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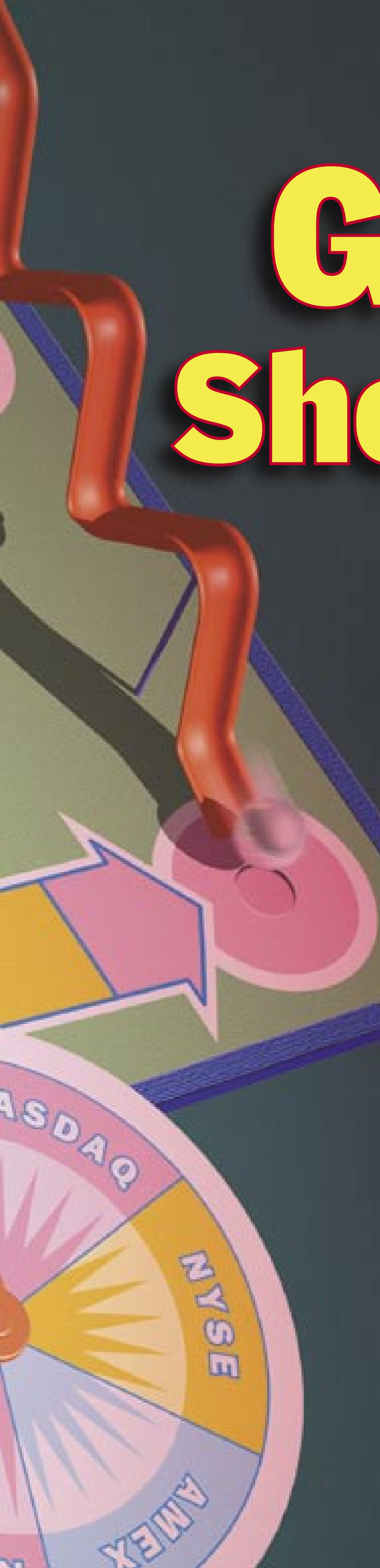


Games Short Sellers Play

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.

DOUGLAS PIZAC/AP-WIDE WORLD

"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.

"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.

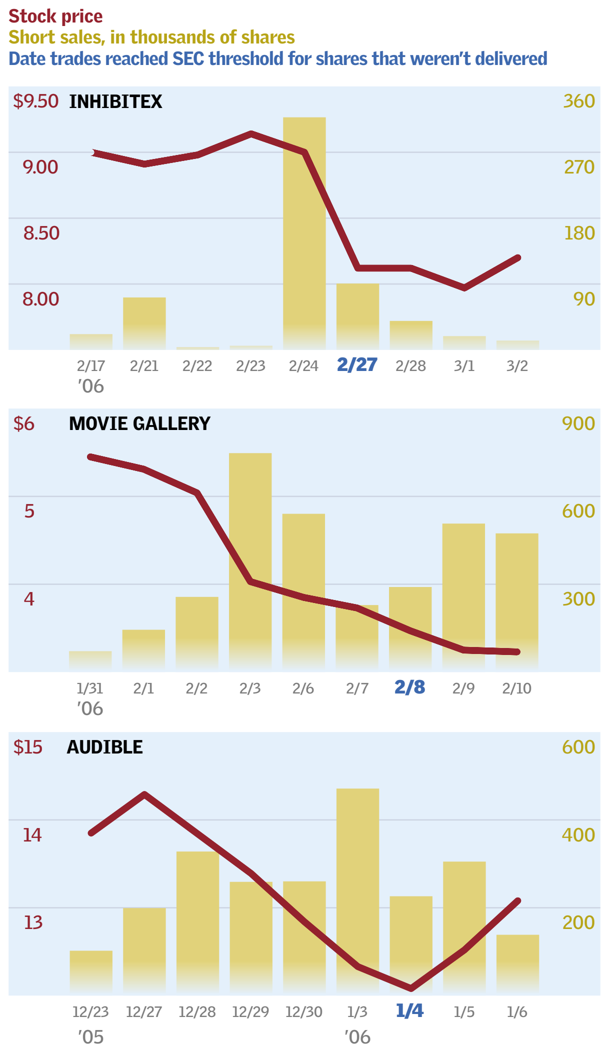
While Reg SHO doesn't outlaw naked short sales per se, it targets companies with enough failed deliveries to raise concerns about naked short selling, and it restricts further short sales of those stocks. Reg SHO's short-selling restrictions took effect in January 2005.

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

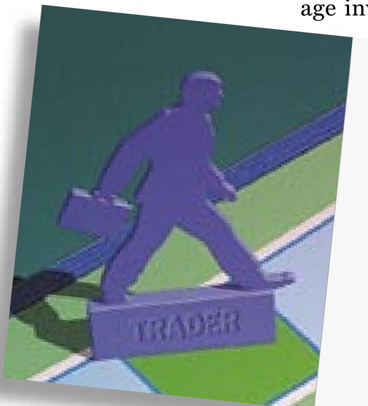
Naked short sales may have driven down share prices before stock exchanges recognized that buyers weren't getting the shares they had bought.



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. 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.



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

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.

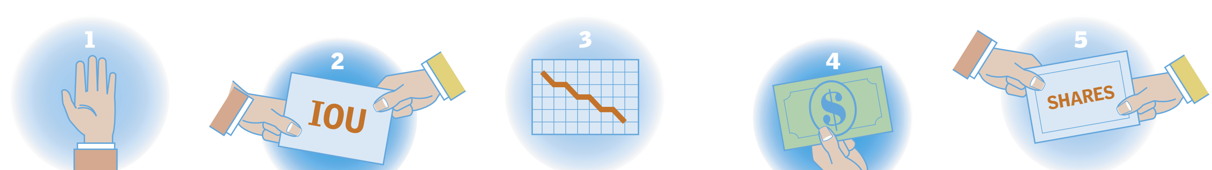
Audible Inc., which sells audio newspapers and books on the Web, had delivery failures that broke Reg SHO's threshold from trading on Jan. 4. Over five days, short sales had averaged 309,000 shares, almost triple the level for the preceding week. Audible, based in Wayne, New Jersey, ranked last in the 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.



1. Trader sells shares he doesn't have for cash. **Doesn't borrow stock; avoids paying fee.**
2. **Buyer gets IOU** promising stock will be delivered later.
3. **Trader keeps selling stock** he doesn't have, **pushing down price.** More buyers get IOUs.
4. After stock drops, trader pays lower price for shares to give buyers; **keeps extra cash as profit.**
5. **Trader uses shares** bought at lower price **to replace IOUs.**

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.

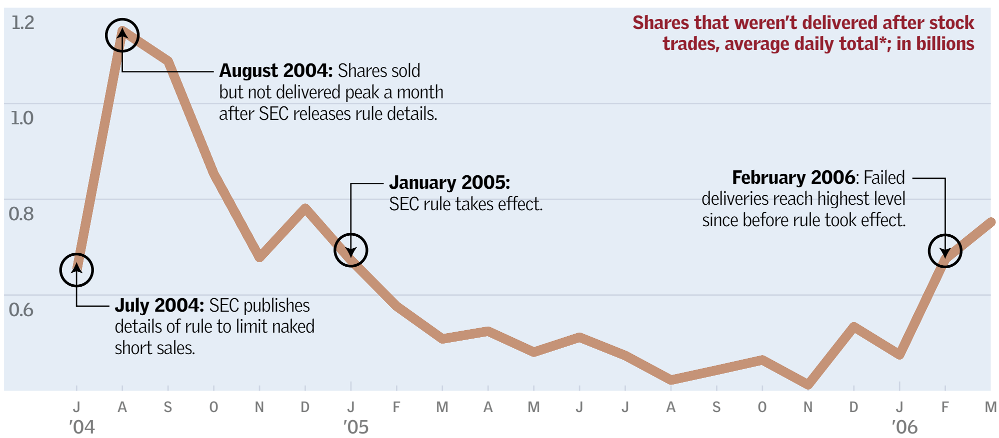
When naked short sellers target a company, the results can be devastating, says David Vey, chairman of King of Prussia,

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.

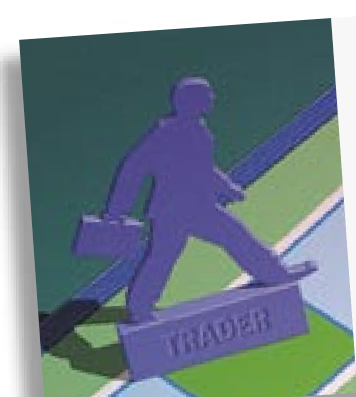
While there's more than one reason shares might not be delivered to buyers, Depository Trust & Clearing statistics for the days immediately after the SEC announced it would have new rules show that there could have been hundreds of millions of naked short sales. In eight trading days after the SEC released 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.

"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



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

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.

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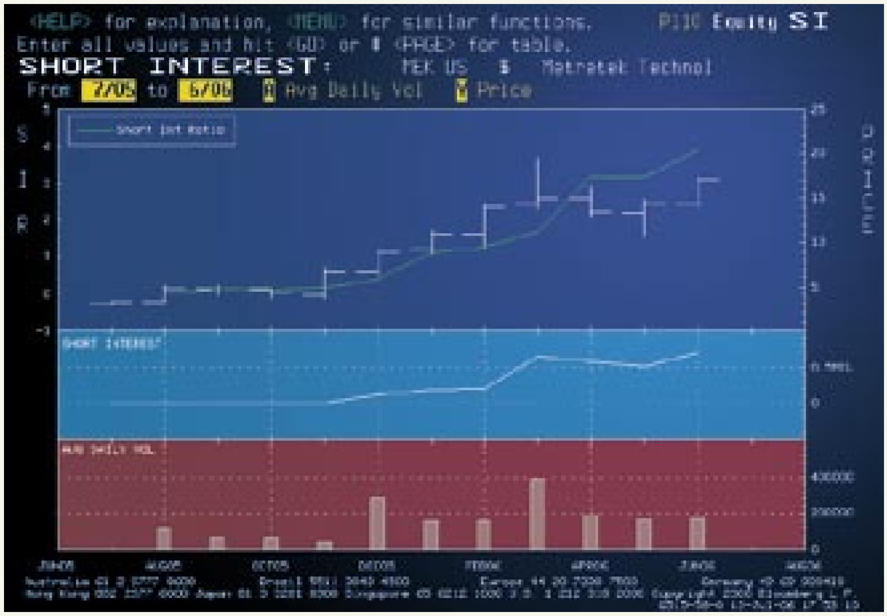
Tracking Short Interest

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



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