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# EAT MY SHORTS! A NAKED SHORTING PRIMER FOR CEOs

The drama surrounding naked shorting has all the elements of a John Grisham novel. Sly, blue blood institutions conspire with shadowy hedge fund cowboys to unmercifully assault a well-meaning but outgunned CEO in his quest for shareholder value. Offshore accounts and corrupt foreign officials veil the crimes for decades until finally being thrust into the open through the hyper-caffeinated efforts of hundreds of message board denizens throughout cyberspace.

As with most Grisham novels, however, liberties may have to be taken with the original story to romanticize an otherwise bland topic. After all, it's hard to

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make CUSIP numbers and stock certificates sound sexy, but that's really the heart of the naked shorting controversy.

Due largely to concerns raised by microcap CEOs and their shareholders, naked shorting is a hot topic on message boards. Opinions range widely on how common it is. Those claiming it pervades the markets and foreshadows a systemic meltdown are met with equally fervent arguments calling it an over-hyped, isolated problem that is becoming the grassy knoll conspiracy theory of Wall Street.

Everyone agrees, however, that risks of naked shorting are heightened in the microcap world. The sheer number of small public companies, combined with high volatility and an almost inevitable need for financing, make detecting this hard-to-prove crime that much more difficult for the microcap CEO. Although the odds seem small that a particular company will be victimized, there is no authoritative data indicating how many microcaps are being naked shorted.



Keeping those odds in perspective, then, this primer is for microcap CEOs curious about the naked shorting fuss. On the off chance that a company attracts naked shorts, CEOs should recognize that there is despairingly little that can be done to stop it from occurring. Due to the nature of the crime, legal expertise may not help.

Although there seem to be few bulletproof ways to stop naked shorts, there are a handful of things a proactive CEO can do to reduce the odds of being blindsided by this notorious lot. This primer includes a rough sketch of how naked shorting works and a brief familiarization with the main players. A worst-case scenario of what it means to be targeted by naked shorts is presented, as are suggestions for wary CEOs. The final section contains a list of links with more about the intriguing world of naked shorting.

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## WHAT IS NAKED SHORTING AND WHY SHOULD A CEO CARE?

### Naked Shorting involves selling shares of stock that don't exist.

In its simplest terms, naked shorting involves selling shares of stock that don't exist. It's performed routinely by market-makers to keep an orderly market, but it is illegal when done to manipulate a company's stock price. Only when someone intends to drive down the stock price is naked shorting breaking the law. Throughout the rest of this overview, any reference to naked shorting will refer to the illegal variety.

It's also worth noting the important distinction between shorting and naked shorting. The former is perfectly legal and occurs extensively as either a way for an investor to mitigate risk or as a bet that a company's share price will decrease (i.e. the short-seller or "short" believes the company is overvalued). Despite the wary glances often cast upon them, shorts are an essential part of a robust market and are often the first to discover financial fraud, as in the case of Enron.

A short will sell borrowed shares as a bet against a company because he believes the price will eventually drop. These borrowed shares come from his broker, which loans the short a certain number of shares (not dollars). As soon as the short receives the borrowed shares in his account, he sells them immediately for cash, which goes to his brokerage account. The short still has that pesky loan to pay back, though, and does so by waiting for the price of the stock to drop. Then he buys some cheaper shares using money from the same pool of cash he received after the original sale, gives the broker his shares back, and keeps whatever cash is left in his account.

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Naked shorts, in contrast, are much more manipulative – they sell short shares that don't exist and then attempt to actively lower the company's share price through constant short-selling pressure. By using pretend shares, of which there is an unlimited supply, naked shorts can effectively

control the share price through this constant pressure, eventually driving the price of a company's shares into the basement.

Where do these fake shares come from? Naked shorts can create them out of thin air, depending on your point of view, due to either (a) glaring inefficiencies in the back-office world of certificate transfers, or (b) institutionalized fraud on a massive scale. Either way, the effects can be disastrous for companies who are victimized.

## WHO IS INVOLVED?

Naked shorting is typically done by hedge funds with arm's length support from several other parties. The extent of active assistance provided to the fund by related groups is unclear but hotly debated. One player is the Depository Trust & Clearing Corp. (DTCC), which tracks the stock certificates of traded shares between brokerages. When a fund sells short a share of stock, the fund's brokerage (another prominent player) has a settlement period of three days to deliver those shares to the buyer's broker. If the transfer doesn't occur, the DTCC notifies the fund's broker that it has "FTD'd" (Failed to Deliver). The DTCC is required by the SEC to enforce delivery of missing shares. While waiting to account for shares, the DTCC may charge the brokerage to borrow similar shares from its own inventory.

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The obvious conflict of interest here is that DTCC is policing its own customers - the brokerages. In response to complaints, the SEC required all exchanges to comply with Regulation SHO in January of 2005. Reg SHO establishes several requirements aimed at broker-dealers, but it does not specifically address the manipulative aspects of naked shorting, which fall under existing securities law.

Regulation SHO specifically requires the major exchanges to provide a daily list of Threshold Securities, defined as those that (1) have an aggregate fail to deliver position of over 10,000 shares (2) equal to 0.5% of the issuer's total shares outstanding for (3) greater than five days. Reg SHO also

requires a broker-dealer to close out any “open fail” position once it has been included on an exchange’s Threshold Security list for 13 consecutive days. The ironic effect of this policy, as noted by its detractors, is that it effectively requires shorts to cover (buy back shares) after they’ve had two weeks to drive the price down - meaning they profit from the trade. Needless to say, the effectiveness of such a regulation is often called into question among the cyberspace crowd.

Links to the Threshold Security list for each primary exchange are included at the conclusion of this article. It’s important to remember that seeing a company included on the Threshold Securities list does not mean that company is being naked shorted, nor that its share price is artificially depressed. It means shares in that company are failing to deliver on time for what may be legitimate reasons, including simple human error. Even shares bought long could FTD and show up on the Threshold list. A daily presence on the Threshold list for more than 13 days at a time, however, might signal the need for deeper digging.

## HOW DOES NAKED SHORTING ACTUALLY WORK?

Based on the accounts of CEOs who believe they have been the target of naked shorts, here is how the worst-case scenario might play out using an ill-intentioned hedge fund (“Fund Malicious”) as an example.

Fund Malicious first identifies a target in the micro-cap world for naked shorting, most likely an obscure company in the development stage or having otherwise questionable fundamentals. The hedge fund

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gets that firm listed on a foreign exchange in, say, Berlin, via a request funneled through a complicit broker or official in that country. Malicious then sells short shares it doesn’t have (naked shorts them), waits three days for the DTCC to call and ask for the shares, and then replies either, “I borrowed them on the Berlin exchange, and they’ll take some time to get here,” or “I’m a market-maker for that company’s shares in Berlin and naked shorting rules don’t apply there.” The DTCC then loans the fund shares from

its inventory and charges the broker a fee until the stock loan is repaid. Malicious, in the meantime, continues to drive the price of the target’s shares down as long and as aggressively as possible. In the event the fund does cover to pay off the stock loan, it doesn’t take much effort to begin the naked shorting cycle again.

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Other theories exist as to how the hedge fund might skirt additional rules. To prevent “piling on,” exchange rules mandate that a stock cannot be shorted on a downtick or decrease in stock price. In other words, Malicious must wait for the stock price to increase briefly before shorting the company. Rather than wait passively for an uptick, though, Fund Malicious can create an uptick in the stock itself by purchasing a few shares through a small offshore account. The hedge fund is then free to short (or naked short) the company with both barrels at home.

Malicious may get additional leverage out of the original naked short by choosing to target an ugly, obscure microcap company. By driving the price down, the fund hopes to scare existing shareholders into selling their shares, too, out of fear that something is going on that they don’t know about (i.e. the fund can “paint the tape”). This, of course, drives the price even lower while further obscuring the role of Fund Malicious.

There is plenty of room for additional mischief in the above scenario. According to the most vocal critics of naked shorting, funds like Malicious have relationships with reporters and/or message board regulars who are compensated to distribute negative news about the company in order to exaggerate the selling. There is also plenty of irony possible, in that a CEO can be her shareholders’ worst enemy by merely uttering the words “naked shorting.” Investors may panic, the stock might dive further and legitimate short-sellers could begin to circle.

## KEEPING THINGS IN PERSPECTIVE

Given the mysterious nature of hedge funds and the convoluted nature of this crime, it’s easy to get carried away with paranoid scenarios regarding naked shorting. The skeptics, however, have some unanswered questions of their own. For instance:

- What's in it for the brokerages? Are they supposed to take all the risk just to get a few more commissions or under-the-table money? Since when have they been that desperate?
- Has anyone ever been found guilty of naked shorting?
- Where is the proof? Are there other pieces of evidence that would suggest a crime is being committed?
- Why aren't more companies making noise about it? Where are the whistleblowers?
- Wouldn't the unintentional buyers of naked-shortened shares voice their concerns when they did not receive proxy votes?
- Why is there no outrage from legitimate funds and brokerages?
- How much regulatory burden should the SEC and other publicly traded companies have to bear to resolve the questionable problems of a few companies?

Both camps raise legitimate issues that simply cannot be addressed definitively yet. Reg SHO is not the deterrent the problem seems to demand. There have been numerous calls on the SEC to increase the scope of data provided in the daily Threshold Securities lists, which may help better gauge the seriousness of this problem. Until those issues are resolved, the SEC continues to consider the surveillance and enforcement of trading activity as being the primary responsibility of the markets and exchanges. The DTCC considers its role to be reporting the FTDs. Brokerages are doing all they can to win commissions from hedge funds. Detection is difficult, accusations are nearly impossible to prove, and nobody has figured out a foolproof way to stop this crime.

**Always surprise on the upside. There is no greater weapon against the shorts.**

So what's all that mean for the microcap CEO? When it comes to naked shorting, you are your own best watchdog.

## **WHAT TO DO IF YOU THINK YOU MAY BE TARGETED.**

**Above all else, be discrete with your public accusations.** A well-intentioned CEO can fulfill his own prophecy by going public with accusations of naked shorting. Investors may flee the stock, further lowering the share price. Meanwhile, other funds may hover, waiting for an uptick to begin shorting your company themselves.

**Watch your trading volume.** If you're seeing four or five times your company's float trade hands in an otherwise ordinary day, and you have no large share overhangs, pay attention. Start documenting those patterns.

**Most cases, the best deterrent for shorts of any kind...communications with your shareholders.**

**Keep your focus on operations.** Your stock price is not declining exclusively due to naked shorting. Weakness in the business, industry, model, communications or management team exists well before naked shorting begins and allows it to continue. In most cases, the best deterrent for shorts of any kind is consistent execution and credible communications with your shareholders.

**Always surprise on the upside.** By maintaining absolute secrecy before good news, you give yourself the best chance to catch the shorts of guard and maybe even squeeze them. Be conscious of unintended signals you may send when in public appearances, conference calls and analyst meetings before a particularly good quarter or other surprising good news. Keep your cards close to your chest and save those glowing press releases for the middle of the trading day.

**Maintain a steady stream of news.** By communicating with your investors as often as possible, you remove some of the mystery surrounding a company that a naked shorter typically targets. In the absence of news, a continuously dropping stock price is the only communication your investors are hearing. Sales of stock by legitimate owners are sure to follow.

**Put floors on your convertibles.** A floorless convertible bond (also known as a "convertible death spiral") is an open invitation for its owners to short

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the stock as aggressively as possible. A constant decline in share price means the convertible owners

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will get more shares because the initial rate of conversion will change. While the original shareholders may very well lose their entire stake in the company, the convertible owners can continue to short the stock until they

can effectively cover the original short with new shares created by a new rate. Should those convertibles be held offshore where naked shorting is not illegal, the potential for price depression becomes even greater. Ensuring you have a floor on those converts will prevent the worst case scenario.

**Monitor small international exchanges.** If your firm unexpectedly turns up on the Berlin-Bremen stock exchange and you, the CEO, did not request a listing there, that might be a sign of a problem. Request the removal of your company from that exchange immediately, and keep asking until it's done.

**Realize your choice of financing vehicle may attract naked shorting interest.** In addition to floorless convertibles, PIPEs may also attract undue attention from potential funders. Since shares in a PIPE are sold for below market price, the provider could short the stock down to that level with no risk of capital loss on his part. When issuing warrants with the deal, you're also effectively pushing the price lower through increased dilution of existing shareholders. While it's true that sometimes beggars can't be choosers when it comes to raising funds, go into those negotiations with your eyes wide open.

**Check the Threshold Security lists.** Links to the lists at each exchange are below. Keep in mind that inclusion on that list does not mean naked shorting or any other improper activity is occurring, just that some shares meet the three requirements mentioned above. An extended presence on the Threshold list, however, in combination with some other signals mentioned above may be an important sign.

**Don't read the message boards.** You'll drive yourself nuts, waste a ton of time and eventually convince

yourself you're a victim of someone's ill wishes, naked shorts or otherwise. If you're that compelled to monitor the boards, ask your IR team to send you weekly summaries of any cogent posts.

**Know your IR company.** Consider your choice of an investor relations firm as your first line of defense. Does the company have expertise in dealing with naked shorting? Does the price of your stock mysteriously rise or fall between the time you send your draft press releases and when they hit the wires? Do they have long-term clients willing to vouch for their integrity? And do they have processes in place to handle sensitive information?

**Know your transfer agent.** Given that the process of naked shorting begins at the brokerage level, there's not much your company's transfer agent can do with regards to those shares. The responsibility for tracking them lies with the brokerage. It is theoretically possible, however, for a corrupt transfer agent to conceal the true float and otherwise manipulate the shares themselves.

Both your transfer agent and IR firm should be able to advise you on the effectiveness of combating naked shorts by changing CUSIP numbers, reverse mergers, and/or reverse splits. Although the long-term effectiveness of these strategies is questionable, it may be useful as part of a larger strategy to deter naked shorting. After changing your company's CUSIP number, for instance, all existing stock certificates must be exchanged for new ones. All issued and outstanding certificates from old shares will no longer represent an interest in the company until exchanged. This may be more trouble than it's worth, however. Once the new shares are in circulation, there's nothing to stop a new round of naked shorting by determined parties. Such tactics may represent a small part of an overall strategy to reduce naked shorting interest in your company.

**Consider your choice of an investor relations firm as your first line of defense.**

## QUESTIONS?

Contact Cale with any questions or comments.

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## LINKS:

**The SEC on Key Points About Regulation SHO**  
<http://www.sec.gov/spotlight/keyregshoissues.htm>

**DTCC on Naked Short Selling and the Stock Borrow Program**  
[http://www.dtcc.com/Publications/dtcc/mar05/naked\\_short\\_selling.html](http://www.dtcc.com/Publications/dtcc/mar05/naked_short_selling.html)

**Professor John Finnerty of Fordham University on “Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation.”**  
<http://ssrn.com/abstract=687282>

**The CEO of Overstock.com explains naked shorting**  
<http://forums.auctions.overstock.com/viewtopic.php?t=6405>

**An open letter from the CEO of Eagletech to the DTCC**  
<http://www.eagletech1.com/prn04052005.html>

**Naked Shorts – What I Have Learned. By Mark Cuban**  
<http://blogmaverick.com/entry/1234000073034082/>

**Motley Fool: The Naked Truth on Illegal Shorting.**  
<http://www.fool.com/news/commentary/2005/commentary05032407.htm?source=eptyh&olnk303100&logvisit=y&npu=y>

**Motley Fool: Who’s Behind Naked Shorting.**  
<http://www.fool.com/news/commentary/2005/commentary05033008.htm>

**The National Coalition Against Naked Shorting**  
<http://www.ncans.net/>

**NASDAQ Threshold Securities List (for NASDAQ, OTCBB and OTC issues).**  
<http://www.nasdaqtrader.com/asp/regsho.aspx>

**NYSE Threshold Securities List**  
<http://www.nyse.com/Frameset.html?displayPage=/threshold/>

**AMEX Threshold Securities List**  
[http://www.amex.com/amextrader/?href=/amextrader/tradingData/RegSHO/TrDa\\_RegSHO.jsp](http://www.amex.com/amextrader/?href=/amextrader/tradingData/RegSHO/TrDa_RegSHO.jsp)

**Chicago Stock Exchange**  
[http://www.chx.com/publications/reg\\_sho.htm](http://www.chx.com/publications/reg_sho.htm)

**ArcaEx**  
[http://www.tradearca.com/traders/regsho\\_th.asp](http://www.tradearca.com/traders/regsho_th.asp)

**Berlin-Bremen Stock Exchange**  
<http://www.berlinerboerse.de/?LANG=en>

**To report alleged abusive naked short selling activity:** [enforcement@sec.gov](mailto:enforcement@sec.gov)

**For more information on how to submit potential violations of Federal securities laws:**  
<http://www.sec.gov/complaint.shtml> or by calling 1-800-SEC-0330.



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Is your company benefiting from strong expectations for a higher Future Value?

At Hawk Associates, we understand the complexities of Wall Street expectations. We provide clients with sophisticated, leading-edge investor relations programs to create visibility and brand identity. We provide a full range of functionality and services including day-to-day IR counseling, financial public relations, media programs, roadshow planning and execution and specific project work. We help build the company’s credibility, provide guidance for full disclosure in setting expectations, generate excitement about the company’s products and assist CEOs in realizing the full potential of the company’s stock.