherx's trial lawyer David Franceski implored the judge to punish the short-seller: "We need to sanction this man for what he's done. He's disregarded this court. He's a total rule breaker."

Intent on avoiding a mistrial, Sheppard did not penalize Asensio, according to trial transcripts. Still, five months after the jury vindicated Asensio, Sheppard ruled that the short-seller's testimony had been unfair to Hemispherx, and he threw out the verdict and ordered a new trial. Asensio is appealing the ruling. The FDA still has not approved Ampligen, which is now being tested as a possible treatment for West Nile virus. The company's stock closed at $2.28 on May 9, down 71 percent from the day before Asensio issued his report. "It was as dramatic as life gets," says Asensio of the trial.

With the S&P 500 up 6 percent as of May 9, short-sellers may be approaching the conclusion of their three-year run. Tice's fund had a return of minus 10 percent for the year as of May 9, and Leuthold's fund was down 8 percent, according to Bloomberg data.

Neither man says he's worried. Whenever the market appears ready to rally, Tice likes to quote short-sellers' patron saint, Bernard Baruch, the New York financier who made a fortune in the early 20th century by shorting stocks like Brooklyn Rapid Transit Corp. "Bears only make money if the bulls push up stocks to where they are overpriced and unsound," said Baruch. If the next bull market is anything like the last one, Tice and his fellow shorts should find plenty of promising opportunities.

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BLOOMBERG TOOLS

Finding the Most-Shorted Stocks in the U.S.

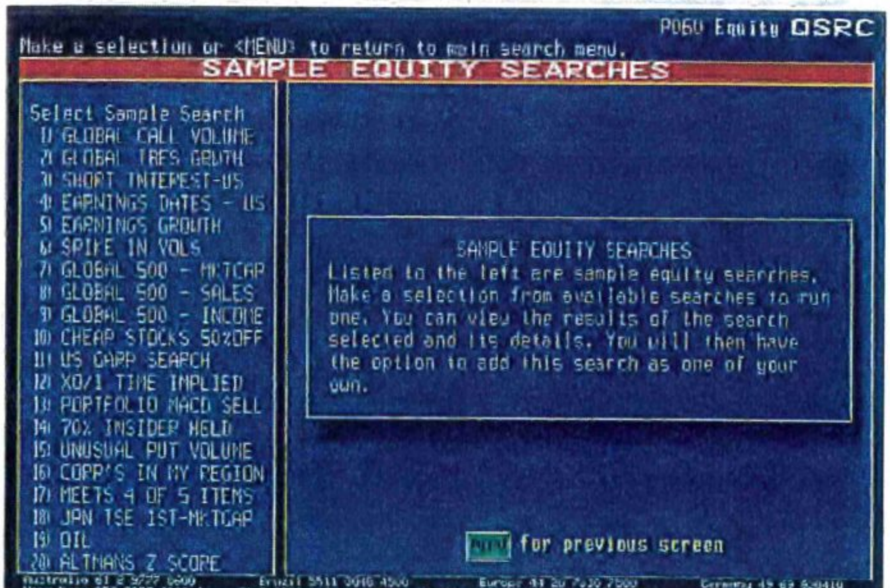
Determining which stocks are being sold short can produce valuable information for investors and traders. In a short sale, a trader borrows shares and sells them, with the hope of repurchasing them at lower prices and earning a profit.

Short-selling activity can be useful for checking your fundamental analysis. If you see there's a lot of short-selling in a company, you might want to do some additional research to determine whether the short-sellers have identified negative factors you haven't considered. Short interest—the number of shares that have been sold short but not yet returned—can also be an indication of future demand for shares.

By comparing short interest with average trading volume to calculate a company's short interest ratio, you can figure how many days it would take for traders to repurchase all of the borrowed shares. A higher ratio can indicate it'll be tougher for short-sellers to cover their positions. If unexpectedly good news comes out, share prices could surge, causing short-sellers to race to repurchase shares before they rise further.

You can use the Equity Search function to rank U.S.-traded companies with a market capitalization of at least $500 million according to their latest short interest ratio. Type QSRC <Go> 30 <Go> for sample searches, as shown below. Click on the sample called Short Interest-US to see the results. Click on the Options button to save the search so you can make your own modifications.

CHRISTOPHER GRAJA



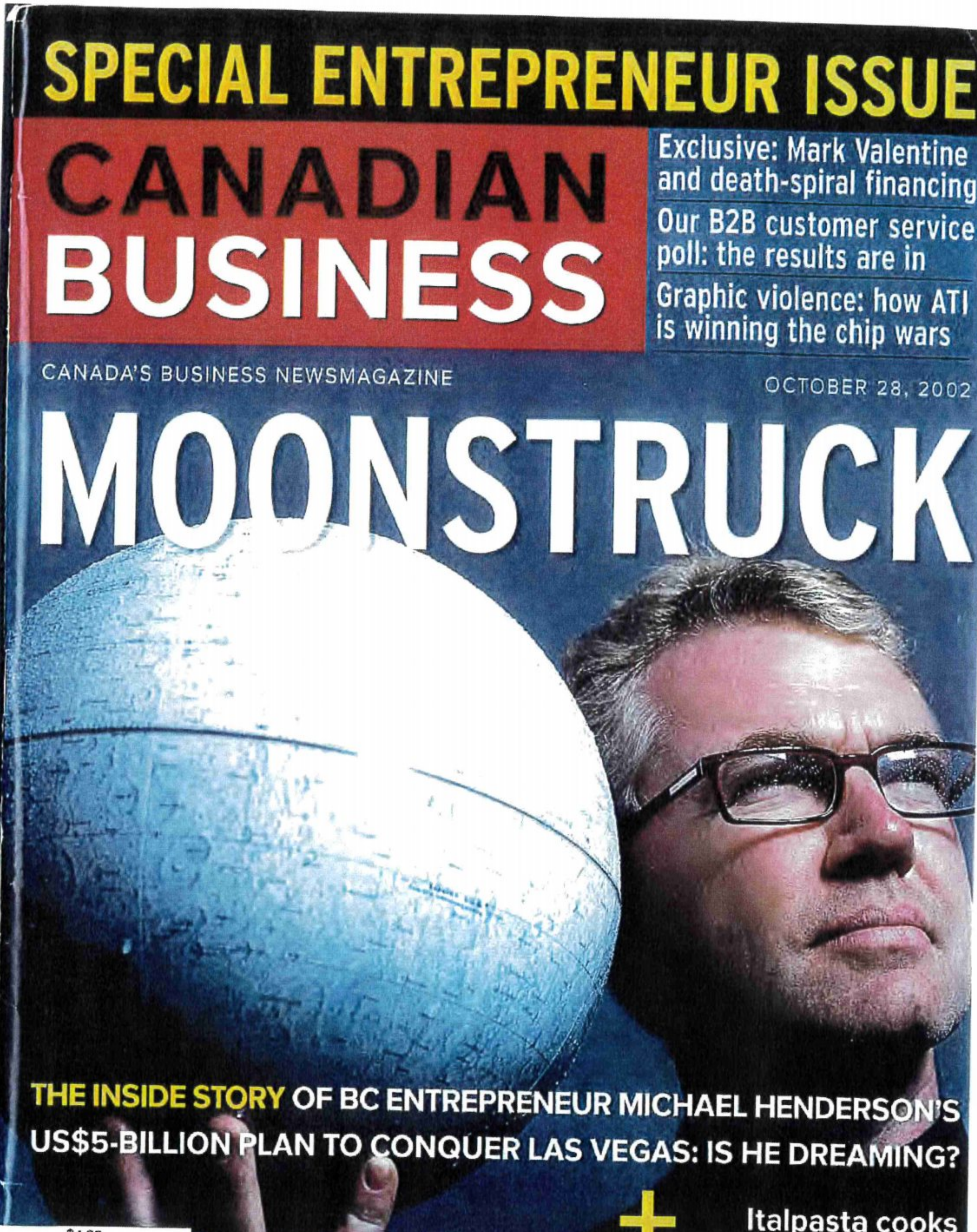
For short interest information on a stock, type its ticker symbol and then <Equity> SI.

Predator or Prey?

Amid a Flurry of Lawsuits and Countersuits, the Murky world of Death-spiral Financings—Ones in Which Toronto Financier Mark Valentine Loomed Large—is Coming to Light.

By: Matthew McClearn

CANADIAN BUSINESS
October 28, 2002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THE INSIDE STORY OF BC ENTREPRENEUR MICHAEL HENDERSON'S US$5-BILLION PLAN TO CONQUER LAS VEGAS: IS HE DREAMING?
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Italpasta cooks
Séxual smells money
Tsang's road to riches
Junk treasure...and more
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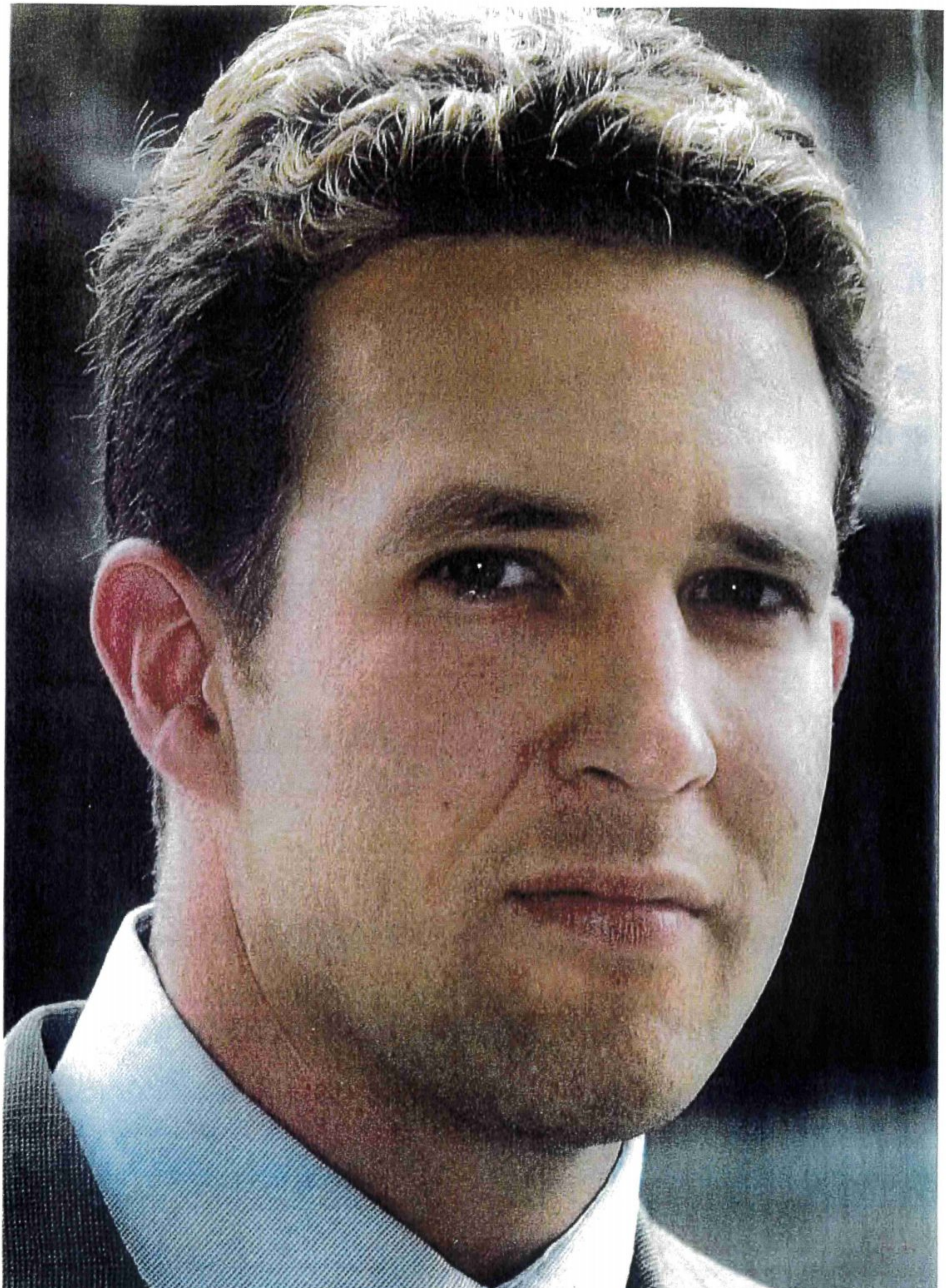


PREDATOR OR PREY?

Amid a flurry of lawsuits and countersuits, the murky world of death-spiral financings—one in which Toronto financier Mark Valentine loomed large—is coming to light

BY MATTHEW McCLEARN

Under the circumstances, Hunter Carr's first impression of maverick Toronto stockbroker Mark Valentine was surprisingly favorable. At the law office of Christian, Smith & Jewell in Houston, Carr sat opposite Valentine (then 31), a business associate named Stephen Hicks and an employee from Thomson Kernaghan & Co. Ltd., the brokerage for which Valentine served as chairman. The way Carr tells it, the encounter in February 2001 resembled any gathering at which routine business matters are discussed—sandwiches, salad and chocolate chip cookies were even brought in. "If you met him on the street, you'd like him," he says of Valentine. "He was just a nice young guy. A little bit arrogant, but nice."

But this was hardly your average meeting. The year before, Carr's company, Internet Law Library Inc., had arranged to raise financing through Hicks's firm. It proved disastrous, and the two groups were now meeting to discuss the lawsuits they'd filed against each other. Over the course of the next hour, Carr says he learned that the wealthy Valentine had provided half of the initial US$3.5 million investment, and that he would be among his adversaries in court. Carr's recollection: "Their message was basically, 'We don't mind throwing US$5 million at litigation.' And my response was, 'You've never met anybody like me in litigation. I suggest you don't fight me.' They said, 'We've heard that story before.'" After five minutes of discussion, the two parties reached an impasse and turned to other topics—like the weather. "We had a pleasant lunch, said goodbye to each other, and that was it."

The deal in question turned out to be what's known as a death spiral or toxic financing. The clauses and caveats found in such agreements can poison companies unwise enough to sign off on them. And increasingly, these financings are heading to law courts, where Valentine and his now-defunct brokerage are emerging as central characters in a mysterious ring of death-spiral financiers. (That's the same Valentine who was suspended by his own brokerage, turfed from the securities business earlier this year by the Ontario Securities Commission—and then arrested by the US Federal Bureau of Investigation.) They waded into an untidy world of faceless offshore investors, oppressive financing arrangements and long-shot companies, some headed by ex-convicts and securities violators. All things considered, you've got to wonder: did Valentine and his associates prey on weak companies? Or did they get snookered themselves?

Convertible debentures. Structured equity lines. Convertible preferred shares. The instruments that bring about death spirals can be bewilderingly complex. Simply put, they are quick financial arrangements between small (and often desperate) public companies and select groups of investors. Take, for example, a standard convertible debenture. It's a

STEVE MITCHELL

debt instrument that pays interest, but can be converted into common stock at a fixed price, often at a discount to the market price on the purchase date. Existing shareholders will see their ownership diluted – perhaps seriously – if the company issues a large number of shares to the debenture holder on conversion. But the debenture holder is also taking risk: the company may not survive long enough to pay back the debt, or its stock could become illiquid or even be delisted. On the other hand, if the deal's crafted properly and the company spends the proceeds wisely, maybe everyone will be rewarded.

The devil is in the details. In a toxic convertible debenture, the debenture holder can convert the instrument for a larger number of shares if the underlying stock price declines after the financing. Theoretically, it's a way of protecting the debenture buyer from market risk. But the caveat – sometimes called a "reset provision" – is the mechanism that triggers a death spiral. If the underlying stock collapses, the debenture holder can obtain mind-boggling volumes of shares, which results in crippling dilution. In fact, critics allege, death-spiral investors can benefit more if the stock tumbles. And should they be particularly Machiavellian, they can *make sure* it goes into a tailspin.

Houston lawyer Wes Christian believes he's figured out how death-spiral rings work. They scan for vulnerable public companies listed on small-cap bourses like the American Stock Exchange and the Nasdaq Over-the-Counter Bulletin Board. "They look at the float, they look at the liquidity in the stock, they look at how much they can pump it and how much they can dump it," he says. They approach prospective victims and tell them: "We like your company. We like your business plan. We like your management. We like your board. We'd like to make you a loan, or we'd like to invest equity in your company."

But while the financiers promise much-needed capital, others within the ring start short-selling the company's stock. Other potential investors are warded off by the tumbling share price, but the ring holds on. "They say, 'We're gonna stick with you, buddy,'" Christian continues. "'We're in it for the long haul.'" A death-spiral financing is soon hammered out – invariably through an offshore entity. "They say, 'We're going to loan you $3 million during the first tranche, and $25 million on the second tranche. But, incidentally, we're not going to give you that second tranche if your stock falls below $1.50.' At the time, the stock is $7. So you're saying, 'Hell, it ain't going below $1.50 – not with this money behind it.' "

The ink is scarcely dry on the agreement, Christian explains, when the ring begins selling shares, short-selling and employing other techniques to drive the share price down further. Critics allege that much of this activity flows through cracks in Canada's regulatory establishment (See "Blame Canada," page 74). "What you don't realize is, they're gonna help get it below $1.50, so they're off the hook for the $25 million," Christian seethes. "Rarely have they funded the second tranche."

Compounding matters, says Brian Overstreet, a private-placement expert and president of San Diego-based PCS Research Technology Inc., other unrelated investors within the short-selling community will pounce on any company that signs a death-spiral financing. "Once the stock starts trending down, a lot of people jump on the bandwagon, and it can get real ugly real fast," Overstreet says.

The stock tumbles into a death spiral, and the financiers begin demanding conversions. They can use those shares to cover their short positions, profiting handsomely from the difference between the price at which the stock was sold short and at which it was converted. If the death-spiral ring can drive the company into bankruptcy, they may not even have to cover their position at all. And the kicker: Christian suspects that the money from the first tranche comes from short-selling profits. "They frigging lend you your own money!"

The alleged pattern – or slight variations of it – appears in at least a dozen death-spiral lawsuits (seven of them for which Christian is serving as co-counsel with Houston litigator John O'Quinn). His theory has yet to be tested in court. Other US companies – including Global Intellicom Inc., ConSyGen Inc., Vitafort International Corp., Americas Senior Financial Services Inc. and Mobile P.E.T. Systems Inc. – have alleged similar behavior by death-spiral financiers in past court actions. Those companies collapsed or settled out of court. Among the few firms to go the distance was Toronto-based D.G. Jewelry Inc., which sued Hicks's firm, Southridge Capital Management LLC, for alleged stock manipulation in connection with a death-spiral financing. In late 2000, a jury rendered an 8-1 verdict in favor of D.G. – a decision overturned by the judge, who said it had no basis in law and ordered D.C. to issue the 317,000 shares it owed to offshore entity Haymarket LLC under a death-spiral agreement. An appeals court upheld that decision last January. Names that appear often in death spiral cases include Mark Valentine, Thomson Kernaghan, Steve Hicks and Southridge. Was there any wrongdoing? The jury's still out.

Hunter Carr used to be in the litigation support business. But during the 1990s, he formed a publishing company and operated Internet databases of legal information. If Internet Law Library (now called ITIS Holdings Inc.) could sign up enough law firms, judges and other subscribers, it could generate revenue and become self-sufficient. But to win them, it needed a substantial body of constantly updated material – and that would cost megabucks.

When Carr went looking for funding in 1999, he was unaware of the risks of so-called toxic financing deals, he says. "We didn't necessarily know at that time what a death spiral was...and we didn't know that people used the death spiral to drive your stock down and make money." He eventually hooked up with Southridge, Hicks's investment advisory firm in Ridgefield, Conn. In May 2000, Internet Law raised US$3 million by selling convertible preferred stock to Southridge's clients. Carr claims he was assured that "although they were buying the stock and would help keep the price up, they were really going to make their money when we became really successful." Hicks and other employees repeatedly promised that Southridge would not short-sell or manipulate his stock, Carr alleges; in fact, he says, they explicitly agreed that they would not sell their shares for one year. Carr checked the references they provided, and was satisfied.

But then things began to unravel. Southridge's name didn't appear in the final draft of the agreement. In its place stood Cootes Drive LLC, an offshore entity registered in the Cayman Islands. In any case, Carr was looking forward to the second tranche, which was to bring up to US$25 million through an equity line – money that Internet Law badly needed. Trouble was, Carr says the company's stock plunged even before the deal was signed. Over the next six months, Thomson Kernaghan, Cootes's broker, sent Internet Law numerous notices declaring that Cootes wanted to convert 139 preferred shares for more than 3.1 million common shares.

Mark Valentine and his wife, Stephanie, outside Florida court

AFP PHOTO/RHONA WISE

With reluctance, Carr acquiesced.

In December 2000, he secured another US$500,000 from Cootes through a promissory note – but more conversion requests soon followed. With its stock in free fall, Internet Law wouldn't qualify for funding under the second-tranche equity line. That's when Carr visited O'Quinn, Laminack & Pirtle, a prominent Houston law firm. John O'Quinn had successfully sued breast implant manufacturers and tobacco companies during his career. He agreed to take the case on a contingency basis. "Now they have to run John out of money," Carr says with a hint of Texan swagger. "And I don't think that's going to happen."

In January 2001, Internet Law refused to convert any more of Cootes's preferred shares to common stock, which was then worth just 10¢. By that time, it alleges, Thomson Kernaghan had a short position of nearly 1.5 million Internet Law shares. Later that month, Internet Law filed suit against Hicks, Southridge and several of its employees, Thomson Kernaghan, and Cootes. The suit alleged that the group had engaged in stock manipulation, federal securities law violations, fraud, conspiracy and other misdeeds. Cootes soon fired back a lawsuit of its own, alleging that Internet Law had breached its contract by failing to convert. Internet Law's war had begun.

Paul Metzinger has the dubious distinction of having been burned twice by death spirals in as many years. His Denver-based company, NanoPierce Technologies Inc. (OTC: NPCT), claims it has developed a microelectronics technology for making electrical connections. But the company experienced frequent liquidity problems, had negligible revenue and was losing millions. In late 1999, Metzinger signed a convertible debenture financing with Equinox Investors LLC. Soon, he alleged, in court documents, Equinox was using short-selling and other techniques to deflate NanoPierce's stock price. To pay off the Equinox debt and clean up the balance sheet, Metzinger went looking for what he calls "replacement" financing.

His search led him to Southridge. At its offices in Ridgefield, he explained his situation to two representatives. According to Metzinger's account, Southridge agreed to provide replacement financing and promised not to repeat Equinox's behavior. In October 2000, the two parties agreed that Southridge's clients would provide US$15 million in two installments through a stock purchase agreement. On the final draft of paperwork, however, Southridge's name wasn't there; the investing fund was an offshore entity called Harvest Court LLC. Also, Southridge insisted that Harvest Court needed "reset" rights to protect its investors against market declines, which would be determined on three dates: 65 days, 130 days and 195 days after the deal closed.

Metzinger agreed, and was optimistic. "For the first time, the company's balance sheet was totally debt free and we had substantial shareholder equity," he recalls. But the day after NanoPierce received its first US$7.5 million, he says, someone began selling large blocks of shares. Within three months, the stock was down 60%. On the first reset date, NanoPierce issued 2.1 million shares to Harvest Court. Given what was happening, the company wouldn't qualify to receive the second tranche of US$7.5 million.

Metzinger hunted for explanations. He mentioned the Harvest Court deal to a friend in the investment banking community. "He did some digging," says Metzinger. "He called us up and said, 'Paul, you've got some trouble ahead of you.'" The second reset date was quickly approaching, at which point NanoPierce would owe Harvest Court an additional 7.4 million shares, worth US$6.7 million.

Metzinger went to O'Quinn. In late April 2001—just before the second reset date—NanoPierce filed actions in several US courts against Harvest Court, Southridge and several of its employees, and Thomson Kernaghan. The suit alleges violations of federal and state securities laws, conspiracy, aiding and abetting and common law fraud, among other things. Concurrently, the company published a press release indicating it would issue no more reset shares to Harvest Court. The following month, Harvest Court fired back its own lawsuit, alleging that NanoPierce violated its purchase agreement. NanoPierce's war had begun.

Wes Christian is a busy man. John O'Quinn will lead the litigations in court, but Christian is co-ordinating pretrial work with a team of 50 lawyers across North America. During the past two years, Christian's and O'Quinn's firms have spent more than US$6 million learning about death-spiral financing. "I've got documents that'll fill up 15 20-by-20-foot rooms, floor-to-ceiling, wall-to-wall," he says. "I'm traveling around the country trying to catch these bastards."

The Internet Law and NanoPierce cases are just the beginning. O'Quinn and Christian represent other companies in death-spiral suits: Hyperdynamics Corp., Restaurant Teams International Inc., Eagletech Communications Inc., and

JagNotes.com Inc. The latest, biotech firm Endovasc Ltd. of Montgomery, Tex., filed a US$250-million suit in September. O'Quinn and Christian represent the cases on a contingency basis -- and will get a substantial cut of any damages awarded. So far, the damages sought total US$1.5 billion.

That number may grow. Christian is preparing to file another seven suits, and he's hunting for more plaintiffs from 800 death spirals he's identified. About 150 of them involve Valentine or affiliates, he claims. "We're going to look at everything, frankly, so we can make more money." Not only that, but Christian is looking for new defendants. "This is bigger than Hicks and Valentine," he adds. "This has been allowed to occur though a lack of supervision by our NASD [National Association of Securities Dealers] and other regulatory organizations -- and equally, your organizations in Canada." He cited the Canadian Depository for Securities Ltd. (CDS) as "vulnerable" in the lawsuits.

None of the allegations have been proved in court. In Los Angeles, lawyer Michael Rosenblum is mounting a legal defence for Southridge in four cases. He's also representing Valentine in the Internet Law matter. This group of clients says that it does not engage in death-spiral financing: in the dozens of convertible deals Southridge has arranged, many companies "have used the capital we have provided wisely and gone on to become successful." Christian's allegations are without merit, Rosenblum claims. In fact, his clients allege that Internet Law and NanoPierce were out to defraud *them*.

The group disagrees with nearly all representations brought forth by Carr and Internet Law. Internet Law knew that an offshore fund would provide the money, it claims. There was no stock manipulation, no misrepresentation and no unauthorized sales. Any selling Cootes did was permissible -- even expected -- under the agreement. Internet Law's falling stock "was the result of market or other factors and not the alleged wrongful conduct" by the group. Far from benefiting from that decline, the group claims, it was injured by it -- an injury compounded by Internet Law's refusal to honor the conversion agreement.

The group is also attacking Carr's credibility. An investigator it hired found that, in the early 1980s, Carr was arrested, indicted and convicted in federal court on one charge of conspiracy to defraud. For that, Carr was sentenced to three years in prison. (He served six months.) Paul Thayer, another Internet Law director, was indicted, pled guilty and was sentenced to four years in prison for obstruction of justice, stemming from a US Securities and Exchange Commission investigation into allegations of insider trading. Thayer had lied to the SEC about his trading practices, and it cost him US$550,000 to settle with the regulator. Internet Law deliberately concealed those facts from Cootes, the group alleges. Had Cootes known, it never would have invested.

Michael Rosenblum's clients, including Mark Valentine, contest almost every allegation brought against them

Similarly, Rosenblum's clients contest almost every allegation brought against Harvest Court. Neither Harvest Court nor its associates ever sold short any NanoPierce shares, they claim. Any normal selling Harvest Court conducted was permissible and expected, they say, and Harvest Court never promised to do otherwise. There was no market manipulation -- in fact, Harvest Court would have benefited more if the stock price increased. NanoPierce's court action, they allege, "involves nothing more than a company seeking both to avoid its contractual obligations because it is disappointed with its stock's poor performance...and divert blame for its own failures to alleged third-party 'conspirators.'"

And then there's Metzinger. The SEC took action against him in the late 1980s for participating in the sale of unregistered securities, making material misstatements and omitting critical information from opinion letters, press releases and reports. Without admitting or denying the SEC's claims, Metzinger signed a consent decree enjoining him from engaging in such activities. Moreover, the group's latest court action alleges that Metzinger participated in a fraudulent scheme to inflate NanoPierce's stock, employing promoters and self-styled "analysts" (one of whom had only a high school diploma for credentials) to pump the stock on Internet bulletin boards. Those touts, the group alleges, were sometimes paid in stock for their services. "Harvest Court purchased the shares at a price that was artificially inflated," it claims. Had Harvest Court known of these facts, it would not have invested.

Others also question the credibility of death-spiral victims. "The reality is, an issuer that's involved in one of these deals is going to have a tough time coming into a courtroom and claiming to be a clean-hands defendant," says Overstreet of PCS Research. "More often than not, the issuer knows that they're getting into bed with someone of lesser stature than Goldman Sachs or another top-tier brokerage. Yeah, they may have screwed you, but you probably knew it was coming."

The age of death spirals is over. At their peak in 2000, PCS Research recorded 395 such deals, worth US$3.2 billion. But so far this year, only 103 have occurred – worth just US$408 million. Even in the context of the decline in the overall market for private placements during that period, it's a dramatic collapse. "It's largely a business that doesn't exist anymore, because everybody got tired of losing money," says Overstreet. "Public companies themselves have eliminated this from the market. They just won't do these types of deals anymore, with anybody." Given the numerous lawsuits, one wonders why any investor would agree to supply money under death spirals, either.

The public's understanding of Valentine's role in death-spiral financing remains confined to vague allegation. How much money he and Thomson Kernaghan invested in such schemes remains similarly unclear. According to PCS Research's data, Thomson Kernaghan and its various related offshore groups – with names like Queen LLC, York LLC, and Nash LLC – executed 36 investments since 1995, worth a total of nearly US$61 million. Most of those were to the technology and communications sectors, and two-thirds of them were of the death-spiral variety. Southridge and its related offshore groups – Sovereign Partners LP, Dominion Capital Fund, Wilson LLC, Jackson LLC, and so on – were involved in another 46 transactions worth US$125 million. Again, more than 60% of them were death spirals.

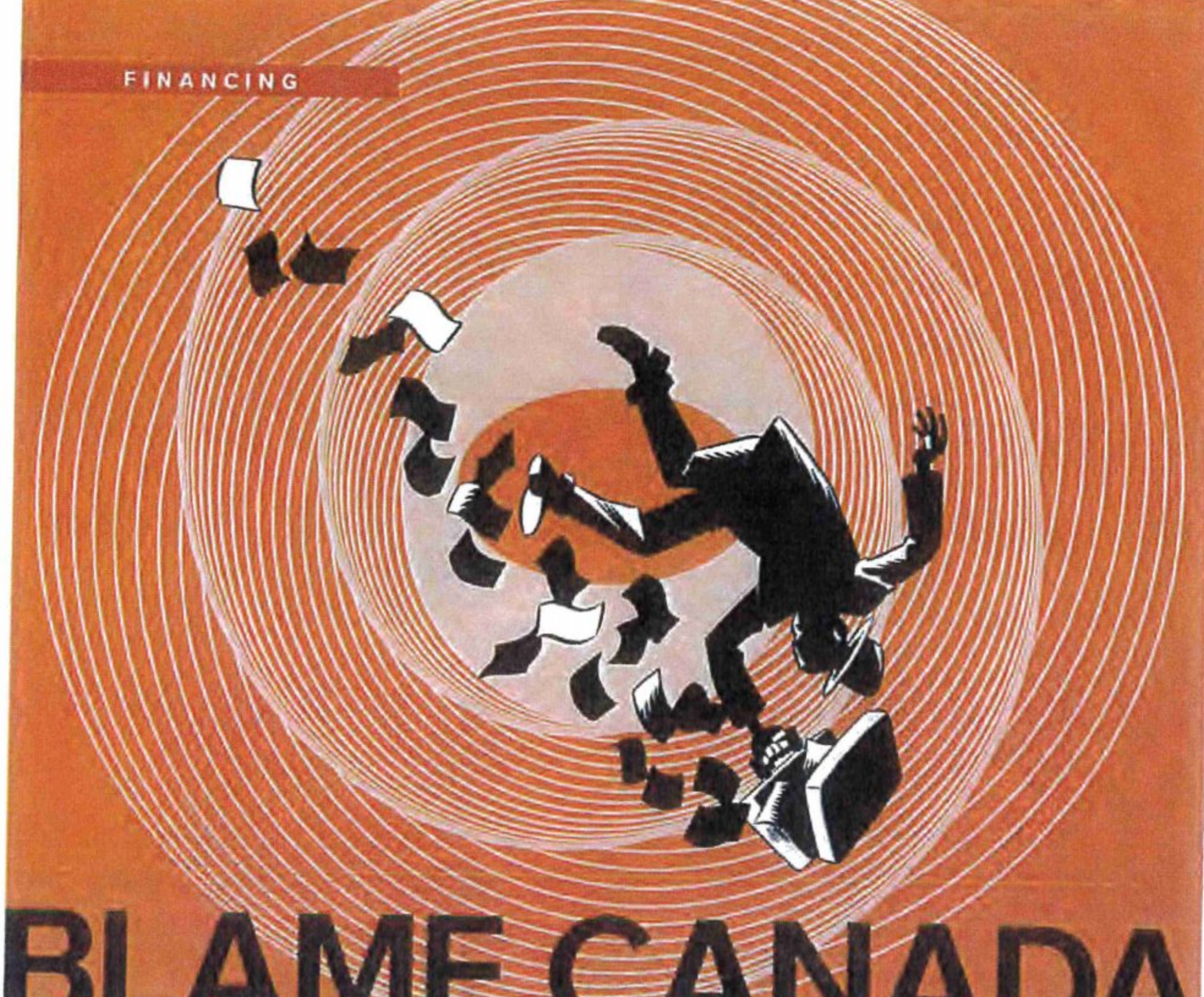
Valentine may be unable to participate in future death spirals, even if there were a demand for them. His meteoric career came to a grinding halt in June, when Thomson Kernaghan took the unusual step of suspending his employment and barring him from its premises. That followed an internal investigation that revealed alleged improprieties in his trading activities. When the Ontario Securities Commission reviewed those trades, it concluded that Valentine had put his own interests over those of his clients. Later that month, the OSC launched an offensive to drum him out of the business, arguing that his continued presence in securities markets constitutes a public hazard. Thomson Kernaghan has since been petitioned into bankruptcy, closed its doors and been permanently suspended. Former customers are suing.

The OSC, too, questions Valentine's death-spiral practices. In mid-2000, Thomson Kernaghan arranged such funding for Toronto-based JAWZ Inc. (cofounded by two of his associates, Robert Kubbernus and Cameron Chell). According to the OSC, Thomson Kernaghan's research department issued a "buy" recommendation on JAWZ shares later that year, but didn't mention the firm's involvement in the death spiral to investors. At the same time, Valentine was motivating other clients to short-sell JAWZ shares, the OSC alleges. (JAWZ folded last fall.) "Valentine failed to deal fairly, honestly and in good faith with clients," the commission concluded. Toronto securities lawyer Joe Groia is defending Valentine in the action.

For Valentine, it gets worse. The US Federal Bureau of Investigation orchestrated Valentine's arrest in mid-August at the airport in Frankfurt, Germany. According to reports, he was preparing to board a Lufthansa flight to Toronto after examining a possible investment in a German brokerage. He's been indicted for wire, mail and securities fraud conspiracy, and for securities fraud—part of a massive sting operation nicknamed "Bermuda Short" that has so far charged 58 people. The FBI claims that Valentine and an associate, financial consultant Paul Lemmon, offered to pay US$7.8 million in kickbacks to an FBI agent posing as a mutual fund manager. In return, the agent's "fund" was to buy $29.4 million worth of shares in three small tech companies from Valentine.

Valentine spent more than a month in a prison south of Frankfurt, until he was escorted by US marshals to Florida to attend a bail hearing in Fort Lauderdale on Sept. 23. Under the terms of his release on $500,000 personal bond, he must stay in Florida and remain at his condominium in Key Biscayne in the evening; he must also wear a security bracelet that police can use to track his movements. "I've done nothing that is illegal," Valentine told reporters following the bail hearing. "I'm 100% confident of my innocence, and I look forward to my day in court." His lawyer, Michael Pasano, said he and his client disagree with "pretty much everything" in the charges.

For both plaintiffs and defendants, the death-spiral lawsuits could wind up being a long, expensive and potentially embarrassing legal nightmare. For small investors, they're a cautionary tale about the hazards of investing in small-cap companies. An examination of death-spiral agreements reveals a particularly troubling clause; you'll find it under the heading "publicity." In some deals, financiers and companies agree to measures that limit the publicity about death-spiral financings to the legal minimum. Unless the common investor is an expert in esoteric financing instruments—and reads every last word of corporate disclosure—he may never know that his investment is destined to plunge into nothingness thanks to a reset clause in a convertible debenture. And since he probably doesn't have US$5 million to throw at litigation, there's very little he can do about it. CB



BLAME CANADA

US companies are saying our lax regulation lets short-sellers get away with murder

BY MARK BROWN

About two years ago, Russell Godwin, a director of Medinah Minerals Inc., noticed some unusual trading of its shares on the Nasdaq Over-the-Counter Bulletin Board service. A client reported purchasing 500,000 shares of the small Nevada-registered mining company, headquartered in Vancouver, when the total trading volume for that day was only 200,000. However, Godwin, now also company president, didn't know the extent of the problem until a "shareholder census" revealed that there were more than 168 million shares outstanding, when only 117 million were available for trading. The extra shares on the market arose from "naked short-selling," a practice banned in the US but perfectly legal in Canada. And it is the reason why many small companies trading mostly on the Nasdaq Bulletin Board or on the Pink Sheets lay the blame for their misfortunes squarely on Canada.

Naked short-selling is not the only way US securities are being manipulated through Canada. Death-spiral financing—one of the instruments of choice for financiers like Mark Valentine, from defunct Toronto-based brokerage Thomson Kernaghan & Co. Ltd.—is also being channeled through Canada, for the same reasons so much naked short-selling comes from the north: our weaker securities regulations. Indeed, "weaker" might not be a strong enough word. When asked about the difference between Canadian and US short-selling rules, a senior official at the NASD, the US association of securities dealers, put it this way: "*What* Canadian rules?"

Basic short-selling, which is legal in both countries, is a high-risk strategy that typically occurs when an investor believes a particular stock is overvalued. Through a margin account, the investor will borrow shares from a brokerage firm, say at $60 apiece, and immediately sell the shares on the market. When the investor is confident the company's shares won't fall further, he will repurchase the shares, say at $40 apiece, and return the borrowed stock to the brokerage (covering the position) for a per-share profit of $20 less fees. In the case of naked short-selling, the brokerage never actually has the shares in its inventory, nor does it have access to the shares, but it still allows the client to complete the short sale.

The effects can be disastrous for a small company. Even when Medinah Minerals would release positive news about its exploration activities, the stock would continue its free fall because of the massive short-selling. What the short-sellers are trying

MICHAEL CHO

to do in many cases is force companies to file for bankruptcy, says Wes Christian, a partner in the Texas law firm Christian, Smith & Jewell, which specializes in business litigation. "Once you get a company down to $1, it can't raise capital, it can't get loans, it can't do anything."

Death-spiral financing adds yet another twist. In some cases, financiers will approach a target company on the pretense of looking to make a long-term investment. In exchange, the financiers ask for some kind of preferred stock or convertible debenture, where the company owes the investors a variable amount of stock that must equal a pre-arranged fixed value. The provision guarantees the financiers more stock if the share price goes down. But despite the confidence the financiers claim to have in the company, the real money for them will come from shorting the stock. And if the high volumes of trading don't scare away bona fide investors, death-spiral financiers can put more downward pressure on the stock by releasing negative news on the company. Often, the short sales start even before the financing agreement is reached. "They're naked short-selling," says Christian, "knowing that they're going to get some conversions [from the preferred stock or debentures] so they *can* cover."

That is what happened to JagNotes.com Inc., a Florida-based market information subscription service, when it signed a deal with Valentine in May 2001. The naked short-selling of JagNotes.com (now JAG Media Holdings Inc.) is the first of what could be a series of cases that high-powered Houston lawyer John O'Quinn, in association with Christian, plans to take to court. Valentine is alleged to have misrepresented himself to JagNotes.com by going against his word that he would not short the company's stock.

US regulators changed the rules regarding short-selling years ago. Broker-dealers are required to make an affirmative determination that stock is available for borrowing so that it can be delivered by the settlement date. In Canada, however, there is no such requirement. "We've looked at it, we may look at it again, but we haven't seen any need for it in the Canadian marketplace," says Keith Rose, vice-president of regulatory policy for the Investment Dealers Association of Canada (IDA).

That's certainly not the way many small companies listed on junior exchanges see it. They argue that the differences between US and Canadian trading rules have made Canada a conduit for stock manipulation schemes. The paper trail created when shares are routed through Canada is so long that most companies simply can't afford to trace all the documents. "I can show you 15 companies that these guys have beaten," Christian says, "not because they're right, not because they're moral, not because they are legally correct, but because they ran them out of money."

US investors can't legally open a trading account with a brokerage firm in Canada. But if they opened a Canadian account before the NASD cracked down and started to vigorously enforce the rules in 1998, they are not barred from trading. "[Canadian brokers] are not blatantly opening accounts for Americans," says short-seller William Cate, managing director of Beowulf Investments in California and author of several books on venture capital financing and private placements. "But if you are there, and you haven't caused any trouble, then they aren't kicking you out, either."

US investors ask a Canadian broker to conduct short sales on their behalf, put up the money and pay a kickback or share a commission

US investors who want to bend the rules might approach a Canadian brokerage firm to conduct short sales on their behalf, put up the money and offer the broker a kickback or commission sharing for its help. "Of course, the guy in Canada, if he's greedy and happy to participate in that kind of scheme, is going to do it," says the NASD official, who spoke on condition of anonymity. Brokers need clients, and without strong rules in place there is nothing to discourage these firms from doing it, he adds.

But if a group of investors is intent on shorting a company's stock, but is not spreading rumors or misleading statements, then a company has little recourse, says Mark DesLauriers, a partner with Osler, Hoskin & Harcourt LLP in Toronto and past chair of the Ontario Securities Advisory Committee — unless the short-sellers were violating some other rule. "It's never clean," he says. "They are selling on the downticks, not disclosing their short to their brokers [or] brokers haven't disclosed their short positions."

So what's a company targeted by naked short-sellers to do? One option is reorganization. Christian and a team of 50 lawyers are currently taking every one of their clients through a recapitalization process that requires the exchange of the actual share certificate. "You must redeem the certificate you supposedly hold in order to get a new certificate," Christian explains. "If you don't got them, and you sold them, then you are liable. Simple." Under the reorganization, as undertaken by JagNotes.com and Medinah Minerals, the company renames itself and the stock undergoes a reverse split of at least 1:1.01, which is the minimum requirement.

However, legitimate shareholders run the risk of taking the biggest hit. In several cases, including Medinah, the company gave investors only 60 days to exchange shares, after which it had the power to cancel any outstanding shares. The reason it could do so was because it is registered in corporate-friendly Nevada, where securities laws allow the board of directors to cancel any outstanding share certificates for "any desirable reason." One such desirable reason might be the fact that forcing investors to claim their certificates could artificially inflate a company's share value, by forcing all the short-sellers to purchase shares they don't want.

The goal of the reorganization is not so much to put a stop to short-selling as it is to expose who is doing the shorting. Still, the short sellers aren't always the only ones at fault. "Some of the companies don't come into this scenario with clean hands," says the NASD official. "The types of stocks that typically are targeted by short-sellers may be companies that may be perpetrating their own violations, in terms of pumping up their own shares through press releases that are materially misleading, or other things."

Regardless of which side shoulders the blame, the shareholders are the ones who really lose out. The IDA plans to revisit this issue in the new year, but it's not a high priority. It's certainly a concern for the NASD, which has tried to put a stop to the practice — albeit with mixed results. In the meantime, a case being built by GeneMax Corp. of Blaine, Wash., against two Vancouver firms, Global Securities Corp., a full-service brokerage, and Union Securities Ltd., an investment dealer, challenges the legality of naked short sales in Canada. But don't count on the case forcing a review of Canadian rules — such actions seldom reach trial, because the plaintiffs rarely have enough money left to see them through. CB

Sinking Fund

Have Financiers Torpedoed Struggling Small Companies They Were Supposedly Helping? Lawsuits Raise Some Ugly Accusations.

By: Brandon Copple

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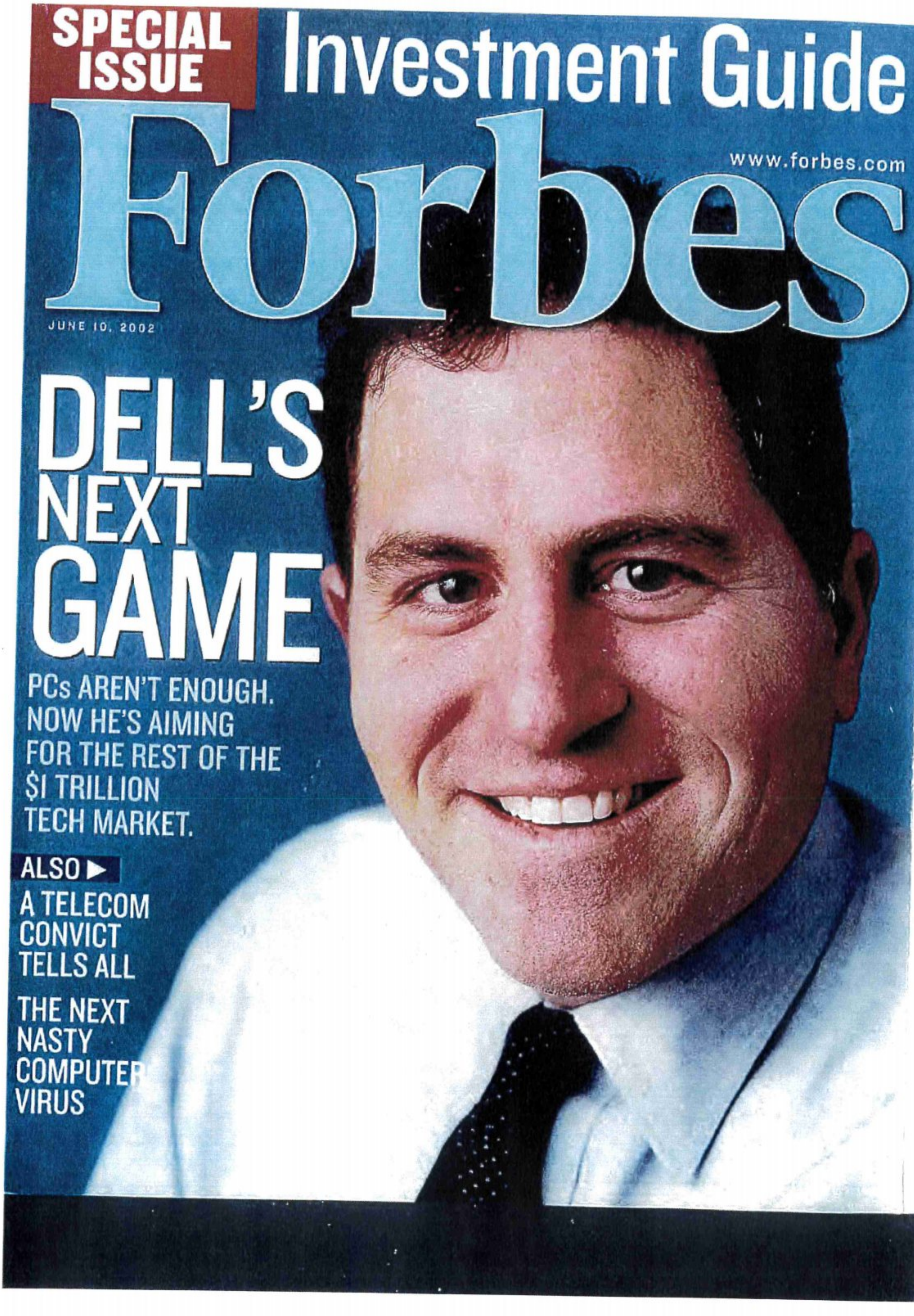
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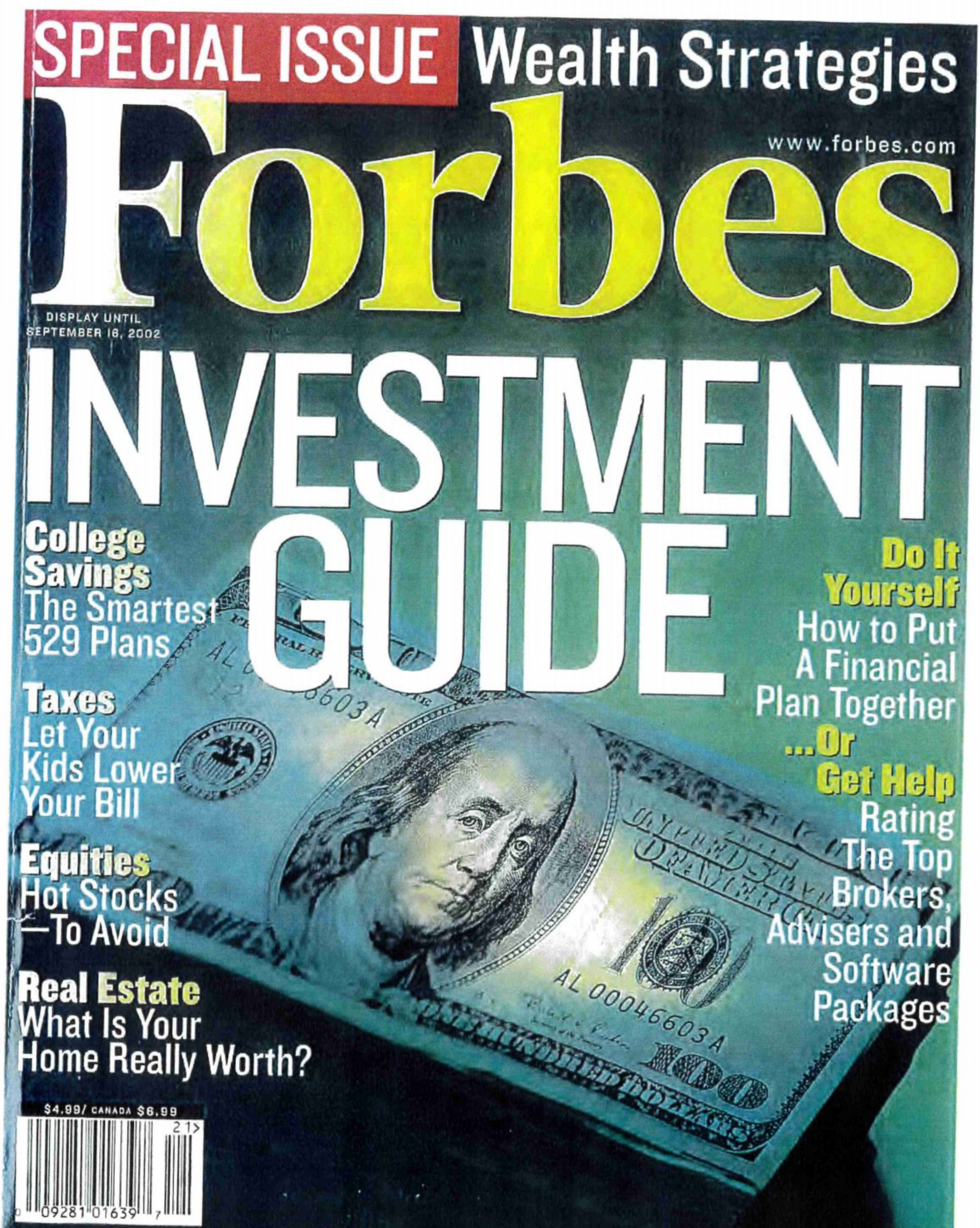
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Sinking Fund

Have financiers torpedoed struggling small companies they were supposedly helping? Lawsuits raise some ugly accusations | BY BRANDON COPPLE

RODNEY YOUNG THOUGHT HE'D hit the big time. For months he had been casting about for cash to save his young telecom-services outfit, Eagletech Communications. Then in March 2000 he sent a team of executives to New York to meet a group of potential investors at Salomon Smith Barney. Young had a patent, but no sales, and yet here were five Salomon officers and a group of investors offering to buy convertible preferred shares from Eagletech for up to $6 million. "I thought these people wanted to help us," he says.

He was soon disabused of that notion. Immediately after the meeting at Salomon, Eagletech's share price began to sink. By November it was down from $14 to 75 cents, erasing $113 million in stock market value. That seemed extreme even for a company that had only $300,000 in cash and was burning $100,000 a month.

Young now claims the wave of selling was led by the very investors at Salomon's table. In a suit filed in Florida, where Eagletech is based, Young alleges that mighty Salomon, along with a group of conspirators, set him up for a fall with convertible-debenture financing, then shorted the common stock all the way down. Salomon has asked the court to throw out the complaint, claiming it did nothing to harm Eagletech.

Eagletech's suit is one of five similar actions. They are led by John O'Quinn, a rapacious plaintiff attorney in Houston who has conjured multimillion-dollar verdicts in breast implants and tobacco. Much of the legal legwork is being done by another Houston lawyer, James W. Christian. Each complaint has been filed on behalf of puny companies against well-heeled financiers who allegedly offered desperately needed capital and then profited by short-selling of shares—all in the thinly regulated world of Bulletin Board stocks. One plaintiff, a legal-research outfit known as Internet Law Library, says it has identified more than 100 companies damaged in convertible-securities schemes, resulting in billions of dollars in lost market value.

The kind of financing at issue, since discredited, goes by the telling name of "death spiral preferred." It worked like traditional convertible securities, except that the conversion price was a movable goalpost. The more the stock went down, the more shares the owner of the convert could claim on converting.

In malevolent hands, this kind of convert could produce a windfall for the owner of the preferred and disaster for the company that issued it. Suppose a company's common stock is trading at $10 and you provide $5 million in convertible financing. In a conventional convert deal, the preferred would be exchangeable for, say, 400,000 shares. In the death spiral variety, the holder of the convertible is entitled to $5 million worth of shares, whatever their price. So you might buy the convertible preferred and immediately short 500,000 shares of common stock. If the stock sinks, you could short more. You might run the stock down to $1, pocketing, say, $20 million on the short sale of 10 million shares. Now you convert your preferred shares, demanding the 10 million common shares you're entitled to and using them to cover short sales. You have shelled out $5 million and collected $20 million.

Whether anything this blatant happened is a matter of dispute. What's certain: Plenty of companies with death spiral financing saw their common shares go into death spirals. Somebody was selling all the way down, and those sellers may have been in cahoots with convert holders.

In O'Quinn's cases the alleged conspirators range from top-tier investment banks like Salomon to mysterious Caribbean-based straw entities. The suits single out two active players in convertible deals: Mark Valentine, former chairman of Canadian brokerage Thomson Kernaghan; and Steven Hicks, president of Southridge Capital. Proving that they either shorted stocks or worked with others who did won't be easy.

ROSS MACDONALD FOR FORBES