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Sitting on the plane yesterday, I was reading over some of the work a friend of mine produced on naked short selling, and it occurred to me that this info belongs in a venue where the public can access it. So I broke my commitment to take a few days off, away from computers, to post this - and then I will really stay offline...

By way of introduction, let me say that there are authorities, and then there are authorities. The gentleman in question is a true expert on the topic, partly because he's been studying the issue for about 25 years – his comments to the SEC on Reg SHO have taken on near mythical status, as they so clearly warned of the abuse that would come should the SEC not implement the safeguards he'd advocated. His name is likely familiar to many who have closely followed this topic – Dr. Jim DeCosta.

The challenge in presenting the true state of the union is to provide data, supported by research, in bite-sized morsels that people can digest. I feel that his work is among the most comprehensive I've seen on the subject, so I leaned on him to allow me to publish a small sampling of his material. His premise has always been that the solution to the entire NSS mess lies in educating the investing public, the regulators, the Judiciary, and anybody else with a vested interest in the clearance and settlement system.

He's written 2-1/2 unpublished books on naked short selling, which contain more data than any other work on the subject I've seen. In Chapter 42 he delineates some of what he calls "Not so bullet points". He lists 40 of them, but I'm only going to publish the first dozen for now, as there is a lot of information to assimilate.

So without further ado, the first of Dr. Jim's bullet points:

"I want to end this Chapter 42 with 40 "Not so bullet points" in regards to DTCC behavior in general. Many of these were revealed in the above analysis of the DTCC's "Self-interview" and others were covered in previous chapters. My goal here is to get all readers on the same wavelength and build a foundation from which we can tackle the concepts in the last 28 chapters of this book and then move onto Book #3.

40 NOT SO BULLET POINTS IN RE: NAKED SHORT SELLING

1) Legitimate and illegitimate electronic book entries at the DTCC: Every trade involving a failed delivery that is allowed to "clear", or more accurately, is bailed out, by a DTCC Stock Borrow Program (SBP) pseudo-borrow (a) results in a "Counterfeit Electronic Book-Entry" ("CEBE") – an electronic book-entry held at the DTCC without corresponding paper-certificated shares held in a DTCC vault, or anywhere else, to justify their existence. (a) "Pseudo-borrow" is defined as an illegitimate borrow made from a self-replenishing anonymous pool especially one whose contents are admittedly not monitored.

Why are these pseudo-borrows illegitimate? Because the admittedly unmonitored contents (or "pseudo-shares" theoretically "borrowed" from the SBP lending pool to cure the failed delivery), are allowed to be replaced right back into the same pool of lendable shares by the new purchaser's broker/dealer, as if they never left in the first place. (Chapter 4) Even if all of the "Shares" residing in the lending pool at a given time were legally there, i.e. a margin agreement was signed approving their being loaned or hypothecated, this policy would still be insane.

The DTCC tells us that 20% of all failed deliveries at the DTCC are dealt with via the SBP's creation of these CEBEs. This violates Section 17A of the '34 Act, as Section 17 A only allowed the DTCC to convert

100 million “Acme” paper-certificated shares held in their vault [and under their legal custody] into 100 million Acme electronic book-entry “Shares” in their “book-entry” system. The reasoning for moving from paper to electronic book-entries was that electronic book-entries are much more efficient to process - especially important in the midst of the 1969 “paperwork crisis” that drove the move to automation.

The CEBEs created by the SBP are above and beyond what Section 17 A permitted. NASD Rule 11830 later expanded the one-for-one ratio of paper-to-electronic shares, and effectively allowed there to be 100.5 million Acme shares (0.5% above the number of shares outstanding) held in electronic book-entry format, before buy-ins of the overage of delivery failures was mandated. Rule 11830 provided the critical “metric” in regards to the number of “Unaddressed delivery failures” (the size of the naked short position at the DTCC) above which action was mandated, to halt the incredibly obvious dilutional damage incurred by an issuer, and the investors therein.

2) CEBEs. CEBEs cause artificial dilution because they represent readily sellable share facsimiles, without any rights attached - misrepresented (a) on an investor’s monthly brokerage statement as being genuine “Shares” (with an attached package of rights). They are readily sellable facsimiles by necessity, because there is no way a DTCC participating b/d could refuse to take a sell order, or refuse to provide voting privileges, for something that it has implied to its client as being genuine “Shares held long” on their behalf (as per the fiduciary duty of care owed as an agent/broker, to its client that paid it a commission).

Recall from earlier chapters how the perceived value of each of the (dozen or so) component rights which make up a genuine “Share” are what gives a “Share” its value. The components of the rights package are the “Share.” As an example, the dividend “Right” attached to a corporation paying a generous annual dividend, would have a commensurately larger perceived value ascribed to that particular right. Paper certificates and electronic book entries are mere formats to account for “Share” ownership; they’re not the “Share” – and formats have no intrinsic value – it’s the package of rights that has the value.

(a) (Misrepresentation: A false representation of a matter of fact that should have been disclosed, which deceives another so that he/she acts upon it to his/her injury)

3) Unaddressed CEBEs kill corporations, via massive dilution, if they are not constantly and rigorously monitored for their quantity, age, and the legitimacy of the failed delivery that procreated them. In naked short selling (NSS), the mere method of placing the bet against a corporation increases the odds of winning the bet, because of the dilutional damage done with each negative bet placed that didn’t involve a legitimate “borrow”. Note that even legal short selling done as sloppily as it is done on Wall Street via “iffy locates” (as the SEC calls them), causes artificial dilution - but legal short selling has a built-in “Governor”: there are only a finite number of legitimate shares legally-loanable. NSS has no such “Governor”, and there’s no limit to the damage that can be inflicted upon an issuer. As mentioned before, “pricing efficiency” mandates that all short sales or “negative votes” against a corporation be counted - but only if they are preceded by a legitimate “borrow”.

This lack of a “Governor” creates the self-fulfilling prophecy aspect of NSS; just keep selling nonexistent shares until the company goes down. It’s analogous to ballot box stuffing. The mindset of the abusive DTCC participants and their co-conspirators becomes, “don't worry nobody's watching and you'll never be bought in, because the DTCC can be 100% counted on to pretend to be “powerless” in collecting the IOUs owed directly to them as the loan intermediary in the SBP “pseudo-borrow” process.

4) The only modality available to address archaic, excessive or illegitimate CEBEs is an open market "buy-in" - except for the extremely rare “negotiated settlement” with the victimized issuer.

5) Buy-ins force the seller of the nonexistent shares (who has refused to deliver them in a timely manner), to open his wallet, grab the investor’s money that he acquired under false pretenses as the share price “tanked,” and spend this money on purchasing the shares that he has already sold, but refuses to repurchase and deliver even after inordinate amounts of time. (See Dr. Boni’s research)

Recall the 2 parameters from earlier chapters that help address any intent to defraud issues – the length of time of this “refusal”, as well as whether or not the price has been declining during the “refusal” period. An abusive MM that refuses to cover even when the share price is tanking is, by definition, not acting in a bonafide market making capacity, and thus isn’t deserving of the pre-short-sale borrowing exemption accorded to “bonafide” MM’s only, and only while acting in that capacity. Recall that a true, bonafide MM deploys the proceeds from naked short sales at higher levels to post bids at lower levels, in order to flatten out the position and stabilize the markets. As we’ve seen time and time again, abusive market makers with these “stabilizing bids” are nowhere to be found as the share price of a victimized issuer drops - in fact, they’re still selling aggressively. If you know that you’re not going to be caught or prosecuted, why would an abusive DTCC participant decrease the size of the pile of booty taken from naïve investors by covering his naked short position? Why not increase the size of this plunder more yet? Decisions, decisions, increase or decrease the stack of stolen money sitting in front of one.

Recall the “triple whammy” from earlier chapters that occurs if an abusive DTCC participant did choose to cover. First of all, if you’ve been the only seller for a couple years, the mere action of stopping the selling will cause the share price to gap upwards, as it has been actively forced downwards in the past. Secondly, this increase in share price from the cessation of active selling will increase the collateralization requirements for the naked short position still on the books. Thirdly, if the abuser not only stops selling but actually starts buying then the share price will have am even greater tendency to gap upwards, which will exacerbate the collateralization requirements, as well as the price needing to be paid for future covering. In other words, THEY CAN’T COVER, and the SEC knew this when they grandfathered in all preexisting delivery failures as part of Reg SHO.

The mandated buy-in approach is extremely efficient because it results in the bill for the buy-in landing in the lap of the fraudster doing the naked short selling, no matter how many layers of “dummy, straw, or nominee” corporations he is acting through (usually in various offshore havens with various banking secrecy laws, that are inexplicably allowed to interface with the DTCC – Canada included). None of the intermediaries in these transactions are going to bail out those that actually placed the order. The clearing firms holding these NSS positions in their “DTCC participant” securities accounts have been well-collateralized, due to the theoretically ultra-high risk nature of the naked short selling of penny stocks -so there is money sitting there ready to be deployed.

6) The very obvious buy-in solution is violently fought by the DTCC, as well as the SEC, as witnessed in the research results of Evans, Geczy, Musto and Reed (2003), showing that only one-eighth of 1% of Rule 11830 mandated buy-ins are ever effected. Why? In the case of the DTCC, it’s because their abusive market maker participants/owners, aware of how easy it is to steal a naïve investor’s money, are net naked short almost all of the development-stage corporations they make a market in. They know how tipped the playing field is and how these OTC markets are essentially rigged in favor of the DTCC participants owing a fiduciary duty of care to their clients - the investors whose money they are rerouting into their own wallets. They wouldn't be caught net long a development-stage micro cap corporation to save their lives. They may or may not know all of the intricacies of naked short selling, but they all know enough to work from a net short position. The reason why the SEC adamantly opposes buy-ins is a little more problematic, and the subject of a variety of theories held by various securities scholars. We’ll review them in future chapters.

A truly bonafide MM will hover near net neutral positions, sometimes net long, sometimes net short. He doesn’t get painted into a corner with a massive naked short position that forces him into criminal behavior to avoid financial catastrophes. He’s happy with living off “the spread”. Unfortunately for most MMs, these spreads became razor-thin after decimalization was instituted 5 years ago. Unlike an abusive MM that’s sitting on an astronomic naked short position in need of constant collateralization, the bonafide MM is not afraid to let a market with an imbalance of buy orders over sell orders advance in price until it reaches its own equilibrium level. The bonafide MM would naturally rather NSS shares at higher levels than at lower levels. The truly bonafide MM doesn’t dictate share price – rather, he buffers the wild swings in share price, and injects much needed liquidity into the markets of thinly-traded securities, and provides “pricing efficiency”, as noted in Chapter 18. The abusive MM, however, does not have the “luxury” of allowing prices to advance in buy order-dominated markets, as the cost to collateralize large naked short positions in advancing share price environments makes it cost-prohibitive. Abusive MMs are often forced to put a blanket of naked short sales over markets where they “accidentally” ran up a huge naked short position, but where buy orders keep coming in. You’ll recognize this scenario when you see victimized issuers mysteriously trading their entire float of shares every 3 or 4 days with the market going absolutely nowhere. Does anybody really think that all of these issuer’s shareholders got up one morning and simultaneously decided to sell all of their shares? Unfortunately for U.S. citizens, this buy order-dominated scenario often occurs in promising development-stage corporations with a wonderful prognosis for success, that now have to be snuffed out, lest abusive DTCC participants take a huge financial hit.

Many NSS proponents are of the mindset that all U.S. development-stage companies that advance in share price are by default “scams” in the midst of a “pump and dump” form of securities fraud. The irony of the SEC’s historical lack of success in stamping out “pump and dumps” is that they inadvertently welcomed an “irrefutable” form of fraud involving the blatant theft of money from naïve investors (NSS), in order to address a “suspected” form of fraud which gave rise to the “vigilante” type of naked short seller.

7) At the DTCC, the deterrence value of untimely buy-ins (which provides the “natural” deterrent to NSS abuses) has been surgically removed by DTCC policies, making the risk/reward ratio of this form of securities fraud incredibly low. The consistent refusal of the DTCC to buy-in the IOUs owed directly to them as the “loan intermediary” in the SBP’s pseudo borrowing process, is one of the two main factors that creates an invitation for fraudsters to pile on naked short sales on already brutalized victim companies. This refusal to buy-in is one of the most important pillars supporting that which many securities scholars refer to as “DTCC sponsored NSS” – namely the 100% certainty the fraudsters have that the DTCC will refuse to call in their own IOUs (while acting as the “loan intermediary” of the SBP) because of their claim of being “powerless” to do so.

An equally important pillar supporting NSS “DTCC style” involves the ability to count on the DTCC to claim to be equally “powerless” in monitoring and buying-in the failed deliveries of their participants/owners held in an “ex-clearing” format. The claim here is that these non-CNS delivery “arrangements” (I love that term “arrangements”!) associated with failed deliveries represent “contracts” between the DTCC’s participants/owners, and that the DTCC does not monitor “contract” law – only “securities” laws. This, despite the fact that they volunteer to process the cash part of these naked short sales (leading to failed deliveries), and still “clear” these trades and issue “securities orders” to allow these “non-CNS delivery arrangements”. This de facto serves to artificially delay settlement, as expressly forbidden by 15c6-1 of the ’34 act.

8) NASD Rule 11830 defines the threshold for the number of CEBEs (above which mandated buy-ins are necessary) as 10,000 shares AND 0.5% of the number of shares legally issued. Any CEBEs exceeding this level indicates that abusive dematerialization (as reviewed in Chapter 3) is occurring. This level is where the alarm bells should create a deafening noise but unfortunately for investors the wire to that alarm bell was effectively short-circuited by several of the rules and regulations of the DTCC and NSCC.

9) The conventional metric for determining the age of CEBEs (above which buy-ins should occur) would naturally correspond to the spirit of Addendum C to the rules and regulations of the NSCC, which created the SBP for deliveries that for legitimate reasons couldn’t quite be delivered by settlement day. The authors of Addendum C were well aware that it was critical to keep the lifespan of the CEBE extremely short. The assumption was that the DTCC would rigorously monitor the age, quantity, and legitimacy of these representations of shares, as they were clearly capable of causing massive damage via artificial dilution.

From a statistical point of view, the question that begs to be asked is: Is it a coincidence that the DTCC management: 1) allows its participants/owners to naked short sell with abandon, 2) refuses to monitor the age, quantity and legitimacy of the resultant failed deliveries, 3) refuses to call in its own IOUs resulting from its participants’ abuse of the SBP (because of its self-imposed “powerlessness” to do so), 4) refuses to monitor its participants’ failed deliveries in the ex-clearing netherworld (because of their theoretical “contractual” nature), despite the DTCC being an SRO in charge of “regulating the conduct and business practices of its members” as well as 17 A’s mandate to “promptly and accurately “settle” all transactions, and 5) goes well out of its way to remove the one natural deterrent to naked short selling abuse - the open-market buy-in? A second question begging to be asked is: when does a long litany of coincidences fail to plausibly remain a coincidence?

Remember, the DTCC is its owners. It's not some independent 3rd party, off to the side. There are 2 parties in the investment arena: the investors, and the DTCC-participating “Wall Street professionals” - with a vastly superior “KAV” factor (Knowledge of, Access to and Visibility of the clearance and settlement system). The DTCC portends to be playing an intermediary role between the buying and selling parties, while acting in the capacity of a “contra-party” to all trades, and the “loan intermediary” in the SBP pseudo-borrow process. But, as mentioned in earlier chapters, you can’t play a legally defensible “intermediary” role when you ARE one of the two parties being “intermediated”.

10) The methodology of monitoring for the legitimacy of failed deliveries was probably assumed by Congress and the SEC to involve the DTCC’s monitoring of their participating market makers’ usage of the bona-fide market maker exemption, and detection of any suspicious trading patterns and failed delivery patterns. These patterns jump out at you when access to this data is attained, and yet no matter how often an abusive clearing firm fails delivery of shares of a given issuer, all further delivery failures of this issuer’s shares by the abusive clearing firm are still assumed to be “legitimate”, as if by default. Recall the Compudyne case cited earlier, involving nearly a thousand consecutive trades failing delivery, without a single alarm bell going off. Every regulator and SRO seems to think that the monitoring for bona fide market making activity is the job of a different regulator and SRO - which leaves us with a regulatory vacuum, and the resultant “Industry within an industry” we refer to as naked short selling.

11) As the DTCC has been recently yelling from the mountaintops, the SEC did indeed authorize the SBP in 1981 to address legitimate failed deliveries – provided that the reason for the delay was of a legitimate nature (and there are indeed “legitimate” reasons for short-term delays in delivery). The assumption was that the DTCC would create checks and balances to monitor for abuses of this ultra-risky gamble (which allowed for the deliberate creation of a minute amount of “counterfeit” share “replicas” in an effort to enhance efficiencies in the clearing process). We have already identified over a dozen of these theoretical “quests for enhanced efficiencies” that have been abused by some DTCC participants to gain leverage over the investors they owe a fiduciary duty of care to, so it is questionable if that assumption was a reasonable one. Be that as it may, the other assumption was that the participants of the DTCC would act in good faith with this gigantic new responsibility (and incredibly large temptation to leverage their “KAV” factor and steal from investors). As it turns out there is way too much money “in play” on Wall Street to assume that those with an inherent advantage won’t leverage it.

12) Dr. Leslie Boni, while working as a visiting economic scholar for the SEC, was given access to the DTCC records. This was heretofore unheard of, except for perhaps the New York Supreme Court’s granting of discovery into the DTCC trading records to the CEO of Eagletech, in their NSS case.

Professor Boni found two distinct sub-types of delivery failures whose “median” (half younger than and half older than) age was about 13 days. Half of delivery failures averaged about 6-7 days, assuming a bell-shaped curve distribution, and were of the type that the SBP was created to address. The older half of delivery failures, however, averaged approximately 106 days, again based upon a bell-shaped curve distribution. The overall average, or “mean” age of delivery failures, was 6 days plus 106 days divided by 2, equaling 56 days as opposed to T+3. These findings were obviously not consistent with the intentions of the SBP, as promulgated by Addendum C. Some DTCC participants had obviously chosen to not act in good faith, but rather to leverage their superior knowledge, access and visibility and abuse the SBP for their own monetary gain. They learned that nobody at the DTCC was rigorously monitoring for the age, quantity, or legitimacy of these failed deliveries, and that they could sell nonexistent shares all day long, and actually get access to the unknowing investors’ money. All they had to do was let the SBP allow these trades to “clear” via a pseudo-borrow, from what turns out to be a self-replenishing lending pool, whose contents are also admittedly not being monitored (see the @dtcc self-interview where the DTCC admits that they have placed their participants on the honor system in regards to what they place into the lending pool). Once this bogus trade cleared, then all the fraudsters had to do was to collateralize this debt on a daily marked-to-market basis. The precipitous fall in share price resulting from all of this artificial dilution involving “Share facsimiles” led to an unconscionable result - the investor’s money actually falls into the lap of the naked short selling fraudsters, despite the fact that they were still refusing to purchase the shares required to cover the short sale after inordinate amounts of time.

As it turns out, short covering is not necessary to gain access to the defrauded investors’ money. One must only collateralize the ever-diminishing debt, as the share price does its 100% predictable plunge driven by all the artificial dilution being created. Unlike the DTCC and its participants, there are those investors and securities scholars who find this concept disturbing – and one hopes that the Senate Banking Committee and the House Financial Services Committee, the overseers of the SEC, will as well.

Recall from earlier chapters that the risk of being bought-in was essentially zero, as the DTCC could be counted on to see to that via their policies and procedures. The closest thing to a real buy-in was just another trip to the self-replenishing lending SBP lending pool via the DTCC’s “Procedure X-1” Policy. “

#SITE REFERENCE

https://cmkxunitedforum.proboards.com/thread/13156/02-analysis-nss-jim-decosta

LAST EXAMPLES

A quip to the SEC from Dr. DeCosta. The man is savage: “7) In 3 (ii) (B) withholding the proceeds of the crime for 90 days is like handing a bank robber the proceeds of the heist after a 90 day waiting period. This is a crime being committed. The motive is greed. The shares that were sold for real money don't exist, they never did. There was no intent to ever cover this naked short position. The "intent to defraud" is typically present right from the "get go" as there is usually not an imbalance of buy orders over sell orders at the higher trading levels of these "bear raid" victims.”

https://www.sec.gov/rules/proposed/s72303/decosta122203.htm