

The Curious Incident of the Shares that Didn't Exist

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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?

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], 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 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 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 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 below). 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."

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 current 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."

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 occurrence and would paralyze our capital market system, even worse than the paperwork crisis that shutdown 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 in depressing 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. 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.

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