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# A Tale of Two Frauds: *Part II* Naked Shorting Since the Financial Crisis: Regulators' Little Secret

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The 2008 financial crisis cost the U.S. more than $22 trillion,[1] or about $70,000 per citizen. The cause of the crisis was fraud by some of the world's largest financial institutions, such as Goldman Sachs and Deutsche Bank, according to a report by the Senate *Permanent Subcommittee on Investigations (the Subcommittee)*.[2] The fraud was baked into the collateralized debt obligations (CDOs) and later the synthetic CDOs which the big banks peddled around the world. Sen. Carl Levin, (D-Mich.) the Subcommittee Chairman, summed up the Subcommittee's 646-page report in a single sentence: "The overwhelming evidence is that those [financial] institutions deceived their clients and deceived the public, and they were aided and abetted by deferential regulators and credit ratings agencies who had conflicts of interest."[3]

Another type of fraud, usually referred to as "naked short selling," likely deepened the crisis. The term "naked short selling" is a misnomer. Naked short selling is not a type of short selling. Rather, it occurs when a market player sells stock—either long or short—that he does not own and does not borrow. In essence, it is the sale of counterfeit stock. Naked short selling was likely a factor in the collapse of Bear Stearns,[4] Lehman Brothers,[5] and the near collapse of Morgan Stanley.[6]

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Content HIGHLIGHTS



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The five-year statute of limitations has all but run out on all of these frauds. Each passing day was meaningful for one reason: neither the SEC nor the Department of Justice filed a case. In this way, the government passively and quietly granted Wall Street immunity for designing and executing its $22-trillion dollar fraud. This grant of immunity drew little media attention. There was nothing to report. No sentences were commuted because no one had been sentenced. No crimes were pardoned because there were no convictions. However, the absence of news created a media void. Left to chance, filling it could get ugly. A crackdown was needed. Sensitive to the media's need for a crackdown, but unwilling to conduct a real one, the government offered a substitute: a crackdown on hedge funds for insider trading.

The media quickly converted the frenzied prosecution of insider trading into something the public wanted to read about: a government crackdown on Wall Street.[7] For its part, the government—specifically the U.S. Securities and Exchange Commission (SEC) and the Manhattan U.S. Attorney's Office (USAO)—embraced the media's adulation of the phony crackdown. Soon each agency spouted statistics to prove it was tougher on insider trading than the other. U.S. Attorney Preet Bharara credited himself with 70 insider trading convictions. Not to be outdone, former SEC Enforcement Director Robert Khuzami claimed 170 case filings for insider trading.[8]

Moving the insider trading sideshow to center stage has been a win-win for all, except the targets and the public. It deflected attention from the Obama administration's utter failure to prosecute Wall Street for designing and delivering its $22-trillion dollar fraud. It was a win for Wall Street executives who accepted the silent grants of immunity and walked away with their pockets stuffed with green, *e.g.*, the top 5 executives from Bear Stearns took home approximately $1.5 billion from 2000 through 2008.[9] It was a win for those public servants who ginned up the insider trading investigations; there are now enough investigations in the pipeline to generate new case filings for the next five years.[10] Those public servants are now switching sides. In July, just six months after leaving the SEC, Khuzami accepted $10 million for a two-year stint with Kirkland & Ellis in its Government & Internal Investigations practice group, the unit that defends insider trading cases.[11] U.S Attorney Bharara expects $6 million per year when he makes his leap.[12]

This is the second of two articles that compare the government's zealous—perhaps overzealous—prosecution of insider trading cases, a non-cause of the financial crisis, with its relatively lax prosecution of the fraudulent conduct that delivered the 2008 financial crisis. The first article, published in the August issue of *Wall Street Lawyer*,[13] focused on the government's six-year crackdown on insider trading. It told how the SEC launched the crackdown to mend its public image after a 2007 Senate report chastised the agency for its bungled investigation of a mega-hedge fund.

This article will focus on the SEC's lax prosecution of market players who have engaged in naked short selling during and since the 2008 financial crisis. As discussed below, there is solid evidence that naked short selling was a factor in the collapse of at least one major investment bank, Lehman Brothers, and perhaps others. Unfortunately, the extent to which naked short selling contributed to the crisis will never be known. Curiously, despite the evidence, the SEC never investigated whether it was a factor in Lehman's collapse, even though the SEC issued 12 emergency orders and Reg SHO amendments to stop naked short sales during and immediately after the firm's collapse.

There is, however, little doubt about the gravity of the harm naked short sales can inflict on the capital markets. Two cases settled by the Financial Industry Regulatory Authority (FINRA) in late 2011 confirm that naked short selling was unchecked before and during the financial crisis. FINRA found that UBS Securities (UBS) had engaged in tens of millions of violations of Reg SHO, the regulation that was supposed to stop naked short selling, and that these violations *threatened the integrity of the capital markets*. And UBS is not alone. Another Swiss Bank—Credit Suisse Securities (Credit Suisse)—also committed massive violations of Reg SHO.

 

## A Shortened History of the SEC's Efforts to Contain Naked Short Selling

In 1985, the National Association of Security Dealers commissioned former SEC Commissioner Irving M. Pollack to conduct a study of short selling.[14] His study included a discussion of the risks of naked short selling and its elevated risks during a financial crisis. In his 1986 study, Pollack warned: "The fail-to-deliver/fail-to-receive problem has the potential for causing serious difficulties in a lengthy bear market."[15] According to Pollack, naked short selling was especially dangerous during a financial crisis. His study also warned that the lack of a mechanism "preventing the substantial buildup of short positions at the clearing corporation and of fails-to-receive in the brokerage firms carries the potential for serious problems, particularly in the event of crisis market conditions."[16] Pollack's study would prove prophetic in 2008, when giant investment banks began to collapse due in part to naked short selling, according to their chief executive officers (CEOs).

The SEC rolled out its comprehensive solution to naked short selling when it released the preliminary version of Reg SHO on October 28, 2003.[17] In the commentary accompanying the final rule, which became operative on January 1, 2005, the SEC expressed its optimism that Reg SHO would contain naked short selling: "The locate and delivery requirements will act as a restriction on so-called 'naked' short selling."[18] The SEC's minimal enforcement of Reg SHO from January 2005 until the financial crisis in September 2008[19] implies its staff continued to believe that Reg SHO had, in fact, contained naked short selling.

This abruptly changed in September 2008 when the CEOs of some of the world's largest investment banks frantically sought protection from Congress and the SEC from the naked short selling which was pushing their banksover the abyss. For the first time, it was not merely the small cap and microcap public companies whose stock value was being hammered by naked short selling. Instead, the victims were the nation's investment banks—Bear Stearns, Merrill Lynch, and Lehman Brothers. On March 14, 2008, shareholders were holding 128% of Bear Stearns' acknowledged float.[20] In Lehman's case, there were 33 million shares of counterfeit stock.[21] A 2013 article co-written by two prominent economists explains why the banks were especially vulnerable to naked short selling during the crisis.[22] The failure of these two investment banks validated Irving Pollack's warning two decades earlier.[23]

The urgency ratcheted up after the three huge banks failed, leaving Morgan Stanley and Goldman Sachs teetering at the edge of the abyss. On September 17, 2008, Barron's reported: "[T]he Securities & Exchange Commission's head Christopher Cox is investigating naked short selling of shares of Morgan Stanley and Goldman Sachs after receiving calls from Morgan Stanley CEO John Mac [sic] about improper short-selling that was responsible for the stock's nearly 30% decline today."[24]

The claims of the banks' CEOs brought instant credibility to the notion that naked short selling could destroy public companies, even huge ones if the time was ripe. The failing banks had unique credibility. Bear Stearns, Lehman Brothers and Merrill Lynch all had their own proprietary desks manned by astute traders who had the skill and technology to recognize naked short selling. Each bank also had affiliated broker-dealers whose traders made markets in thousands of public companies. No one was better equipped than these huge banks to grasp that the unthinkable happened; they were now in the crosshairs of traders who were pulling the trigger on naked short sales.

The SEC responded with a dozen releases during the 2008 financial crisis relating to the risks posed by naked short selling, including emergency orders and amendments to Reg SHO. The release on October 14, 2008, was typical of those orders and amendments in describing how naked short selling could cause a downward price spiral:

> **To the extent that fails to deliver might be part of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price, such fails to deliver may undermine the confidence of investors. These investors, in turn, may**

> **be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver in the issuer's security. Unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security's price (footnotes omitted).[25]**

After the 2008 amendments were adopted, the cases filed by the SEC again gave the impression that naked short selling was more an irritant than a serious threat to public companies. It brought two classes of cases to enforce Reg SHO between 2008 and 2013: one alleged intentional violations against minor market participants who used options to circumvent Reg SHO,[26] and the other alleged inadvertent and narrow violations against broker-dealers affiliated with large investment banks.[27] None of these cases hinted that the violations of Reg SHO were systemic or created a risk to the stability of the capital markets. Nor did the SEC even investigate whether naked short selling was a factor in Lehman's collapse.

But this was about to change. As discussed in the next section, the settlement of two Enforcement cases—not by the SEC—would reveal that broker-dealers had ignored Reg SHO for years without getting caught.

## The UBS-Credit Suisse Reg SHO Mystery

For five years, including the entire period of the financial crisis, UBS placed tens of millions of short sale orders of stock it did not own, had not borrowed, had not contracted to borrow, and had not tried to borrow. Sometimes UBS marked these trades as "short sales," sometimes as "long sales." It placed these trades for its own accounts and for more than 270 of its clients. In so doing, UBS found more than 30 different ways to commit *tens of millions of violations of SEC Regulation SHO*. These were facts found by FINRA in its October 2011 settlement with UBS.[28]

None of the stock existed before UBS sold it. UBS had no license to create the stock. No public company had ever registered any of the stock with the SEC for sale to the public. None of the stock was included in the float of any public company. No board of directors had ever voted to issue a single share that UBS sold. Rather, these imaginary shares suddenly materialized with no corporate gestation period in the milliseconds or less it took for a computer to decide it was time to sell and execute the trade. In this way, UBS created counterfeit stock for five years when it placed tens of millions of orders in public companies whose number and identity remain unknown. And in this way, UBS artificially increased the supply of stock and artificially skewed the intersection of supply and demand curves, invariably lowering the execution price of the stock.

The FINRA findings left many crucial questions unanswered. Who were the 270 UBS clients whose orders were traded in violation of Reg SHO? Why weren't enforcement proceedings initiated against them? Who were the public companies victimized by UBS's tens of millions of Reg SHO violations? Did UBS close short sales without borrowing the stocks? Were any of the public companies harmed by UBS's tens of millions of violations? Were any public companies forced into bankruptcy? How did UBS get away with tens of millions of violations of Reg SHO for five years without being flagged by the SEC, FINRA, the Depository Trust & Clearing Corporation (DTCC) or any of the exchanges where the trades were executed? Even more of a mystery, how did UBS circumvent Reg SHO for more than two years after the SEC had beefed it up with numerous amendments during the height of the 2008 financial crisis?

And UBS was not the only culprit. According to FINRA, Credit Suisse had done the same for at least 4½ years.[29] Credit Suisse had placed an estimated 10 million orders to sell stock in violation of Reg SHO. Credit Suisse did not own, had no contract to borrow, and had not tried to borrow the stock it sold in 10 million transactions, all violations of Reg SHO. Like UBS, Credit Suisse had sometimes marked the trades as "sells" and other times as "short sells." Again like UBS, in placing these trades, Credit Suisse had found approximately 30 different ways to violate the securities act and SEC regulations and rules.

Despite Credit Suisse's creativity in committing massive violations of Reg SHO, its dubious achievement was dwarfed by UBS. While Credit Suisse had committed approximately 10 million violations of Reg SHO over 4.5 years, FINRA found, UBS "violated Rule 203(b)(1) of Reg SHO by effecting *tens of millions of short sale orders* without locates" from January 3, 2005, through December 31, 2010 (emphasis added)." In short, UBS's violations were an unknown multiple of Credit Suisse's violations.

The magnitude of UBS's violations may be more easily grasped if thought of as the dollar value of the counterfeit stock created. Under the conservative assumption that the average size of each trade was 100 shares and the average price was $10, the average transaction would have created $1,000 worth of counterfeit stock. Since UBS engaged in tens of millions of transactions creating counterfeit stock, it likely created tens of billions of dollars in counterfeit stock. By way of example only, if UBS created counterfeit stock in 50 million transactions, it would have created $50 billion in counterfeit stock. If the assumptions are less conservative, the $50 billion, of course, goes higher.

Perhaps one fair question to FINRA would have been: How much counterfeit stock measured in dollars did UBS create? The likely answer is that FINRA could not ascertain the quantity. The best it could do in calculating the number of violations was to estimate that they ran into the tens of millions.

But FINRA offered a different measure of the magnitude of UBS's violations which is quite sobering. UBS's violations did not merely harm a public company or two. Rather, its violations had the potential to destabilize the market itself. FINRA found and UBS conceded that the "duration, scope and volume of the trading [violations] created a *potential for harm to the integrity of the market* (emphasis added)."[30] The only aspect of the settlement more stunning than the scope of UBS's violations—whose sale of counterfeit stock threatened the integrity of the capital markets—was the tiny fine paid by this $2 trillion company: $8 million. And Credit Suisse paid $1.75 million for its 10 million violations of Reg SHO, roughly 18 cents a violation.

Significantly, the FINRA decisions did not indicate how much UBS and Credit Suisse profited by their tens of millions of Reg SHO violations. Since many of the stocks were hard to borrow, the profit was likely more than 18 cents a violation. A penalty which is less than the profit from violating the law is no deterrent. Indeed, it is an invitation to continue.

The penalties imposed on UBS and Credit Suisse make interesting comparisons with the sums paid by those targeted by the insider trading crackdown. Mega-hedge fund SAC Capital Advisors paid the SEC $600 million for insider trading in two drug stocks, $300 million per violation. A few months later, the SEC filed an administrative proceeding against Steven Cohen, SAC Capital's chief executive officer. The USAO quickly followed suit with a criminal case against SAC Capital, which the Wall Street Journal aptly headlined as "U.S. Attorney Bharara Seeks Another Notch." Is there a rational principle in these prosecutory choices?

The UBS-Credit Suisse duo raises a deeper concern: Is engaging in wholesale violations of Reg SHO a uniquely Swiss practice? Are such practices beneath the brokerage affiliates of German, U.K., French and U.S. banks? Are there only Swiss cockroaches in the cupboard? History says no. Mega-banks and their affiliates quickly emulate a practice of their competition, legal or not, when it generates cash flow, profit, or both. The mega-banks and their affiliates played follow-the-leader with toxic debt, manipulating Libor rates, insider trading, market timing and late trading. With two cockroaches in the naked short cupboard, the classic pattern is beginning to form. Indeed, Goldman Sachs and Merrill Lynch cockroaches may also reside in the cupboard, as evidenced in a memorandum inadvertently released this year by Goldman Sachs counsel in the Overstock.com litigation.[31]

And then there is the complicity of the exchanges for profit in naked short selling, like the Chicago Board Options Exchange (CBOE). A case recently settled by the SEC, *In the Matter of*

*CBOE*,[32] offers some insight why the exchanges are so reluctant to provide public companies with any information relating to short sales. Simply put, *they are in on it*. These are some of the relevant findings by the SEC against the CBOE:

> **Not only did it fail to enforce the Commission's rules by not adequately investigating a member firm's compliance with [Reg SHO], CBOE's conduct also interfered with the Commission's Division of Enforcement …investigation of the same member firm. …CBOE also failed to enforce Reg. SHO because it employed a Reg. SHO surveillance program that failed to detect a single violation, despite numerous red flags that its members engaged in violative conduct.[33]**

The massive violations by two huge banks and the willingness of an exchange to conceal the violations create the very real risk for naked short selling to destabilize the capital markets. If the brokerage firms of two of the largest 25 banks could violate Reg SHO for years without getting caught, it is likely that some or all of the other top 25 will get into the game. If UBS's Reg SHO violations could alone threaten the integrity of the capital markets, that threat quickly grows as other mega-brokerage firms copycat UBS and Credit Suisse. The failure of CBOE to enforce Reg SHO is likely a symptom of its for-profit status. Adding to the risks, the exchanges and trade reporting facilities are unwilling to share information with public companies whose stock is being illegally traded.

Supposedly, Reg SHO should have kept UBS and Credit Suisse in check. The regulation was not untested when it became operative in January 2005. It incorporated the SEC's enforcement experience with earlier regulations designed to curb naked short selling.[34] The SEC released the preliminary version of Reg SHO on October 28, 2003.[35] It then went through a 14-month trial process before it became operative on January 1, 2005. Since then, it has been refined from time to time to work out the kinks.[36] It was significantly amended in October 2008 to stop the naked shorts which were destabilizing the nation's investment banks during the financial crisis.[37] Yet, UBS and Credit Suisse were able to engage in massive violations of Reg SHO for years after the regulation became operative, including for the 27 months after the 2008 amendments were supposed to have cured the flaws in Reg SHO. In its current form, Reg SHO is obviously ineffectual in curbing naked short selling.

"Asleep at the switch" may be too kind a description for the SEC's failure to detect the massive violations of Reg SHO by UBS and Credit Suisse from 2005 to 2010. The CEOs of the major investment banks repeatedly told the SEC in 2008 that naked short selling was the catalyst causing the banks to collapse. In March 2009, the SEC's Inspector General (IG) published his audit confirming that Enforcement rarely investigated complaints about naked short selling. The IG recommended that Enforcement take 11 steps to strengthen enforcement efforts directed at naked short selling. Enforcement rejected all but one of the IG's recommendations, contending there was little evidence of naked short selling and, to the extent it might exist, the practice "can provide needed market liquidity… ."[38] Finally, the SEC cited its "imited resources" and need to "intelligently leverage those resources."[39] It is hard to reconcile the SEC's self-proclaimed need to "intelligently leverage" its limited resources with its decision to devote unlimited resources to the prosecution of insider trading over the past six years.

## Lack of Transparency

The UBS and Credit Suisse cases highlight the lack of transparency in every nook and cranny in the stock trading system when a short sale passes through it. Both UBS and Credit Suisse engaged in massive violations of Reg SHO for years—UBS for five years and Credit Suisse for 4.5 years—without detection. This suggests that the conduct of these two huge financial institutions was not even visible to regulators. In reality, by inadvertence or design, the lights are switched off for short sales as they are electronically processed by the executing broker, the clearing broker, the exchanges, and the DTCC.

And the lack of transparency continues even when enforcement cases are made public. Despite the tens of millions of violations of Reg SHO admitted by UBS and Credit Suisse, not a single public company was identified as a victim of those violations. Although at least 270 UBS customers participated in those violations, none were identified. The same is true of the SEC's releases describing its settlements with Goldman Sachs in 2007[40] and 2010,[41] and UBS in 2011.[42] The silence surrounding Reg SHO violations is deafening, and that silence is inexplicable in view of the potential and acknowledged harm those violations can cause. Again, according to the FINRA-UBS settlement, "The duration, scope and volume of the trading created a potential for harm to the integrity of the market."[43]

Not surprisingly, the only real outcry from public companies came in 2008, when the nation's giant investment banks began to fail, one after the other. That the banks screamed loudly and in unison could be expected. These banks—through their proprietary desks and affiliated brokerage firms—are perhaps the only public companies equipped to track naked short selling by other financial institutions. Had those who engage in naked short selling not chosen the banks as victims, the scope of these violations would likely remain unknown. Now that the banks are prospering again, there is little motivation for them to speak publicly about naked short selling.

Aside from the banks, few public companies have ever pursued claims against the culprits who routinely engage in naked short selling. They lack the tools necessary to detect naked short selling and violations of Reg SHO, much less prove it. Not surprisingly, the information needed to uncover the culprits engaged in naked shorting is withheld by the DTCC, the exchanges, and broker-dealers who consummate the trades. A 2009 article in the Journal of International Banking Law and Regulation confirms that the data needed to detect naked short selling is unavailable and how that void harms investors and public companies:

> **While useful information about the level of covered short selling can be derived from the volume of shares on loan (assuming that information is generally available to market participants), naked short selling cannot, other than through the imposition of mandatory disclosure requirements, ordinarily be detected. This has significant implications. For investors, selling pressures and the demand for shares can be misrepresented if a bear raid is underway. Also, companies themselves would not have material information about the pressures that their shares are under.[44]**

Invisible fraud was also a cause of the 1929 crash, according to Ferdinand Pecora, the Chief Counsel to the U.S. Senate's Committee on Banking and Currency during its investigation of the Great Crash of 1929. His words ring true today about naked short selling just as they did 74 years ago about the causes of the 1929 Crash: "The Public was always in the dark. It could not tell whether sales were due merely to the 'free play of supply and demand,' or whether they were the product of manipulated activities… *It all looks alike on the ticker* (emphasis added)."[45] Today, it all looks alike on a computer screen.

The light with the highest wattage was switched off by the DTCC. It has a virtual monopoly in clearing and settling all the stock trades in the U.S., with the exception of internalized trades which broker-dealers need not report to it. The DTCC refuses to provide public companies with any useful information regarding violations of Reg SHO and naked short selling, unless it is ordered to do so by a court. As a private institution, the DTCC is not subject to the Freedom of Information Act (FOIA). Consequently, absent a court order, every window into the DTCC is shuttered from view.

The DTCC stance on naked short selling is boldly stated on its website, where it lists 14 cases which were filed against it, mostly by public companies. In a statement which provokes images of a chest beating 800-pound gorilla, the DTCC speaks of its win-loss record in these cases:

> **There have been 14 cases filed against DTCC involving naked short selling. All 14 cases have been either dismissed by the courts involved or withdrawn by the plaintiffs. In one case, the court allowed legal**

**sanctions against the plaintiff, which allowed DTCC to seek partial reimbursement of its legal costs.**[46]

The DTCC must share credit for its perfect record with a friend: the SEC. When public companies and investors have sued the DTCC for allegedly participating in naked short selling schemes, the SEC has repeatedly filed *amicus* briefs arguing in the alternative that the DTCC had fully complied with the securities acts, naked shorting did not exist, or Reg SHO was an adequate remedy.[47] One might be forgiven for asking: on whose side is the SEC?

According to its website, the DTCC is owned by "its principal users."[48] Its Board of Directors is dominated by the nation's largest banks.[49] UBS and Credit Suisse are likely two of the DTCC owners.[50] These interrelationships offer a clue why the brokerage arms of two megabanks were able to engage in tens of millions of violations of Reg SHO for four to five years without detection by the DTCC.

Little useful information relevant to Reg SHO violations is available from the exchanges and trade reporting facilities. And the more poorly lit the exchange, the greater the probability it will be a favorite of market participants that engage in naked short selling. As noted in a 2012 academic study, broker-dealers and their customers prefer more "user-friendly" venues like the CBOE,[51] where the rules have been bent or ignored so price manipulation through naked short sales can flourish.[52]

Unfortunately, the SEC has done little to bring transparency to short selling. Its Form 13-F does not even require hedge funds or other financial institutions to disclose their short positions. One potential vehicle to ascertain information regarding naked short selling is FOIA. Unfortunately, the SEC has one of the worst records among federal agencies for compliance with FOIA.[53] The SEC's defiance of FOIA reaches the extreme when a requester seeks records which would shed light on the SEC's failure to enforce the securities acts.[54]

## Reg SHO's Rule 204: the Honor Code

The UBS and Credit Suisse cases involved Rule 203 violations. Subject to several exceptions, Rule 203 requires a broker to locate borrowable stock before placing a short sale. UBS and Credit Suisse together placed tens of millions of short sales that did not qualify for an exception and without locating borrowable stock.

There is a second prong to Reg SHO, Rule 204. In essence, Rule 204 is supposed to prevent short-term naked shorts from becoming long-term naked shorts. In simple terms, if the seller's broker fails to timely deliver the stock, Rule 204 requires the clearing broker to acquire and deliver the stock by the market's opening on the fourth day after the trade for non-market makers[55] and by the sixth day after the trade for market makers.[56] The SEC issued Rule 204 at the height of the financial crisis, after three investment banks (Bear Sterns, Merrill Lynch and Lehman Brothers) had failed and Morgan Stanley and Goldman Sachs were teetering on the edge of failure.

As with Rule 203, there is little transparency whether broker-dealers comply with Rule 204. The transparency boils down to a list published by the SEC every two weeks identifying the public companies that have had failures to deliver and the amount of those failures.[57] No other information, *e.g.*, the identity of the broker-dealer who failed to deliver the stock, is undisclosed.

One might draw the inference that any violation of Rule 203 borrow requirements must have been cured if a Rule 203 violation does not also result in failure-to-deliver the stock at the closing date. This would be a faulty assumption. There are ways—due to the market's poor transparency—to engage in naked short selling in violation of Rule 203, hold the naked short long-term, and never have it appear on the failure-to-deliver list.

A recent ruling found in an SEC administrative decision, *In the Matter of optionsXpress,*[58] tells how a broker dealer, optionsXpress, and its customers committed securities fraud by designing and using an option scheme to circumvent the delivery requirements of Rule 204. OptionsXpress played by the rules—delivered stock as required by Rule 204—when it placed short sales of easy-to-borrow stock, meaning it was inexpensive to borrow. "[H]owever, as a matter of policy, it would not borrow shares where the borrowing cost was above the threshold of a negative one percent."[59] In other words, if the carrying costs for borrowing the stock exceeded 1%, optionsXpress would go naked. Regulators, broker-dealers and market participants commonly refer to a huge loophole in Rule 204 with the comforting euphemism: "internalization." As a practical matter, it is more accurate to think of it as a *de facto* exception to Rule 204. It allows executing and clearing brokers to happily engage in naked short selling, so long as neither party tattles on the other. With billions to be made, tattling is extremely rare.

In the official lexicon, "internalization" occurs where broker-dealers execute client trades as agents or principals within their own trading system.[60] These internalized trades are not reported to the DTCC, and thus the DTCC will never know whether the trade resulted in a failure-to-deliver. The DTCC has repeatedly informed the SEC that it recognizes this exception.[61] On this point, the DTCC's April 2013 Rule 19b-4 filing with the SEC stated:

> **Trades executed in the normal course of business between a Member that clears for other broker/dealers, and its correspondent, or between correspondents of the Member, which correspondent(s) is not itself a Member and settles such obligations through such clearing Member ("internalized trades") are not required to be submitted to the Corporation and shall not be considered to violate the "pre-netting" prohibition.[62]**

A DTCC white paper has defined internalization in even broader terms than hinted in the DTCC's Rule 19b-4 filings with the SEC. It defined the term as follows:

> **Internalization**
>
> **Internalization, for purposes of this paper, is the execution of separate correspondents' trades by a clearing broker within its own record keeping system, and the related practice of failing to submit trade data on these "internalized" trades to the clearing corporation, so that not all activity is reported to the clearing corporation. For example, a clearing broker has a correspondent relationship with two separate broker-dealers. One correspondent enters into a transaction with another correspondent of the same [National Securities Clearing Corporation] NSCC member. In effect, one correspondent is short and one is long. The NSCC member, however, is net flat for the transaction. The member clears the activity internally and does not report it for clearance at NSCC.[63]**

The same DTCC paper discussed the risks of internalization:

> **Internalization and summarization (a first cousin of internalization) have come into play recently because while these trade data submission techniques enable members to reduce their trade recording and clearing fees, these practices also introduce** ***new clearing risks because all trades are not submitted for clearance and because correspondent broker activity may not be reported accurately*** **(emphasis added).[64]**

In effect, "internalization" results in the DTCC, a Self-Regulating Organization, delegating its duty to monitor failures to deliver to broker dealers and thereby licenses them to self-regulate. Self-regulation did not work well before the 1929 Crash nor before the 2008 financial crisis.[65]

Concealing naked shorts through "internalization" is elegantly simple. For example, assume two cooperating broker-dealers make naked short sales to each other of the same or a different stock. Neither delivers the stock and thus both violate Rule 204. The risks are reduced if one of the executing brokers is also acting as the clearing broker. Under the DTCC's internalization principle, neither short sale is reported to the DTCC and the chance of getting caught is marginal. This friendly arrangement becomes increasingly profitable as the short sold stock becomes harder to borrow. Hard–to-borrow stocks carry a negative rebate (the equivalent of an interest rate charge to the short seller) which may reach 30%, 40% or more. So long as neither side tattles on the other, and both are motivated to be silent, the naked shorts can exist indefinitely. The big pay day comes when the company is driven into bankruptcy.

## Conclusion

No rational policy of deterrence can be inferred from the government's enforcement of the securities laws over the five years since the financial crisis struck. The U.S. General Accounting Office (GAO) has fixed the cost of the 2008 crisis at $22 trillion. A Senate investigation isolated a cause: pervasive fraud, mostly by the major investment banks such as Goldman Sachs and Deutsche Bank. Yet, there have been no criminal prosecutions of the banks or their executives. Nor any SEC prosecution against any bank executive higher on the corporate ladder than former Goldman Sachs trader Fabrice "Fabulous Fab" Tourre.

Even worse, the Wall Street executives who guided their banks into the 2008 train wreck have been richly rewarded for their skill in doing so. A Harvard study found that the top five executives of Lehman and Bear Stearns pocketed $1.5 billion and $1 billion respectively for the decisions that buried their companies.[66] The total sum pocketed by top bank executives for engineering the crisis is unknown. But one thing is clear: they kept their billions. The SEC did not collect a dime from top bank executives for their role in delivering the financial crisis.

One fraud which deepened the crisis was the sale of counterfeit stock. The SEC briefly awakened to this threat at the height of the crisis when the CEOs of the largest Wall Street banks cried out for the cavalry: their banks were in the crosshairs. In a burst of hyperactivity, the SEC issued a dozen releases to stop naked short selling. As the banks' vital signs improved with the infusion of trillions of dollars, the SEC's interest in prosecuting naked short selling quickly waned. By March 2009, the SEC had reversed its thinking: naked short selling did not exist, but if it did, it brought needed liquidity to the markets.[67]

On the other hand, the SEC and the USAO have spared no cost in waging war against insider trading, even though this offense was not a factor in the 2008 financial crisis. As discussed in my first article,[68] the SEC launched the crackdown on insider trading to defend its image in 2006 during the Senate's public inquiry into the SEC's bungled insider trading investigation of Pequot Capital Management. The USAO joined the insider trading crackdown in early 2007. The ongoing prosecutions of insider trading were very handy in 2009 when it was time for the government to prosecute Wall Street for delivering the financial crisis. For whatever reason, the government did not crackdown on Wall Street for the financial crisis. Instead, it reinvented the crackdown on insider trading as "the crackdown on Wall Street." The media has been cementing that notion in the public's mind ever since.

It is hard to conceive how the Department of Justice, the USAO or the SEC could have done more to encourage Wall Street executives—this generation and the next one—to concoct an even bigger fraud. The crisis brought the nation to its knees. No Wall Street executive has been prosecuted civilly or criminally. All were allowed to keep the billions in cash they received for delivering the crisis. The message is simple: Wall Street crime pays big and there's no downside. Sadly, the country may not be able to borrow its way out of the next crisis while still paying for the last one.

**NOTES**

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