Short sellers: The good, the bad and the ugly
Some have exposed fraud; others become the scandal themselves

By Martin Ritchie | MarketWatch
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SAN FRANCISCO (MarketWatch) — In the escalating debate over whether short sellers do more harm than good, the case of Anthony Elgindy neatly gives detention to the bogeyman they can use to drum up support for their cause.


Less than three hours later, Elgindy emailed a message to subscribers of his investment Web site, 'NEROL', CEO, Dr. Paul Maurice Brown, is a convicted felon.

In the following days, Elgindy and others put out still more information on the Internet about Brown's alleged criminal record. Over the next month, his shorted shares of the nuclear-waste technology company several times and recommended that his subscribers do the same. From early December 2001 to the end of January 2002, shares of the Nuclear Solutions lost almost half their value.

Elgindy's lawyer, borrowing from a common short-sellers refrain, sought to portray his client as a hero for trying to expose 'phony companies'. To U.S. Attorney Alan Vinegrad, the scheme was 'a shocking partnership between an experienced stock manipulator and law-enforcement agents, undertaken for their illicit personal gain.'

Last year, a jury in Brooklyn agreed and convicted Elgindy of conspiracy, securities fraud and extortion surrounding Nuclear Solutions (NSOL) which is now called Fuel Frontiers. Brown, who founded Nuclear Solutions (NSOL), wasn't a convicted felon after all. An illegal drug possession charge against him was dismissed in 1991, the Wall Street Journal reported. He died in a car crash in April 2002.

The Elgindy case does little to help defenders of short sellers, who frequently claim they help keep markets ticking and contribute to accurate share prices by making sure the prices reflect negative as well as positive information about companies.

Elgindy's scheme, and several similar ones described in the grand jury indictments that followed, is at one extreme end of the debate about whether short sellers are good or bad for the markets.

On the other end of the spectrum, short-seller advocates like David Rocker want investors and regulators to focus on the supposed benefits that shorts have.

"Although there have been occasional instances in which short sellers have been accused of circulating misleading stories, these instances are dwarfed both in number and magnitude by the misleading stories circulated by long holders and the issuers themselves," Rocker, a leading short seller, told a Congressional hearing in 2003.

Rocker cites a long list of frauds and accounting abuses at companies including Enron, Tyco International Ltd (TYC), Comerica Inc (CMA), Boston Chicken and Lernout & Hauspie Speech Products that he says were uncovered by short sellers.

"Out of this air"

In the most visible case in which short sellers are credited with performing a public service, Jim Chanos of Kynikos Associates, the world's largest short-selling firm, unearthed problems at the once-mighty energy trading company.

Chanos's interest in Enron was first piqued in October 2000 when he met about an accounting method used by the company called 'gain-on-sale' accounting, according to the text of a statement he gave the Securities and Exchange Commission in 2003.

If used aggressively, the accounting method could help companies create earnings "out of the air," Chanos said.

Delegating financial statements Enron had filed with the SEC, Chanos found a laundry list of other warning signs, including a mismatch between the company's cost of capital and its return on investment, the now famous "widedparty transactions," lots of insider selling and a puzzling initiative to expand into broadband trading.

In November 2000, Chanos began shorting Enron stock, and then increased his bet against the company after Chief Executive Jeffrey Skilling abruptly resigned in August 2001.

"The effort we devoted to looking behind the numbers at Enron, and the actions we ultimately took based upon our research and analysis, show how we deliver value to our investors and, ultimately, to the market as a whole," Chanos told the SEC. "Short sellers are the professional skeptics who look past the hype to gauge the true value of a stock.'

"Stretching the truth"

In 1999, Tyco International was just the type of company David Tice's research newsletter, Behind the Numbers, liked to put in the spotlight.

At the time, as Tice recalls, Tyco was a Wall Street darling with lots of buy recommendations and no sells from the analysts who followed the company.

But when Tice and his fellow researchers studied the company's financial statements closely, they concluded its intrinsic growth rate was low. Growth was being fueled instead by continuous acquisitions.

Tyco was also using restructuring charges to hide future expenses, said Tice, who manages the $150 million Prudent Bear Fund (SEACO), a short-selling mutual fund.

"We told people that Tyco was stretching the truth on reported performance, which didn't represant future growth prospects," he added.

Shortly after his report came out in Behind the Numbers, Tyco's stock sank 49% and the SEC began to investigate.

In the years that followed, Chief Executive Dennis Kozlowski and Chief Financial Officer Mark Swartz went on trial on charges of stealing $500 million from the company. They were later convicted of most of the charges. In April, Tyco agreed to pay the government $500 million to settle charges it overstated financial results by at least $1 billions between 1996 and 2002.

For Tice, the episode stands as a painful example of the good that short sellers do:

"You might not like the pain, but it’s better to get it out now than later," he said. "If there are no short sellers, some stocks would rise more, for longer, creating even more pain when it’s determined the emperor has no clothes."
Background check

In June 1998, Rocker Partners LP (now called Copper River) began shorting shares of Lernout & Hauspurg, a developer of speech-recognition technology.

The Belgian company had listed on Nasdaq in 1996. Two years later, after a $45 million investment from Microsoft Corp. (MSFT), it had become a high-flying tech stock.

Rocker Partners, which at the time was run by David Rocker and Marc Cohodes, questioned the hype. They started to look into the background of Lernout & Hauspurg's top executives.

They thought management had a poor track record when they ran Quantek, which floundered on an aggressive acquisition-fueled growth strategy that Lernout & Hauspurg appeared to be repeating, according to court filings made as part of a Rocker lawsuit against the company.

Rocker and Cohodes also thought the market for Lernout's products was limited. But as the company continued to report strong results, the stock rallied to a high of more than $70 in 2000.

In the summer of that year, the Wall Street Journal published a series of reports that questioned Lernout's fast revenue growth and prompted investigations by U.S. and Belgian authorities.

In the scandal that followed, the company fired most of its management. A report from its own audit committee uncovered several accounting tricks that inflated revenue by a total of $373 million from 1998 to 2000. By late 2001, Lernout & Hauspurg was bankrupt.

Shorting Sedona

But as the Elgin case shows, some short sellers can be the subject of scandal themselves, rather than exposing it.

In 2003, Thomas Badman, president of New York investment firm Rhino Advisors Inc., agreed to pay a $1 million penalty to settle SEC charges that he illegally shorted more than 1 million shares of Sedona Corp. (SEDU) as part of a scheme to force down the price of the stock.

In late 2000, Badman agreed to invest $2.5 million in convertible securities that Sedona planned to issue, according to the SEC.

The agreement obligated Sedona to pay Badman $3 million in March 2001 and gave him the right to convert the payment into shares of the company at a 35% discount to where the stock was trading during the five days leading up to the conversion.

The agreement prohibited Badman from shorting Sedona shares, but he ignored that and shorted more than 1.1 million shares of the company, the SEC said.

During the first quarter of 2001, Sedona's stock lost almost half its value under the pressure of Badman's shorting.

That helped him collect far more new shares at much lower prices the conversion happened, the SEC explained.

The scheme, according to regulators, involved a massive volume of improper "naked shorting," a form of shorting that is done through legitimate means. Badman took out such large naked-short positions on Sedona, that regulators had to place restrictions on any further shorting of the shares, the SEC said.

Instead of stopping the practice, Badman continued to short another 350,000 Sedona shares through Canadian brokers that weren't subject to U.S. restrictions, the SEC said.

CompuDyne

Last year, Hillary Shane, manager of hedge fund FRY Millennium Partners LP, paid $1.45 million to settle charges by the NASD and SEC that she was involved in a similar scheme.

In 2001, CompuDyne Corp. (CDY), a security systems company, planned to raise more than $29 million by selling restricted stock to wealthy investors and institutions in a private offering.

The new securities were offered at a discount to CompuDyne's share price at the time, but investors had to agree to hold the stock for a set period before selling.

After agreeing to invest in the offering, Shane shorted more than 500,000 CompuDyne shares, forcing the stock lower. When Shane was free to sell the new securities she'd bought, the manager used them to cover her huge short position, generating a tidy profit, the NASD said.

Damasces

Sedona's clash with short sellers shows how a company's plans can be knocked off course by the practice.

The maker of customer relationship management software is suing Badman, Rhino and others it alleges were involved in forcing its shares lower.

It claims it was harmed by a falling stock price, which in turn made it more expensive to raise money by selling new shares. A higher cost of credit also cramped its ability to finance growth, the company says.

"We had a plan to grow the company, but we lost four years of our life," Sedona Chief Executive Marco Emmrich said in an interview. "Sedona is a legitimate business and with legal support we can be very successful by eliminating these unfortunate situations."

Alden Barr is a reporter for MarketWatch in San Francisco.
'Naked' short selling is center of looming legal battle
Companies on the defensive seize upon an aggressive form of shorting

By MarketWatch | 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.

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

Naked shorting is a way to bet that a stock is going to fall, without actually owning the shares. It's a method that allows traders to make money even when the stock price goes down, by selling shares they don't own.

Thawing the shorts

An array of advertisers 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 vilified with equal fervor, but little is known about their influence.

Good, bad and the ugly

Some short-sellers are frauds, but others end up being heroes and making the market.

"There are a group of bad guys rigging the market by selling tens of millions of shares every day that they don't own and never deliver."

- Mike Christian, securities lawyer

"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."

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.

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

Undelivered shares

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.

So far, those law firms have spent $25 million on the way toward filing 13 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 to 60 by early 2007.

The system's problem is that naked short selling creates billions of dollars of shares that don't actually exist. Individual investors may unknowingly purchase those "phantom" stocks, undermining the legitimacy of the market.

"There is a group of bad guys rigging the market by selling tens of millions of shares every day that they don't own and never deliver," Shapiro said. "A result of that is that shares of our clients are being artificially depleted."

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

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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.

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

Overstock.com'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 hasn't done naked shorting.

In Utah, where Overstock is based, lawmakers in May passed a measure intended to crack down on naked short selling. Creasing the wrath of brokerage, the new law allows Utah-based firms to collect $10,000 a day from brokers who fail to sell the state's securities regulator within 24 hours to fix up any shares on designated lists of stocks about which the regulator has concerns.
Opinions on 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 short stocks the legitimate way, thinks naked short selling 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. "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 Asemis, an outspoken short seller in the late 1990s, said naked short selling was done "safely" 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," Asemis said, adding that he still thinks there's nothing wrong with the practice.

Asemis's brokerage firm agreed to pay a $7.5 million fine in 2001 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 1970s, there used to be a rule that if stocks were sold and not delivered within 12 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 squeeze," 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 undisguised 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.

Georgeson University's Angel says some stocks, including Netflix Inc. (NFLX), Knopp Vene (NKOT), and Martha Stewart Living (MSLP), have been on the list since it was first introduced. "There's just not 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."
Short sellers: A rarer breed of investing
Organized to thwart shorts, adversaries now make strategy more difficult

By Marty Fras, MarketWatch
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SAN FRANCISCO (MarketWatch) -- When asked if he knew of other leading firms specializing in short selling, the representative at the headquarters of Copper River Management LLC couldn't be very helpful.

"Where are the other three or four short sellers? If you can find them, give us a call," the person said, before declining to give his name and getting off the phone at the New Jersey-based investment firm.

Copper River, a $1.3 billion asset manager run by Marc Cohodes, is one of a shrinking group of firms that specialize in betting on stock declines. Others include Ryerson Associates, Kingspoint Capital and Water Street Capital.

What was already a difficult and sometimes gut-wrenching strategy has only gotten harder in recent years. Nowadays, more of the short sellers target are fighting back with lawsuits. They also mount sophisticated public relations campaigns against shorts. And if that weren't enough, there's a new crop of newsletters designed to "squeeze" short sellers.

"The game has become so stacked against the short seller that it's just not worth the periodic emotional and monetary high that comes from seeing a stock fall," said Marc Cohodes, who used to specialize in short strategies, told newsletter Value Investor Insight earlier this year.

Feithbach and his brothers Matthew and Kurt built a $1 billion hedge fund in the 1990s by aggressively shorting stocks. They then tone down a fund that does the opposite: investing in stocks and other securities it thinks have dropped too far on negatives such as government investigations, accounting errors and profit warnings. See related story.

"The business of shorting has only gotten tougher since my brothers and I left it in the early 1990s," he added.

Harry Shrock, president of Palm Beach, Fla.-based consultant Aspen Grove Capital Management LLC, has been tracking the performance of short sellers since the early 1990s. Back then, he followed as many as 25 short selling firms. That's down to roughly 10 now.

"It's a very difficult strategy," Shrock said. "The market trends upwards in the long term, so short sellers are swimming against the current. And there's a lot more risk involved.

"The hype surrounding aggressive, no-holds-barred short selling, combined with the controversy, made it very difficult for us."

— Manuel Asensio, investor

Shrock said the potential returns are limited to how far a stock can drop, while their losses are in theory unlimited because shares can keep going indefinitely, Feithbach said.

Feithbach and his brothers Matthew and Kurt built a $1 billion hedge fund in the 1990s by aggressively shorting stocks. They then tone down a fund that does the opposite: investing in stocks and other securities it thinks have dropped too far on negatives such as government investigations, accounting errors and profit warnings. See related story.

"I spent six years in litigation on several multi-million dollar trials," Asensio said. "The hype surrounding aggressive, no-holds-barred short selling, combined with the controversy, made it very difficult for us."

— Manuel Asensio, investor

A recent study by the National Association of Securities Dealers shows that on average, short sellers lose 2% to 3% per quarter. Shrock said that's a good return considering the risks involved.

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Asensio said he was the first to be sued, and it cost him $375,000 in legal fees. He added that he has lost more than $1 million in his own money.

He said he learned his lesson and now only invests in stocks that are "robust" and have a "strong" balance sheet.

"It's just too expensive to fight," he said.

A Web site, called Asensioexposed.com, still tracks his legal tussles.

Asensio, a Cuban refugee who grew up in Brooklyn and describes himself as a radical liberal, said it would be even more difficult to set up a pure, aggressive short selling operation today.

"Hedge fund salaries have jumped, so such a firm today would have to spend a lot more to hire analysts to research and track short ideas. Lawsuits from targeted companies also require being a personal lawyer plus a law firm for representation," Asensio added.

"The infrastructure necessary to run that type of business and the legal risks create an anatomy of scale that is very difficult," he said. "Layer on top of that the personal and financial costs of being deposed all the time and taking personal liability, then it's just not worth it.

"That's a bad thing," Asensio argues, because short sellers help keep valuations of stocks accurate and ensure that capital is allocated more efficiently to the most promising companies.

"There's no benefit to society and financial markets from restricting the flow ideas, capital and the employment of that capital in the short-selling community," he said.

Legal push
A growing number of companies, supported by experienced class-action law firms, disagree, claiming short sellers conspire to force down shares of vulnerable firms.
John O’Quinn, who triumphed over tobacco companies in the 1990s, is leading the legal push that also includes two other Houston-based firms, Christian, Smith & Jewel and Heard, Robins, Cloud, Lavel & Greenwood.

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

Other companies suing with the help of O’Quinn’s consortium include Internet Law Library, Nanoparticle Technologies, Pet Quarters Inc. (CGED) Hyperdynamics Corp. (BDC) and Sedona Corp. (SDNA).

The law firms have so far filed 12 suits naming 10 companies and are closing another five cases. Ten more suits are in the works and the total may reach 50 by early 2017. The law firms have spent $25 million so far preparing cases.

The focus of the attacks is on so-called naked short selling, which the group says is illegal. It naked shorting, a trader sells a stock without first making the necessary arrangements to borrow shares.

PRL short squeezes

A cadre of public-relations firms are also supporting companies that do battle with short sellers.

Vancouver-based RPM Communications Inc. specializes in helping “junior public companies in bringing their corporate story to investors,” according to the firm’s Web site.

Most of the firm’s Web site is devoted to exposing what it calls “the illegal practices of naked short selling,” “death spiral financing” and “stock fraud.”

Shareholders and companies that have been affected by naked short selling are encouraged to sign an online petition asking for the SEC to be investigated for not doing enough to stop naked shorting.

Newsletters too are devoted to “squeezing” short sellers. In a short squeeze, investors aim to buy so much stock that the supply used for borrowing dries up and the broker collects shares already lent out. To return stock, short sellers have to buy them back, forcing the price up. As the stock rises, it can spur other shorters to have to cover their positions, fueling further gains.

Erfanger Squeeze Play, run by former Fidelity technical analyst Phil Erfanger, tracks short-selling activity to measure investor sentiment on stocks. Web site shortsqueeze.com provides short interest data and alerts to subscribers.

The Shortseller Club was run by Ray Dilks at Sky Capital LLC, although a representative at the New York-based firm said it doesn’t offer the service anymore and Dilks no longer works at Sky Capital.

Rocker noted some of those newsletters when arguing against more regulation of short sellers during Congressional testimony in 2003.

Rocker retired earlier this year in the midst of Overstock’s lawsuit against the firm. Copper Bower said his departure wasn’t related to the suit.

Alistair Barr is a reporter for MarketWatch in San Francisco.