

## **Blame the 'Stock Vault'?**

### **Clearinghouse Faulted On Short-Selling Abuse; Finding the Naked Truth**

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*Wall Street Journal*

July 5, 2007

Depository Trust & Clearing Corp. is a little-known institution in the nation's stock markets with a seemingly straightforward job: It is the middleman that helps ensure delivery of shares to buyers and money to sellers.

About 99% of the time, trades are completed without incident. But about 1% of the shares -- valued at about \$2.5 billion on a given a day -- aren't delivered to the buyer within the requisite three days, for one reason or another.

These "failures to deliver" have put DTCC in the middle of a long-running fight over whether unscrupulous investors are driving down hundreds of small companies' share prices.

At issue is a nefarious twist on short-selling, a legitimate practice that involves trying to profit on a stock's falling price by selling borrowed shares in hopes of later replacing them with cheaper ones. The twist is known as "naked shorting" -- selling shares without borrowing them.

Illegal except in limited circumstances, naked shorting can drive down a stock's price by effectively increasing the supply of shares for the period, some people argue.

There is no dispute that illegal naked shorting happens. The fight is over how prevalent the problem is -- and the extent to which DTCC is responsible. Some companies with falling stock prices say it is rampant and blame DTCC as the keepers of the system where it happens. DTCC and others say it isn't widespread enough to be a major concern.

The Securities and Exchange Commission has viewed naked shorting as a serious enough matter to have made two separate efforts to restrict the practice. The latest move came last month, when the SEC further tightened the rules regarding when stock has to be delivered after a sale. But some critics argue the SEC still hasn't done enough.

The controversy has put an unaccustomed spotlight on DTCC. Several companies have filed suit against DTCC regarding delivery failure. DTCC officials say the attacks are unfounded and being orchestrated by a small group of plaintiffs' lawyers and corporate executives looking to make money from lawsuits and draw attention away from problems at their companies.

## **Historic Roots**

The naked-shorting debate is a product of the revolution that has occurred in stock trading over the past 40 years. Up to the 1960s, trading involved hundreds of messengers crisscrossing lower Manhattan with bags of stock certificates and checks. As trading volume hit 15 million shares daily, the New York Stock Exchange had to close for part of each week to clear the paperwork backlog.

That led to the creation of DTCC, which is regulated by the SEC. Almost all stock is now kept at the company's central depository and never leaves there. Instead, a stock buyer's brokerage account is electronically credited with a "securities entitlement." This electronic credit can, in turn, be sold to someone else.

Replacing paper with electrons has allowed stock-trading volume to rise to billions of shares daily. The cost of buying or selling stock has fallen to less than 3.5 cents a share, a tenth of paper-era costs.

But to keep trading moving at this pace, the system can provide cover for naked shorting, critics argue. If the stock in a given transaction isn't delivered in the three-day period, the buyer, who paid his money, is routinely given electronic credit for the stock. While the SEC calls for delivery in three days, the agency has no mechanism to enforce that guideline.

### **'Phantom Stock'**

Some delivery failures linger for weeks or months. Until that failure is resolved, there are effectively additional shares of a company's stock rattling around the trading system in the form of the shares credited to the buyer's account, critics say. This "phantom stock" can put downward pressure on a company's share price by increasing the supply.

DTCC officials counter that for each undelivered share there is a corresponding obligation created to deliver stock, which keeps the system in balance. They also say that 80% of the delivery failures are resolved within two business weeks.

There are legitimate reasons for delivery failures, including simple clerical errors. But one illegitimate reason is naked shorting by traders looking to drive down a stock's price.

Critics contend DTCC has turned a blind eye to the naked-shorting problem.

### **Denver Lawsuit**

In a lawsuit filed in Nevada state court, Denver-based Nanopierce Technologies Inc. contended that DTCC allowed "sellers to maintain significant open fail to deliver" positions of millions of shares of the semiconductor company's stock for extended periods, which helped push down Nanopierce's shares by more than 50%. The small company, which is now called Vyta Corp., trades on the electronic OTC Bulletin Board market. In recent trading, the stock has traded around 40 cents. A Nevada state court judge dismissed the suit, which prompted an appeal by the company.

DTCC says the roughly dozen other cases against it have almost all been dismissed or not pursued by the plaintiffs.

Nanopierce garnered support from the North American Securities Administrators Association, which represents state stock regulators. The group filed a brief arguing that if the company's

claims were correct, its shareholders "have been the victims of fraud and manipulation at the hands of the very entities that should be serving their interest."

### **DTCC's Defense**

DTCC General Counsel Larry Thompson calls the Nanopierce claims "pure invention." DTCC officials say the main responsibility for resolving delivery failures lies with the brokerage firms. DTCC nets the brokerage firms' positions but it is the brokerages that manage their individual client accounts and know which client failed to deliver their stock.

DTCC officials say that Nanopierce had internal business problems -- including heavy losses -- to explain its stock-price drop. DTCC received support in the suit from the SEC, which filed a brief defending the trade-processing system and arguing that federal regulation pre-empted state-court review.

In January 2005, the SEC made an initial swipe at the naked-shorting problem by requiring that if delivery failures in a particular stock reached a high enough level, many of those failures would have to be resolved within 13 business days. But some failures weren't covered by the rule. The SEC action in June aimed to cover those remaining delivery failures. Naked shorting could "undermine the confidence of investors" in the stock market, SEC Chairman Christopher Cox says.

However, it doesn't seem likely that the SEC's latest move will end the debate that has been raging in the market for years. While lauding the SEC action, critics are questioning whether it is sufficient. The SEC still hasn't taken all the steps necessary to ensure "a free and transparent market" as required under federal securities laws, says James W. Christian, a Houston attorney who represents several companies that claim to have been damaged by naked shorting.

Among other things, authorities need to make public much more trading data related to stock-delivery failures, he says.

Critics contend that DTCC and the SEC have been too secretive with delivery-failure data, depriving the public of important information about where naked shorting might be taking place. Currently, DTCC's delivery-failure data can only be obtained through a Freedom of Information Act request to the SEC, which has released some statistics that are generally two months old.

In light of the controversy, DTCC has proposed making more information available and the SEC says it is looking at releasing aggregate delivery-failure data on a quarterly basis.

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