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Naked Short Sales Hint Fraud in Bringing Down Lehman

By Gary Matsumoto

March 19 (Bloomberg) -- The biggest bankruptcy in history might have been avoided if Wall Street had been prevented from practicing one of its darkest arts.

As Lehman Brothers Holdings Inc. struggled to survive last year, as many as 32.8 million shares in the company were sold and not delivered to buyers on time as of Sept. 11, according to data compiled by the Securities and Exchange Commission and Bloomberg. That was a more than 57-fold increase over the prior year's peak of 567,518 failed trades on July 30.

The SEC has linked such so-called fails-to-deliver to naked short selling, a strategy that can be used to manipulate markets. A fail-to-deliver is a trade that doesn't settle within three days.

"We had another word for this in Brooklyn," said Harvey Pitt, a former SEC chairman. "The word was 'fraud.'"

While the commission's Enforcement Complaint Center received about 5,000 complaints about naked short-selling from January 2007 to June 2008, none led to enforcement actions, according to a report filed yesterday by David Kotz, the agency's inspector general.

The way the SEC processes complaints hinders its ability to respond, the report said.

Twice last year, hundreds of thousands of failed trades coincided with widespread rumors about Lehman Brothers. Speculation that the company was being acquired at a discount and later that it was losing two trading partners both proved untrue.

After the 158-year-old investment bank collapsed in bankruptcy on Sept. 15, listing $613 billion in debt, former Chief Executive Officer Richard Fuld told a congressional panel on Oct. 6 that naked short sellers had midwifed his firm's demise.

Gasoline on Fire

Members of the House Committee on Government Oversight and Reform weren't buying that explanation.

"If you haven't discovered your role, you're the villain today," U.S. Representative John Mica, a Florida Republican, told Fuld.

Yet the trading pattern that emerges from 2008 SEC data shows naked shorts contributed to the fall of both Lehman Brothers and Bear Stearns Cos., which was acquired by JPMorgan Chase & Co. in May.

“Abusive short selling amounts to gasoline on the fire for distressed stocks and distressed markets,” said U.S. Senator Ted Kaufman, a Delaware Democrat and one of the sponsors of a bill that would make the SEC restore the uptick rule. The regulation required traders to wait for a price increase in the stock they wanted to bet against; it prevented so-called bear raids, in which successive short sales forced prices down.

Driving Down Prices

Reinstating the rule would end the pattern of fails-to- deliver revealed in the SEC data, Kaufman said.

“These stories are deeply disturbing and make a compelling case that the SEC must act now to end abusive short selling -- which is exactly what our bill, if enacted, would do,” the senator said in an e-mailed statement.

Short sellers arrange to borrow shares, then dispose of them in anticipation that they will fall. They later buy shares to replace those they borrowed, profiting if the price has dropped. Naked short sellers don’t borrow before trading -- a practice that becomes evident once the stock isn’t delivered. Such trades can generate unlimited sell orders, overwhelming buyers and driving down prices, said Susanne Trimbath, a trade-settlement expert and president of STP Advisory Services, an Omaha, Nebraska-based consulting firm.

The SEC last year started a probe into what it called “possible market manipulation” and banned short sales in financial stocks as the number of fails-to-deliver climbed.

‘Unsubstantiated Rumors’

The daily average value of fails-to-deliver surged to $7.4 billion in 2007 from $838.5 million in 1995, according to a study by Trimbath, who examined data from the annual reports of the National Securities Clearing Corp., a subsidiary of the Depository Trust & Clearing Corp.

Trade failures rose for Bear Stearns as well last year. They peaked at 1.2 million shares on March 17, the day after JPMorgan announced it would buy the investment bank for $2 a share. That was more than triple the prior-year peak of 364,171 on Sept. 25.
Fuld said naked short selling -- coupled with “unsubstantiated rumors” -- played a role in the demise of both his bank and Bear Stearns.

“The naked shorts and rumor mongers succeeded in bringing down Bear Stearns,” Fuld said in prepared testimony to Congress in October. “And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers.”

Devaluing Stock

Failed trades correlate with drops in share value -- enough to account for 30 to 70 percent of the declines in Bear Stearns, Lehman and other stocks last year, Trimbath said.

While the correlation doesn't prove that naked shorting caused the lower prices, it's "a good first indicator of a statistical relationship between two variables," she said.

Failing to deliver is like "issuing new stock in a company without its permission," Trimbath said. "You increase the number of shares circulating in the market, and that devalues a stock. The same thing happens to a currency when a government prints more of it."

Trimbath attributes the almost ninefold growth in the value of failed trades from 1995 to 2007 to a rise in naked short sales.

"You can't have millions of shares fail to deliver and say, 'Oops, my dog ate my certificates,'" she said.

Explanation Required

On its Web site, the Federal Reserve Bank of New York lists several reasons for fails-to-deliver in securities trading besides naked shorting. They include misunderstandings between traders over details of transactions; computer glitches; and chain reactions, in which one failure to settle prevents delivery in a second trade.

Failed trades in stocks that were easy to borrow, such as Lehman Brothers, constitute a "red flag," said Richard H. Baker, the president and CEO of the Washington-based Managed Funds Association, the hedge fund industry's biggest lobbying group.

"Suffice it to say that in a readily available stock that is traded frequently, there has to be an explanation to the appropriate regulator as to the circumstances surrounding the fail-to-deliver," said Baker, who served in the U.S. House of Representatives as a Republican from Louisiana from 1986 to February 2008.
"If it's a pattern and a practice, there are laws and regulations to deal with it," he said.

Fines and Penalties

Lehman Brothers had 687.5 million shares in its float, the amount available for public trading. In float size, the investment bank ranked 131 out of 6,873 public companies -- or in the top 1.9 percent, according to data compiled by Bloomberg.

While naked short sales resulting from errors aren't illegal, using them to boost profits or manipulate share prices breaks exchange and SEC rules and violators are subject to penalties. If investigators determine that traders engaged in the practice to try to influence markets, the Department of Justice can file criminal charges.

Market makers, who serve as go-betweens for buyers and sellers, are allowed to short stock without borrowing it first to maintain a constant flow of trading.

Since July 2006, the regulatory arm of the New York Stock Exchange has fined at least four exchange members for naked shorting and violating other securities regulations. J.P. Morgan Securities Inc. paid the highest penalty, $400,000, as part of an agreement in which the firm neither admitted nor denied guilt, according to NYSE Regulation Inc.

Enforcement 'Reluctant'

In July 2007, the former American Stock Exchange, now NYSE Alternext, fined members Scott and Brian Arenstein and their companies $3.6 million and $1.2 million, respectively, for naked short selling. Amex ordered them to disgorge a combined $3.2 million in trading profits and suspended both from the exchange for five years. The brothers agreed to the fines and the suspension without admitting or denying liability, according a release from the exchange.

Of about 5,000 e-mailed tips related to naked short-selling received by the SEC from January 2007 to June 2008, 123 were forwarded for further investigation, according to the report released yesterday by Kotz, the agency's internal watchdog. None led to enforcement actions, the report said.

Kotz, the commission's inspector general, said the enforcement division "is reluctant to expend additional resources to investigate" complaints. He recommended in his report yesterday that the division step up analysis of tips, designating an office or person to provide oversight of complaints.

Schapiro's Plans
"Our audit disclosed that despite the tremendous amount of attention the practice of naked short selling has generated in recent years, Enforcement has brought very few enforcement actions based on conduct involving abusive or manipulative naked short selling," the report said.

The enforcement division, in a response included in the report, said "a large number of the complaints provide no support for the allegations" and concurred with only one of the inspector general's 11 recommendations.

SEC Chairman Mary Schapiro, who took office in January, has vowed to reinvigorate the enforcement unit after it drew fire from lawmakers and investors for failing to follow up on tips that New York money manager Bernard Madoff's business was a Ponzi scheme. She has "initiated a process that will help us more effectively identify valuable leads for potential enforcement action," John Nester, a commission spokesman, said in response to the Kotz report.

Last September, the agency instituted the temporary ban on short sales of financial stock. It also has announced an investigation into "possible market manipulation in the securities of certain financial institutions."

No Effective Action

Christopher Cox, who was SEC chairman last year; Erik Sirri, the commission's director for market regulation; and James Brigagliano, its deputy director for trading and markets, didn't respond to requests for interviews. John Heine, a spokesman, said the commission declined to comment for this story.

"It has always puzzled me that the SEC didn't take effective action to eliminate naked shorting and the fails-to- deliver associated with it," Pitt, who chaired the commission from August 2001 to February 2003, said in an e-mail. The agency began collecting data on failed trades that exceed 10,000 shares a day in 2004.

"All the SEC need do is state that at the time of the short sale, the short seller must have (and must maintain through settlement) a legally enforceable right to deliver the stock at settlement," Pitt wrote. He is now the CEO of Kalorama Partners LLC, a Washington-based consulting firm. In August, he and some partners started RegSHO.com, a Web-based service that locates stock to help sellers comply with short-selling rules.

Postponed 'Indefinitely'

Pitt began his legal career as an SEC staff attorney in 1968, and eventually became the commission's general counsel. In 1978, he joined Fried Frank Harris Shriver & Jacobson LLP, where as a senior corporate partner he represented such clients as Bear Stearns and the New York Stock Exchange. President George W. Bush appointed him SEC chairman in 2001.

The flip side of an uncompleted transaction resulting from undelivered stock is called a "fail-to-receive." SEC regulations state that brokers who haven't received stock 13 days after purchase can execute a so-called buy-in. The broker on the selling side of the transaction must buy an equivalent number of shares and deliver them on behalf of the customer who didn't.

A 1986 study done by Irving Pollack, the SEC's first director of enforcement in the 1970s, found the buy-in rules ineffective with regard to Nasdaq securities. The rules permit brokers to postpone deliveries "indefinitely," the study found.

The effect on the market can be extreme, according to Cox, who left office on Jan. 20. He warned about it in a July article posted on the commission's Web site.

Turbocharged Distortion

When coupled with the propagation of rumors about the targeted company, selling shares without borrowing “can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions,” he said in the article.

“‘Naked’ short selling can turbocharge these ‘distort-and- short’ schemes,” Cox wrote.

“When traders spread false rumors and then take advantage of those rumors by short selling, there’s no question that it’s fraud,” Pollack said in an interview. “It doesn’t matter whether the short sales are legal.”
On at least two occasions in 2008, fails-to-deliver for Lehman Brothers shares spiked just before speculation about the bank began circulating among traders, according to SEC data that Bloomberg analyzed.

On June 30, someone started a rumor that Barclays Plc was ready to buy Lehman for 25 percent less than the day’s share price. The purchase didn’t materialize.

‘Green Cheese’

On the previous trading day, June 27, the number of shares sold without delivery jumped to 705,103 from 30,690 on June 26, a 23-fold increase. The day of the rumor, the amount reached 814,870 -- more than four times the daily average for 2008 to that point. The stock slumped 11 percent and, by the close of trading, was down 70 percent for the calendar year.

“This rumor ranks up there with the moon is made of green cheese in terms of its validity,” Richard Bove, who was then a Ladenburg Thalmann & Co. analyst, said in a July 1 report.

Bove, now vice president and equity research analyst with Rochdale Securities in Lutz, Florida, said in an interview this month that the speculation reflected “an unrealistic view of Lehman’s portfolio value.” The company’s assets had value, he said.

‘Obscene’ Leverage

During the first six days following the Barclays hearsay, the level of failed trades averaged 1.4 million. Then, on July 10, came rumors that SAC Capital Advisors LLC, a Stamford, Connecticut-based hedge fund, and Pacific Investment Management Co. of Newport Beach, California, had stopped trading with Lehman Brothers.

Pimco and SAC denied the speculation. The bank’s share price dropped 27 percent over July 10-11.
Banks and insurers wrote down $969.3 billion last year -- and that gave legitimate traders plenty of reason to short their stocks, said William Fleckenstein, founder and president of Seattle-based Fleckenstein Capital, a short-only hedge fund. He closed the fund in December, saying he would open a new one that would buy equities too.

"Financial stocks imploded because of the drunkenness with which executives buying questionable securities levered-up in obscene fashion," said Fleckenstein, who said his firm has always borrowed stock before selling it short. "Short sellers didn't do this. The banks were reckless and they held bad assets. That's the story."

'Market Distress'

On May 21, David Einhorn, a hedge fund manager and chairman of New York-based Greenlight Capital Inc., announced he was shorting stock in Lehman Brothers and said he had "good reason to question the bank's fair value calculations" for its mortgage securities and other rarely traded assets.

Einhorn declined to comment for this story. Monica Everett, a spokeswoman who works for the Abernathy Macgregor Group, said Greenlight properly borrows shares before shorting them.

Even when they're legitimate, short sales can depress share values in times of market crisis -- in effect turning the traders' negative bets into self-fulfilling prophecies, says Pollack, the former SEC enforcement chief who is now a securities litigator with Fulbright & Jaworski in Washington.

The SEC has been concerned about the issue since at least 1963, when Pollack and others at the commission wrote a study for Congress that recommended the "temporary banning of short selling, in all stocks or in a particular stock" during "times of general market distress."

Airport Runway

On Sept. 17, two days after Lehman Brothers filed for Chapter 11 bankruptcy, the number of failed trades climbed to 49.7 million, 23 percent of overall volume in the stock.

The next day, the SEC announced its ban on shorting financial companies in 2008. The number of protected stocks ultimately grew to about 1,000. On Sept. 19, the commission announced "a sweeping expansion" of its investigation into possible market manipulation.

The ban, which lasted through Oct. 17, didn't eliminate shorting, according to data from the SEC, the NYSE Arca exchange and Bloomberg. Throughout the period, short sales averaged 24.7 percent of the overall trading in Morgan Stanley, Merrill Lynch & Co. and Goldman Sachs Group Inc. on NYSE Arca. In 2008, short sales averaged 37.5 percent of the overall trading on the exchange in the three companies.

To date, the commission hasn't announced any findings of its investigation.

Pollack, the former SEC regulator, wonders why.

“This isn’t a trail of breadcrumbs; this audit trail is lit up like an airport runway,” he said. “You can see it a mile off. Subpoena e-mails. Find out who spread false rumors and also shorted the stock and you’ve got your manipulators.”