

Alan M. Newman's Stock Market **CROSSCURRENTS**

COMMENTARY EXCERPT - APRIL 3, 2006

"We believe a crisis in investor confidence is brewing, quite possibly the greatest crisis for investors in stock market history. This story has much further to go and we believe you will see some huge developments in the weeks to come..."

⌘ Who & What Can You Trust? ⌘

We have railed for many months about the shorting mechanics of our market, a system that takes extraordinary advantages of customers while profiting the proprietors of the store. The process goes far beyond what might be considered ethical. In the best possible spin, the customer gains nothing other than a very expensive loan for stock in a margin account. However, even that spin is inexcusably inept. In reality, once Customer A's stock is borrowed by the broker for a short, *Customer A owns exactly nothing but a wager on the price of the shares*. You heard that right, Customer A does *not* actually own the shares. According to the definitions promulgated by the industry's authorities, when shares are loaned to a short seller and sold, share ownership is passed along to the new purchaser. Of course, if those shares are subsequently loaned to another short, Customer B will own only the wager on the price and true ownership will again pass along the line of duplicated shares.

Recognition of the circumstances is widening. A recent report by Steve Nelson, chairman of Continental Stock Transfer & Trust Company (<http://tinyurl.com/q7s52>), highlights the DTCC's obsession with control over a situation that may now be beyond control. Nelson comments, "Many issuers sought to 'smoke out the shorts' by de-listing from DTC or by passing by-laws to prevent share ownership in the name of a depository. In a fit of pique and hubris, DTC

responded by saying it would not honor an issuer's request for de-listing. This was ironic because DTC has often threatened to de-list issuers who did not toe the line with DTC wishes and practices." Bear in mind, the DTCC is owned by the banks and brokers who enable all transactions.

The system is now so broken and indefensible that the DTCC has seen fit to recently issue public statements impugning the cogent analyses of critics Susan Trimath and Robert Shapiro. Ms. Trimath is a senior research economist who was formerly employed by the DTCC and Mr. Shapiro heads an economic advisory firm and was formerly the U.S. Under Secretary of Commerce for Economic Affairs. The DTCC has no answers or solutions to ownership questions and no rationale to end the duplicative shorting that is capable of effectively increasing trading floats infinitely. The cat is out of the bag, but putting the cat back in is of paramount importance. *It may now even be a matter of survival for the DTCC.*

The more you know, the worse it appears. As more shares are duplicated by repeated lending and shorting and by naked short sales, wherein shorted shares are never even delivered to their new "owners," the effective capitalizations of companies may be inflated well beyond what the company has authorized. In the case of Overstock, 19.44 million shares are authorized but the short position has now climbed to 9.58

million shares. Bear in mind, every share that is borrowed and shorted is purchased, thus another brokerage account is credited with the *same* shares that were borrowed and shorted. Thus, at a bare minimum, Overstock shares held by those who "own" the stock now total more than 29 million. Worse, DTCC has only 8.97 million shares on deposit, thus the short position now exceeds the apparent float.

One enterprising "owner" of NovaStar Financial (NFI) recently won his Freedom of Information Act appeal for data on failures to deliver and the response was staggering. On the first trading day of 2005, more than 6.5% of NFI's entire outstanding capitalization had failed to deliver, 13 times the amount needed to make the SEC's Reg. SHO Threshold list. As of last week, NFI's fails were still at the 5% level. Who is served by this process, that allows capitalizations to be significantly inflated and substantial numbers of shares that are undelivered for months? *Clearly, shareholders do not benefit!*

The system is now horribly broken, so broken that the industry cannot allow the monopoly on depository ownership of shares to be threatened. But what can you say about an industry where analysts routinely gamed customers, where mutual fund managers front ran their own customers, where corporate executives fictionalized their opera-

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tions, and where brokerages gladly encouraged their customers to participate as the greatest stock market mania of all time ramped up to well beyond sane levels?

What can you say about an industry where former New York Stock Exchange chairman Dick Grasso has now taken the Fifth Amendment in a deposition to the SEC about improper trading by NYSE specialist firms. *Who is getting the short end of the stick?* The customers or the proprietors? If the NYSE's ex-head honcho has reason to believe he may incriminate himself in

testimony to the SEC, what level of trust can the American public have in the U.S. stock market? Moreover, what level of trust can you have for an industry when every subpoenaed journalist has declared his records and even his contacts to be inviolable, hidden behind a First Amendment curtain, *despite a far more urgent obligation to the public vis-a-vis the allegations made by both Biovail and Overstock?*

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lieve you will see some huge developments in the weeks to come. No one wants the public to know what is actually going on. Not brokerage firms, not the DTCC, not the former NYSE Chairman and not journalists, who are now complaining that the SEC should not even pursue investigations of any contacts the journalists may have had. How is the public's interest served in this matter? The public be damned. *Who can you possibly now trust?*

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