

# Samex Capital's Stock Market **CROSSCURRENTS**

U.S. STOCK MARKET COMMENTARY for FEBRUARY 7, 2005

## ☞ "...Targeted For Destruction" ☛

It seems the U.S. Chamber of Commerce's Institute For Legal Reform has publicly stated their petition of William Donaldson, the chairman of the SEC, asking for an investigation into whether short sellers and the law firm of Milberg Weiss ("MW") had engaged in securities fraud. MW represented a class action suit led by an investment company that was also shorting the stock of the company targeted by the class action. MW is best known for their role in pursuing class action suits against publicly traded companies. The U.S. Chamber of Commerce was apparently fed up after the recent dismissal of a suit in California against Terayon Communications, a maker of broadband cable equipment. Incredibly, federal judge Marilyn Hall Patel found that the lead plaintiff in the suit, Cardinal Investments, had been shorting Terayon since August 1999 and had also bought put options that expired the day after the class action suit was filed. Although the class action claimed Terayon had misled investors over its prospects, resulting in a stock price decline in April 2000, it is clear to see who would benefit from the filing of the suit. It was clearly not for the benefit of Terayon share holders. As well, the court actually speculated whether MW had "...actively participated in or provided advice to plaintiffs regarding their scheme to cause a fall in Terayon's stock price."

*We have nothing against the practice of short selling.* We've been around for 15 years in print and al-

most all of that time, have presented a hedged stance, with both long and short ideas. If a stock is overvalued and you can borrow the shares to sell to another sucker, why not?

What concerns us is the rapidly expanding database of allegations about *concerted efforts* to bring down the prices of certain companies through the dispersal of misinformation, subsequent "shareholder" class action law suits designed simply to take share prices lower, regardless of

would only benefit the very sizable short contingent and the attorneys filing the suit. But we have yet to tackle the third dimension of how shares of certain companies are targeted for destruction.

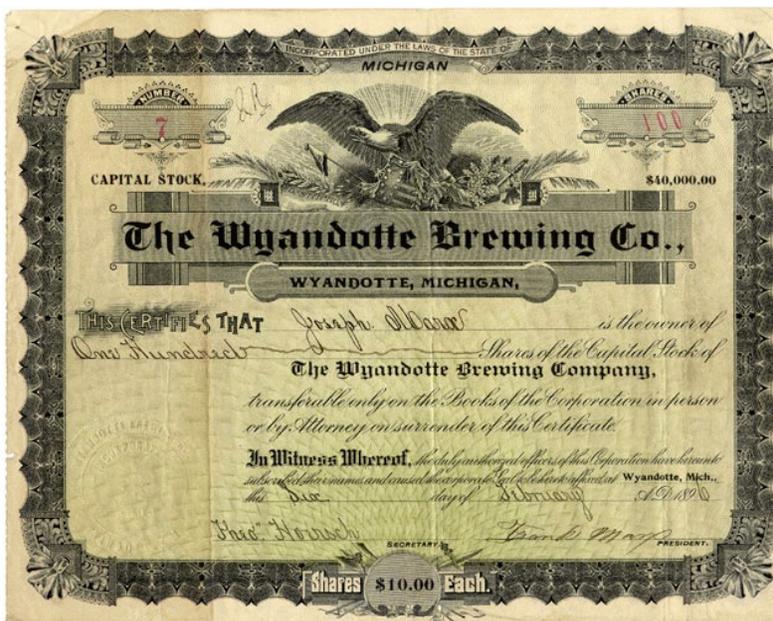
When we short for our own account, the dealer must "locate" shares available to borrow before the ticket can be marked "short sale" and entered. *When executed, the shares must then be borrowed by the settlement date so they can be delivered to the purchaser.* You can't sell what you don't own, unless you are able to borrow it from someone else, the rule since 1934. Just for the sake of argument, let's say you are able to pull off a short sale of 100 shares of XYZ without borrowing them. The buyer still sees the shares credited to his account by his broker. A "naked" short occurs when the trade remains unsettled because the shares are not delivered to the buyer. There are now two actual owners of the *same* shares; the original owner plus whomever bought the shares you sold short.

The EXACT SAME shares

now show up long in *both* accounts. Strange but true. Every 100 shares of a naked short is a duplication of real shares, just as if the shares had been photocopied and distributed.

Regulation SHO is supposed to take care of this problem by forcing dealers to cover short positions that have failed-to-deliver after a period of 13 days (current settlement procedures are mandated at 3 days).

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the damage done to present shareholders, and manipulations of price made possible via naked shorting, resulting in "counterfeit" shares.

Regarding misinformation, over a series of articles lasting two months, we attempted to show that even a \$1 billion market cap NYSE company can be subject to propaganda. We also covered in some detail how the class action suit in that case had no apparent merit and

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But the SEC has taken an astonishing step, "grandfathering" in all failures-to-deliver prior to Reg. SHO's implementation. *Theoretically, these transactions may never be settled.* Yes, we said *never*. Thus, every failure-to-deliver prior to when Reg. SHO went into effect on January 3rd has created extra shares out of nothing, *ipso facto* "counterfeit" shares that have not been approved nor authorized by corporate treasurers.

In many of these cases, it is clear that short sellers EXPECTED all along to do nothing about deliveries and indeed, probably repeated the procedure as often as required to depress prices further. This is just one of the beefs of John O'Quinn, the 62-year-old senior partner of O'Quinn, Laminack & Pirtle in Houston. O'Quinn is on the accusatory side of 15 lawsuits alleging that certain brokerages and market makers have conspired to drive prices down. In O'Quinn's own words, "If you short a stock for the sole purpose of killing the value, that's a threat to the view that we have an honest market." Since the vast majority of security holdings today do not involve delivery of actual certificates, most positions are book entries and are transferred through the ether similarly to the way email is. The Depository Trust & Clearing Corp. is responsible for maintaining the process and in their normal course of business, tolerates fails-to-deliver when the seller does not have the certificates in hand but promises to soon deliver them. O'Quinn's lawsuit alleges that brokerages have permitted undelivered shares to be traded over and over, resulting in implied but significant expansions in

capitalization. *As always, a dilution to shareholders will tend to depress price.*

Although the SEC did levy a \$1 million civil fine against Rhino Advisors for using offshore accounts to short shares of Sedona Corp., they appear slow to act to punish such collusive efforts and by tolerating "grandfathered" fails-to-deliver, they are condoning any collusion that might still be present. From what we are able to view via a few very simple

**"... when market participants enter into naked short sales on a massive scale, they could have an endless supply of shares and "could drive down the price in an abusive or manipulative way."**

**- James Brigagliano, Assistant Director, SEC Division of Market Regulation.**

Google searches (i.e., "counterfeit shares," O'Quinn + sedona," etc.), this intrigue has been carried out on a horrific scale. A July 30th press release from Pet Quarters, Inc., clarified, "The perpetrators typically operate through multiple

tiers of offshore funds, advisors, directors and agents for the purpose, we believe, of obscuring the identity of the investors and impeding investigations by regulatory authorities in order to avoid civil liability." The impetus to cause a "death spiral" is not only profit but that the profit may never have to be declared for tax purposes. As long as the short sale remains uncovered, the transaction remains open. Positions marked-to-market offer the short seller the opportunity to withdraw his profits without tax consequence, to begin the same process all over again with another victim.

Regarding the complaint against transactions from "offshore,"

**"What happened to us, SEDONA, and other companies like us is a travesty.... We were targeted for destruction."**

**- Steve Dempsey, Chairman and CEO of PetQuarters Inc.**

bear in mind that the uptick rule for short selling is currently enforced in the U.S. but not everywhere else. As well, it is likely that many of the "fails-to-deliver" in the system are as a result of brokers being asked to wait for delivery from foreign brokers or offshore accounts. In fact, in the last few weeks, Celgene (CELG) has been only one of four stocks that had to request delisting from the Berlin Stock Exchange where unauthorized trading had taken place. *It is estimated that hundreds of U.S. companies have been traded in Berlin, Frankfurt and on other foreign exchanges without any authorization.*

Title 18, Part 1, Chapter 25 of federal law covers counterfeiting and forgery, and specifically claims "any false or fictitious instrument, document, or other item appearing, representing, purporting, or contriving through scheme or artifice, to be an actual security or other financial instrument issued under the authority of the United States, a foreign government, a State or other political subdivision of the United States, or an organization, shall be guilty of a class B felony." If fails have been designed so that shares will never be delivered, as now "grandfathered" by the SEC, the effect of the fail must be to

increase the number of shares available to trade, without any authorization by the company. *These fails are the equivalent of counterfeit shares.*

By "grandfathering" previous fails and ignoring the effects of counterfeiting shares

via naked shorting, the SEC has aided any of those responsible for what appear to be class B felonies. The SEC must rectify this problem and demand that ALL fails be settled within a reasonable period of time.

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