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TAIBBLOG

Accidentally Released - and Incredibly Embarrassing - Documents Show How Goldman et al Engaged in 'Naked Short Selling'

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AP Photo/Douglas C. Pizac

It doesn't happen often, but sometimes God smiles on us. Last week, he smiled on investigative reporters everywhere, when the lawyers for Goldman, Sachs slipped on one whopper of a legal banana peel, inadvertently delivering some of the bank's darker secrets into the hands of the public.

The lawyers for Goldman and Bank of America/Merrill Lynch have been involved in a legal battle for some time – primarily with the retail giant Overstock.com, but also with *Rolling Stone*, the *Economist*, *Bloomberg*, and the *New York Times*. The banks have been fighting us to keep sealed certain documents that surfaced in the discovery process of an ultimately unsuccessful lawsuit filed by Overstock against the banks.

Last week, in response to an Overstock.com motion to unseal certain documents, the banks' lawyers, apparently accidentally, filed an unredacted version of Overstock's motion as an exhibit in their declaration of opposition to that motion. In doing so, they inadvertently entered into the public record a sort of greatest-hits selection of the very material they've been fighting for years to keep sealed.

I contacted Morgan Lewis, the firm that represents Goldman in this matter, earlier today, but they haven't commented as of yet. I wonder if the poor lawyer who FUBARred this thing has already had his organs harvested; his panic is almost palpable in the air. It is both terrible and hilarious to contemplate. The bank has spent a fortune in legal fees trying to keep this material out of the public eye, and here one of their own lawyers goes and dumps it out on the street.

The lawsuit between Overstock and the banks concerned a phenomenon called naked short-selling, a kind of high-finance counterfeiting that, especially prior to the introduction of new regulations in 2008, short-sellers could use to artificially depress the value of the stocks they've bet against. The subject of naked short-selling is a) highly technical, and b) very controversial on Wall Street, with many pundits in the financial press for years treating the phenomenon as the **stuff of myths** and conspiracy theories.

Now, however, through the magic of this unredacted document, the public will be able to see for itself what the banks' attitudes are not just toward the "mythical" practice of naked short selling (hint: they volubly confess to the activity, in writing), but toward regulations and laws in general.

"Fuck the compliance area – procedures, schmecedures," chirps Peter Melz, former president of Merrill Lynch Professional Clearing Corp. (a.k.a. Merrill Pro), when a subordinate worries about the company failing to comply with the rules governing short sales.

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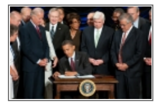
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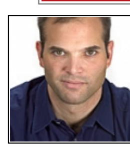
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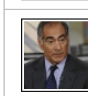
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We also find out here how Wall Street professionals manipulated public opinion by buying off and/or intimidating experts in their respective fields. In one email made public in this document, a lobbyist for SIFMA, the Securities Industry and Financial Markets Association, tells a Goldman executive how to engage an expert who otherwise would go work for "our more powerful enemies," i.e. would work with Overstock on the company's lawsuit.

"He should be someone we can work with, especially if he sees that cooperation results in resources, both data and funding," the lobbyist writes, "while resistance results in isolation."

There are even more troubling passages, some of which should raise a few eyebrows, in light of former Goldman executive Greg Smith's recent **public resignation**, in which he complained that the firm routinely screwed its own clients and denigrated them (by calling them "Muppets," among other things).

Here, the plaintiff's motion refers to an "exhibit 96," which refers to "an email from [Goldman executive] John Masterson that sends nonpublic data concerning customer short positions in Overstock and four other hard-to-borrow stocks to Maverick Capital, a large hedge fund that sells stocks short."

Was Goldman really disclosing "nonpublic data concerning customer short positions" to its big hedge fund clients? That would be something its smaller, "Muppet" customers would probably want to hear about.

When I contacted Goldman and asked if it was true that Masterson had shared nonpublic customer information with a big hedge fund client, their spokesperson Michael Duvally offered this explanation:

> *Among other services it provides, Securities Lending at Goldman provides market color information to clients regarding various activity in the securities lending marketplace on a security specific or sector specific basis. In accordance with the group's guidelines concerning the provision of market color, **Mr. Masterson provided a client with certain aggregate information regarding short balances in certain securities**. The information did not contain reference to any particular clients' short positions.*

You can draw your own conclusions from that answer, but it's safe to say we'd like to hear more about these practices.

Anyway, the document is full of other interesting disclosures. Among the more compelling is the specter of executives from numerous companies admitting openly to engaging in naked short selling, a practice that, again, was often dismissed as mythical or unimportant.

A quick primer on what naked short selling is. First of all, *short selling*, which is a completely legal and often beneficial activity, is when an investor bets that the value of a stock will decline. You do this by first borrowing and then selling the stock at its current price; then, after the price drops, you go out, buy the same number of shares at the reduced price, and return the shares to your original lender. You then earn a profit on the difference between the original price and the new, lower price.

What matters here is the technical issue of how you borrow the stock. Typically, if you're a hedge fund and you want to short a company, you go to some big-shot investment bank like Goldman or Morgan Stanley and place the order. They then go out into the world, find the shares of the stock you want to short, borrow them for you, then physically settle the trade later.

But sometimes it's not easy to find those shares to borrow. Sometimes the shares are controlled by investors who might have no interest in lending them out. Sometimes there's such scarcity of borrowable shares that banks/brokers like Goldman have to pay a fee just to borrow the stock.

These hard-to-borrow stocks, stocks that cost money to borrow, are called *negative rebate* stocks. In some cases, these *negative rebate* stocks cost so much just to borrow that a short-seller would need to see a real price drop of 35 percent in the stock just to break even. So how do you short a stock when you can't find shares to borrow? Well, one solution is, you don't even bother to borrow them. And then, when the trade is done, you don't bother to deliver them. You just do the trade anyway without physically locating the stock.

Thus in this document we have another former Merrill Pro president, Thomas Tranfaglia, saying in a 2005 email: "We are NOT borrowing negatives... I have made that clear from the beginning. Why would we want to borrow them? We want to fail them."

Trafaglia, in other words, didn't want to bother paying the high cost of borrowing "negative rebate" stocks. Instead, he preferred to just sell stock he didn't actually possess. That is what is meant by, "We want to fail them." Trafaglia was talking about creating "fails" or "failed trades," which is what happens when you don't actually locate and borrow the stock within the time the law allows for trades to be settled.

If this sounds complicated, just focus on this: naked short selling, in essence, is selling stock you do not have. If you don't have to actually locate and borrow stock before you short it, you're creating an artificial supply of stock shares.

In this case, that resulted in absurdities like the following disclosure in this document, in which a Goldman executive admits in a 2006 email that just a little bit too much trading in Overstock was going on: "Two months ago 107% of the floating was short!"

In other words, 107% of all Overstock shares available for trade were short – a physical impossibility, unless someone was somehow creating artificial supply in the stock.

Goldman clearly knew there was a discrepancy between what it was telling regulators, and what it was actually doing. "We have to be careful not to link locates to fails [because] we have told the regulators we can't," one executive is quoted as saying, in the document.

One of the companies Goldman used to facilitate these trades was called SBA Trading, whose chief, Scott Arenstein, was **fined $3.6 million in 2007** by the former American Stock Exchange for naked short selling.

The process of how banks circumvented federal clearing regulations is highly technical and incredibly difficult to follow. These companies were using obscure loopholes in regulations that allowed them to short companies by trading in shadows, or echoes, of real shares in their stock. They manipulated rules to avoid having to disclose these "failed" trades to regulators.

The import of this is that it made it cheaper and easier to bet down the value of a stock, while simultaneously devaluing the same stock by adding fake supply. This makes it easier to make money by destroying value, and is another example of how the over-financialization of the economy makes real, job-creating growth more difficult.

In any case, this document all by itself shows numerous executives from companies like Goldman Sachs Execution and Clearing (GSEC) and Merrill Pro talking about a conscious strategy of "failing" trades – in other words, not bothering to locate, borrow, and deliver stock within the time alotted for legal settlement. For instance, in one email, GSEC tells a client, Wolverine Trading, "We will let you fail."

More damning is an email from a Goldman, Sachs hedge fund client, who remarked that when wanting to "short an impossible name and fully expecting not to receive it" he would then be "shocked to learn that [Goldman's representative] could get it for us."

Meaning: when an experienced hedge funder wanted to trade a very hard-to-find stock, he was continually surprised to find that Goldman, magically, could locate the stock. Obviously, it is not hard to locate a stock if you're just saying you located it, without really doing it.

As a hilarious side-note: when I contacted Goldman about this story, they couldn't resist using their usual P.R. playbook. In this case, Goldman hastened to point out that Overstock lost this lawsuit (it was dismissed because of a jurisdictional issue), and then had this to say about Overstock:

> *Overstock pursued the lawsuit as part of its longstanding self-described "Jihad" designed to distract attention from its own failure to meet its projected growth and profitability goals and the resulting sharp drop in its stock price during the 2005-2006 period.*

Good old Goldman -- they can't answer any criticism without describing their critics as losers, conspiracy theorists, or, most frequently, both. Incidentally, Overstock rebounded from the 2005-2006 short attack to become a profitable company again, during the same period when Goldman was needing hundreds of billions of dollars in emergency Fed lending and federal bailouts to stave off extinction.

Anyway, this galactic screwup by usually-slick banker lawyers gives us a rare peek into the internal mindset of these companies, and their attitude toward regulations, the markets, even their own clients. The fact that they wanted to keep all of this information sealed is not surprising, since it's incredibly embarrassing stuff, if you understand the context.

More to come: until then, here's the **motion**, and pay particular attention to pages 14-19.

UPDATE: Well, I guess I shouldn't feel too badly for the lawyer who stepped on this land mine. For Morgan Lewis counsel Joe Floren, karma, it seems, **really is a bitch**.