

Alan M. Newman's Stock Market CROSSCURRENTS

COMMENTARY EXCERPT - JULY 24, 2006

"The sudden concerns voiced by the current and past SEC Chairpersons clearly signal that the financial industry will have to take a few giant steps to resolve the issues of fairness to investors and transparency of our markets."

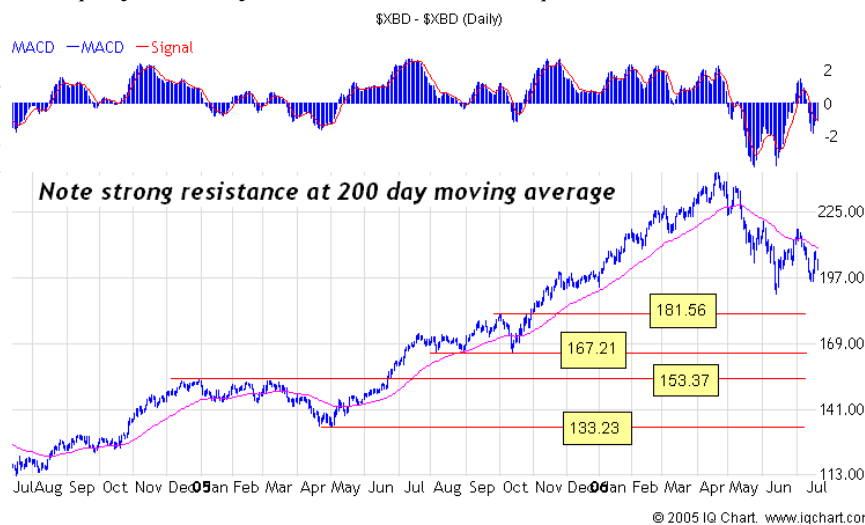
☞ Prime Brokers In Trouble? ☛

The Securities & Exchange Commission held an "Open Meeting" on Wednesday, July 12, 2006. In his opening statement, SEC Chairman Christopher Cox cited the second Item on the agenda, proposed amendments to Regulation SHO. Cox said, *"The next item on our agenda is the serious problem of abusive naked short sales, which can be used as a tool to drive down a company's stock price to the detriment of all of its investors. The Commission is particularly concerned about persistent failures to deliver in the market for some securities that may be due to loopholes in the Commission's Regulation SHO, adopted just two years ago."* So, it appears our analysis has been dead on correct all along. The Threshold lists clearly show the grandfathering of fails has allowed naked short positions to remain undelivered since Regulation SHO first went into effect on January 5, 2005.

On several occasions, we wrote about two companies that appear regularly on the "Threshold list," indicating fails above a level the SEC initially deemed intolerable. We wrote with strong conviction that each of these companies, along with others, were "targeted for destruc-

tion." We also wrote about other negative effects of naked shorting, including the loss of voting rights for investors and taxable income paid in lieu of qualified dividends that would otherwise be treated preferentially for tax purposes. We were and are still 100% correct in our analysis. In his statement, Chairman Cox confirmed our criticisms, stating *"We are particularly concerned about the potential*

demine the confidence of investors who may believe that the fails to deliver are evidence of manipulative naked short selling in the stock. In turn, issuers may be harmed, as investors may be reluctant to commit capital to a stock that they believe is subject to abusive naked short selling."



negative effect that substantial and persistent fails to deliver may be having on the market in some securities. Specifically, these fails to deliver can deprive shareholders of the benefits of ownership - voting, lending, and dividends from issuers. Moreover, they can be indicative of abusive naked short selling, which could be used as a tool to drive down a company's stock price. They may also un-

And if this was not sufficient to finally turn some heads, we also have former SEC Chairman Harvey Pitt's article in Forbes online (<http://tinyurl.com/zv4aq>), "Covering Up Naked Shorts." Finally, after close to two years of covering this story, there is a widening recognition of severe problems in the industry by those who are sworn to protect investors. While it must be clear that the vast majority of companies do not face disruptive short sale tactics, Pitt's admission that *"... companies have been victimized by professional short-sellers, some of whom, on occasion, resort to dubious tactics—and even market manipulation—to ensure the success of their bearish gambles,"* should be ample proof that investors cannot trust the stock market as long as these practices continue.

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The two stocks we have cited most often as "targeted for destruction" remain heavily shorted. Incredibly, NovaStar Financial (NFI) sports an annual dividend of \$5.60, a 17.4% yield, and in addition, will likely pay out a Special Dividend of \$3 in the fall. Short sellers are liable for the dividends. Thus, even if NFI simply trades sideways, shorts lose money. The company's shares fell dramatically in April 2004, when hit by a two-pronged attack by a negative Wall Street Journal article followed immediately by a succession of class action suits. Amazingly, none of the concerns voiced in the article have materially impacted the company's business and the initial class action lawsuit brought within 48 hours of the WSJ article, was filed by a firm that has now been indicted for criminal practices regarding their class action zeal. But nearly one-third of NovaStar's shares remain short and the stock trades at virtually the same price as in April 2004. In the interim, NFI (and the shorts) have paid out \$13.25 in dividends. However, with such a huge position in place, those short have no hope of covering without engineering their own demise in a short squeeze of epic proportions. Thus, their best bet appears to *continue to short the shares*, naked or

not, in order to keep heavy pressure on the share price in the hope that eventually, *something* goes wrong at NovaStar. As a result, short interest has risen 35% since soon after the big plunge in April 2004.

Nearly two of every five shares of Overstock.com remain shorted, while the company's CEO and business continue to be vilified by the media and certain interested parties. Meanwhile, after factoring in insider holdings (<http://tinyurl.com/rwcq4>), it would appear that well over 100% of the public "float" has been shorted. As we have discussed before, the shorting mechanics of the U.S. market not only permit this circumstance, there is theoretically no limit whatsoever on the number of shares that may be shorted. *Via a concerted effort, shorts could conceivably create an unlimited supply of shares.*

The sudden concerns voiced by the current and past SEC Chairpersons clearly signal that the financial industry will have to take a few giant steps to resolve the issues of fairness to investors and transparency of our markets. The lawsuit recently brought by a group of NFI shareholders against several of the largest brokerage firms for assisting in the na-

ked shorting of NFI shares should act as a pointed reminder that the industry faces enormous liabilities in this matter. As well, two law suits have been filed by hedge funds against the largest "prime" brokers for conspiring to charge exorbitant fees for borrowing stock to lend to shorts, and not actually borrowing or delivering said stock. We expect the giant steps will ultimately reveal liabilities measured in many billions of dollars.

Our April 24th call was "... from here on, it may all be downhill for the brokers," catching the *exact* top in the XBD Broker-Dealer Index. Next was our May 22nd call to "Avoid Banks, Avoid Brokers." The initial decline of 22% in less than two months was followed by a corrective rally that may have now ended. We continue to look for much lower prices for the broker dealer issues. *Eventually, we believe even the summer lows of 2004 for the XBD could possibly be threatened, more than 40% below today.* While any of the supports shown above could hold, we harbor no optimism for the sector. The time has come. The piper must be paid.

Alan M. Newman
July 24, 2006

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