SPECIAL REPORT

'Naked' short selling is center of looming legal battle

Companies on the defensive seize upon an aggressive form of shorting

By Alistair Barr, MarketWatch
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SAN FRANCISCO (MarketWatch) -- For years, companies have accused short sellers of manipulating their shares and spreading false information, but rarely have their allegations gone anywhere in court.

A MARKETWATCH SPECIAL REPORT
WHO ARE THE SHORT SELLERS?

Thwarting the shorts
An array of adversaries is making it harder to be a winning short seller.

Case vs. 'naked' players
"Naked shorting" adds fuel to the debate over the legality of shorts.

Masters and maligned
Short sellers are criticized and lionized with equal fervor, but little is known about their influence.

Good, bad and the ugly
Some shorts expose fraud, but others end up becoming a scandal themselves by plying their trade.

Now, after seeking out a more effective basis to make their case, a growing number of companies and class-action attorneys have seized upon a particularly aggressive -- and often illegal -- form of short selling called naked shorting.

Like mainstream short strategies, naked shorting is also a way to bet on a stock dropping -- only it's easier to think of it as shorting on steroids.

In a typical short sale, traders sell borrowed shares and then -- if all goes according to plan - buy them back at a lower price and return them to the lender. The difference is kept as profit.

In naked shorting, a trader shorts a stock without first making necessary arrangements to borrow shares. That often means the seller often fails to deliver the stock to the buyer and the trade can't be settled, running afoul of securities laws.

By one contentious estimate, it's a big problem plaguing more than 10% of stocks on the New York Stock Exchange and Nasdaq. An NYSE probe into whether naked shorting was used to force down shares of Vonage Holdings Corp. (VG) lower during the Internet phone company's May initial public offering has added fuel to the fire. See full story.

Because naked short selling involves the violation of technical trading rules, it could be easier to prove than more broadly based accusations like manipulation or conspiracy.

"It's very hard to prove manipulation," said lawyer Barry Barbash, formerly a senior official with the Securities and Exchange Commission. "That pattern of behavior by short sellers has rarely, if ever, been proved in any legal case. It's been alleged and asserted over and over again by companies, but not proved."

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>
> — *Wes Christian, securities lawyer*

"There have been instances of enforcement cases against short-selling hedge funds, but these focus on more technical violations of trading rules," he added. Barbash, a partner at the law firm of Willkie Farr & Gallagher LLP, represents both companies and fund managers on either side of the issue and said he doesn't have opinions on specific cases.

James Angel, associate professor of finance at Georgetown University, said some hedge fund managers have already been charged by the SEC and the National Association of Securities Dealers with violations related to naked shorting.

If companies can gather evidence charting a pattern of rule-breaking by short sellers, then judges and juries could be more open to hearing about other allegations such as manipulation, he explained.

"It would certainly look bad if companies point to these guys and show they have a predilection for breaking rules," Angel said. "Whether a judge and jury buy that in court is another story."

Angel said the legal strategy could end up producing more settlements between companies and short sellers.

Law firms unite

Three class-action law firms, headed by John O'Quinn, are leading the legal push against short sellers and naked short selling.

O'Quinn, who achieved fame for winning big lawsuits against tobacco companies in the 1990's, is joined by two other Houston-based firms, Christian, Smith & Jewell and Heard, Robins, Cloud, Lubel & Greenwood.

The firms are also representing Overstock.com (OSTK) in the Internet retailer's suit against short seller Rocker Partners LP and research firm Gradient Analytics.

Other companies suing with the help of O'Quinn's consortium include Internet Law Library, Nanopierce Technologies, Pet Quarters Inc. (PDEN) , Hyperdynamics Corp. (HDY) and Sedona Corp. (SDNA) .

So far, these law firms have spent $25 million on the way toward filing 12 suits involving 10 companies, and they're close to filing another five cases. Ten more suits are in the works and the total may reach 50 by early 2007.

The thrust of their complaints is that naked short selling creates billions of dollars of shares that don't actually exist. Individual investors may unknowingly purchase these "phantom" stocks, undermining the legitimacy of the market.

"There are a group of bad guys rigging the market by selling tens of millions of shares everyday that they don't own and never deliver," lawyer Wes Christian, a partner at Christian, Smith & Jewell, said. "A result of that is that shares of our clients are being artificially devalued."

"We're going to ultimately shed light on this bad behavior," Christian added. "This is killing young Corporate America, costing jobs and cheating people out of hundreds of millions of dollars with fake shares."

Undelivered

There are currently about half a billion shares in the U.S. that have been sold in the past but not delivered for settlement in the required three days, according to Robert Shapiro, a former undersecretary in the Commerce Department under President Bill Clinton, who's researching the issue as a paid consultant for O'Quinn's group.

These so-called fails-to-deliver trades can go on for a long time, and Shapiro estimates that roughly 12% of NYSE and Nasdaq stocks have fails-to-deliver that are at least two months old.

The legal group is also suing the Depository Trust & Clearing Corporation, which settles equity trades in the U.S., over the naked shorting issue. The clearing unit, however, disputes Shapiro's analysis and says that fails-to-deliver represent much less than 1% of the 26 million transactions it handles daily.

Patrick Byrne, head of Overstock.com, has been this year's most outspoken executive in the growing assault on naked short selling.

Overstock's lawsuit against Rocker Partners stops short of any allegations of naked short selling. But in public speeches Byrne has accused many short sellers of using the strategy to force the company's stock lower. For its part, Rocker has said the firm doesn't use naked shorting.

In Utah, where Overstock is based, lawmakers in May passed a measure intended to crack down on naked short selling. Drawing the wrath of brokerages, the new law allows Utah-based firms to collect $10,000 a day from brokers who fail to tell the state's securities regulator within 24 hours as to how many shares on designated lists of short stocks they won't be able to deliver on time.

Opinions of naked short selling and how much of a problem it is range from the extreme to the sanguine.

"What do you think about murder?" Julian Robertson, founder of hedge fund giant Tiger Management LLC said in an interview. "It's obviously wrong and against the law."

Buffett's view

Robertson, who says he shorts stocks the legitimate way, thinks naked shorting isn't used very much.

On the other end of the spectrum, Warren Buffett, chairman of Berkshire Hathaway (BRKA) (BRKB) , said last month that he has no problem with naked short sellers betting against the company. "If anybody wants to do that with Berkshire, more power to them," he said during Berkshire's annual meeting.

Buffett said that while the many companies that attract a lot of interest from short sellers "very often" are later revealed to be frauds, he noted that "the one my friend runs is not at all." Jack Byrne, who is Patrick Byrne's father and until recently served as Overstock's chairman, serves on Berkshire Hathaway's board and for years headed Geico, automobile-insurance subsidiary.

Manuel Asensio, an outspoken short seller in the late 1990's, said naked short selling was done "routinely" through Canadian brokerage firms that weren't governed by U.S. trading rules. "It was not controversial and was a very established business in Canada," Asensio said, adding that he still thinks there's nothing wrong with the practice.

Asensio's brokerage firm agreed to pay a $75,000 fine in 2000 to settle allegations of violations tied to naked shorting.

Forced buy-ins

Shapiro, O'Quinn's consultant, said there's a relatively simple way to solve the problem of naked short selling.

During the 1970's, there used to be a rule that if stocks were sold and not delivered within 13 business days, the DTCC would go into the market to buy the shares and charge the account of the brokerage handling the sale

But the Securities and Exchange Commission has said that the DTCC doesn't have the authority to execute these so-called forced buy-ins.

The DTCC has also noted that forced buy-ins would increase risks during clearing and settlement and could interfere with the trading and pricing of securities.

"They're concerned that there would be lots of short squeezes," Shapiro said. "But I don't think short squeezes against naked short sellers would be a bad thing. That's how the market should deal with undisciplined short sellers."

Amid the growing controversy, the SEC introduced new rules that tightened up on short selling at the beginning of 2005. As part of the new regulations, a list of stocks with lots of failed trades is published regularly.

But some experts question whether the regulations have been effective.

Georgetown University's Angel says some stocks, including Netflix Inc. (NFLX) , Krispy Kreme (KKD) and Martha Stewart Living (MSO) , have been on the list since it was first introduced. "There's just about enough information for the public to know there's something wrong here," Angel said.

There isn't enough information to know whether most fails-to-deliver are caused by naked shorting or not, he added.

"All we get is the list, which just adds more smoke to the fire," Angel said.

The SEC says it's aware of the situation and can't comment on current investigations, but Angel says the agency has lost credibility.

"I assume that either there's an active investigation or the SEC is ignoring the issue ..." he concluded. "It's hard to say what's going on."

Alistair Barr is a reporter for MarketWatch in San Francisco.